advance

JONES LANG LASALLE®

Russia in 2007: the Year of the Millionniki

The Millionniki, 11 Russian cities with populations of 1 to 1.5 million, will feature increasingly on the radar screen of the real estate community

The combined real estate potential of the Millionniki is similar to that of Moscow

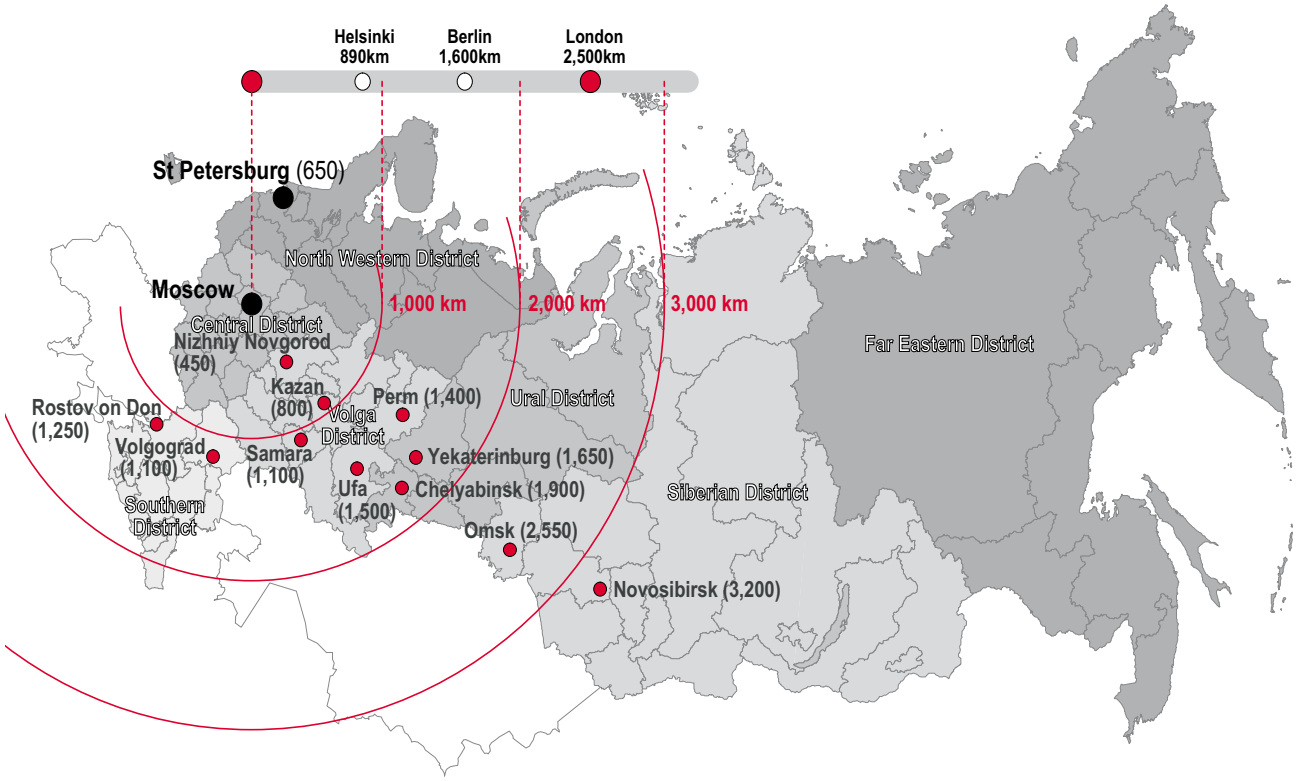
Market "catch-up" will be a defining feature over the next decade

The retail market is most developed, but other sectors will gradually emerge

Yekaterinburg and Samara have the strongest overall real estate potential

The Millionniki at a Glance

The Millionniki Distance to Moscow*



*distance in kilometres

The Millionniki Dashboard

City	Population	GRP	FDI	Income	Higher Education	Real Estate	
	2005 Millions (Growth % 2002-2005)	2004 Billions US$ (Growth % 2004)	2005 FDI Millions US$	2005 Personal Income US$	2005 Institutions (Alumni '000)	2006 Retail Stock (2008) '000 sq m	2006 Office Stock (2009) '000 sq m
Moscow	10.407 (2.8)	95.8 (7.3)	2 060.4	10 600	223 (194.5)	1 555 (2 654)	5 843 (10 500)
St Petersburg	4.600 (-1.3)	18.0 (7.2)	249.4	4 800	90 (71.8)	702 (1 676)	748 (1 326)
Novosibirsk	1.406 (-1.4)	6.9 (5.7)	5.9	3 400	24 (17.3)	29 (343)	175 (365)
Yekaterinburg	1.304 (0.8)	12.7 (8.9)	13.3	4 100	29 (34.5)	191 (408)	110 (310)
Nizhniy Novgorod	1.289 (-1.7)	9.2 (4.3)	39.7	3 100	18 (25.2)	165 (350)	100 (190)
Omsk	1.143 (0.8)	7.3 (28.0)	3 081.0	3 700	20 (15.0)	31 (121)	30 (130)
Samara	1.133 (-2.2)	9.7 (8.7)	38.3	4 500	30 (26.3)	138 (338)	50 (200)
Kazan	1.110 (0.5)	14.3 (5.4)	54.5	3 100	35 (29.6)	264 (338)	100 (125)
Chelyabinsk	1.095 (1.7)	10.6 (4.9)	10.8	3 000	21 (24.8)	32 (168)	80 (120)
Rostov-on-Don	1.058 (-0.9)	7.8 (13.3)	60.2	3 400	33 (34.0)	56 (420)	30 (260)
Ufa	1.036 (-0.6)	11.7 (6.2)	51.5	4 000	17 (27.3)	39 (446)	90 (150)
Volgograd	0.999 (-1.2)	5.6 (9.3)	2.9	2 800	17 (17.3)	73 (352)	30 (60)
Perm	0.989 (-3.2)	9.3 (2.4)	12.7	4 100	15 (15.6)	79 (147)	50 (100)

The Millionniki – Their *Competitive* Position

Russia has 13 cities with over one million inhabitants, all with interesting real estate potential. Moscow and St. Petersburg, as Russia's two largest cities, are currently the prime focus of commercial real estate activity. Yet the country has a further 11 lesser known "secondary" cities with populations of 1 to 1.5 million - the Millionniki[1].

