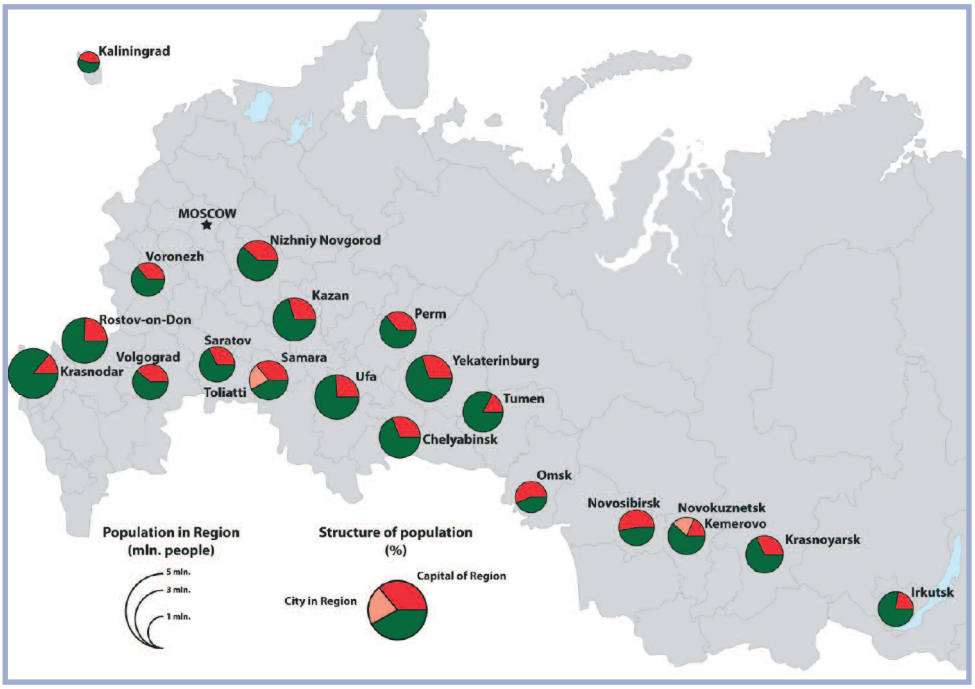
Knight Frank

Russian Regions

Real Estate Markets in 2007

Contents



Executive summary

- The economic situation in Russia creates favourable conditions for the development of regional real estate markets. The most important positive factors are the overall economic growth, the dynamic development of financial markets, and the availability of stabilisation funds to guard against external financial crises.
- The regional economies are developing in disparate ways. The greatest potential is concentrated in the 15 to 20 regions which have strong mining or processing industries. There are as yet no regions where the retail and service sectors dominate the economy but this situation is gradually changing.
- The retail market is the most developed of all the real estate sectors in the regions. There is the characteristic active development of the "second echelon" cities by developers, the relatively high level of competition between shopping centres, and the implementation of large-scale projects
- A characteristic feature of office real estate markets is the dominance of local developers. Partly this is the reason why there is no universally accepted classification of property even in the most developed markets in cities of more than one million people.
- Considering the volume of declared projects, there is more potential for growth in the warehouse realty market. This part of quality developments will happen primarily through the implementation of network projects.

Knight Frank Newmark Global

''The influence exerted on the economic growth by the customer and investment demand significantly grew.''

Overview of National Economy

Russia's Main Economic Indicators

Indicator	2006	2007	2008*
GDP growth (%)	6.7	8.1	6.4
Inflation rate (%)	9.0	11.9	8.5
Real wages growth (%)	10.2	10.4	10
Retail trade turnover (%)	13.0	15.2	11.4
Fixed capital investment growth (%)	13.7	21.1	13.2
Industrial production index (%)	4.4	6.3	5.2
GDP ($ bln)	985	1,341	1,462
Foreign trade surplus ($ bln)	139.2	128.7	83.6
Gold and currency reserves at the year-end ($ bln)	303	474	n/a
Stabilization Fund at the year-end ($ bln)	89.1	156.8	n/a
Average exchange rate (RUB/USD)	26.3	24.6	25.3

*Forecast of Russian Ministry of Economic Development and Trade.
Sources: Russian Ministry of Economic Development and Trade, Russian Ministry of Finance, Bank of Russia

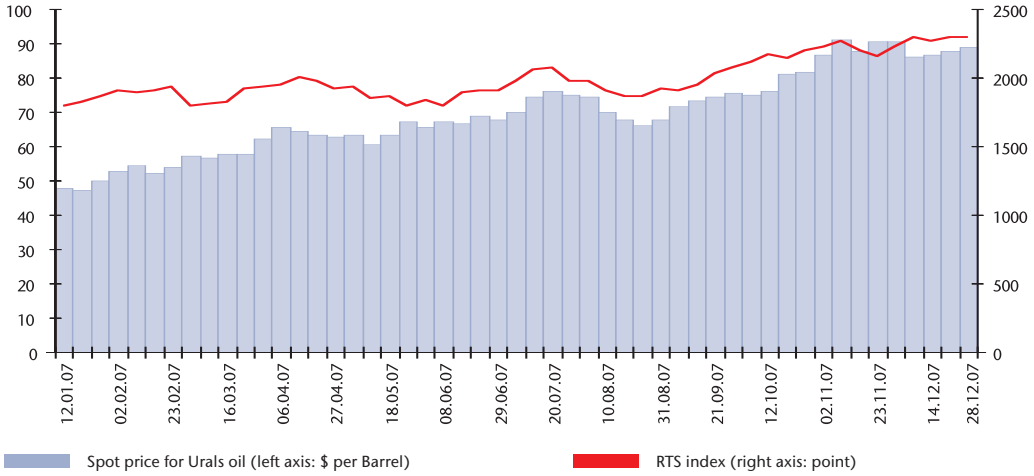
Main Positive Trends of the Year

- In 2007, economic growth increased its pace despite the fact that initially the government officially forecasted a decrease in the majority of macroeconomic indicators against previous year.
- The influence exerted on the economic growth by the customer and investment demand significantly grew. Therefore the Russian economy first demonstrated that it has the potential for development based on domestic factors and goods' markets.
- Industrial production indicators improved, first of all those of the processing industry, which most experts did not predict. The main reason for the improvement was the high demand for industrial use goods formed by companies that upgraded their fixed assets.
- Capital markets developed dynamically. The total volume of funds attracted by Russian issuers in IPO exceeded $30 bln. The growth of bank credits issued to non-financial organizations in the 11 months of 2007 reached $107 bln.
- The RTS index reached new records by year-end. The strong correlation between the index and the global oil prices was preserved. However, this is mainly caused by the large weight of oil and gas companies in the index. Generally, the Russian financial sector was stable against the unfavorable situation on the world's financial markets.
- The government continued to implement economic initiatives aimed at stimulating economic growth. These include founding and property contributions to such institutions as the Bank for Development and Foreign Economic Affairs (Vnesheconombank) and the Russian Corporation of Nanotechnologies.

''The government continued to implement economic initiatives aimed at stimulating economic growth.''

"Year 2007 demonstrated the Russian economy's stability against external factors and the existence of the internal growth potential."

