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REAL ESTATE IN RUSSIA

RUSSIA IN TRANSITION

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The opening of Russia's real estate to foreign investment was brought about by legislation in 2001. Previously private land ownership was not allowed. This paper will provide you with an overview of the real estate market, the growth and challenges in commercial and residential real estate.

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INTRODUCTION

Real estate is an important ingredient to the majority of businesses operations throughout the world. When business strategy calls for entering a new market, understanding the real estate environment as well as the procedures and obstacles unique in a particular country or region may prove to be invaluable knowledge. Leases, ownership regulations, code, permits, logistics, expenses, and bureaucratic practices are a few factors that play key roles in expansion into global or local markets. Russia is a unique environment where change and transition is occurring daily. Whether you represent a western company considering opening operations in Russia, or you are an investor, this paper is meant to provide you with a general overview and understanding of real estate in Russia. This brief will touch upon land and building ownership, the registry, permits, as well as the commercial and residential arenas. The commercial market is overviewed in two sectors, namely retail and office and includes competition, opportunity, red tape, supply, demand and a forward looking forecast. The residential market includes growth, apartment development, ownership, rentals, mortgages, non-resident ownership tax policy and avoiding transaction risk in the buying process. Finally, a personal interview with a Director of a St. Petersburg Real Estate firm is presented to add insights and first-hand experience to this subject.

Selecting the type of business entity will be one of the first considerations. Foreign investors intending to conduct business in Russia may select from various forms of legal organization. The Civil Code of Russian allows various forms of legal entities including limited-liability companies, joint-stock companies, general/limited partnerships, as well as individual entrepreneurs. It is also possible to open a representative office, which has traditionally been the simplest way for a foreign company to establish a presence in Russia.ⁱ A prior understanding of potential legal liability and tax policy issues are important proceeding in the most optimal manner. It should be recognized that other official and informal taxes such as registrations, inspections, code compliance issues, bureaucratic hassles and import duties increase the burden on companies. In addition, changes in legislation may occur unexpectedly and should be given attention. As an example, the St. Petersburg Chapter of the American Chamber of Commerce hosted a March 17, 2009 discussion of recent changes to the Russian LLC-related legislation.ⁱⁱ The Chamber of Commerce can be helpful in understanding and foreseeing policy change as well as be instrumental in bureaucratic relations. It is important to understand the administrative

process varies from region to region, as you will see noted in the retail section with Ikea's experience. Officials may often delay the opening of foreign retailers' stores with red tape compliance issues. As noted in Richmond's "From Nyet to Da", bureaucrats still issue licenses and permits, control municipal housing and land transfers and give approvals for new businesses. Opportunities for corruption are everywhere.ⁱⁱⁱ

REAL ESTATE

The opening of real estate to foreign investment was brought about by legislation in 2001. Previously private land ownership was not allowed and a 49-year lease was standard. The 49 year lease was by its nature a right-to-use and consequently impeded the development of the real estate market in Russia. The Land Code of 2001 allows the private ownership of land and properties, both by locals and foreigners. The Land Code integrated land ownership and the right-to-use. However, there are some instances where legislation is not applied consistently and foreigners can still not penetrate certain land markets, namely Moscow.^{iv} In addition, foreign individuals and enterprises may not own farmland, although they may lease it. Implemented on January 27, 2003 and amended on July 7, 2003, the Law on Circulation of Agricultural Land (No. 101.FZ, dated July 24, 2002) imposed the same limitation concerns on Russian companies whose charter capital is more than 50% controlled by foreigners.^v

LAND and BUILDINGS

The rights to land and buildings differ materially and Russian law treats them separately. The general provisions of land ownership are contained in the Constitution of the Russian Federation of 1993 and the Principle of Private Land Ownership was established by Article 9. The Land Code of the Russian Federation (No. 136.FZ, dated October 25, 2001, amended June 30, 2003) makes the purchase and sale of non-agricultural land legally permissible. It not only lays the foundation for a commercial land market, but provides for the use of land as collateral. On the other hand, the Civil Code of the Russian Federation sets the rules on the use and sale of buildings. The law provides for building ownership on equal terms by Russian, foreign nationals and other legal entities.

St. Petersburg passed fairly advance land laws in regard to land sales prior to the Federal Land Code. Throughout Russia, regional legislation on acquiring land was enacted over a number of years in the regions where the local administration allowed land ownership. As expected, the Federal Land Code supersedes regional legislation. However, when issues are not stipulated in the Federal Code, local authorities may refer to their own land policy for resolution. Therefore, it is recommended that careful and detailed due-diligence be conducted to avoid potentially harmful discrepancies. Another important development in this area was the signing into law of the Urban Development Code on May 7, 1998. Municipalities were given the right to plan the use of land within their borders and need not wait for federal approval. The implications may be that fewer applications for use are required and that investors' interests "may" be safer.