Apart from major retail developers, who can now be found in all the Millionniki, these cities are still largely unexplored by the commercial real estate community. We predict that these cities' profiles will change in 2007; and that the Millionniki will feature increasingly on the radar screen of real estate occupiers, developers and investors.

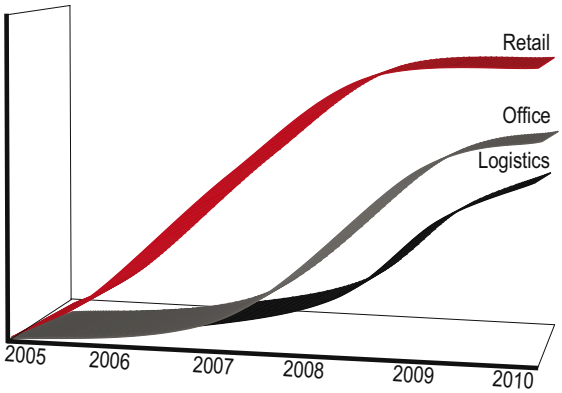
This report assesses the economic potential and real estate opportunities of the 11 Millionniki, as part of the World Winning Cities Research programme. Given their common history, the Millionniki show striking similarities. At the same time, however, their important idiosyncrasies testify to the vastness and diversity of contemporary Russia. Jones Lang LaSalle's research investigates each Millionnik's distinctive characteristics and assesses the way in which these are shaping the cities' economic and real estate market potential.

[1] The name *Millionniki* is the plural noun of the Russian word 'Gorod-Millionnik', referring to a city with a population of around one million inhabitants. Both terms are frequently used in Russian.

- **Novosibirsk** is the largest Millionnik and the prime hub of Siberia. It is the furthest from Moscow
- **Yekaterinburg** is the primary hub of the Ural Region and Russia's third largest city economy
- **Nizhniy Novgorod** is the closest to Moscow and is a leading city of the Volga Region
- **Omsk** is Siberia's second city. Its prospects are improving on the back of oil prosperity
- **Samara** is a wealthy city developing as an important business hub and FDI location
- **Kazan** has the most developed commercial real estate market
- **Chelyabinsk** is a strong production centre and the second city of the Ural Region
- **Rostov-on-Don** is the key business centre of the South District
- **Ufa** is an industrial city of the Urals and an important FDI destination
- **Volgograd** is an industrial and agricultural hub
- **Perm** is an industrial city with considerable investment potential

The *Long Tail* of Russian Real Estate

Perceptions of Property Market Growth in the Millionniki
Based on construction activity and occupational demand



Source: Jones Lang LaSalle, 2007

Russian regional cities with a population over 1 million are now emerging as hot real estate destinations. The Russian economy is developing quickly and the real estate market is expanding geographically in line with this rapid growth.

The Millionniki form the Long Tail[2] of Russian real estate. The combined population of the 11 Millionniki broadly equals that of Moscow, yet this has not been matched by commercial real estate market activity.

The Millionniki are now starting to present interesting opportunities for both developers and investors, and still offer a potential premium for the first wave of market entrants. The Millionniki real estate markets are poised for growth on the back of strong domestic economic drivers and a gradual transition from production to service based economies, geared by the forthcoming WTO accession, expected this year. Market development will be further boosted by international real estate developers/investors eager to buy into growing markets.

The 'catch-up' factor will be a defining feature of the Millionniki real estate markets over the next decade. The Moscow bias of the Russian cities network is having a strong impact on market evolution; the development lag between Moscow and the most active Millionniki, namely **Kazan**, **Yekaterinburg** and **Samara**, is as much as 5-6 years. Despite relatively high per capita retail stock as in the case of **Kazan**, the types or the quality of real estate development in the regions remain inferior to those in Moscow. Nonetheless we expect the development lag to have narrowed substantially by the end of this decade.

The emergence of commercial real estate markets in the Millionniki is being led by the retail sector. Millions of dollars are being poured into retail schemes as developers compete for a slice of the regional markets. The combined modern retail stock is projected to increase from its current 1 million sq m to 3.4 million sq m by 2008, the Millionniki thereby overtaking Moscow (at 2.6 million sq m). **Yekaterinburg, Kazan, Samara** and **Nizhniy Novgorod** are the favoured retail locations due to large retail catchment areas and in the case of **Samara** and **Yekaterinburg** also above average incomes. **Ufa, Rostov-on-Don** and **Novosibirsk** are also expected to show strong growth in retail provision, as retail demand remains strong in the large cities across the country.

The office market remains embryonic, with a combined modern stock of only 850,000 sq m, barely 15% that of the Moscow region. It is, however, expected to emerge as a key sector by 2010. Demand estimates suggest a long term office requirement for as much as 8 million sq m, compared to up to 11 million sq m of potential outstanding demand in Moscow. We expect the emergence of a new regional office hierarchy as the majority of both Russian and foreign companies are locating their regional offices in hubs such as **Yekaterinburg, Novosibirsk, Samara** and **Rostov-on-Don**.

