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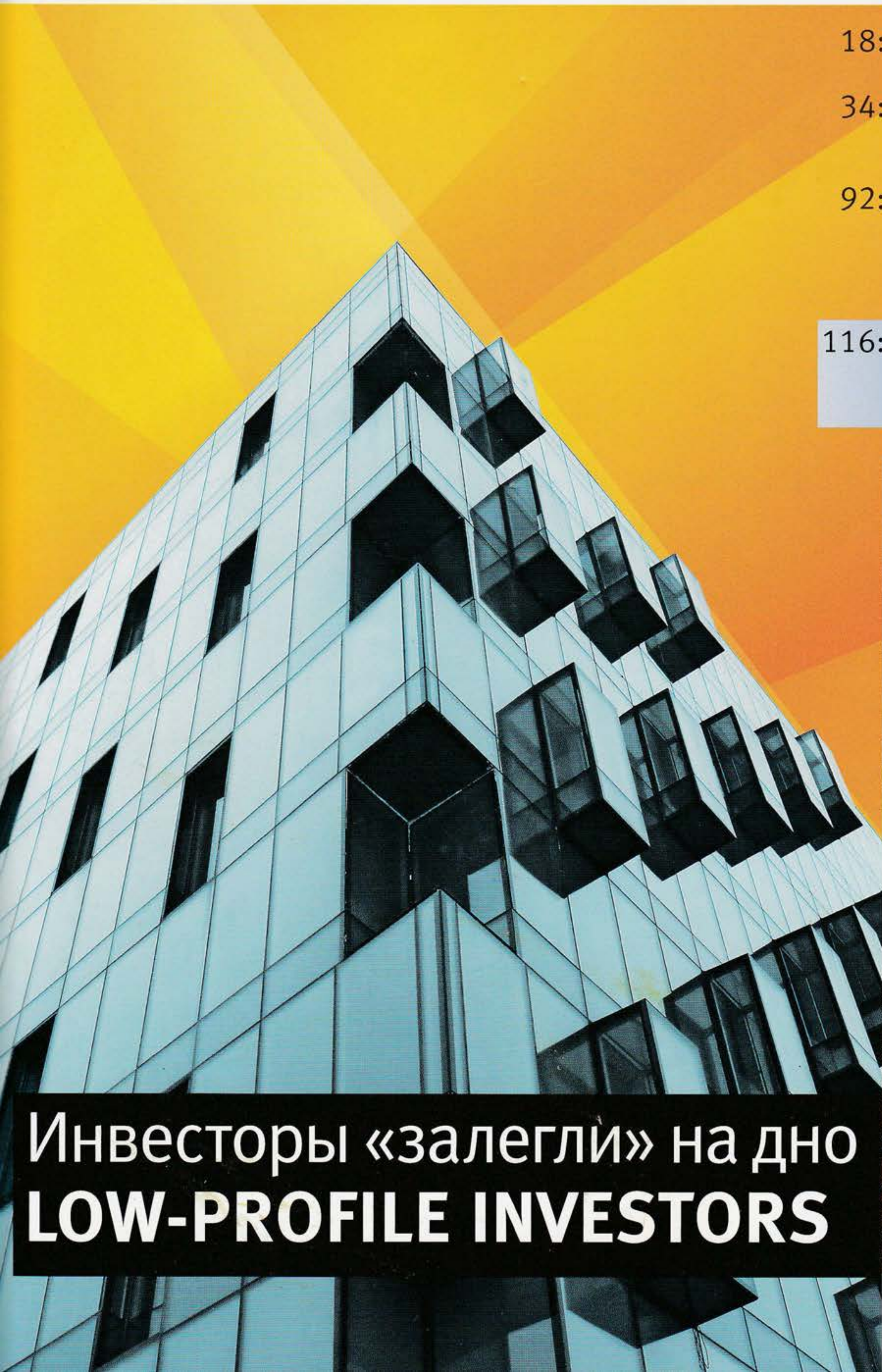