Along with private ownership, Russian legislation provides that local authorities may grant land to be held or used. Russian law also provides regimes of land ownership such as "permanent perpetual use" and "life inherited ownership" of land, which are very close to private ownership. Most companies use temporary land-use rights, granted under short-term or long-term lease. When land is leased for a designated use, it will be specified in the lease agreement.

State land sales raise other issues. Although the legislation appears incomplete and vague, local administrators can proceed with land sales, if and when they are willing to do so. However, one of the greatest difficulties in arranging State land sales is determining whether State land belongs to the Federal or Regional authorities. Although the Property Ministry has issued various regulations to clear up this issue, buyers should proceed diligently and be alert for legal loopholes.

In Russia, there is another consideration to take into account while pursuing an acquisition. It is known as the "correction factor". This is the factor by which the cost of the land occupied by buildings will be multiplied. The Land Code stipulates that the correction factor can raise or lower the cost by up to 30%, depending on the nature of the enterprise. Paying the full 30% is one means to protect against future attempts to annul a property purchase. However, according to the Ministry of Federal Property paying the full amount to protect the interest this is not absolutely necessary. Buyers can also protect themselves by requiring a certificate of sale and asking for a record of sale from the local land registry. Even if property holders received permanent and unlimited rights to the use of their land, they might not be able to purchase or lease the land under the existing terms.^{vi}

Buying land is not without risk and careful diligence is recommended. Two main problems arise from the system of land registration. One is that Federal and Regional laws can change unexpectedly and frequently. The other is that the transfers of ownership are not well documented and this can create a fundamental insecurity for owners. It has been known that predatory mafia-like groups have made a business of launching tactical threats on private owners, utilizing corrupt municipality officials and corrupt land registry officials to dispossess the rightful owners.^{vii} A title search should clearly be conducted to ensure that there is no lien on the property and to insure proper chain of title. Rights pertaining to building and land, whether foreign or domestic may only be claimed after they are registered with the State in the Unified Register of Rights.

REGISTRY

The Russian Federation has been advancing ownership and record keeping of private property ownership since the mid-1990s. The Register is based upon Federal Law 122.FZ: Registration of Rights and Transactions with Immovable Property, dated July 21, 1997. Registrations of real property and rights to real property and transactions are now carried out separately. At present, the Federal Agency of Real Estate Cadastre performs registrations of land, as regulated in detail by the Federal Law on the State Land Cadastre, No. 28.FZ dated January 2, 2000, which specifically governs land. Land plots in Russia are also subject to State cadastral registration and conducting transactions with land plots that have not undergone State cadastral registration is prohibited.

Consequently, the system of registering real-property sites is now being changed to develop a single real-property cadastre (registry). According to a recent Ernst and Young economic report, the Russia Federation recently adopted changes to its system of recording in order to create an upgraded unified system that will be stored on electronic media by the year 2012.^{viii} As testament to these efforts, a Russian delegation visited the Plymouth County and the Norfolk County Registry of Deeds in Massachusetts in 2008. Members of the Russian judiciary from the Tomsk Region of the Russian Federation, which is located in the southeast area of the West Siberian Plain, sought to gain insights into modeling the emerging Russian system of land ownership after the registered land (Torrens) system of certificates of title utilized in Massachusetts.^{ix} Tomsk, the main city in the region, is the administrative and legal center of the

province. It was designated as a special economic zone by the Russian Federation in 2005 and is home to approximately 500,000 people. Tomsk is also home to the first University in Siberia where the book reserve is considered one of the richest in Russia, as well as Tomsk Polytechnic University, Siberian State Medical University, Tomsk State Pedagogical University, Tomsk State Architectural University, Tomsk University State Control System and Radio-electronics, Tomsk Economics and Law University, and Tomsk Institute for Business.^x

PERMITS

Enterprises must apply to the local authorities responsible for zoning, environmental, architectural, sanitary, fire, safety and other issues to obtain preliminary permission to begin industrial construction or expansion projects. Final permission, which includes registration that the construction is complete, is supposed to be required as a way to round out contracts and show compliance with all standards and inspections. According to the World Bank DoingBusiness.org website, it takes on average 54 procedures, and 704 days, to finalize construction permits in Russia. This is clearly a lengthy process and such undertakings should not be considered lightly.