The logistics market is now on developers' radar screens. It will evolve on the back of retail growth with the primary focus on the East-West Corridor, favouring cities such as **Novosibirsk, Samara, Rostov** and **Yekaterinburg**.

There is also strong demand for quality residential projects and hotels, but these sectors have only recently emerged in the Millionniki. The residential and hotel markets boast excellent potential.

The Millionniki investment market is attractive given limited competition and the availability of freehold title on land. The investment market in the regional cities emerged only in 2004/2005, when Meinl European Land bought its first Park House projects in **Volgograd** and **Yekaterinburg**. In 2006 the Millionniki had been already responsible for 1/3 of the total volume of Russian retail investment, Russia being the fastest growing investment market in Europe. While competition over the limited number of quality assets is likely to increase in 2007, the Millionniki will still have a considerable advantage over Moscow with yield premium, freehold land tenure and an increasing emphasis on investment incentives from local governments. Office and logistics investment markets in the Millionniki are to emerge in 2007.

[2] The "Long Tail" is the colloquial name for distributions where a high-frequency or high-amplitude is followed by a low-frequency or low-amplitude which gradually "tails off." In many cases the infrequent or low-amplitude events - the Long Tail - can *cumulatively* outnumber or outweigh the high-frequency in volume, such that in aggregate they comprise the majority.

A *Booming* Retail Market

A deepening consumer pool is developing in the Millionniki

Domestic and international retailers are extending their geographical coverage

Shopping centre pioneers: IKEA with MEGA

Retail stock is to increase from 1 to 3.4 million sq m by 2008

Retail investment is growing: yields from 10% - 12%

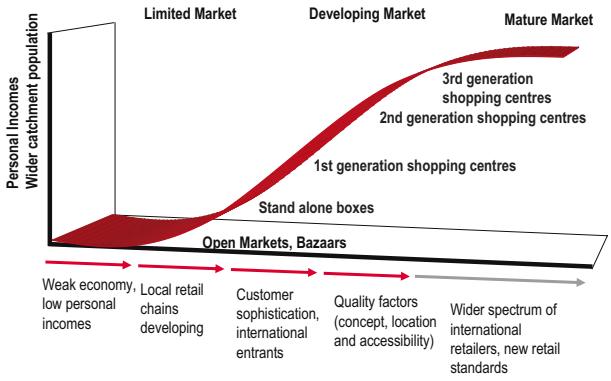
Yekaterinburg, Kazan, Samara and Nizhniy Novgorod are the retail hotspots

Ufa, Rostov-on-Don and Novosibirsk will show strong growth in retail provision

Gaps in the retail network are the next focus for retail developers

The boom in the Russian retail market is little short of breathtaking, and the market is still far from being saturated. While the real estate focus is primarily on Moscow and St Petersburg's booming retail markets, the Millionniki have also started developing rapidly. They are attracting international retailers such as IKEA, Metro, Obi, Auchan, Castorama, Real and Ramstore. Russian retailers, such as X5 Retail Group (the parent company of leading supermarket chains Pyaterochka and Perekrestok, which merged in May 2006), Tander, 7Continent, Kopeika, and Mosmart, are driving retail expansion in the regions. The X5 Retail Group, Russia's largest grocery retailer with over 1000 stores, plans to create an additional 900 stores with a target of US$6 billion annual sales by 2008.

Regional Retail Market Development



Source: Jones Lang LaSalle, 2007

At the end of 2006 hard-discounter Magnit launched a new chain of upscale supermarkets under the name Tander. With around 1,600 shops Magnit is a leader of the Russian hard-discount sector, and the biggest competitor to soft-discounter Pyaterochka. The company, which has so far focused on regional markets in the Southern, Central and Volga Regions, is now targeting more upscale shoppers in the country's fast-growing regional cities with its new brand Tander. The first two outlets opened in Samara, Russia's wealthiest regional city, and Volgograd.

Source:www.magnit-info.ru

IKEA was one of the first international retailers to enter the Russian market, arriving in 2000. They now have three stores in Moscow and two in St Petersburg, but have ambitious plans to roll out schemes into all the Millionniki by 2010. They have already opened schemes in Kazan, Nizhniy Novgorod and Yekaterinburg, and other schemes will follow in Rostov-on-Don (due to open 2007), Novosibirsk (2007), Samara (2007), Ufa (2007), Volgograd (2008), Omsk (2009), and Perm (2009).

IKEA have accessed the Russian market by developing MEGA shopping malls of circa 150,000 sq m. They are often built on the outskirts of large urban hubs, but in the centre of densely populated regions. They are capitalising on the eagerness of Russian consumers who, in search of modern household goods, are willing to travel large distances. Experience from Moscow suggests that catchment areas may reach as far as a five hours drive.

Source: www.megamall.ru, Jones Lang LaSalle

The New Millionniki Consumer

Purchasing Potential in the Millionniki
Up to 88% of income is spent on retail

	Personal Income in US$	Retail Expenditure Share of Personal Income in %	Estimated Retail Expenditure per Capita in US$
Moscow	**10.558**	**72.3**	**7.633**
St. Petersburg	**4.830**	**63.4**	**3.062**
Samara	4.526	83.4	**3.774**
Perm	4.062	64.0	**2.599**
Yekaterinburg	4.057	67.0	**2.718**
Ufa	4.016	73.5	**2.951**
Omsk	3.711	65.9	**2.445**
Rostov-on-Don	3.408	75.0	**2.556**
Novosibirsk	3.402	88.5	**3.010**
Kazan	3.142	68.6	**2.155**
Nizhniy Novgorod	3.117	72.1	**2.247**
Chelyabinsk	3.025	67.2	**2.033**
Volgograd	2.800	72.3	**2.024**
Average in Millionniki	**3.570**	**72.5**	**2.592**