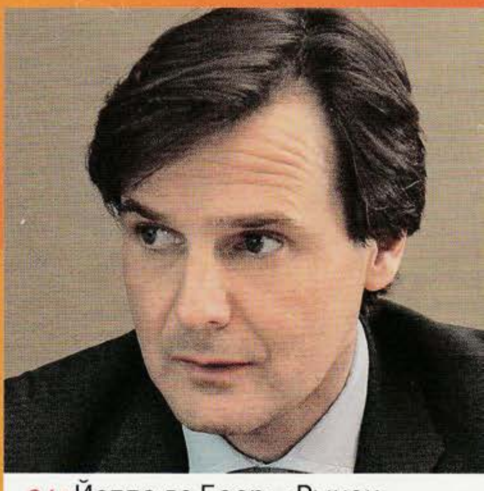

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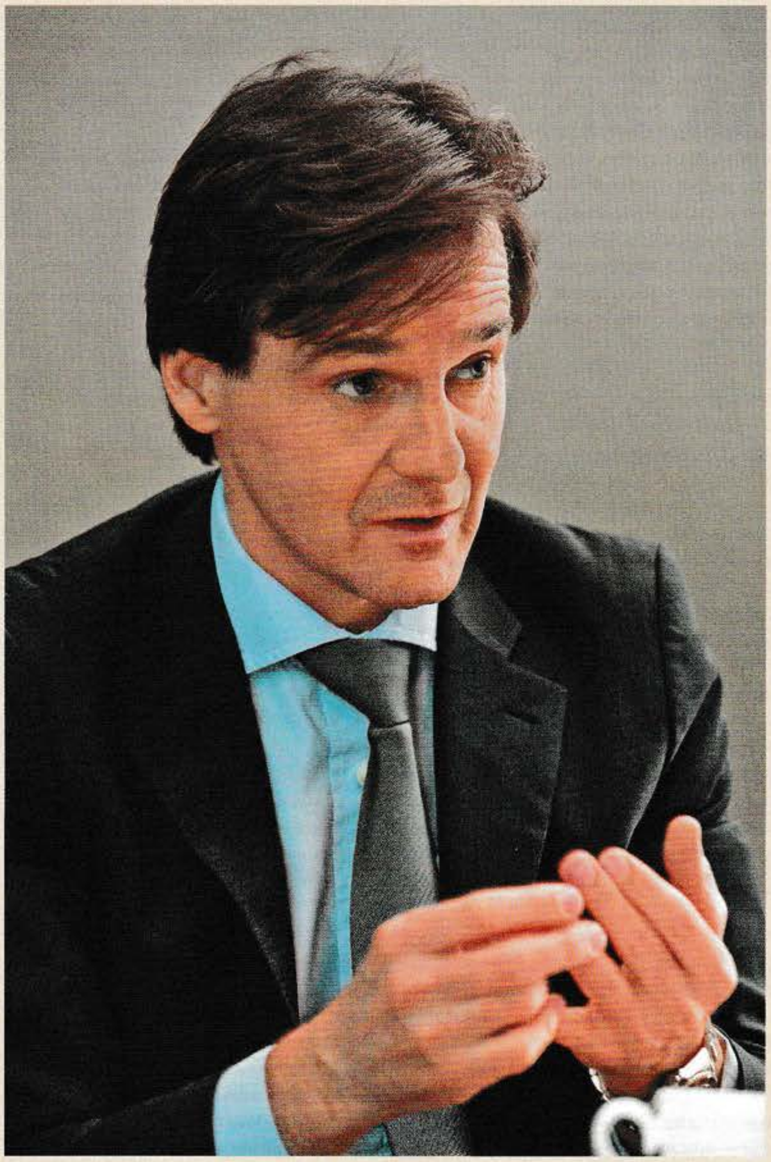
LOW-PROFILE INVESTORS



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What will signal the market recovery? What is the outlook for M&A? Is Russian real estate still an attractive destination for Western capital? Jeppe de Boer of Renaissance Capital shares his thoughts from an investment banker's point of view. De Boer joined Renaissance Capital from Goldman Sachs in 2007 and runs the firm's market-leading real estate investment banking practice.

"The M&A market in Russia is starting to gather momentum"

When do you think we can expect the markets to recover? Have we reached a bottom?

