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Elite Residential Market of Moscow after a Year of Financial Crisis

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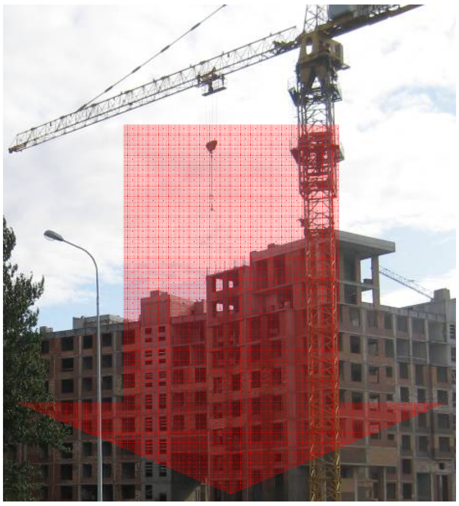
Introduction



It's been a year since the financial crisis struck the Russian real estate market. All the market players faced challenges and searched for different ways to adjust to the new reality. Developers focused on their projects close to completion postponing projects in the pipeline, offered discounts, reduced prices, tried to stimulate demand in every possible way. Buyers adopted a wait-and-see approach due to the uncertain times and unstable situation in the labor market. The crisis affected all the industries and all the segments of the real estate market, and the elite residential market was no exception. Currently the market is showing signs of stabilization but the crisis has not been localized yet, that's why it's too early to make conclusions.

The market has seen changes which deserve attention of all the players. In this Research, we've analyzed the impact of the financial crisis on the elite residential market of Moscow and its players over the last year.

Crisis evolvement

The operation of all the markets, including the residential real estate market is affected by the current global financial crisis which could be compared to the Great Depression of the 1930s in terms of its scale and depth. There's no historical precedent of such a global economic disaster.

The current crisis emerged in the US after its mortgage market collapsed in 2007. The subprime mortgage crisis was triggered by a dramatic rise in foreclosures.

After the US mortgage market reached a high degree of maturity and saturation, it could provide the so-called sub-prime credits, that is, credits for those borrowers who couldn't get mortgage loans given by the main mortgage agencies supported by the US government. Among these borrowers, were people with low income, or people with disastrous credit scores or bankruptcies. Obviously, subprime loans carried a far greater risk, yet their share in the total amount quickly increased, 20% in 2006 versus 6% in 2002. The crisis in the sub-prime segment resulted in the collapse of the whole mortgage market as interest rates on credits were raised due to high inflation pressure.

In 2007, the events in US took a sad turn: borrowers failed to pay off credits, companies which worked mainly in the subprime segment went bankrupt, banks put up foreclosure houses for sale, as a result, the amount of supply expanded sharply and demand plummeted. All these factors contributed to further aggravation of the crisis in the US residential market and a considerable price reduction.

Therefore, the crisis in the US hit the mortgage and the residential real estate markets first. As the country's macroeconomic factors were negative, the crisis' toll on the industrial sector was harder than expected. The dismal residential and mortgage markets became even worse since solvent demand fell.

While the US continued to wallow in the worst financial disaster since the Great Depression, the crisis struck in other countries. It soon spread worldwide due to the crucial role of the US economy for the global financial system and also due to the openness of economies and financial markets of most developed and emerging countries. As a consequence, the crisis hit not only American banks but also financial structures of other countries resulting in the global liquidity crisis.

The residential real estate market was badly damaged by the liquidity crisis as it became difficult to obtain construction loans, demand fell due to tough lending terms, and living standards in general deteriorated. Besides, we observed a major price reduction in the whole residential real estate market.

Crisis influence over the Russian residential real estate market

Over a long period of time, Russia remained a quiet haven but in the end of Q3 2008, it gave in and found itself in the epicenter of the crisis. One of the reasons for such a sharp change of sentiments in the Russian market was unfulfilled expectations: most forecasts about economic stability and financial situation in Russia were based on the anticipated **localization of the crisis**. It was expected that in autumn, the market, as usual, would return back to life. However, in mid-September it became clear that those expectations were in vain as the global crisis was not localized but continued to gain momentum affecting new industries and new countries. Russian real estate market was among the first to be hit by the financial crisis.

The residential real estate market in Russia, as we know it today, emerged in the 1990s when residential construction on a commercial basis, other that upon the government's request, began. Therefore, the residential market is less then 20 years old (for comparison, the US market has been growing for more than 70 years). Nonetheless, the Russian market faced serious challenges over its short history.

One of the most difficult periods of market development is the crisis of 1998 resulting in savings losing value, capital outflow and overall unstable situation in the country. In this period, residential sales volume decreased, and prices dropped, the average home prices declining by 45%. It took the market 1,5 years to enter the trajectory of growth and 3,5 years, to reach the same level as before the crisis. When this troubling period was over, the market began to grow actively.