Source: Rosstat, 2006

The Russian regions are now experiencing the levels of prosperity until recently reserved almost exclusively for the inhabitants of Moscow and St Petersburg. Incomes in Russia grew by over 20% in 2005 and a further 20% in 2006. In December 2006 the average monthly wage was up to US$390 per month– still low but four times higher than in 2000. In 2007 the incomes are expected to grow by another 20% to US$490 per month. Average incomes in **Samara**, the wealthiest Millionnik, are now only slightly lower than in St. Petersburg. With the improving economic situation, consumers are becoming less financially restrained and are shifting more and more towards better quality products. Russian consumers in the Russian regions spend on average 72%, and up to 88% of their incomes on consumer goods; the highest ratio in Europe, as they seek to satisfy their huge demand for consumer goods.

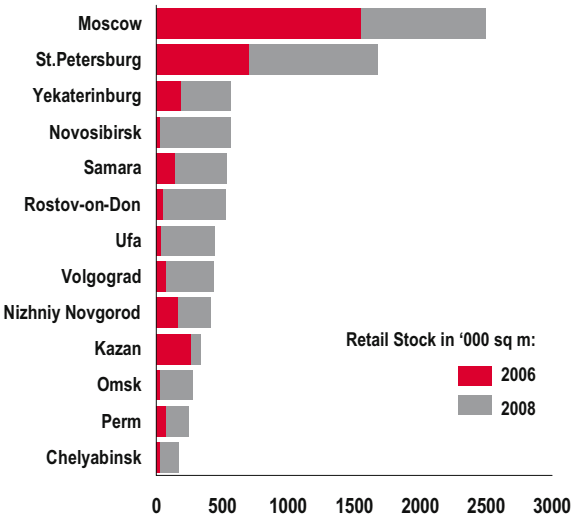
Consumer credit in Russia (including mortgage and housing loans) has expanded from zero a few years ago to about US$40 billion. This is barely 5% of GDP and one-tenth of west European levels, so there is still plenty of room for further growth. The Economist Intelligence Unit predicts that total retail sales will double from US$245 billion in 2006 to US$526 billion by 2010, taking Russia up from the 12th to 9th largest retail market in the world. In 2006 AT Kearney's Global Retail Development Index ranked Russia second, behind only India, in terms of its potential for international retailer expansion.

A Boom in Mall Development

The volume of modern retail space is growing rapidly and Russia has the largest development pipeline in Europe. By 2008 the Millionniki are expected to have a combined stock of 3.4 million sq m, compared to 2.6 million sq m in Moscow. **Samara, Nizhniy Novgorod, Kazan** and **Yekaterinburg** remain the retail hotspots. On the other hand, **Novosibirsk, Ufa,** and **Rostov** will also see strong retail provision growth. Shopping mall concepts with large entertainment components dominate the regional pipeline.

We anticipate that after an initial period of rapid expansion in 2007 and 2008, there may however be a slowdown in development activity in the Millionniki. This is in contrast to Moscow which will continue to grow strongly. Moscow's estimated total retail demand is still twice the size of the Millionniki's combined, which will help sustain high levels of retail development in the capital city. Nevertheless, we expect the demand gap between Moscow and the Millionniki to diminish over time.

Millionniki Retail Market Development



Source: Jones Lang LaSalle, 2007

The Millionniki's Investment Offer is a Good Alternative to Moscow

The retail investment market in Russia is growing very rapidly with US$1.8 billion of retail real estate transactions recorded in 2006, a 15-fold increase on 2005. In terms of retail investment volumes, Russia moved from virtually bottom of the European rankings in 2005 to 7th by 2006. Jones Lang LaSalle estimates that Russia could potentially become Europe's 3rd largest retail investment market by 2007, competing with the likes of the UK, Germany, Spain and Poland.

The first retail transaction in the Millionniki only took place in 2004 but regional cities are quickly making up the investment gap. One third of Russia's retail investment transactions in 2006 were recorded in the Millionniki, as the markets witnessed their first wave of investment. The regions are increasingly being viewed by many investors as providing more opportunities due to the lack of competition, the availability of freehold titles to land, and attractive incentives offered by local governments. Meinl European Land has been the most active regional purchaser, followed by Marta Holding and Troika Dialog. Given the growing interest in the regional cities, we expect 2007 to be another record year in terms of the numbers and volumes of deals in the Millionniki.

Russian regional retail real estate offers attractive investment yields and competitive pricing despite the risk premium attached. Though less mature than most other European markets, this is largely a timing issue and the value proposition is strong. In the last five years shopping mall yields in Moscow compressed from 17% to 9%. A similar trend is now occurring in the Russian regions with current prime shopping mall investment yields now at 10-12%, compared to less than 5% in Western Europe and less than 6 % in the Central European markets. However, as investment grade shopping mall space is delivered to the market, initial investment yields are expected to quickly converge with those of Moscow and St Petersburg. As in Central Europe, the key to acquiring shopping malls in Russia will be a keen eye on sustainability.

While exposed to less competition and similarly positive trends in yield compression, a decisive feature of Russia's regional markets is of freehold tenure strongly influencing development decisions by allowing investors a familiar and more secure title over their investment. The recent introduction of cadastre valuations and rent re-calculations, at last favouring freeholders over the leaseholders, triggered land title purchases in 2006. Freehold title is available in locations outside Moscow.

