OVERVIEW

EXECUTIVE SUMMARY

- There was moderate positive trend in terms of lending to the construction sector in Q3 2011.
- Investment activity remained at the high levels observed since the beginning of 2011. International investors’ activity rose significantly - foreign capital accounted for 44% of total transactions on the commercial real estate market in nine months of 2011.
- Retail kept its leadership among commercial real estate segments by levels of investment, mainly it was due to large volume of transactions typical for the segment.
Main events

- Moscow government plans to offer more than 700 lots (modestly-sized real estate assets and shares in investment contracts) for sale by the end of the year as part of its programme of municipal asset sales. The first lots for auction will be a part of Gostiny Dvor the Oktaybr cinema on Novy Arbat street and municipal stakes in the International Trade Centre and the Novinsky Passazh mixed-use complex.
- A number of transactions involving western investors were closed in Q3. The most significant were as follows:

* As of 10 October 2011 the 24.99% municipal stake in OJSC Novinsky Bulvar, 31, which owns the Novinsky Passazh shopping and office centre, had been sold.
**Financing**

The first nine months of 2011 saw an upturn in lending. Total lending to the real sector of the economy in Q3 was 6475 bln rubles, which is 43% more than in the same period of 2010. The construction sector accounted for 5-6% of total lending to legal entities and to self-employed individuals in 2010-2011.

Borrowing increased in Q3 compared with Q2, but the rate of growth was much slower. This was primarily due to reduction of the money mass in Russia and also to stabilization of average bank interest rates at 8% following a period of steady decline.

As before, large Russian and foreign banks are mainly financing projects that are already at an advanced stage of completion. A large share of lending is for completion of existing objects.

*Source: Knight Frank Research based on Central Bank data, 2011*

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**Main transactions for financing/refinancing of commercial real estate projects in Q3 2011**

<table>
<thead>
<tr>
<th>Lender</th>
<th>Borrower</th>
<th>Purpose</th>
<th>Transaction details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sberbank</td>
<td>Arban Construction Company LLC</td>
<td>Non-renewable credit line for construction of an office and hotel complex in Krasnoyarsk</td>
<td>1.24 bln rubles</td>
</tr>
<tr>
<td>RGI</td>
<td></td>
<td>Refinancing of a loan for construction of the Tsvetnoy Central Market shopping centre in Moscow</td>
<td>$150 mln</td>
</tr>
<tr>
<td>Tashir</td>
<td></td>
<td>Loan for purchase and development of the Raikin shopping and entertainment centre</td>
<td>$220 mln</td>
</tr>
<tr>
<td>MLP Podolsk LLC</td>
<td></td>
<td>Credit line for construction of the 2nd phase of the class-A MLP Podolsk warehouse complex</td>
<td>$143.8 mln</td>
</tr>
<tr>
<td>VTB</td>
<td>Adamant</td>
<td>Non-renewable credit line for construction of 2 phase of Kontinent shopping centre</td>
<td>44 mln euro</td>
</tr>
<tr>
<td>Gazprombank</td>
<td>City Palace LLC</td>
<td>Credit line for construction of Evolution Tower mixed-use complex</td>
<td>$345 mln</td>
</tr>
<tr>
<td>Sberbank</td>
<td>Stroitel</td>
<td>Credit line for financing and refinancing of construction projects Stroitel</td>
<td>4.2 bln rubles</td>
</tr>
<tr>
<td>KIT Finance</td>
<td>DVI Holding Immofinanlz</td>
<td>Credit for completion of construction work at the KomsoMALL shopping centre in Volgograd</td>
<td>1.65 bln rubles, $70-72 mln</td>
</tr>
<tr>
<td>Rosbank</td>
<td>俄军资本</td>
<td>Partial financing for construction of Vnukovo Outlet Village</td>
<td>$20 mln</td>
</tr>
<tr>
<td>UniCredit Bank</td>
<td>Hines</td>
<td>Credit line for the Ducat Place III business centre</td>
<td>$205 mln</td>
</tr>
<tr>
<td>Nordea Bank with Marfin Popular Bank</td>
<td>Finstroy</td>
<td>Refinancing of completed shopping centres in Ufa and Lipetsk</td>
<td>1.1 bln rubles</td>
</tr>
<tr>
<td>Nordea Bank</td>
<td>AFI Development and Snejiri Development</td>
<td>Refinancing of a $143 million credit line at MDM Bank for construction of the Four Winds business centre</td>
<td>$170 mln</td>
</tr>
</tbody>
</table>

*Source: Knight Frank Research based on open-access sources, 2011*
Retail remained the most attractive commercial real estate segment in Q3: its share increased by 7 p.p. in comparison with the first quarter and reached 50% of total investments in commercial real estate.