COMMERCIAL REAL ESTATE

RETAIL REAL ESTATE - GROWTH

In the commercial retail development boom that swept across Europe in mid 2000's, Russia by far became the most active to lead the world in retail shopping center development according to Jones Lang LaSalle. LaSalle's new report "Shopping Centre Development – Boom or Bust? 2008" emphasized a record year for development growth with Russia once again being the most active market, accounting for 13% of new space delivered.^{xi} In the fourth quarter of 2008, Neville Moss, Head of EMEA Retail Research, gave the opinion that much of the proposed space for 2009 is already under construction and it is doubtful that it would be stalled. He felt that corrections to the development pipeline will be absorbed mostly by those markets that have grown considerably over the past three years, notably Russia. James Dolphin, Head of pan-European Retail Agency, concluded: "Retailer demand will have an amplified impact on development over the next two years and while brands are still looking for opportunities, it has become harder for lease contracts to be agreed as retailers look to minimize risk by searching for the most favorable deals. Retail centers already opened with high vacancy rates, and there is

evidence of retailers withdrawing from projects, delaying market entry and reducing expansion plans. Developers who have scheduled new schemes to open over the next two years will let consumer and retailer demand shape decisions on whether to delay or start construction.”^{xii}

On March 17, 2009, Kathy Clarke of Retail Forward, a global management consulting and market research firm specializing in retail intelligence and strategies provided short and long term insights. Her viewpoint recognizes the short-term challenges from price inflation and a growing global financial crisis. Her views of Russia’s long-term retail prospects are promising. Retail Forward forecasts the size of the Russian retail market to surpass \$900 billion by 2012, more than doubling the size of the country’s retail market in 2007. “The double-digit pace of growth in Russia’s retail sales in recent years is forecast to be moderate but remain strong in the coming years,”^{xiii} comments Frank Badillo, Senior Economist, Manager of the company’s Global Retailing Program and co-author of *Russia’s Retail Landscape*. “Russia’s long-term growth prospects should continue to draw foreign retailers and suppliers to the country,”^{xiv} he adds. While the near-term retail outlook is threatened, Retail Forward’s forecasts indicate that Russia will become the fifth-largest retail market in the world by 2012, moving from its position as the eighth-largest market currently. Russia would surpass Italy, France and Germany in the process. “Russia’s climb in market size will be driven primarily by its markets for apparel, home-goods and food at home,” states Badillo.^{xv} [RETAIL - Sales by category](#)

COMPETITION

Furthermore, Clarke’s opinion is that new entrants will find tougher competition from domestic retailers such as X5, which now ranks among the top 200 largest retailers in the world amid the ongoing consolidation in the Russian retail market. The predominance of small, independent retailers such as “Taste of Fashion” (men’s & women’s apparel) with whom we met in Russia suggests that there remains a significant opportunity for market share gains by big chain retailers in Russia. About 90% of the market for fast-moving consumer goods (FMCG) is estimated to be held by small, independent retailers, according to Europanel data. Significant market share gains by the big chain retailers are evident in the hypermarket, supermarket, discount, and cash and carry channels. Europanel data also indicates that private label products are gaining a significant slice of sales at the largest retailers. The proprietor of Taste of Fashion explained the apparel that he provides is private label and is gaining ground as the quality is

being recognized. Among product categories, personal care products are gaining a growing share of spending by Russian shoppers as well. We saw this first hand in while visiting “Natur-Produkt” a growing Russian natural pharmaceutical company. Soft drinks and home care products are also showing gains according to Retail Forward.^{xvi}

OPPORTUNITY

On April 1, 2009, Magnit, a Russian budget food retailer reported doubling net profit in 2008, and forecasts its business will grow almost as quickly in 2009. Magnit, which operates discounters and hypermarkets in Russia's industrial south and northeast regions, reported sales rose more than 40 percent to \$5.3 billion from \$3.7 billion last year, and stuck to guidance for a 35 percent increase this year.^{xvii} Magnit plans to open another 380 stores this year.

The potential opportunity in Russia is not going without notice as demonstrated by Carrefour, the French hypermarket chain who is on track to open its first store in Moscow in May. This is a long-awaited move by the world's No.2 food retailer into Russia, real estate sources told Reuters. The company also plans to open a hypermarket in the southern city of Krasnodar, a prosperous region on Russia's Black Sea coast, possibly by summer 2009. A top French competitor, Auchan, was among the first foreign hypermarket chains to hit Russia, opening its first Moscow store in 2002 and now has more than 30 stores. It has expanded widely in the provinces and plans to open another six stores this year. Global retailers, many of whom missed their chance to expand on Russia's once-buoyant market during the 10-year oil-fuelled economic boom, are now taking steps to enter a sector which still has more growth potential than mature markets despite a downturn. In March, Swedish fashion giant Hennes & Mauritz opened two stores in Russia and pledged to open at least two more by the end of 2010. Wal-Mart which is increasingly looking overseas to expand joined the Russian retail lobby group, after hiring an executive to head its efforts to explore business opportunities in Russia and nearby markets. Wal-Mart appears to have hired 30 Russian office staff and is in acquisition talks with local chains that may need a cash injection to cope with the financial crisis.^{xviii} Personally, I would not be surprised if Lenta is one of those targets for Wal-Mart's entry. After all, Lenta's Board consists of former WalMart executives.