A buoyant capital market is quickly reshaping market practice and the regional investment markets are proving to be increasingly attractive to international and domestic investors alike. With the arrival of professional investors interested in institutional quality premises, local developers are quickly adapting their approach and implementing exit strategies. This has encouraged the adoption of best practice techniques and has led to the standardisation of lease agreements, increasing transparency of cash flows and a higher quality of construction. As a result, the attractiveness of the regional markets increased and so did the competition over limited number of assets. International investors are increasingly pushed to consider alternative options, such as development or acquisitions at the construction stage; this being a more risky option in Russia, as legal title to the building is only secured when a development is completed.

In 2004/2005, Meinl European Land (MEL) invested in GK Vremya's Park House malls in Volgograd and Yekaterinburg. MEL are now procuring finance for the implementation of GK Vremya's 2007/2008 development programme which comprises the construction and management of shopping malls in Kazan, Nizhniy Novgorod, Ufa and Rostov-on-Don. All Park House projects share broadly similar characteristics, with investments amounting to approximately US$90 million, GLA of about 70,000 sq m, and anchored by leading Russian and international retail chains.

Source: www.en.parkhouse.ru

The Millionniki Retail Potential Index

Russia's 11 Millionniki all offer considerable retail potential but on different scales. Cities which by themselves constitute large markets and which are located in urbanized areas are better equipped to become retail hubs. Since the Millionniki already play the role of regional hubs, and the density of modern retail is low when compared to demand, their catchment areas reach far beyond their administrative boundaries. A large proportion of retail turnover is generated by customers coming from their extended catchment zones. Some large retailers, such as IKEA, are already capitalizing on the willingness of Russian consumers to cover large distances in order to gain access to high quality goods, and are adjusting their national networks of shops accordingly.

Our Retail Potential Index for Moscow, St Petersburg and the 11 Millionniki is based on the potential retail turnover of each city's extended catchment zone, including all urban areas with over 50,000 people within a 200 km radius. Such extended limits of retail catchment capture over 26.3 million people living in the regions, representing the vast majority of potential consumers outside of Moscow and St Petersburg. The existence of these larger catchment areas also helps explain the success of some Millionniki as retail destinations. While Moscow is by far the country's strongest retail hub, interestingly **Yekaterinburg** nearly beats St Petersburg into second place in terms of retail potential, although its 2008 retail pipeline is nowhere near that of St Petersburg. The densely populated catchments zones of both **Samara** and **Kazan** contribute to their dynamic retail environments. Conversely the limited metro populations of **Omsk, Volgograd** and **Perm** are reflected in their less developed retail sectors.

The Millionniki Retail Potential Index

Source: Jones Lang LaSalle, 2007

Retail Catchment Lacunas are the Next Place to Go

The bulk of regional wealth is concentrated within the Millionniki's catchment zones, but some other locations also merit consideration. Although the regional expansion further east and deeper into smaller cities has been delayed due to logistics problems experienced by retailers, there are several "retail lacunas", large areas beyond the Millionniki catchment zones, consisting of significant and wealthy catchment populations:

- Krasnodarsky Kray with cities such as Krasnodar, Novorossiysk, Sochi and Maykop;
- Eastern Tatarstan and cities: Nizhnekamsk, Naberezhnye Chelny;
- Kuzbas (Kemerovo region) with the main centre in Novokuznetsk, Kemerovo;
- Krasnoyarsk;
- Chernozem with the key hubs in Voronezh and Lipetsk.

Park House, Yekaterinburg

Millionniki Offices *Will Emerge* as a Key Sector

High value services will emerge in regional cities

Growth will be driven by the banking and IT sectors

Future possibility of "near-shoring" activities from high cost Moscow

Existing stock of 850,000 sq m is set to more than double by 2009

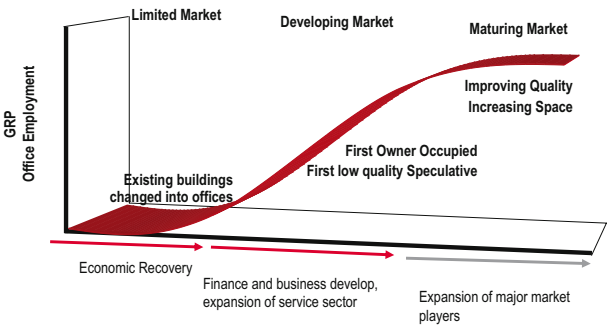
The office investment market is embryonic

Favoured locations: Yekaterinburg, Novosibirsk, Samara and Rostov-on-Don

The office markets in the regional cities are at the embryonic stage, but we expect the combination of economic prosperity, rising FDI inflows and a shift from industrial to service based economies to lead to the development of the market over the next five years. The existing combined stock of 850,000 sq m is expected to more than double to 2 million sq m by 2009.

TRCUP, Tcheluskintsev Street, Yekaterinburg

Regional Office Market Development



Source: Jones Lang LaSalle, 2007

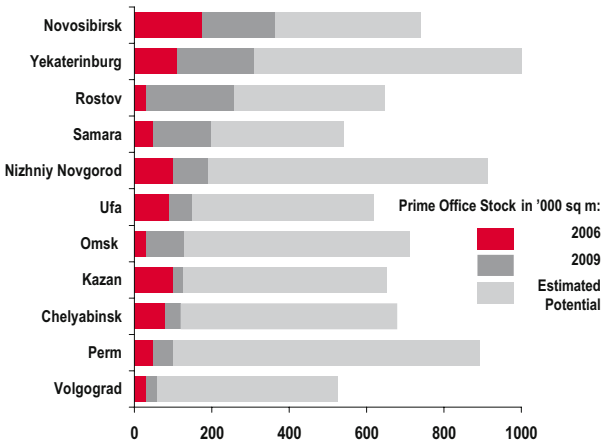
Currently the regional office markets have limited potential for development as local companies do not generate revenues supporting Class A or B office space occupation. **Novosibirsk** has the largest stock of about 175,000 sq m, but a large percentage of it remains vacant as supply does not match the needs of existing demand. Demand from multinational corporates is still limited, as Russia remains by far the largest world economy outside of the ranks of the WTO or the General Agreement on Trade in Services (GATS). Domestic companies in the regions are looking for space up to 200 sq m, and 1,000 sq m tenants' requirements are rare. Large occupiers such as banks, telecoms, insurance companies, as well as local major companies primarily from the extraction and raw materials production sector, prefer to build for owner occupation. As a result, modern office stock is scarce in the Millionniki.