Growth on the RTS Index and Spot Prices for Oil (Urals) in 2007



Sources: Russian Trading System, US Department of Energy

Main Negative Trends of the Year

- A significant growth in consumer prices demonstrated the limited efficiency of the government's measures against inflation.
- There was a certain relaxation of the budget policies. By the end of 2007 the additional expenses incurred by the federal budget exceeded the additional revenues by 2.2 times.
- The outrunning growth of imports stimulated by the unsatisfied domestic demand and the strengthening of ruble (in 2007 import of goods and services grew by 37%).
- The external debt of the Russian corporate sector grew rapidly and reached a record $378 bln as of October 1, 2007 exceeding the external debt of the state authorities by 9.5 times.
- A strong trend toward the outrunning growth of wages as compared to labour efficiency leads to the growth in the risk of inflation.

On the whole 2007 demonstrated the Russian economy's stability against external factors and the existence of the internal growth potential even though it is based on the redistribution of revenues from gas and oil. The main disappointment of the year was the high inflation rate (though it is difficult to restrain the prices growth in and speed up economic growth simultaneously). Generally, Russian economy showed again that it deserves a better appraisal from the rating agencies.

Sovereign Credit Ratings of Russia

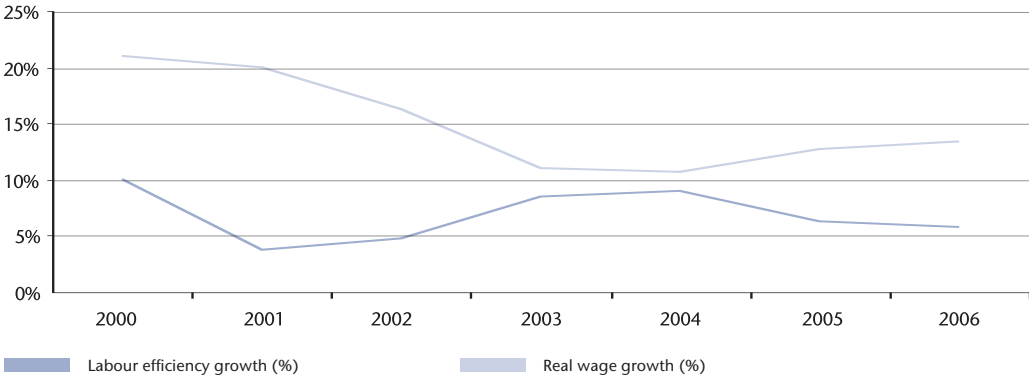
Agency	Foreign currency	Onlook	Local currency	Onlook	Last update	Comparable countries
Standard & Poor's	BBB+	Stable	A-	Stable	04.09.06	Bulgaria, Croatia, Hungary
Fitch Ratings	BBB+	Stable	BBB+	Stable	25.07.06	Poland, Thailand, RSA
Moody's Investors Service	Baa2	Stable	Baa2	Stable	26.10.05	Kazakhstan, Mauritius, Tunisia

Sources: Standard & Poor's, Fitch Ratings, Moody's Investors Service

"Russian economy deserves a better appraisal from the rating agencies."

''The planned increase in the tariffs which will preserve the high inflation pressure.''

Changes in Wages and Labour Efficiency from 2000–2006.



Sources: Federal State Statistics Service, European Bank for Reconstruction and Development

Forecast for 2008

- Resulting from the limited liquidity of the world's financial markets major borrowers will start to work with the domestic capital markets. Companies and banks whose external debts already account for a significant share in liabilities might face certain problems.
- The expected increase in global oil prices coupled with the high consumer demand and the weakening of US dollar will result in the continued increase in import volume and positive changes in budget revenues from oil and gas.
- The future presidential election will not create any essential risks for economy as it is highly possible that the current economic policy will be preserved.
- The planned increase in the tariffs (for electricity, gas, utilities and railway traffic) will exceed the increase registered in 2007, which will preserve the high inflation pressure.
- The preserved pace of import growth will result in further decreasing the positive foreign trade balance, which will shift the emphasis in the monetary policy of the Bank of Russia from currency intervention to refunding tools.

''The subjects of the Russian Federation develop in many disparate ways.''

The Economies of the Russian Regions

The subjects of the Russian Federation develop in many disparate ways. In order to form a comprehensive understanding of the development level it is better to apply complex analysis without emphasising this or that parameter. The following features are to be analysed:

- The economy's structure;
- Industry development;
- Consumer market development;
- Investment activity;
- Independence of the regional budget from the support of the national capital.

The regions that contribute most to gross regional product (GRP) of Russia can be divided into several groups.

The first group is formed by regions whose economies are oriented toward the natural resources sector. A good example is Tyumen Region (including the Yamalo-Nenets Autonomous District and the Khanty-Mansijsk Autonomous District). The main development factor of such regions is their mineral wealth.

The second group is formed by regions with strong industry and includes Krasnoyarsk Territory, Sverdlovsk, Chelyabinsk, Omsk and other regions. These regions are located around the Urals and in Western Siberia – the traditional industrial centres of Russia.

The third group is formed by regions with relatively diversified economies. Such regions have several industries forming no less than 10% of the gross regional product and it is impossible to single out a predominant industry among them. They include Krasnodar Territory, Rostov Region, Republic of Bashkortostan and Novosibirsk Region. It is noteworthy that in these regions the mining industry has limited influence on economic development.

Unfortunately it is as yet impossible to single out the forth group of regions dominated by the institutional sector.

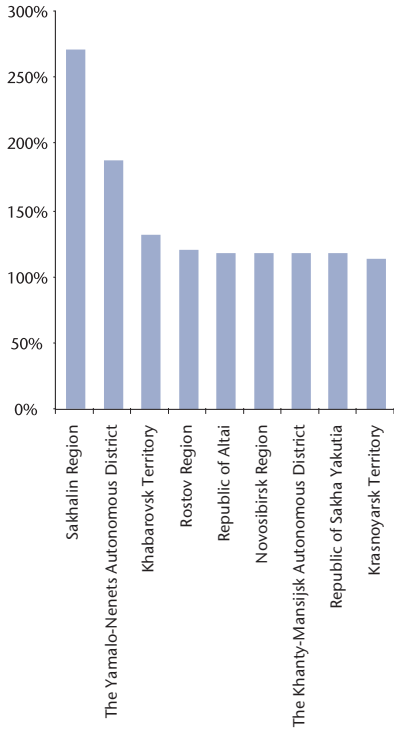
As far as a mid-term forecast is concerned, there will be more and more regions with diversified economies among regions that are leaders in GRP volume. It is conditioned by the expected rapid development of the service sector, for example the share of retail volume will possibly grow in the regions where about one third of the GRP is currently formed by industries involved in processing.

''As far as mid-term forecast is concerned, there will be more and more regions with diversified economies among regions that are leaders in GRP volume.''

As for industrial development, a high concentration of industrial production in certain regions should be emphasized. 14 Russian Federation regions account for 60% of the country's industrial production. These regions include Moscow, Moscow Region, Saint Petersburg, Yamalo-Nenets Autonomous District and the Khanty-Mansijsk Autonomous District, Sverdlovsk, Samara, Chelyabinsk, Nizhny Novgorod, Kemerovo regions, Republics of Tatarstan and Bashkortostan, Krasnoyarsk and Perm territories.

However, this situation is not a static one. In the near future the share of these industrial leaders in Russia's overall industrial production will inevitably decrease. In the mid-term future an impressive growth will be most probably demonstrated by regions where mineral mining is planned – Sakhalin Region (Sakhalin-1, Sakhalin-2 projects), the Nenets Autonomous District, etc. The rapid growth of the processing industry is expected in certain regions, in particular in Khabarovsk Territory and Rostov Region.