At the moment it looks like the oil price has stabilized and the ruble has stabilized. I think—I certainly hope—you can call this the bottom; it's hard to imagine that things can get much worse. That's especially true if you look at the listed market which has dropped dramatically and in the financing market. The next question is when the market recovery is going to happen. That depends to a large extent on the oil price and on the ruble. What happens to the ruble also depends on what is happening to dollar. In recent months the dollar has been very, very strong. Buying dollars has been the biggest consensus trade on the planet—everyone from cash-rich governments to sophisticated hedge funds in New York to grandmothers in Russia have been putting their wealth in dollars. But that trend is going to be reversed. There will come a moment when governments, corporate entities and private investors start pulling their money out of the US dollar. I believe we are starting to see the beginning of that now. The US dollar weakening will, first of all, mean the appreciation of the ruble-dollar rate and, secondly, this will be a signal that money is going to be redeployed into more productive investments, such as real estate and the real economy at large.

Will Russia recover faster or slower than the rest of the world?

There are several interesting points that can be made here. First of all, fundamentally the long-term growth story of Russia and other emerging markets remains pretty much intact. The basic trend is that the emerging markets are taking up growing parts of the international trade and B2B market. This is an unstoppable trend and it's not going to change. Secondly, the major issue that will slow down North America and Europe for many years to come is too much debt in the system: on the government level, on the corporate level and on the household level. This will hold back the economic growth in North America and Western Europe. That issue is far smaller in Russia. This second factor will cause Russia to go forward faster on a relative basis. Thirdly, if you take China, for example, for the Chinese economy to recover the global market at large must recover. On the other hand for Russia to recover one mainly needs the oil price to recover, which is probably a more immediate thing to happen. These are just some fundamental reasons why we can be quite optimistic about Russia. Taking this reasoning one step further to the real estate sector, by and large, all of the factors that made this sector very attractive for international investors a year ago are still here, i.e. the long positive growth trend, fundamental undersupply of real estate and relative strictness of the planning regime. These old factors are very much in place, except that today prices are just a faction from what they were a year ago. These fundamentals make Russia a very attractive destination for real estate money.

Is Russia still an attractive destination for Western institutional real estate investors when compared to Europe?

Many investors currently shun Russia and are more attracted to the UK for instance. We don't believe that this is justified. At first glance UK real estate looks attractive. Prime yields have risen from 4.5-5% to 7.5-8% and bank financing is still available. However, real estate prices are unlikely to increase given that much of the British economy is driven by the financial sector which now faces serious difficulties. 30% to 40% of all jobs in investment banking have probably disappeared forever. This situation will also impact related industries such as law firms and accounting firms. This means that UK rental levels may remain under pressure for years to come. Continental European valuations have hardly corrected; so there will probably be another knockdown before the market becomes attractive again. If you compare those markets to the Russian market the latter is becoming more and more attractive. The long-term GDP growth story is intact, the market remains fundamentally undersupplied and valuations are correcting downwards very quickly. The only reason why investors may get nervous is the level of rental rates and office rents, in particular. We'd probably argue that Moscow office rents of up to $2,000 per square meter were perhaps too optimistic. On the way down, rental levels are likely to overshoot as well to levels as low as $600-700 per square meter for prime office space. This would then leave plenty of room for potential upside. There exists a correlation on the worldwide basis between rental levels, on the one hand, and on the other hand the size of cities, the strictness of the planning regime and long term GDP growth. Moscow is the largest city in Europe, the economic outlook is very positive and the planning regime is strict. This means that long-term sustainable office rents in Moscow should probably be in the same range as London or Paris at around USD 1000 square meters.

What are Renaissance Capital's priorities with regard to real estate? How have they changed over the last year?

As a full-service investment bank, Renaissance has a wide range of offerings depending on the market. Eighteen months ago we were doing IPOs and public equity offerings for clients such as Open Investments, KDD and EPH. When the IPO market leveled off we got very active in private placements, for instance arranging a private placement for the Russian developer Teorema a year ago. As the market environment deteriorated we started putting more emphasis on debt restructuring, which we expect to be the main theme over the next six months. Because debt restructurings typically do not include the injection of new capital, a round of capital-raising using debt and/or equity instruments is likely to follow debt restructuring.