Office Potential Grows

However, with favourable economic conditions, by 2009 the total (both active and latent) long term office space requirement in the Millionniki could be much larger than the currently planned pipeline. We have assessed that by the end of this decade the total office space requirement could range from 500,000 sq m in **Volgograd** to as high as one million sq m in the strongest office market, **Yekaterinburg. Nizhniy Novgorod** and **Perm** also have significant latent office demand. The combined regional office market requirement of 8 million sq m by 2009 compares to 11 million sq m in Moscow.

Growth in regional office demand will be driven by the retail sector, as well as the banking sector also growing on the back of retail. Forthcoming WTO accession will bring more international companies to the regions. The IT sector shows considerable potential, as many international high-tech companies are eager to tap into the pool of highly skilled Russian specialists. There is also the possibility that some business services will be relocated from Moscow, as international companies seek to "near-shore" their activities from high cost Moscow to lower cost Millionniki. If the current positive situation persists, we anticipate a surge in office development in the Millionniki by the end of the decade.

Millionniki Office Stock Potential



Source: Jones Lang LaSalle, 2007

The PLP Development Group, set up in 2005 by Lanta Bank and Polish developer Polnord, has started its first development project in Russia. The 23,000 sq m Business Lanta BC in Novosibirsk is expected to be delivered by mid 2008. The building is expected to be offered for sale during 2007. Polnord is one of the first foreign developers (from outside the CIS) to enter the Russian regions.

Source: www.polnord.pl

Russian and foreign companies are building their regional networks, and developers are responding to this new requirement. Apart from St Petersburg, **Samara, Rostov, Yekaterinburg,** and **Novosibirsk** are the favoured regional destinations, and these Millionniki will see the largest increases in modern office provision over the next three years. Both **Novosibirsk** and **Yekaterinburg** are expected to have over 300,000 sq m of modern office space by 2009.

Due to the small stock, the office investment market in the regional cities has yet to take off, but the first deals are expected to be finalised during the first half of 2007.

Gogol and Karl Marx Streets, Yekaterinburg

Retail *Driving* Logistics Development

Existing freight transport infrastructure restricts market development

Modern warehouse stock in the Millionniki is virtually non-existent

Significant demand from international logistics companies

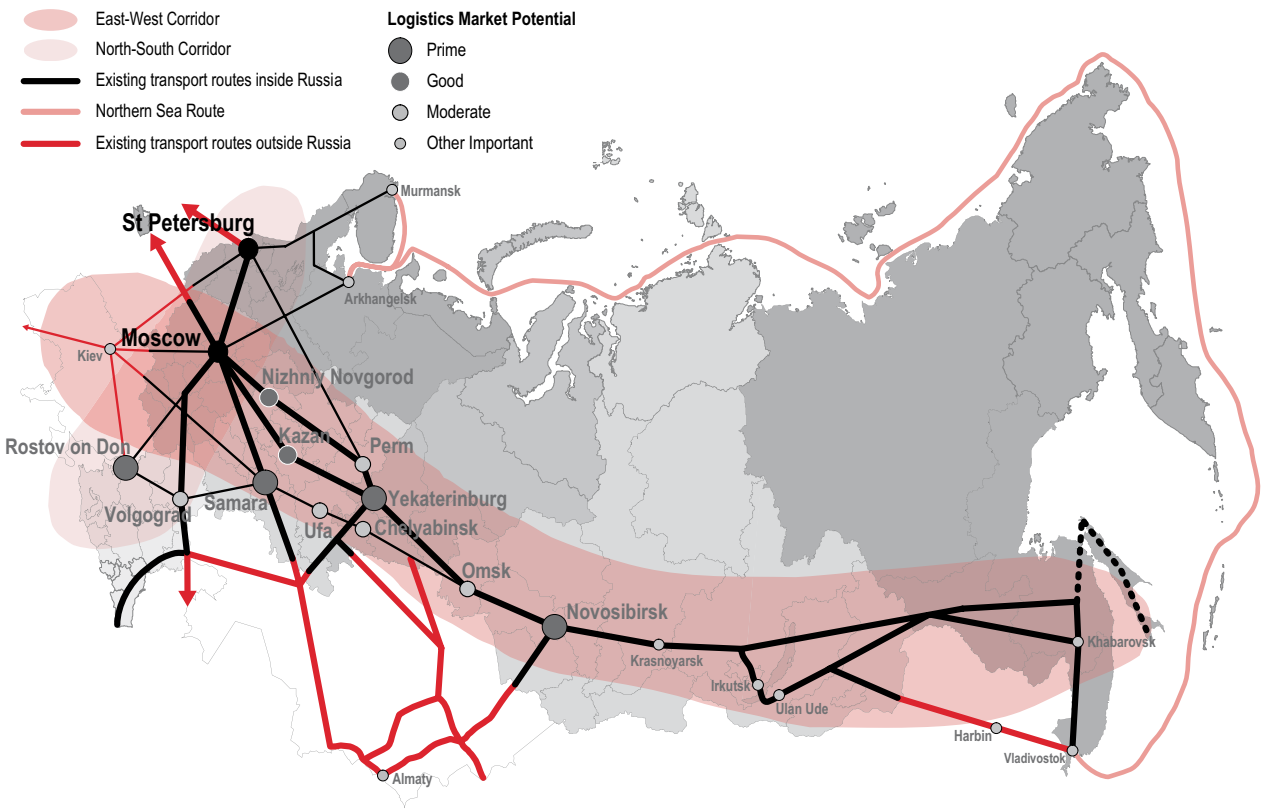
The investment market is still embryonic, but the 2008 pipeline is impressive