Regions-Leaders by the Projected Growth Rate of Industrial Production, 2008 against 2006 (%)



Source: The Ministry of Economic Development and Trade

Economy Structure in Regions-Leaders in GRP Volume (% of GRP)

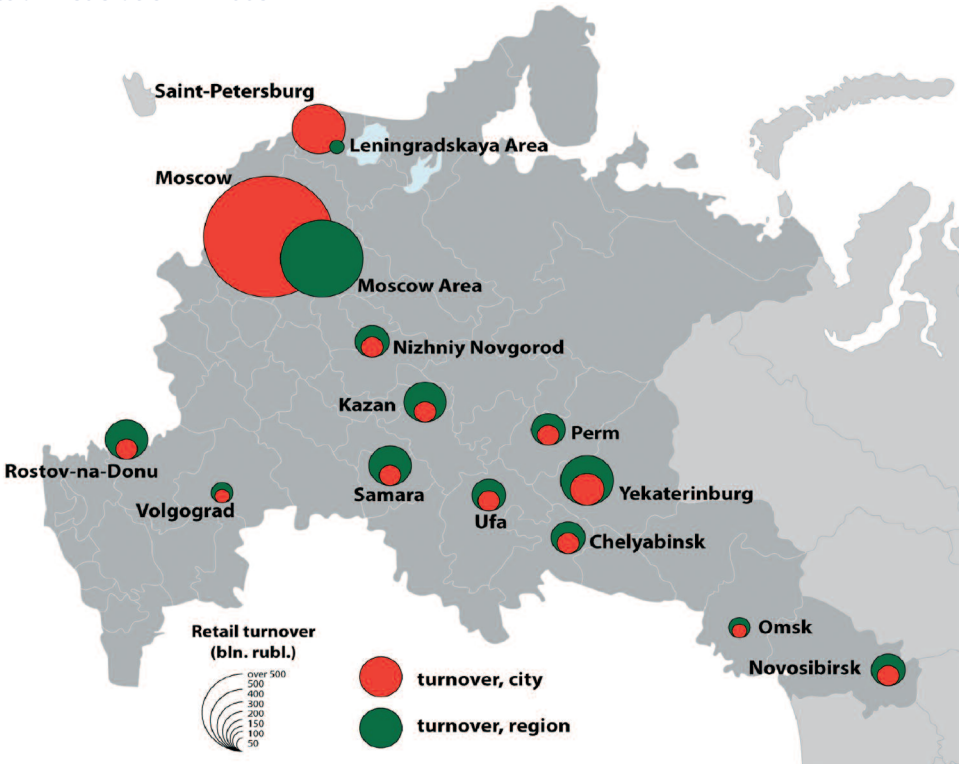
Federal Subject of Russia	Agriculture	Mining	Processing	Trade	Transport and communications	Services
Tyumen Region	0.8	59.2	10.9	4.8	7.6	5.8
Republic of Tatarstan	7.8	30.6	16.7	11.7	6.9	4.8
Sverdlovsk Region	4.7	4.3	31.6	21.5	11.4	6.4
Krasnoyarsk Territory	5.1	3.9	47.1	8.1	10.4	4.8
Samara Region	4.4	11.1	32.4	15	11.8	7.3
Republic of Bashkortostan	10.6	12.7	27.8	10.5	9.6	6.8
Krasnodar Territory	15.4	1.9	13.2	13.8	19.5	5.8
Chelyabinsk Region	8.3	0.9	41.4	12.6	9.5	7.1
Perm Territory	3.9	15.2	28.2	14.4	9.6	10.3
Nizhny Novrogod Region	5.8	0	31.8	17.9	12	10.9
Kemerovo Region	3.5	27.1	16.8	13.8	9.4	5.6
Irkutsk Region	8.9	3.2	25.7	14.1	20	4.8
Rostov Region	13.2	1.1	18.5	23.2	10.2	7.7
Novosibirsk Region	9	3.4	17.9	13.5	17.2	13.3
Omsk Region	9.8	0.5	46.9	10.9	7.8	5.2

the industry accounts for more than 30% of GRP — the industry accounts for more than 10% of GRP (but less than 30%)

Note: Data on the GRP is given for 2005 and include autonomous districts.
Sources: Federal State Statistics Service, Knight Frank Research, 2008

The key consumer markets of Russia are in cities of 1 million residents. Currently there are 11 such cities in Russia besides Moscow and Saint Petersburg (Perm and Volgograd are traditionally included into this list). The main advantages of such consumer centres are the large population constantly growing due to migration and the income level that is above the Russian average.

Retail Turnover in Cities of 1 million residents and the Corresponding Subjects of the Russian Federation in 2006



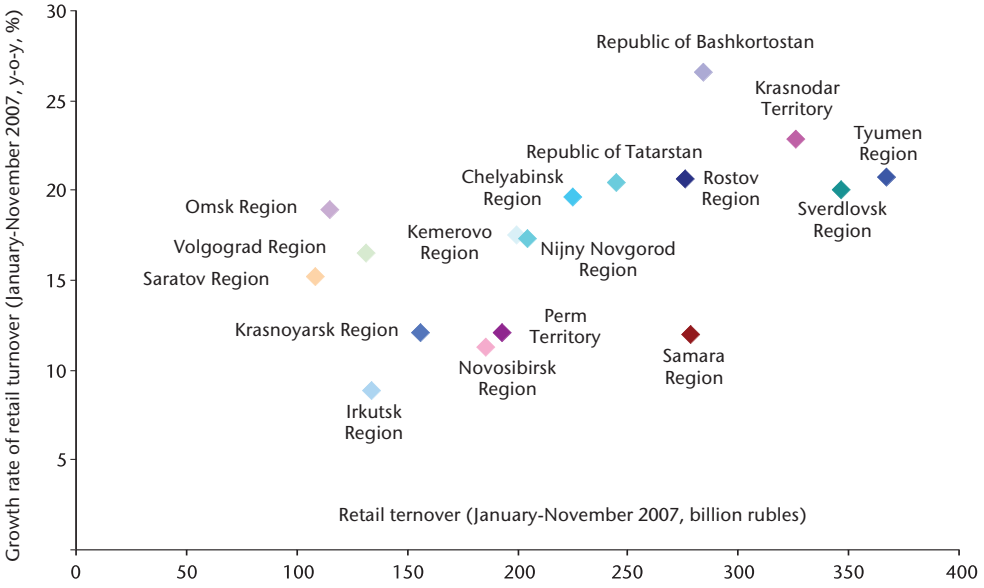
Source: Federal State Statistics Service

''The key consumer markets of Russia are in cities of 1 million residents.''

''A certain 'second echelon' of the major consumer markets of Russia is formed by certain regions with developed mining or processing industries and administrative centres of 500 thousand residents and more.''

A certain 'second echelon' of the major consumer markets of Russia is formed by certain regions with developed mining or processing industries and administrative centres of 500 thousand residents and more. They include first of all Irkutsk and Saratov regions, Krasnodar and Krasnoyarsk territories.