The market went through other difficult stages: the stagnation caused by the bank crisis in 2004, the crisis of 2006 resulting in an unprecedented price growth when many constriction companies were forced to leave the market. Nonetheless, these crises didn't change the market development trajectory. Over the last two years, the market experienced a phase of sharp growth based on such factors as deficit of high quality supply, growing demand and credit availability. The current financial crisis brought about some changes, and the market reaction was sharp.

Contrary to previous financial crises, the Russian market today is **much more advanced** as borrowed capital has become a crucial element in the market. Besides, not only did the crisis affect separate market segments, it hit the whole market system influencing almost all the factors which form supply and demand (please, see the Influence of crisis over supply and demand dynamics in residential market. Short- and mid-term perspectives). Russia is behind many developed and emerging countries in terms of supply of residential space per person, and this is the only fundamental factor which remains unchanged and which will determine the recovery of the Russian residential market in a long-term perspective.

The crisis in the Russian residential estate market followed the same scenario as in other countries (please, see the Crisis in the primary residential market of Moscow chart). The liquidity crisis made banks reconsider their crediting policy both for developers (project financing) and buyers (mortgage lending). Terms of underwriting have become tougher and interest rates due on credit have increased. Besides, several banks curtailed their construction loan and mortgage lending programs.

Interest rates due on credits rose from 8-16% to 25-30% annual for developers. The construction companies with serious debts which were unable to prolong their current credits or get refinancing on acceptable terms began to abandon projects at an initial stage. In a blink of an eye, dozens of millions of announced square meters became hundreds of thousands.

On the other hand, tough lending terms resulted in a significant decrease in solvent demand. Banks cut minimum and zero down payment mortgage programs. Despite the fact that rates due on mortgage loans were much higher than in developed countries before the crisis, the interest rates increased considerably in 2008: some banks raised them up to 25-30% per annum. Banks were strict checking their clients' income. As a result, getting a mortgage loan became difficult and unprofitable.

Buyer activity, first of all investment activity, decreased due to the uncertainty in the residential real estate market as many people expected the prices to fall. Since many buyers lack financial resources to purchase properties, they focus on the rental market instead.

Influence of crisis over supply and demand dynamics in the residential real estate market

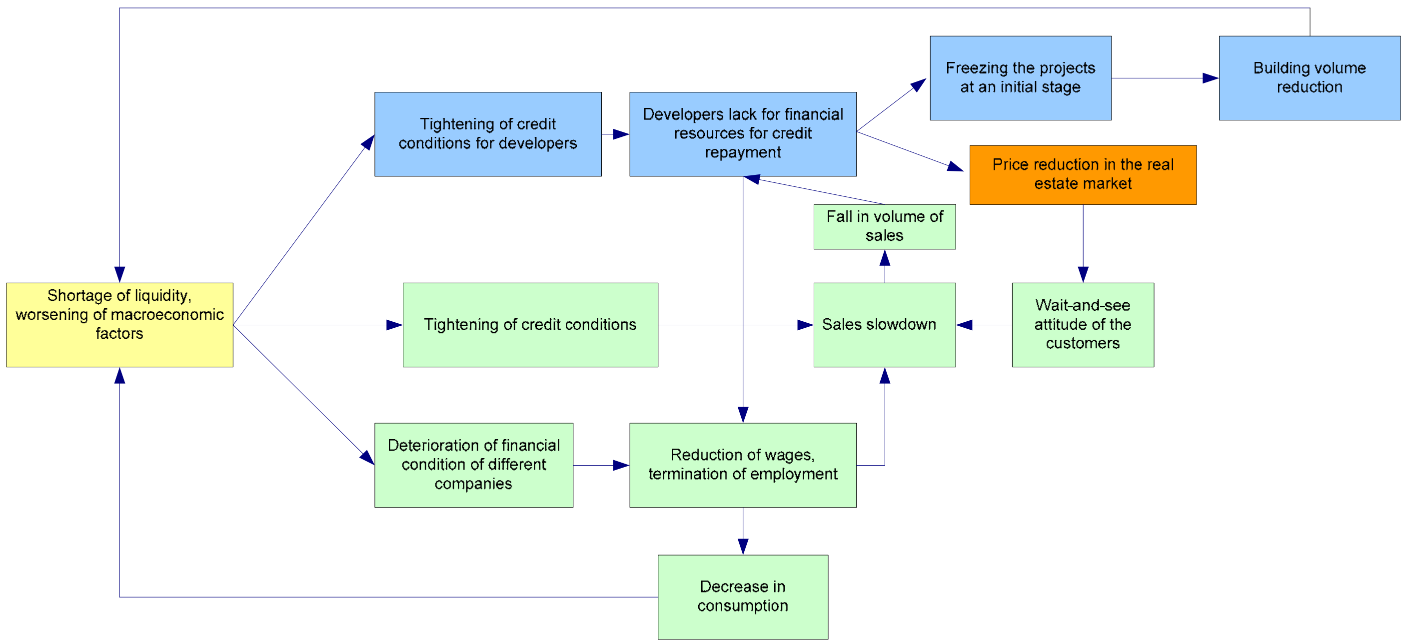
Demand	*Influence of crisis*	*Influence over demand dynamics*
Revenue of population	Corporate defaults, decline in living standards	↓
Savings	Depreciation of investments in the stock market, remove savings from the former assets	↓↑
Mortgage	Tough terms, stagnation	↓
Price expectations	Insecurity in the market, price decrease	↓
Price availability of residential housing	Mortgage availability decline; decrease of residential real estate price	↓↑
Investment appeal	High risk of investments at a construction stage, but on the other hand growth of appeal of investments as a result of price decrease	↓↑