Novosibirsk, Yekaterinburg, Rostov-on-Don, and Samara are best positioned to develop into logistics hubs

The rapid development of a modern retail sector in the Millionniki, combined with a steady increase in trade flows across the Russian regions, is stimulating demand for efficient supply chains and an effective logistics infrastructure. However, the poor quality of the existing freight transport system and the huge distances between cities are hindering market development. Cumbersome bureaucracy and existing land use regulations are also to blame.

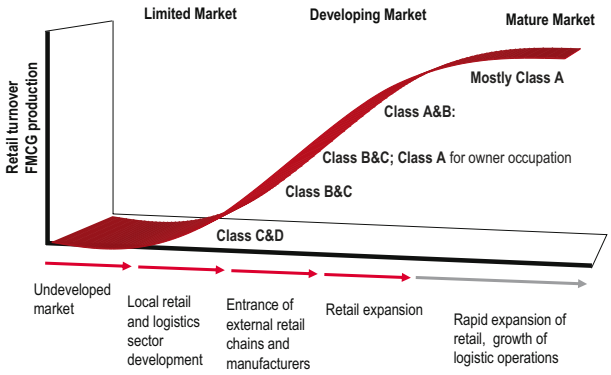
The changing global economy and the WTO accession are already reshaping the Russian logistics market. We expect both trade flows across the Russian regions and domestic production to grow considerably. As China develops into a global production centre, ever greater quantities of goods will be freighted overland via the East-West route. China's rapid economic development will also stimulate logistics activity in Russia's eastern extremes, notably in the port city of Vladivostok. The expected production boom in the automotive business, both in finished vehicles and components, will give an extra boost to industrial and logistics locations east of the Urals.

Major Transport Corridors, Emerging Warehouse Locations



Source: Jones Lang LaSalle, 2007

Regional Warehousing Market Development



Source: Jones Lang LaSalle, 2007

Q Park, Kazan

Novosibirsk, **Yekaterinburg**, **Samara**, and **Rostov-on-Don** are expected to emerge as important regional logistics hubs given their location on the East-West Corridor, the development of their retail sectors and a growing and increasingly diversified production. **Nizhniy Novgorod** and **Kazan,** two retail-driven logistic hubs, also boast considerable potential to develop logistics markets. However, they are not expected to develop as logistic transit locations given their proximity to Moscow.

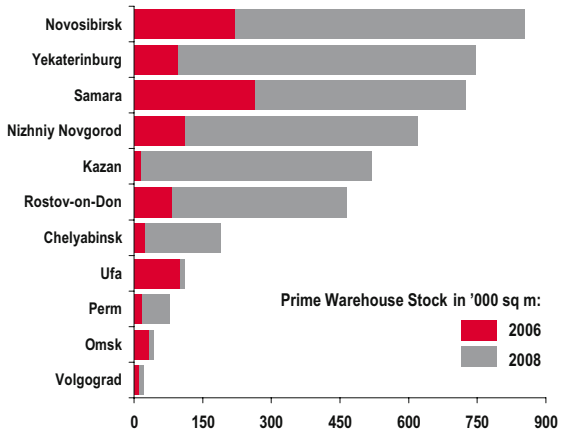
The modern logistics market outside of Moscow and St Petersburg remains in its infancy. The current warehouse stock in the Millionniki largely consists of refurbished buildings of inferior quality. Currently regional warehouse markets account for about a quarter of the total logistics stock in Russia. **Samara,** with 185,000 sq m of modern warehouses is the largest logistics market among the Millionniki, but is expected to be overtaken by **Novosibirsk** and **Yekaterinburg** by 2008.

Established in 2004, the Multinational Logistic Partnership (MLP) is a market leading company for the development and management of institutional quality logistics facilities in Russia and Ukraine. MLP is currently building two logistics parks in Moscow and one in St Petersburg and was Russia's first company to be granted a loan by Hypo Real Estate International for the construction and refinancing of its first warehousing facility in Moscow. It plans to establish and operate the largest chain of prime logistics parks in Russia and Ukraine with a total warehouse space of up to 1.3 million sq m. In the next 2-3 years MLP plans to locate nearly half of its new projects in the Russian regions and has identified Yekaterinburg, Novosibirsk, Kazan and Rostov as its next locations.

Source: www.mlprussia.com

These three largest regional markets are expected to reach the size of, or overtake in terms of the volume of space, the St Petersburg market. The first modern developments are likely to be constructed for occupation by large logistics providers such as NLK, Schenker, Asia-Europe Logistics System, Tablogix, DHL, Avalon Logistic, and RLS. Speculative logistic developers are yet to emerge in the Millionniki. RosEvroDevelopment, Eurasia, Raven/Avalon, and MLP have all announced their regional expansion plans. Jones Lang LaSalle estimates that by 2008 the total logistics stock in the Millionniki will reach over 4.3 million sq m, cumulatively overtaking by then the logistics stock in Moscow.