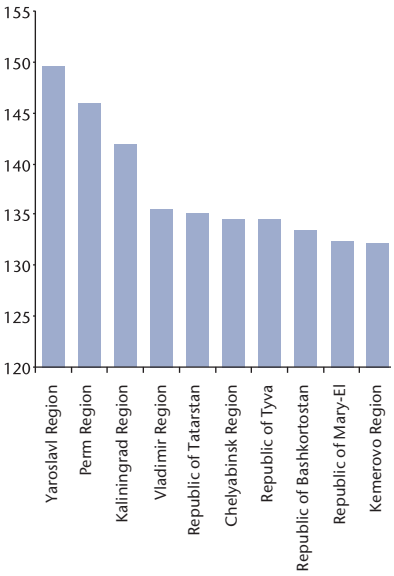
Major Consumer Markets of Russia



Sources: Federal State Statistics Service

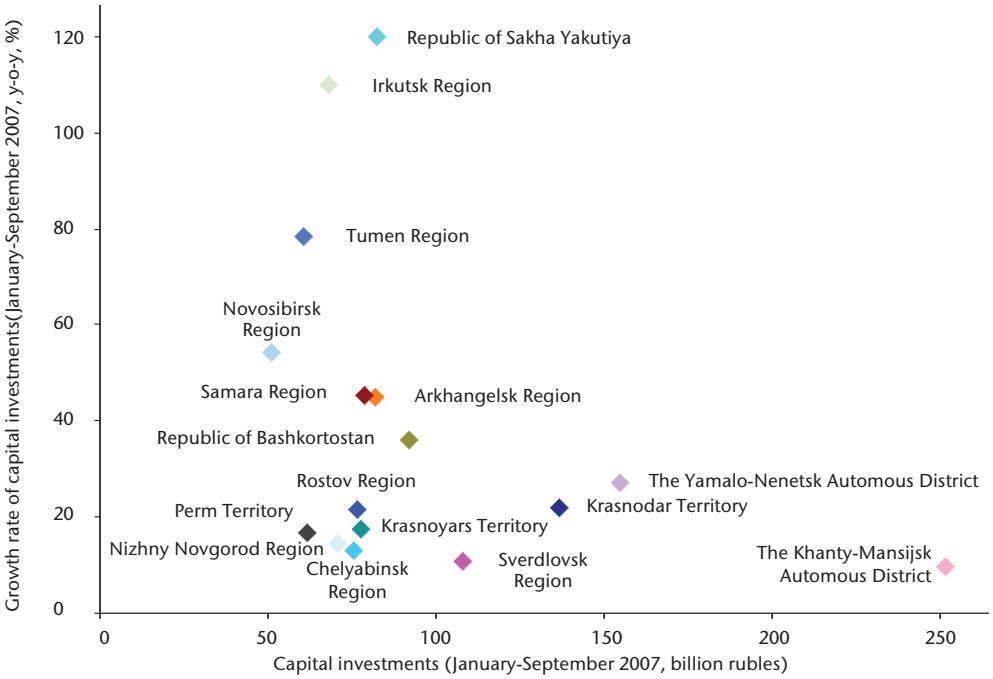
In the mid-term future the highest growth of retail turnover is expected in the regions with traditionally developed consumer markets but also in certain regions of the Central Federal District (Yaroslavl, Vladimir regions) and in Kaliningrad Region.

Region Leaders by Expected Retail Growth, 2008 against 2006 (%)



Sources: The Ministry of Economic Development and Trade, Knight Frank Research, 2008

Regions with the Highest Investment Activity in January-September 2007 (%)



Note: Information on Tyumen Region does not include data on the Yamalo-Nenets Autonomous District and the Khanty-Mansijsk Autonomous District.
Sources: Federal State Statistics Service, Knight Frank Research, 2008

''20 leading regions accounted for approximately 63% of capital investments.''

As far as regional investment activity is concerned, we register a high concentration of investments in the regions with the most developed economy. In the period of January - September 2007, 20 leading regions accounted for approximately 63% of capital investments (42% without Moscow, Moscow Region and Saint Petersburg).

However, this situation may change in the near future owning to the stimulating measures taken by federal and regional authorities, including:

- Development of special economic zones (SEZ): the special legal regulation of business, industrial, investment activities in Kaliningrad Region, the SEZ for industry and production in Lipetsk Region and the Republic of Tatarstan, the SEZ of technology and research in Tomsk, SEZ of tourism and recreation in Kaliningrad and Irkutsk regions, and in Krasnodar, Stavropol, Altai territories, and the Republics of Altai and Buryatia.
- The technology park projects (for example, Grabtsevo technology park in Kaluga suburb, a technology park in Akademgorodok of Novosibirsk).
- The Co-funding of infrastructure development projects from the Investment Fund of the Russian Federation (construction of Nizhnekamsk oil refinery facility in Tatarstan, complex development of Nizhneye Priangarye (Lower Angara region), etc).

Due to regional authorities insufficiently using the tools of debt financing or by being insufficiently open for external investors; credit ratings by leading international or national rating agencies are available for rather a small number of regions. Meanwhile the regions that regularly undergo the credit rating assignment procedure have rather high ratings with stable and positive outlook.

We should separately discuss the issues of budget relations as a good balance of regional and territorial budgets form the basis for the general stable development of a region. Traditionally regions have been divided into recipients and donors depending on the budget situation (deficit/surplus).

Credit Ratings of Regional and Municipal Authorities

City/region	Standard & Poor's	Moody's Investors Service	Fitch Ratings	Expert RA – AK&M
Municipal authorities				
Nizhny Novgorod	BB-/Positive/- -			
Novosibirsk	B+/Positive/--			
Omsk	B/Stable/--			
Ufa	B+/Positive/--			
Federation Subjects				
Volgograd Region	BB-/Stable/--			
Irkutsk Region	B+/Stable/--			
Kemerovo Region				A/Stable
Krasnodar Territory	BB-/Positive/--	Aa1.ru	BB/Stable	
Krasnoyarsk Territory	BB+/Stable	Aa2.ru	BB/Positive	
Nizhny Novgorod Region		Aa2.ru	BB-/ Stable	
Novosibirsk Region			BB-/ Stable	
Omsk Region		Aa2.ru		
Perm Territory		Aa1.ru		
Republic of Bashkortostan	BB/Positive/--			
Republic of Tatarstan	BB-/Positive/--		BB+/ Stable	
Rostov Region		Aa2.ru		A+/Positive
Samara Region	BB/Positive/--	Aa1.ru		
Sverdlovsk Region (Yekaterinburg)		BB/Stable/--		
Chelyabinsk Region		Aa1.ru		

Note: Standard & Poor's and Fitch Ratings sections give information on foreign currency ratings and onlook, while Moody's Investors Service gives the national scale rating.
Sources: Standard & Poor's, Fitch Ratings, Moody's Investors Service, Expert RA

''The list of donor regions accounting for the major share of tax proceeds is rather stable.''

The main source of subsidies aimed at the leveling of budget capacities of different subjects is the Federal Fund of Financial Support of Constituent Entities of the Russian Federation (though there are other funds with similar functions, for example, Federal Fund of Regional Development). This fund provides the main share of funding for regional recipients.

The list of donor regions accounting for the major share of tax proceeds is rather stable and comprises such regions as Sverdlovsk Region, Republic of Tatarstan, Tyumen Region with the corresponding autonomous districts and a number of other regions. The Russian economy is quite dependent on the prosperity of such regions. For example, 10 regions of the Russian Federation (including Moscow and Saint Petersburg) account for 65% of the total taxes and receipts.