What's the share-price outlook for traded real estate companies?

Price targets from our equity research department for all the publicly traded real estate companies are five, ten or even fifteen times their current levels. There is tremendous value for investors in public real estate companies but many companies will have to restructure their debt before investors start returning to them in any serious way. A few companies are far less dependent on debt financing and these are certainly very attractive as potential investments. At the same time it may take a long time before development companies start trading on the same levels where they were trading a year ago.

We see that many projects are now frozen in Moscow and throughout Russia. Do you think the development sector in Russia is too dependent on bank loans and bond issues, or perhaps European developers are in the same situation?

A massive amount of financing is required for any development any where in the world. Real estate projects generate negative cash flows for quite a long time before cash flow turns positive. Consequently, the real estate development sector is incredibly finance-driven anywhere. Not just in Russia but around the world development projects are stalling. It is fair to ask whether Russian developers should have done some things differently. In a number of cases, Russian developers embarked on very large development programs without financing in place for the whole program and this was a risky proposition. Those developers who have been more conservative and made sure they have full financing secured, may comfortably complete their projects. In too many cases developers were relying on the successful placement of equity and bond issues and other financial instruments. Once the financing flows dried up they got into trouble. It is true that in a number of cases Russian developers have been more aggressive than their European counterparts.

Are there any other viable financing alternatives for developers besides credit lines from banks right now? There has been talk about private Russian companies that are ready to invest in real estate projects.

As we are at the bottom of the cycle right now, many entities that provided debt financing have abandoned the market. Some state-linked institutions in Russia, including Sberbank, are considering putting some extra cash to work to help finish some projects. And then there are certain private international investment funds also open for business. Finally, there are a handful of private equity firms that have raised funds specifically earmarked for investments in the Russian real estate sector. What these funds are doing now is sitting and waiting a bit and making sure all opportunities are very carefully analyzed. They will start committing capital over the next six months.

Do you expect to see an uptick in M&A transactions?

Definitely. Most of the large real estate projects in Russia are potentially for sale right now. As we come through the bottom of the market, buyers who understand the long-term attractiveness of the Russian market will appear. The growth story here is simply far more attractive than in Western Europe, for example. Locally, companies that have fewer debt issues may merge with companies that have major debt problems and we may also see reorganization deals when a management company ends up running a larger entity. There may be mergers as a result of pressure from banks who are trying to consolidate their debt exposure. One example is the acquisition of Deripaska's Glavstroy SPb by Suleyman Kerimov's Nafta-Moskva. My impression is that the ownership transfer deals will gather momentum in Russia.

What potential obstacles do you see to these kind of deals?

One of them is price expectations: there is a disconnect between the expectations of sellers and buyers, with many sellers clinging to something closer to pre-crisis valuations. The second obstacle is that in many cases, when you are dealing with a potential seller, you may also be dealing with the bank of this potential seller. So sellers may not be at liberty to sell off properties because they had earlier mortgaged them to banks, which means you need to take into account the interests of several parties in such deals.

Do you think the state can become a major player in the commercial real estate market in the years to come?

Governments are an important player in any jurisdiction – including the Russian real estate market – because they control the planning and permissioning process. It's also clear that governments rely on large homebuilders to provide affordable housing to their citizens. Again, that is true in Russia as it is all over the world. So I was not surprised to see quite a number of residential developers on the list of companies that have access to government support. On the commercial side, in my view it would be less logical for the government to get directly involved in real estate development.

The consensus is that there are a lot of distressed assets on the market right now. What is your view?

There is a marked difference between distressed assets and distressed sellers. And many sellers are distressed indeed. There are very few players who have no problems now as financing has dried up. Many are struggling to refinance their debts. The total debt exposure of the Russian real estate and construction industry is approximately $80 billion. Less than 10% of this exposure is in the form of traded vehicles such as Eurobonds and ruble bonds the remainder sits in the Russian banks. That means that down the line banks may potentially be the largest owners in the Russian real estate market. c|R|e