Warehouse Market Development



Source: Jones Lang LaSalle, 2007

The Residential and Hotel Markets have a *Great Future*

Residential to Become a Main Source of Real Estate Growth

Residential real estate is expected to become a main source of growth of real estate for the remainder of the decade. Residential demand in Russia remains highly unsatisfied and housing provision is one of Russia's national priorities. The average housing stock per inhabitant in Russia, at about 21 sq m, is lower than in Central European countries (e.g. over 23 sq m in Poland) and much lower than in Western Europe (e.g. average 36 sq m in EU15 capitals). As a result of the communal housing stock privatization in the early 1990's home ownership now exceeds 65%. Existing residential stock remains of a poor quality and is ageing rapidly. Nearly two-thirds of total housing stock is more than 30 years old, roughly 60% of all housing requires renovation, about 15% is in a critical condition, and 12% of dwelling space is officially considered uninhabitable.

Unsatisfied housing demand is estimated to be at least 1.5 -1.7 billion sq m. Surveys suggest that around 50 to 60% of Russians feel the need to improve their accommodation, but this hasn't been accompanied by the provision of new apartments. A federal target programme aims to add about 230,000 new apartments (approximately 20 million sq m) by 2010 and the Millionniki have their share of the plan: **Nizhniy Novgorod**, according to its local administration, is to add over 2.2 million sq m to its residential stock between 2007 and 2010. While the public sector remains an important housing supplier, the residential developer's market is taking off. Modern mortgaging, while not the solution to all of Russia's housing problems, is having a positive impact on Russian home buyers' potential. The 2006 introduction of laws underpinning mortgage-backed securities that allow banks to refinance housing loans for the first time made mortgages the hot financial product for retail banks in 2007.

According to the March 2007 Bank of Russia quarterly report, in December 2006 the housing and mortgage loans market reached RUB350 billion (US$13.5 billion), showing an impressive 2.8 - fold increase y-o-y, but still representing less than 1% of GDP. However, the European Bank of Trust estimates that currently 11% of Russian households can already afford to buy economy-standard residential property, using either their own or borrowed funds.

Moscow and St Petersburg are the biggest and most attractive residential markets in Russia, accounting for a quarter of total space, although the growth rate of new construction in the regions is already higher. Average residential prices in the Millionniki are in range of US$700 per sq m in **Nizhniy Novgorod** to US$1,200 per sq m in **Yekaterinburg** – over three times less than in the capital and half the average residential price in St Petersburg. However, the Moscow market is becoming increasingly competitive and primarily domestic but also international residential developers, such as SU-155, RBI and YIT DOM, are increasingly looking to the Millionniki.

YIT DOM, a Scandinavian developer specialising in residential construction is developing its portfolio in Moscow and St Petersburg, and its 2007 residential construction expansion plans include projects in Kazan, Samara, Nizhniy Novgorod, Rostov-on-Don and Yekaterinburg. Other residential developers, such as RBI Holdings, are actively searching for multi-use investment land plots in Russian regional cities.

Although the total number of modern apartments in the Millionniki remains very small, their visibility and impact on the city skyline can be considerable, as in case of "Volga Sails", two 100 m+ high residential towers currently under construction in Volgograd.

Source: www.yitdom.ru, www.vparusa.ru

Hotel Operators Display their Flags in the Millionniki

Apart from the already established tourist destinations, such as Moscow and St. Petersburg, a modern hotel market has only recently emerged in the Millionniki. The existing stock largely consists of older hotels constructed during the Soviet period. However, reflecting regional economic development, and growing interest from domestic and international investors and developers in regional hospitality markets, many Soviet-built properties are beginning to undergo considerable reconstruction and expansion aimed at achieving higher levels of quality and service. Various hotel operators are extensively eyeing regional cities. Rezidor SAS, for example, is already present in **Yekaterinburg** and is expanding further to **Rostov-on-Don** as well as other destinations. Other international hotel chains expanding into Russian regional cities include Accor, InterContinental Hotels Group, Kempinski Hotels & Resorts and Marriott International who are reported to be displaying their flags in **Nizhniy Novgorod, Novosibirsk** and **Samara** respectively.

Final *Observations*

While Moscow and St Petersburg will continue to create considerable opportunities, regional cities are emerging as a good alternative. In some markets, such as retail and logistics, the cumulative potential of the regions is soon to overtake that of Moscow and individual potential of the best real estate performers among the Millionniki, such as **Yekaterinburg,** is similar to that of St Petersburg. Demand drivers across all real estate sectors are strengthening in the Millionniki as many real estate market players discover that accessing the Millionniki will capture the vast majority of emerging Russian middle class located outside of Moscow and St Petersburg.

A new Russian cities network is starting to crystallise. Moscow is a global city and is clearly head and shoulders above the other Russian cities in terms of its economic profile and dynamism. However, further down the hierarchy, changes in city competitive positioning are creating a new cities network and new real estate opportunities. If, according to expectations, the Russian cities network is allowed to grow more organically over the next decade, we would expect two or three of the Millionniki to rise above the parapet, and gradually narrow the economic gap with St Petersburg. Our analysis suggests that the cities of **Yekaterinburg** and **Samara,** followed by **Novosibirsk** and **Rostov-on-Don,** are best positioned to develop into larger urban agglomerations. These four cities will attract higher-order business functions, and will require larger and more sophisticated real estate provision and are likely to narrow the economic gap with Russia's second city, St Petersburg.

As the competition among Russian cities accelerates the Millionniki are already feeling the breath of a number of smaller cities (of below one million population). Cities to watch include:

- Krasnodar and Yaroslavl with their rapidly developing retail markets
- Saratov, a major port on the Volga River, with strong economic performance
- Kaliningrad region, which is benefiting from its location close to the EU, and its privileged status as a Special Economic Zone
- Togliatti, an important industrial and transport hub on the Volga River. Only 60 km from Samara, the city forms parts of the Samara-Togliatti-Syzran metro region of more than three million inhabitants
- Sochi, a resort city on the Black Sea coast, with significant hotel potential. The city has been short-listed for the 2014 Winter Olympics

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