The transfer to a three-year budget plan is to create a certain stability in the regional financial situation. Major changes here can be related only to a renewal of registration of major tax payers or to the lowering of tax proceeds from export-oriented companies due to unfavorable conditions in foreign markets.

Regions-Donors in 2007–2010

Subject of Russian Federation	2007	2008	2009	2010
Astrakhan Region	■			
Vologda Region	■	■	■	■
Krasnoyarsk Territory				■
Lipetsk Region	■	■	■	■
Orenburg Region	■			
Perm Territory			■	■
Komi Republic	■			
Samara region	■	■	■	■
Sverdlovsk region	■	■	■	■
Republic of Tatarstan	■	■	■	■
Tomsk Region	■			
Tyumen Region	■	■	■	■
the Khanty-Mansijsk Autonomous District	■	■	■	■
Chelyabinsk Region	■			
the Yamalo-Nenets Autonomous District	■	■	■	■
Yaroslavl region	■			

■ there are no subsidies for the region from the Regional Financial Support Fund

Sources: Russian Ministry of Finance, Knight Frank Research, 2008

''Office markets are developing most actively in cities of 1 million residents.''

Office Market

Office Markets in Major Cities

City	Total supply of quality office space (thousand sq m)	Provision of office space (sq m per an economically active person)
Yekaterinburg	245.0	0.42
Novosibirsk	183.3	0.41
Rostov-on-Don	67.0	0.17
Perm	51.6	0.16
Kazan	63.0	0.14
Samara	73.1	0.12
Nizhny Novgorod	43.8	0.10
Chelyabinsk	37.3	0.08
Omsk	26.2	0.08
Ufa	29.0	0.08

Source: Knight Frank Research, 2008

Trends

- Office markets are developing most actively in cities of 1 million residents. The key development factor is the demand created by the expansion of branches and representative offices of national and foreign companies.
- The most developed office markets are in Yekaterinburg and Novosibirsk, though even there the demand for quality office space remains unsatisfied.
- It is hardly possible to find more than two or three operating state-of-the-art business centres in the cities of 500 thousand – 1million residents and in less developed markets of bigger cities.
- The high level of rents in new business centres is the reason why small- and medium-sized companies are still unable to afford such premises. This provides conditions for the simultaneous active development of semi-professional and unprofessional units (for example, office blocks on the ground floors of residential houses under construction).
- Due to the fact that the office market is dominated by local developers and the competition level is rather low, the office market remains immature in many ways. The characteristic features include the absence of the clear classification of properties, insufficient experience of management companies, and the neglect of professional consultants' services in the design and implementation of projects.

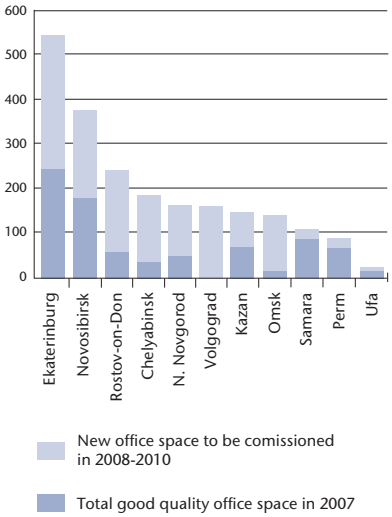
Bel-Plaza Business Centre
Samara

Supply

Regional markets are still dominated by semi-professional and unprofessional units (old administrative buildings, extensions, etc). Such properties satisfied the mass demand for office premises. The total area of office premises regardless of the class reaches 1 million sq m in Yekaterinburg and 0.4 to 0.7 million sq m in other cities of 1 million residents.

In regard to quality office space (business centres of classes A or B), its supply does not exceed 200,000 sq m in any city of 1 million residents. Therefore the share of quality office properties does not exceed 20% of the total supply in cities with 1 million residents and in most cases it amounts to 5–10%.

Office Markets of cities of 1 million residents (thousand sq m)



Source: Knight Frank Research, 2008

Examples of Business Centres Opened in 2007

Project Name	Class	Location	Total area, sq m
Greenwich*	A	Novosibirsk (Krasnoyarskaya st.)	34, 000
KPD	B	Ufa (Oktyabrya av.)	21, 500
Kobra*	A	Novosibirsk (intersection of Revolutsii st. and Dimitrova av.)	15, 100
BEL Plaza*	A	Samara (Molodogvardeiskaya st.)	14, 430
Residence Park	B	Yekaterinburg (Dobrolyubova st.)	10, 400
Parus*	A	Perm (Ostrovskogo st.)	4, 570
Avangard*	A	Perm (25 Oktyabrya st.)	4, 500

* The project's consultant is Knight Frank.
Source: Knight Frank Research, 2008

If we consider the quality space only, the office markets of major cities can be conditionally divided into four groups:

- The most developed markets, leading in terms of the number of operating properties and projects under construction (Yekaterinburg, Novosibirsk).
- Markets that will take a major step forward almost reaching the leaders' level provided that the projects, previously announced, are implemented (Rostov-on-Don, Chelyabinsk, Omsk).
- Small markets where the number of announced projects is limited but the economic potential is high (Perm, Ufa, Samara).
- Markets in 'second echelon' cities that are currently in an emerging state (Tyumen, Krasnodar, Kaliningrad).

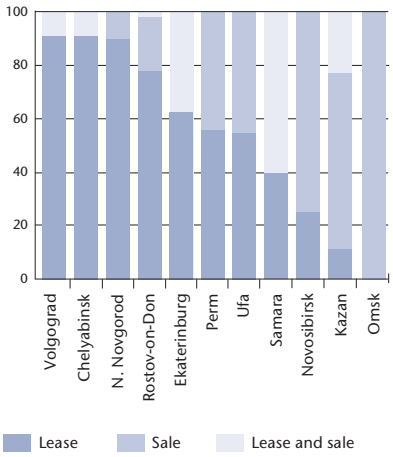
A typical feature of office supply in all regional cities is the absence of a clear classification of office properties. Most developers prefer to position their projects as Class A or B properties based on their own concept of quality. This being said, premises are often sold by blocks in the so named class A properties that have no underground parking and no developed policy of tenants selection which would take into account their influence on the property's image.

Another important characteristic of the supply is that it is almost completely formed by local developers who often sell and rent premises and manage the properties via related parties. One of the few exceptions here was the project of a class A business centre of BEL Plaza implemented in 2007 in Samara by BEL Development company.

As for the projects that will enter the market in the near future, business centres offered exclusively for rent make up slightly more than a half of the total supply. However, it is a step forward compared to the previous years when developers would finance the construction by selling shares in the properties at the construction stage.

Approximately 15% of the future office supply in the cities with 1 million residents is offered both for sale and rent. However, many landlords announce their intention to pass from sales of premises to renting them as the completion of the property draws near. Therefore we can make a conclusion that there is a gradual transfer from sales to rent in business centres.

Supply Breakdown of Office Properties under Construction and Design (%)



Source: Knight Frank Research, 2008

''The main demand for quality office facilities comes from large national players and foreign companies.''