RED TAPE

The potential opportunity is not without red tape and obstacles. Foreign retailers entering or expanding in Russia are subject to varying degrees of delays. Officials often delay the opening of foreign retailers' stores with red tape compliance issues. The Moscow Times reported on March 30, 2009 that the Swedish retailer Ikea is "questioning future investment in Russia due to the unpredictability of the administrative process in some regions"^{xix}. The world's biggest home furnishing retailer has invested more than \$3 billion in Russia, built 11 stores and had planned to add four more this year. Ikea's opening operations in Samara has been delayed since late 2007. Samara is situated in the southeastern part of Russia in the Volga Federal District. It is one of the largest cities in a Russia with a population of Population: 1,157,880.^{xx} The extended period of waiting for documents resulted in Ikea notifying 245 employees of discontinuing their employment at the Samara site that is slated to open this spring of 2009. On a positive note Ikea's plans to open an outlet in Omsk, a city in southwest Siberia that is 1,700 miles from Moscow, before summer 2009 has not reported any problems.

OFFICE REAL ESTATE

SUPPLY

The supply of high quality office space increased in 2008 by 1.7 mln. sq.m. according to Blackwood Real Estate research group. Class A office space represented 30% of that supply and Class B represented 70%. By year-end 2008, the total supply volume of newly built and reconstructed space amounted to 8,3 mln. sq. m. Although this was approximately half of the announced volume projected, its shortfall is attributed to traditional delays of delivery as well as the outbreak of the financial crisis in September 2008.

DEMAND

Demand for high quality office space as well as the absorption rate remained high and the vacancy rate remained low for the first nine months of 2008. Thereafter, the world-wide financial crisis affected the market and demand went down sharply. The number of deals made in fourth quarter of 08 was extremely small, and vacancy rates increased to 15% on average in

Moscow. Vacancy in class A office space increased up to 20%. The market decline even resulted in new high quality office properties at less than a 50% lease-out. Construction projects were frozen, while some developers sought joint venture capital partners and others offered their less than completed projects for sale. In the fall of 2008, the market saw a record number of offices for sale, leading to a considerable reduction of the average asking prices. Demand for acquisition declined to low levels. Potential buyers have expectations of acquisitions 30-50% below the current level of asking prices.^{xxi}

FORECAST

The financial crisis is likely affect the market structure and many developers will be forced to leave the market or decrease their market presence. This will most likely result in less office space delivered to the market place in 2009. Due to the liquidity crisis, demand is likely to remain at a low level, and the number of deals will be few and at discounted prices. This is the emergence of “a buyers’ market” as well as “a tenant’s market”. Offices located outside of the city center are likely to be sought after for economic advantage and tenants will rather consider fit-out and ready-to-move space. Rental rates should continue to decline and renegotiations will follow to keep current tenants and attract new ones. Tenants will pursue shorter term lease agreements such as 1- 3 years, rather than a 3- 5 year standard to lessen exposure to risk. Since many companies will face financial difficulties in 2009, they will be less apt to relocate or expand their business activity leading to a decline in demand. Delivery of new supply is being postponed, and the office property market is unlikely to see saturation any time soon. In 2009, rental rates and sales prices should fall and the vacancy rate increase, providing the best time to make lease transactions and investment acquisitions.

The office market should reemerge as the economy shows signs of recovery, but there is likely to be lag in reaction due to uncertainty. The basics of supply & demand dictate that as soon as demand recovers, Russia will have a gap between supply and demand considering significant decrease of supply volume. At that time prices should start climbing again.

RESIDENTIAL REAL ESTATE

RESIDENTIAL MARKET

There has been enormous house price increases across Russia since 1998 according to figures from Rosstat, the Russian Federal Service of State statistics and the predecessor to Goskomstat – the centralized agency dealing with statistics in the Soviet Union.^{xxii} However, the price increases that peaked in 2006 started to weaken in 2007. In 2006, residential prices in Russia's secondary market (re-sale properties) rose 54.4%, while prices in the primary market (new build properties) rose 48%. In 2007, price increases were more moderate at 20.6% for the secondary market, and 23.4% for the primary market. From 2000 to 2007, prices in the secondary market have risen 436%, while primary market prices have risen 362%.^{xxiii} Housing Price Trends

The Global Realty Property Guide provided the following primary and secondary market data.