**Office real estate**

Relatively low volume of investment transactions in the office segment was mainly due to shortage of quality projects capable of attracting investors, although foreign funds showed some interest in the segment. Heitman European Properties closed acquisition of a building at the Metropolis business centre and UFG Real Estate bought two business centres (Concord and Pushkinsky Dom) from Capital Group.

Growth of supply remained sluggish: about 620,000 sq m of new quality office space came onto the market in nine months of 2011. Demand was relatively strong at about 650,000 sq m, according to preliminary estimates. We expect some slowdown in growth of demand and stabilization of rental rates if the current economic uncertainty continues to prevail.

**Supply and demand**

Investment activity remained at high levels in Q3 and total investments in the first nine months of 2011 were nearly double their level in the same period of 2010.

Increased activity by international investors was a defining feature of commercial real estate investments in Q3. A number of transactions involving foreign capital were closed in the third quarter, including purchase by Heitman European Property Partners of a building in the Metropolis multi-use complex in Moscow from Capital Partners.

Foreign capital represented 44% of the value of transactions in the first three quarters of 2011. In view of the traditionally conservative approach of western investors, this points to lowering of risks on the Russian commercial real estate market and its increasing attractiveness on global capital markets.

During the first nine months of 2011 the share of the Russian capital sank to 63% in total transaction volume, while in 2008-2010 more than 90% of investments were in Moscow. This was accompanied by substantial growth in the share of St. Petersburg, which accounted for 34% of total commercial real estate investments in the first three quarters of 2011. Investors also showed interest in other regional cities (acquisition by DVI Group of the project for construction of the KomsoMALL shopping centre in Irkutsk is one example).

The market is moving back to the situation in 2007-2008, when more than half of transactions represented foreign capital.

**The share of Moscow in total commercial real estate investments declined significantly in the first nine months of 2011**

![Graph showing the share of Moscow in total commercial real estate investments in nine months of 2011.](image)

Source: Knight Frank Research, 2011

**The share of Moscow in total investment in nine months of 2011**

![Graph showing the share of Moscow in total investment in nine months of 2011.](image)

Source: Knight Frank Research, 2011
**Retail real estate**

Transaction volumes in the retail segment exceeded $3 bln in the first nine months of 2011, representing about 50% of the total value of commercial real estate transactions in the period. The largest transaction for three years was closed in the third quarter of 2011 when Morgan Stanley investment bank bought the Galereya retail and leisure complex in St. Petersburg. Investor activity on the Moscow market was also intense: Tashir Group bought the Raikin shopping and leisure centre in Marina Roscha district and UFG Real Estate acquired the Metromarket shopping centre. A number of other large transactions are also being finalized at present, several of which concern street retail.

The retail property market in Moscow is still experiencing very low levels of new supply. No shopping centres were opened in Q3 2011. Rapid expansion by retail operators has therefore led to a shortage of retail space in Moscow, which is confirmed by lowering of the vacancy rate to 2.5%.

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**Hotel real estate**

Investor interest in the hotel segment was significantly greater during the first nine months of 2011 than in the same period of 2010. Market development has been supported by the policy of Moscow city hall, which is selling off its non-core assets. City hall’s share stake in OJSC Dekmos, which is rebuilding the Moskva hotel, was sold in Q3 2011 and city stakes in various hotels – the National, Radisson SAS Slavyanskaya, 30% of shares in the Hilton Leningradskaya, and other assets – will be offered for sale in the near future.

Hotels continued to show strong operating indicators in Q3. Total supply grew by 770 rooms in nine months of 2011 despite postponement of several scheduled openings. This is a relatively high rate of growth for the Moscow market, although it is below the rates achieved in 2010. We expect the positive trends to be continued in coming months, although some slowdown is possible.
Warehouse real estate

Investors in a large number of transactions in the third quarter of 2011 were end-users. Two transactions were closed involving large Russian retail companies, which invested their own money in construction of warehouses designed and built to meet their specific needs (build-to-suit). PNK Group was the developer in both cases.

Foreign investment funds are studying investment projects. Raven Russia plans to invest in construction or purchase of warehouses, and the American fund Hines Global REIT has announced its intention to acquire the PNK-Chekhov warehouse complex. Value of the complex is estimated at $450 mln.

Warehouse property is currently in short supply: vacancy in the class-A segment had fallen to 0.5-1% by the end of Q3. About 770,000 sq m of new space is scheduled to open in 2012, but new properties are already 70% let to tenants before opening.

Forecast

We expect commercial real estate investments to exceed $7 bln 2011, which will be a record level for the Russian market. If various transactions now at the negotiation stage are completed in Q4, the share of foreign capital could rise above 50% of the value all transactions in 2011. However, the uncertain economic climate and high levels of volatility on world financial markets can inhibit expansion of investment market in 3-6 months term.
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