Demand

Demand for office real estate in regional cities can be divided into several spheres:

- Local companies with small or medium-sized businesses, who essentially look for low-quality properties because the determining factor in their choice is price.
- Some successful medium-sized businesses try to rent small offices in well-known business centres in an attempt to improve their status by having well known brands as neighbours.
- Local leaders, including members of vertically-integrated companies (subsidiaries of Gazprom, Lukoil, etc.), prefer sites built-to-suit. This is because these companies have the opportunity to fund the construction of major facilities. Until recently, the market simply did not have anything that could meet their requirements; therefore, these companies represent a significant potential demand. This potential will be realized when major repairs are needed, and they will have to choose between the repair of their existing administrative building, constructing a new office, or leasing new space
- The main demand for quality office facilities comes from large national players and foreign companies actively upgrading their presence in the regions. These are mainly companies from industries such as financial services, consulting and information technology. For them, the primary motivation of opening regional offices is proximity to both corporate and retail customers.

Commercial Terms

Currently we cannot state that there is an established rent level in one city or another. Due to the limited supply, landlords often offer high rents and do not risk losing clients. In some cities rents for properties claiming to be exclusive may exceed 1,000 $ per sq m per annum.

The highest rents were registered in the two biggest markets: in Novosibirsk and Yekaterinburg. On the whole rents are higher in the Urals and the Siberian regions (including Perm and Chelyabinsk) than in the Volga region (Samara, Ufa).

Due to the large number of office properties under development (coupled with the small number of completed projects) rents for quality office space in the last 1 or 2 years rapidly grew at 40-50% annually. It is largely conditioned by the fact that when a developer starts a project considered to be brand new for the relevant market, they set the rent at the high threshold of the rent range. The next developer who also considers their project to be brand new sets a higher rent. This process is completely typical of markets with speculative demand, but as soon as landlords start experiencing problems with leasing out the premises, the rapid rent growth will stop.

''The highest rents were registered in the two biggest markets: in Novosibirsk and Yekaterinburg.''

Sales Prices and Rents in State-of-the-art Business Centres

City	Rents ($ per sq m per annum, net of VAT)	Sales prices, $ per sq m
Volgograd	450–700	2,550 and more
Yekaterinburg	575–1,200	2,500–5,600
Kazan	335–385	1,800–3,150
Nizhny Novgorod	245–1,150	1,350 and more
Novosibirsk	410–1000	2,200–4,350
Omsk	325 and more	1,800–4,000
Perm	325–720	4,800–6,000
Rostov-on-Don	530–610	2,250–7,000
Samara	265–480	1,100–4,000
Ufa	450–670	2,600–4,000
Chelyabinsk	575–870	up to 4,400

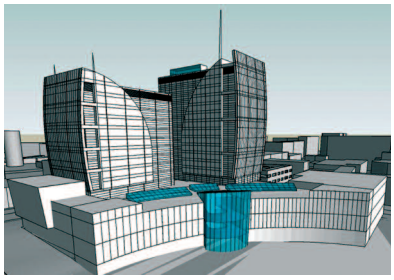
Source: Knight Frank Research, 2008

''The popularity of projects with several functional components will rise.''

As for the commercial terms, in most cases the landlord sets a monthly rent in rubles. The VAT inclusion is optional. It is usually not included when the management company is not a VAT payer or if there is an aim to artificially lower the rents (in this case it does not include any operating expenses). Electricity and communication costs are usually paid as a separate entry. Other operating expenses (security, cleaning services etc) are included into the base rent depending on the landlord's preference.

Forecast

- The popularity of projects with several functional components (office, retail, hotel, etc.) will rise. Developers will use projects like these to reduce their risks. In addition, developers will try to emphasise the individuality of their projects, such as their expanded opportunities for conferences.
- Thanks to the entry into the market of a large number of high quality projects, the difference between the rents for business centres of different classes will increase. As a result, the rents will become better grounded.
- Considering the saturation in other spheres of the real estate market (especially retail) in major cities, large national developers will first start to participate in the implementation of office projects in the regions.
- In some cities, such as Kazan and Volgograd, new comprehensive construction projects will be implemented in insufficiently developed areas, as well as new business centres in the style of Moscow's "City," which will include the building of entire complexes of office buildings.
- There will be some changes in the structure of demand for office space from large national companies. While currently the main determining factor for opening an office centre is proximity to regional customers, in future it may be the creation and development of corporate administrative centres, including front- and back-office operations. These centres will coordinate the activities of companies in several neighboring regions (for example, the Office for the Southern Federal District in Rostov-on-Don).
- Rents for office space have considerable growth potential in the next 1 or 2 years. However, the pace of growth is unlikely to exceed 20-25% per year, and after primary market saturation the rent growth pace will slow.



A retail and business centre at Radishcheva st. Ekaterinburg

Business Centres Planned for Completion in 2008–2010

Project Name	Class	Location	Total area, sq m	Completion date
Manhattan (Phase II)*	A	Novosibirsk	75, 000	2008
Onegin Plaza*	A	Yekaterinburg	60, 000	2008
A retail and business centre at Radishcheva st.*	A	Yekaterinburg	37, 300	2009
Peter Veliky	B	Tumen	27, 000	2008
Chelyabinsk-CITY*	A	Chelyabinsk	30, 860	2008

* The project's consultant is Knight Frank.
Source: Knight Frank Research, 2008

''The imbalance between the supply and demand of quality warehousing space makes it possible for the landlords to keep the rents at a high level.''

Warehouse Market

Warehouse Real Estate Markets in the Major Cities

City	Total stock of state-of-the-art warehouse space, sq m
Yekaterinburg	235,000
Samara	164,300
Novosibirsk	109,500
Kazan	104,600
Rostov-on-Don	94,000
Perm	51,500
Nizhny Novgorod	45,000
Chelyabinsk	25,000
Voronezh	25,000

Source: Knight Frank Research, 2008

Trends

- The market is still dominated by the low quality supply (small-sized obsolete premises) and warehouses of average quality built by companies for their own use.
- The largest supply of quality warehouses is registered in Yekaterinburg, Samara, Novosibirsk, Kazan and Rostov-on-Don. However, even in these cities the market for high quality warehouse space is at emerging stage.
- There is active implementation of chain projects envisaging the construction of similar warehouses in the most promising cities in the terms of social and economic development and transport locations (projects by Eurasia Logistic, MLP, Megalogix, etc).
- The imbalance between the supply and demand of quality warehousing space makes it possible for the landlords to keep the rents at a high level close to that of the developed Moscow market.
- Unlike other areas of real estate, the rapid growth of the warehouse market in the regions is still something of the future.

Supply

The total supply of warehouses of all classes in regional cities of 1 million residents lies in the range of 300–1000 thousand sq m depending on the city. The total warehouse stock regardless of the class reaches 1 million sq m in Yekaterinburg, 600,000 sq m in Omsk, 465,000 sq m in Voronezh and 410,000 sq m in Novosibirsk.

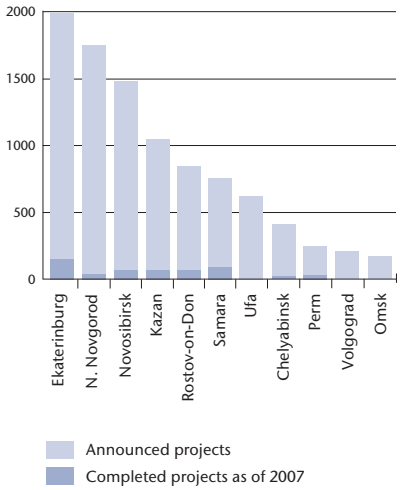
Ninety percent of the supply is formed by low quality premises of classes C and D, comprising, first of all, reconstructed industrial premises of the Soviet era. A separate category of supply is formed by built-to-suit warehouses of class C (or class B in case these are recently constructed or reconstructed buildings).