- **The Central Federal District (FD), which includes Moscow**, registered the highest secondary market house price increases from 2000 to 2007, at 589%. Primary market prices rose 345% over the same period.
- **House prices in the Northwestern FD, which includes St. Petersburg**, rose the least from 2000 to 2007, 338% for the secondary market and 293% for the primary market.
- In the primary market, **Urals FD (593%), Siberian FD (507%), and Far Eastern FD (400%)** experienced the fastest house price increases from 2000 to 2007. The increased amount of mineral and fuel extraction from these districts partly explains the huge price increases.^{xxiv}

Russia's housing market appeared insulated from the global financial meltdown throughout most of 2008. However, the situation turned abruptly during the last quarter of 2008. Property prices fell, transactions and sales plummeted, projects were cancelled, and the limited mortgage lending disappeared as interest rates rose. The market downturn hit property investors knocking several off the Forbes' Billionaire list. The property bubble burst with varying estimates of decline. Statistics from Blackwood Real Estate Group indicate an 8% - 10% price drop to Q4 2008 from the previous quarter. Some real estate agents note that many sellers are

accepting offers 15% to 30% lower than their initial asking prices.^{xxv} Property prices are expected to slide further in 2009, by 20% - 25% for newly built- economy class housing and by 30% for business-class housing, says Maria Litinetskaya, acting director of Blackwood. Prices in the secondary market are expected to fall by 20% to 35%.^{xxvi} One key indicator of impending change is affordability limits. Some experts believe prices in the provinces pushed against the affordability limits. The ratio between per square meter prices and GDP per capita in Russia is one of the highest in the world – always a danger signal.^{xxvii} [Price / GDP ratio](#)

APARTMENT DEVELOPMENT

The number of new dwellings built in Russia fell sharply during the late-1990s. In 1990 more than one million apartments were completed, but from 1996 to 2004, less than 500,000 apartments were constructed yearly. Supply did not match demand, leading to higher property prices. The majority of Russians live in ageing Soviet-era housing stock, particularly outside the main cities. More than half these units badly need repair and have not been repaired for 40 to 50 years. The lack of supply is particularly evident in major cities such as Moscow and St Petersburg. There are even accusations that developers are concealing new supply in anticipation of higher prices. It was only in 2006 that new apartments constructed exceeded 600,000. In 2007, the number reached 721,000, according to Rostat. In 2008, completions of new apartments reached record highs. Rostat estimates that a total of 72.5 million sq. m. of new apartments were expected to be constructed in 2008, which translates to more than 850,000 new units, assuming an average size of 85 sq. m. per apartment. [Apartment Construction](#)

However, several major developers have now put new projects on hold. The Mirax Group, Russia's largest property developer, announced in September 2008 that it was halting work on 10 projects. The 10 projects make up 83% of the company's total portfolio, and amount to 10 million sq. m. of real estate. Mirax cited the cost of credit as its main reason for freezing the projects and expected the delay to be at least one year. Other developers such as Sistema-Hals, Inteko, and the PIK Group have also announced cancellation or suspension of real estate projects.

MORTGAGE MARKET

Russia's mortgage market is still very small compared to Russia's economy, at a mere 2.5% of GDP in 2008. Only 14% of homes were bought using mortgages in 2007, while only 26% of purchases of newly-constructed apartments were leveraged with credit. In 2008, the mortgage market expanded by 120%. Its recent rapid growth was not due to widespread adoption of mortgage-financing for house purchases. It was mainly driven by a few houses bought by the relatively wealthy. Less than 20% of Russians can afford an average monthly mortgage payment of approximately US\$700. Compounding this affordability problem, interest rates remain high, at more than 12.5% per annum in 2008 and in the first quarter of 2009.

The development of the mortgage market has been hindered by inadequate legislation, immature financial markets, and lack of unified market standards. In 2006, laws underpinning mortgage-backed securities were introduced, allowing banks to refinance housing loans for the first time. Two state banks held more than 50% of the mortgage market in 2008, Sberbank with a 38.7% share, and VTB Bank with 12.7%. Mortgage growth is likely to be less than vibrant in 2009, due to higher interest rates, falling real estate prices and the credit crisis. I expect that it will not grow at all given the economic situation. The Agency for Home Mortgage Lending (AlZhK), a secondary mortgage loan provider, received no additional funding for mortgage under the revised 2009 budget. In January this year, it bought 1,980 mortgages worth US\$56 million from banks. The tightening credit market has made it more difficult for homebuyers to get a mortgage. Previously, banks only required a 20% down payment for home purchases. Now this has been raised to 30%. The minimum monthly income requirement for loans has been raised to RUB25,000 from RUB15,000. Homebuyers must also prove that their income is taxable and comes from legitimate sources, a process that involves certification from several government officials.^{xxviii} [Average Loan Rate](#)

RESIDENTIAL RENTALS

As property prices declined, rents began a decent as well. Rents for economy-class, one room apartments fell by 8% from November to December 2008. Rents for other units fell from 4% to 6% over the same period. In January 2009, Vedomosti, a business newspaper, reported

that rents in Moscow declined by 10% since the beginning of the year. They predict rents will drop by another 10% before summer. Another factor contributing to the weakness in the rental market has been the privatization of State-owned housing. Owner occupancy rose from 41% in 1995 to 70% in 2004. Approximately 94% of households received their units free of charge.