State-of-the-art warehousing facilities account for less than 10% of the market. It is noteworthy that during the last year this share grew as large projects started entering the market.

Both local and national-scale developers form the new supply. Locals specialise in relatively small projects with a maximum area of 20–30 thousand sq m. National developers implement projects of class A and B with the total area of 100,000 sq m and more.

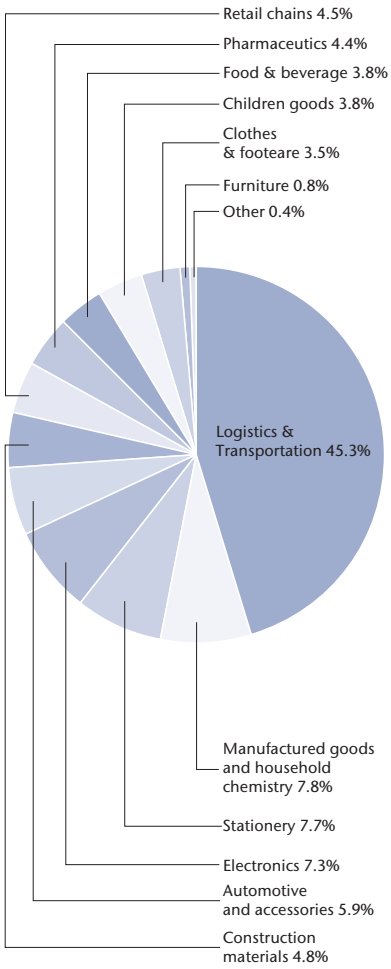
Pyshma logistics park
Ekaterinburg

Warehouse Markets of cities of 1 million residents (thousand sq m)



Source: Knight Frank Research, 2008

Demand Breakdown for State-of-the-art Warehouse Premises in all Regions



Source: Knight Frank Research, 2008

Examples of Warehouse Facilities Completed in 2006–2007

Project name	Developer/Investor	City	Total area, sq m	Completion year
Pyshma logistics park (Phase 1)	Eurasia Logistics	Yekaterinburg	85, 000	2007
Q Park Kazan	RDS Developments/ Quinn Group	Kazan	70, 000	2007
NLK-Bataisk	NLK	Rostov-on-Don	50, 000	2007
A class B warehouse	BeeLogistic	Novosibirsk	20, 000	2006
Warehouse complex	Povolzhskaya Logistics Company	Kazan	15, 000	2007
Class A warehouse	Altex	Nizhny Novgorod	13, 000	2007
Siberia logistics park	NLK	Novosibirsk	10, 000	2006

Source: Knight Frank Research, 2008

Demand

The main demand for state-of-the-art warehousing facilities comes from logistics operators. Logistics companies are interested in premises in virtually every Russian city of 500 thousand - 1 million residents. Their main interest concerns the cities that are potential transportation hubs. Such companies consider multiple variants on how to enter the regional markets including construction and redevelopment.

Retail operators and FMGG companies also form a significant demand for warehousing premises. Due to the limited supply and the high rents in the existing state-of-the-art warehousing facilities, retailers often try to construct properties for their own use. Currently this approach really minimizes the time and material costs. As time goes by, this situation will change as it becomes more profitable to outsource certain parts of the supply chain to specialised companies (3 PL operators). In their turn, 3 PL operators very rarely consider the option of constructing a warehouse of their own, therefore the market demand grows.

Medium- and small-size companies operating on the local markets usually cannot afford to rent high class premises. This is a result both of unaffordable rents and operating expenses, and also by the too large units offered for rent. Therefore such companies create a potential demand both for low quality warehouses and for relatively small projects of class B with affordable rents.

Commercial Terms

- Rents for class A premises in regions are determined by chain projects, and are rather similar, amounting to 105–140 $ per sq m per annum, which is approximately commensurate with the rents on the Moscow market. Rents for warehouses of class B amount to 100–120 $ per sq m per annum.
- Rents for warehousing premises of class C are 40–100 $ per sq m per annum. The fact that lower class warehouses are easy to lease out at the highest rent of this range shows that the regional markets are immature.
- The triple net rents (the base rent that does not include operating expenses, utilities and VAT) is just emerging. Triple net rents are currently used only in class A warehousing facilities constructed by large national developers.

''Certain cities may strengthen their position as major transportation hubs.''

Rents for Warehouse Premises ($ per sq m per annum)

	Average rent range, class C	Maximal rents, class B	Base rents, class A
Yekaterinburg	60–90	100–125	140
Irkutsk	45–50	60–80	
Kazan	50–90	90–140	120–135
Krasnodar	40–60	100–120	
Novosibirsk	70–90	100–115	140
Omsk	45–70	80–90	
Rostov-on-Don	70–85	120–150	140
Samara	40–50	80–100	105–120
Saratov	40–80	70–115	
Ufa	40–60	90–100	140
Chelyabinsk	45–50	80–90	

Source: Knight Frank Research, 2008

Forecast

- As the number of regional projects grows, investment transactions will involve the purchase of properties at different implementation stages.
- There will be industrial park projects implemented in the regions – both by private companies and in the framework of federal programs aimed at the development of special economic zones.
- Certain cities may strengthen their position as major transportation hubs, while other cities in a less favourable location that are still situated close to such hubs may form a part of the served logistic flows which can be transferred to the more competitive neighboring cities. Therefore developers should very carefully analyze the prospects of the market before entering it.
- Implementation of the existing projects will make it possible to increase the current supply several times over which will restrain the growing rents. However, it is a matter for the mid-term future (3 years and more).

Warehouse Complexes to be Completed in 2008–2010

Project Name	Developer/ Investor	Location	Total area, sq m	Completion Date
Sigma*	DK Mir	Ufa	85, 000	2008-2009
Class A Warehouse Complex*	Izdatelstvo Ural L.T.D.	Chelyabinsk	85, 000	2009
Trilogy Park Nizhny Novgorod*	Investicionnyi Trust	Nizhny Novgorod	160, 000	2009-10
Q Park Kazan	RDS Developments/ Quinn Group	Kazan	230, 000	2007-2010
Pyshma (Phase II, III)	Eurasia Logistics	Yekateringburg	195, 000	2008
Biek Tau	Eurasia Logistics	Kazan	155, 000	2008-2010
Megalogix-Ufa Megalogix-	Raven Mount / Avalon	Ufa	100, 000	2010
Rostov-on-Don	Raven Mount / Avalon	Rostov-on-Don	215, 000	2008–2009

* The project's exclusive consultant is Knight Frank.
Source: Knight Frank Research, 2008

''Implementation of the existing projects will make it possible to increase the current supply several times over.''

Shift of chain-developers attention to markets of cities which have a population of between 500 thousand and 1million residents.

Retail Market

Trends

- Shift of chain developers attention to relatively unsaturated markets of cities which have a population of between 500 thousand and 1million residents.
- The appeal of development projects can be attributed to the high demand for retail properties from retail operators, in the context of steadily increasing purchasing power of the population.
- Retail operators, owners of which aim to sell off the business after some period of time, seeking all suitable ways to speed up business growth (acquisition of small retail chains with help of loan financing, franchising schemes, etc). At the same time there are several operators oriented on long-term growth which use more balanced strategies.
- Projects have been gradually getting bigger. 100,000 sq m shopping centres are no longer uncommon. However, most of these projects will only enter the market in the next few years.
- In the context of the large number of emerging shopping centres with elaborate concept and a high quality range of tenants, the difference between rents in the professional and semi-professional segments is widening.

Chain developers which came into the market in 2007

Retail chain	Developer	Geography of projects
Jam Mall	Hermitage Construction & Management	Kirov, Irkutsk, Smolensk, Pskov, Omsk, Anapa
Unspecified	Otkritie-Nedvizhimost	Tambov, Yekaterinburg, Novocherkassk, etc
Strip Mall	Midland Development	Ryazan, Saratov, Volgograd, Tula, Kurgan, Sterlitamak, etc
Unspecified	BV Development	17-20 shopping centres in different cities including Surgut, Krasnodar, Tula, Izhevsk, Perm, etc
Serpantin	Douglas Development	Petrozavodsk, Novorossiysk, Cheboksary, Lipetsk, Smolensk, Bryansk, etc
Unspecified	Finstar Properties	Barnaul, Belgorod, Ulyanovsk, Lipetsk, etc
RIO-Grande	Tashir	Ivanovo, Kostroma, Petrozavodsk, Vologda, Yaroslavl, Vladimir, Kirov

Source: Knight Frank Research, 2008

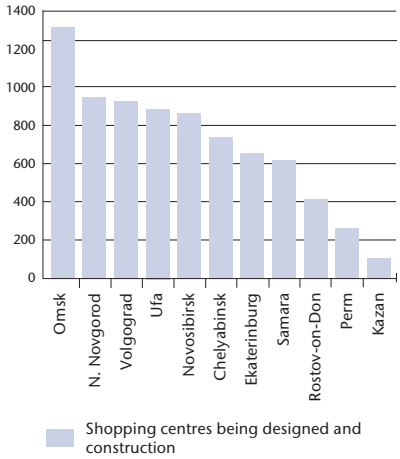
Professional shopping centres opened in 2007 in cities of 1 million residents

Project Name	Developer	Location	Total area, sq m
MEGA-Novosibirsk	IKEA	Novosibirsk	150,000
MEGA Rostov-on-Don	IKEA	Rostov-on-Don	150,000
Park House	Mall Management	Kazan	69,560
Rock-n-mall	DVI Group	Yekaterinburg	66,300
Semya	EKS	Perm	61,000
Gorki	City-Park	Chelyabinsk	55,000
Royal Park	Avtoyarus	Novosibirsk	43,600
Clover Plaza	Clover Group	Rostov-on-Don	23,000
REAL	ENKA	Volgograd	15,100

Source: Knight Frank Research, 2008

Europe Retail Centre
Ekaterinburg

Retail Markets of Certain Cities of 500 thousand – 1 million residents (thousand sq m)



Source: Knight Frank Research, 2008

Ranking of attractiveness of consumer markets

Major consumer markets

Region	Capital	Population of capital (on 01.01.2007, thousand citizens)	Retail turnover per capita (2007, thousand RUB)	Personal income per capita (nov. 2007, thousand RUB)*	Integral estimatie of region attractivness (grade)
Sverdlovsk region	Yekaterinburg	1,315.1	89.2	15,056	5
Samara region	Samara	1,139	98.2	15,445	3.9
Novosibirsk region	Novosibirsk	1,391.9	79.7	12,096	3.2
Rep. of Bashkortostan	Ufa	1,022.6	79.8	13,236	2.95
Perm territory	Perm	990.2	79.7	14,610	2.8
Rep. of Tatarstan	Kazan	1,116	73.1	12,424	2.7
Omsk region	Omsk	1,134.7	63.9	12,676	2.15
Volgograd region	Volgograd	986.3	56.5	11,450	2.1
Chelyabinsk region	Chelyabinsk	1,091.5	71.6	12,202	2.1
Nizhny Novgorod region	Nizhny Novgorod	1,278.3	67.8	10,517	1.75
Rostov region	Rostov-on-Don	1,051.6	73.4	10,824	1.7

*Date from Federation Territories
Source: Knight Frank Research, 2008

Integral estimation of consumer market attractiveness was made for 11 regions with capitals with population of 1 million citizens or more.

Next, these economical indicators were used during calculations:

1. Average wages
2. Personal income
3. Consumer credit per capita
4. Retail turnover per capita
5. Market services per capita
6. Personal expenses
7. Output of manufacturing industry per capita
8. Expenses of consolidated regional budget per capita

The aforementioned indicators allow us to judge the level of people's welfare in the regions from different points of view. In particular we consider sources of consumer budget (wages, bank loans), ways of spending citizens' funds (retail, market services) and indirect indicators of region's prosperity (condition of industry production and state finances). To make the comparison of regions with different populations more objective instead of absolute indicators we use relative (per capita) indicators.

As a result among the reviewed regions those which are most developed from a position of economic conditions are Sverdlovsk, Samara and Novosibirsk regions and republic of Bashkortostan.

Integral estimate of region attractiveness (Rj) was calculated as sum of products of grades for each indicator on its weight.

$Rj = \sum (Bi*Di)$

Where:

Bi – grade of region j after ranking by indicator i (region with maximum value of indicator get grade 5, region with minimum value of indicator get grade 1).

Di – weight of indicator i, which shows its importance for the consumer market of region (sum of all weights of indicators equals 1).

Demand

As a rule, demand for state-of-the-art retail premises in the regions is formed by large national operators who are actively developing retail chains in the regions. Sufficient funding and rather sophisticated business methods help major chains to cover more and more regions. The only possible hindrance here may be opposition from the local authorities due to lobbying from local companies.

At the same time, there are strong local players in almost all retail sectors who can rent premises at relatively high rates and successfully attract visitors to shopping centres. Hence such companies are good clients for management companies.

During the implementation of large-scale retail projects, there will be a redistribution of areas of influence within the local consumer markets in the regions. The large national players with better funding have an advantage here.

Commercial Terms

Rental rates in professionally-managed shopping centres in relatively developed markets in cities of 1 million residents are $100–350 per sq m per annum for anchor tenants and $600–1900 per sq m per year for shopping mall tenants. Maximal rents reach $3,000 per sq m per annum.

On the whole, the local owners of shopping centres use the established local range of rents as a basis (especially for popular retail streets), setting their rate in the upper end of the range and adding a premium for quality. Large national players more often base their rates on the rents offered on the Moscow retail market and determine a discount rate based on the comparative attractiveness and capacity of the local customer market.

As far as standard lease terms are concerned, short term lease agreements (11-12 months) are becoming less popular. Lease agreements in new shopping centres are signed for 3-5 years and for anchor tenants the term can be up to 10 years.

Forecast

- As the supply volume grows, competition between shopping centres will increase. Properties with bad conceptual designs will have difficulty keeping their occupancy rates high.
- The merger and acquisition of retail chains will continue. The share of large national companies in local markets will grow.
- Within the context of high expectations for returns on investment in the regional real estate market, there will be more investment deals.

Retail projects to be completed in 2008–2009*

Project name	Developer	Location	Total area, sq m	Date of completion
Talisman	ASPEK-Domostroy	Izhevsk	45,000	2008
360	GRAND LAND	Cherepovec	41,200	2009
Shopping centre	SK INTERCITY	Lipetsk	39,000	2009
Office and retail centre	Omskvinprom	Omsk	35,000	2009
Evropa	Avangard-Stroy	Yekaterinburg	35,000	2008

* Projects consultant is Knight Frank.
Source: Knight Frank Research, 2008

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