In November 2008, Moscow News Weekly reported that Real estate prices in new developments across St. Petersburg could drop between 20 and 40 percent by the middle of 2009, according to a report prepared by consulting company GVA Sawyer. The report notes, however, that the market in St. Petersburg is characterized by high uncertainty and is highly subject to the influence of external conditions. The report stated that "within the period September to October 2008 there was a 40 percent reduction in the volume of sales. Potential buyers took a 'wait and see' attitude because of the conditions of the financial crisis,"^{xxix}. Depending on how the global financial crisis develops, the report predicts the market will develop in one of two ways. An optimistic scenario sees continuing stagnation and an average price drop of 10 to 15 percent, followed by growth. However, if financial stimulation efforts fail and the crisis continues to erode, then instability in the labor market will lead to a drop in demand. In such a scenario, there could be up to a 40 percent drop in real estate prices before the end of next year, followed by growth in 2010.^{xxx}

RESIDENTIAL BUYING PROCESS OVERVIEW

Most real estate transactions are conducted in cash and paid in full with US dollars. It may appear buyers and sellers use banks simply to avoid being mugged while exchanging cash. A St. Petersburg GSOM student informed me that banks will offer security personal to insure cash transactions and exchanges and deliveries are secure. It is also important to know that buyers must reserve U.S. currency - dollars days in advance to insure availability.

The buyer and the seller are required to present documents necessary for formalizing the sale transaction. Passports of all participants, apartment title documents, and Urban Registration Office of Rights on Real Estate statement about absence of limitations on property disposal are a short list of essential documents needed. The buyer and seller then execute a preliminary agreement, which describes all the conditions of the future deal, and outlines the list of necessary

documents to be provided by the seller. Sale transactions always take place in banks. The buyer deposits the full purchase cash amount in a safe deposit box on the condition that the bank will release the money to the seller only upon the presentation of the complete package of registered documents under the buyer's name. Wire transfers are considered riskier as compared to cash purchases since escrow accounts are not well-established in Russia. The advice for at least some transactions is to avoid or decrease risk by utilizing cash instead of wiring funds.

After the payment, both parties proceed to sign the purchase and sale agreement in front of the realtor or a notary. The signed agreement is sent for State registration, after which actual transfer of ownership right takes place. An Acceptance Act needs to be executed by both parties on the date of transfer of the property, certifying that the property is being transferred to the buyer in an acceptable condition. The regular term of registration is 30 days. There are fees that you will incur depending upon the service required such as a US\$50 fee to hire someone to file your registration paperwork or a US\$200 plus fee to expedite the process. Rather than diving too far into fees, one realization is that buying costs in Russian are considered among the highest in Europe.^{xxx1}

TAX POLICY

There is a dramatic difference in tax rates for those who qualify as residents in Russia and those who are non-residents. Residents are defined as individuals actually present in Russia for more than 183 days in a calendar year. The personal tax rate in Russia is one of the lowest in the world at a flat 13% for residents. The tax rate for non-residents on Russian sourced income is 30%.^{xxxii}

In Russia, the direct sale of real property is subject to VAT at a rate of 18%. As a non-resident selling a Russian property, your realized capital gains are subject to a flat tax rate of 30%. From a taxation point of view, the sale of shares in a real property company may be more advantageous than the direct sale of real property, since unlike the sale of real property, the sale of shares is not subject to VAT.^{xxxiii} This ownership concept is utilized more by investment firms in multi-property ownership scenarios, than by an individual buying an apartment. Rental payments are generally subject to VAT at a rate of 18%. As a non-resident owner, you are subject to non-resident tax policy. If you rent you dwelling and therefore receive rental income,

as a non-resident you are taxed at the flat rate of 30%. The rental income of foreign legal entities without a permanent establishment in Russia may be subject to withholding tax, levied on gross rentals at 20%.^{xxxiv} The tax code can be confusing and complicated for those not in the profession and with changes bound to occur the complexity will continue.

SUMMARY

I hope you found this paper interesting and trust it provided a good overview to the Russian real estate market. In depth research and understanding in the sector of your interest can be obtained through professional research and real estate firms specializing in this area. In addition an experienced Russian attorney, real estate professional, and tax expert may prove to be a necessary component to successful investment or business venture in the “mother land”. As pointed out, it is important to understand regional differences in terms of dealing with the red tape of bureaucracy. Russia has truly been a land in transition. The Russian real estate market is young and the rules and practices are bound to change.

INTERVIEW

To conclude this paper, I will share with you a sit-down meeting with Nikolay Viknyanschuk. He is the General Director of Octava, a real estate investment and consulting firm located at 76 Nevsky av in St. Petersburg, Russia. I was fortunate to have Roman Lukaschuk, a highly resourceful GSOM student, arrange and accompany this meeting for March 17, 2009. Nikolay Viknyanschuk spoke a reasonable amount of English but some translation was required during the discussion. Roman and I traveled most of the way the rapid and crowded subway system and then continued upon foot through a light snow fall on the busy sidewalks. We entered a doorway of an unimpressive building and proceeded to the 2nd floor, where we were greeted by a receptionist as we entered an expansive office. As a westerner, one may expect a grimly lit office with gray walls. In the several company offices I visited on this trip including Octava, the office environment was just the opposite. The nicely illuminated and vanilla painted office contained approximately a dozen desks, several agents and what appear to be two residential customers.

Octava manages both residential and commercial real estate business. After we entered Nikolay's private office, the door was closed perhaps as usual practice and to avoid disruption. I was thankful a bottle of vodka was not opened, since Russian tradition as detailed in Yale Richmond's "From Nyet to Da" would dictate that it was emptied. We eased into the conversation with small talk to find common ground as two people with interest in another's country. Nikolay told me of his recent visit to the Carmel Valley, CA area and his involvement in a Russian-American real estate and business association. We also found common ground as two real estate professionals as Nikolay's been in the business for about 14 years, and I just a few years more. We experienced some similar economic and business challenges. The dramatic difference in our experience is that when he started 14 years ago, so did the real estate industry in Russia. Octava started with small residential rehabs and management and grew into commercial opportunity. He explained his business with one St. Petersburg manufacturing firm, who's interest was to sell a few of their buildings scattered throughout the city. They also wished to sell their "sanatorium" that existed for the care of the plant's employees during the Soviet days. Nikolay recognized an opportunity and purchased this property located in Southern Russia not far from Sochi, the city hosting the 2014 Winter Olympic Games. Nikolay explained the great

fan fare behind the Olympics at Sochi. On March 17, 2009 the New York Times stated “that the games have begun” alluding to the politics and power surrounding the coming event. One Moscow based tycoon, Aleksandr Lebedev, called the Sochi Olympics, one of Prime Minister Vladimir V. Putin’s pet projects and an “idiotic” expenditure of State Money.^{xxxv} The new mayor will have some control over \$12.5 billion in government money for the Games. Nikolay viewed this as a value-add to his property that is located beach front on the Black Sea. His plans are to redevelop the property as a resort and sell off approximately half of the units and retain the other half for rental. He is presently seeking funding for this venture and explained the rise in interest rates to above 12% and sometime ranging above 15% to 20% are prohibitive. Private funding can be more attractive as he explained by having other projects funded by German investors. I was curious about his relationship with the manufacturer that led to such a prize opportunity on the Black Sea. In Russia, relationships are important and sometimes vital to such opportunity. Interestingly, the St. Petersburg plant manufactures missiles. In Nikolay’s pleasant demeanor, he jokingly exclaimed “to shoot at you guys in the US”, as we all shared a laugh. As I wondered about his connection to the plant, it was brought to my attention that this was the first real estate professional I met that by education is a nuclear physicist, which explains the connection to the plant directors. This was an invaluable experience providing an inside look at an industry that has been mature and operating for decades in the US but that is at its infancy in Russia.

APPENDIX

RETAIL - Sales by category

Russia - Retail Sales by Category

| | Market Size (US\$billions) | | Nominal or unadjusted growth rate | | Category rate of inflation/deflation | | Inflation-adjusted or real growth rate | |
|---------------------------------|-------------------------------|----------|--------------------------------------|---------------|---|---------------|---|---------------|
| | 2007* | 2012F ** | CAGR | CAGR | CAGR | CAGR | CAGR | CAGR |
| | | | 2002- 2007 | 2007- 2012 | 2002- 2007 | 2007- 2012 | 2002- 2007 | 2007- 2012 |
| Total sales (excluding autos) | \$439 | \$909 | 21.6% | 15.7% | 9.2% | 7.5% | 12.4% | 8.2% |
| Spending by broad category: *** | | | | | | | | |
| Clothing and footwear | \$83 | \$174 | 24.2% | 15.9% | 8.2% | 6.0% | 16.0% | 9.9% |
| Home furnishings and equipment | \$72 | \$157 | 26.4% | 16.7% | 4.5% | 3.0% | 21.9% | 13.7% |
| Food at home | \$225 | \$447 | 18.9% | 14.7% | 10.7% | 7.5% | 8.2% | 7.2% |
| Food away from home | \$18 | \$40 | 28.4% | 17.7% | 10.7% | 7.5% | 17.7% | 10.2% |

*Estimated

**Forecast assumes a constant currency exchange rate

***The product categories do not add up to total sales because they exclude sales of other miscellaneous categories

Sources: National statistics sources and TNS Retail Forward

RESIDENTIAL**Housing Price Trends**

| | SECONDARY MARKET | | | PRIMARY MARKET | | |
|--------------------|------------------------|-------|-------------|------------------------|------|-------------|
| | Change in house prices | | | Change in house prices | | |
| | (%) | | | (%) | | |
| | 2006 | 2007 | 2000 - 2007 | 2006 | 2007 | 2000 - 2007 |
| RUSSIA | 54.4 | 20.6 | 435.8 | 47.7 | 23.4 | 362.0 |
| Central FD | 55.2 | 12.2 | 589.3 | 55.2 | 19.9 | 344.7 |
| Southern FD | 56.3 | 21.1 | 391.8 | 46.3 | 21.9 | 334.0 |
| Northwestern FD | 24.7 | 134.2 | 337.9 | 23.3 | 31.4 | 293.4 |
| Far Eastern FD | 57.8 | 24.7 | 419.7 | 54.9 | 29.9 | 400.5 |
| Siberian FD | 46.3 | 20.9 | 486.7 | 55.6 | 15.7 | 507.0 |
| Urals FD | 34.0 | 41.4 | 567.3 | 55.6 | 34.9 | 592.7 |
| Volga FD | 24.4 | 30.4 | 410.1 | 18.0 | 17.1 | 279.9 |

Source: [Rosstat](#)
xxxvii

Price / GDP ratio

| | AVERAGE PRICE (US\$ PER SQ. M.) | | | | ANNUAL HOUSE PRICE CHANGE (%) | | | |
|-----------------------|---------------------------------|--------|--------|---------|-------------------------------|-------|------|---------|
| | 2005 | 2006 | 2007 | H1 2008 | 2005 | 2006 | 2007 | H1 2008 |
| MOSCOW | | | | | | | | |
| New build | 7,490 | 12,589 | 17,973 | 21,862 | 28.1 | 68.1 | 42.8 | 23.7 |
| Re-sale | 8,866 | 15,387 | 19,307 | 24,840 | 21.1 | 73.6 | 25.5 | 29.5 |
| ST. PETERSBURG | | | | | | | | |
| New build | 1,967 | 3,013 | 4,283 | 8,867 | – | 53.2 | 42.2 | 15.1 |
| Re-sale | 1,081 | 2,291 | 3,124 | 7,115 | – | 111.9 | 36.4 | 14.4 |

Source: [Knight Frank](#)
xxxviii

Buying Costs in Russia

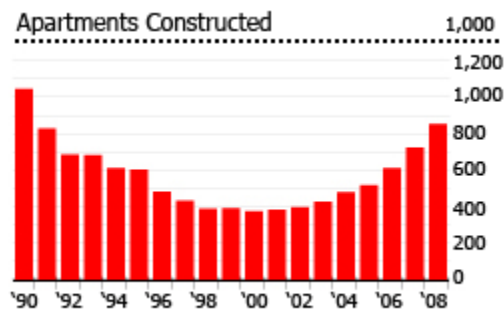
Transaction Costs are among the highest in Europe

| | | |
|------------------------------------|------------------------|--------------------|
| Agent's fees | 2% - 5% | Who Pays? buyer |
| Notary fees | 0.7% - 1.5% | buyer |
| Registration fees | 0.01% - 1% | buyer |
| VAT | 18% | seller |
| Costs paid by buyer | 2.71% - 7.50% | |
| Costs paid by seller | 18% | |
| ROUNDTRIP TRANSACTION COSTS | 20.71% - 25.50% | |

Source: [Global Property Guide](#)

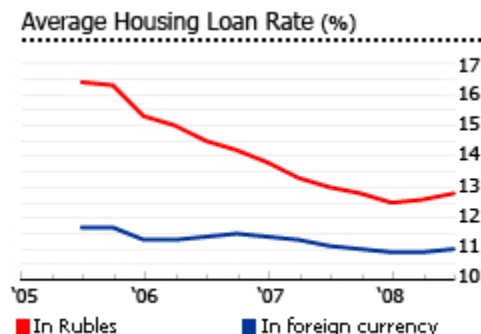
18% VAT is charged on the purchase price of buildings (premises). Sale of land plots is VAT-exempt.

Apartment Construction



Source: Rostat

Average Loan Rate



Source: Bank of Russia

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