Итог: Significant decrease of demand in comparison with pre-crisis level, growth of customers activity as a result of price decrease

Supply	*Influence of crisis*		*Influence over supply (mid-term)*
Primary market			
Available land resources	Growing number of land plots offered for sale, price decrease	≈	Appearance of opportunities for more active development; Possible increase of supply volume but only in long-term period (resource base formation)
Price availability of construction resources, power capacity	Construction materials and services became more available	≈	
Financial possibilities of developers	Developers possibility are limited due to credit deficit	↓	Decrease of the amount of new projects, market players and supply volume in short- and mid-term period.
Solvent demand	Demand decrease, low sales volume	↓	
Secondary market			
Price expectations	Insecurity in the market, expectations of price decrease	↑	
Personal factors	Urgent necessity in resources	↑	

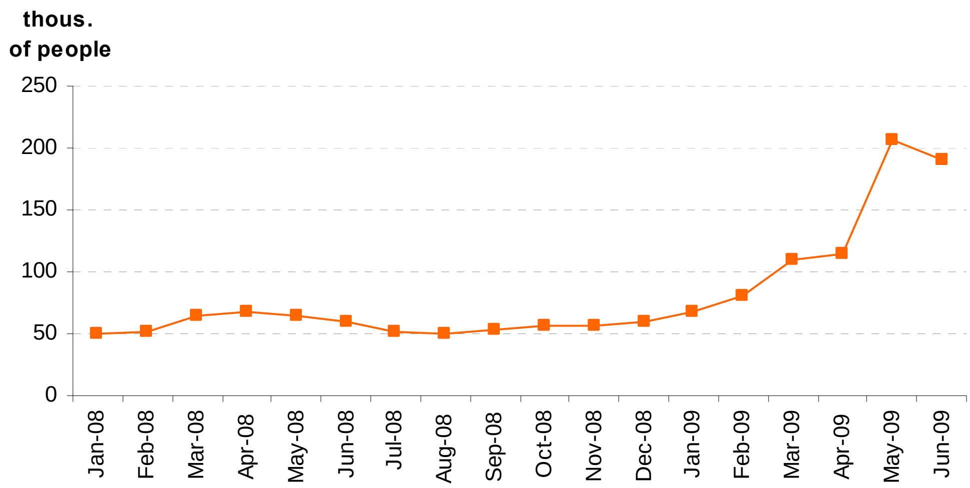
Итог: Growth of supply volume in the secondary market
Decrease of the new supply in the primary market

Crisis evolvement in the primary residential real estate market in Moscow



The solvent demand decreased as the bad situation in different industries got worse: first banks, financial insurance, investment and construction companies, then companies operating in other sectors began to lay off their personnel and reduce salaries in order to cut expenses. According to the Federal Service of State Statistics, the unemployment rate in Russia grew 40% over H2 2008. This index started to decline since February 2009, yet, it's still 28% above the level reached before the crisis. In Moscow, the main unemployment growth took place in H1 2009, the number of unemployed people increased nearly fourfold from January through June[1].

Dynamics of the number of unemployed people, Moscow

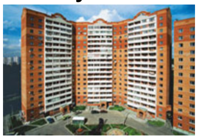


Source: Moscow Government

As a result of the changes, sales of residential property fell across all the price categories.

[1] The latest data in public access as of the date hereof

Crisis influence over different classes of residential property

	Negative factors	Constraint factors
Economy class 	• Low population income • Mortgage lending decrease	• Some buyers may come from the business class segment • Government support
Business class 	• Decline in living standards of the middle class • Mortgage lending decrease • Dependence upon borrowed funds	• Landmark projects may find support
Prime class 	• Buyers adopt a wait-and-see approach	• Less strong dependence upon borrowed funds. • Demand is more stable.

Traditionally, the prime segment is the most stable one since supply of these properties is relatively limited in any economic and financial situation, and demand for them is sustained. Besides, the prime segment doesn't depend much upon borrowed funds (both in terms of construction loans and mortgage lending). Yet, this segment was also hit by the financial crisis.

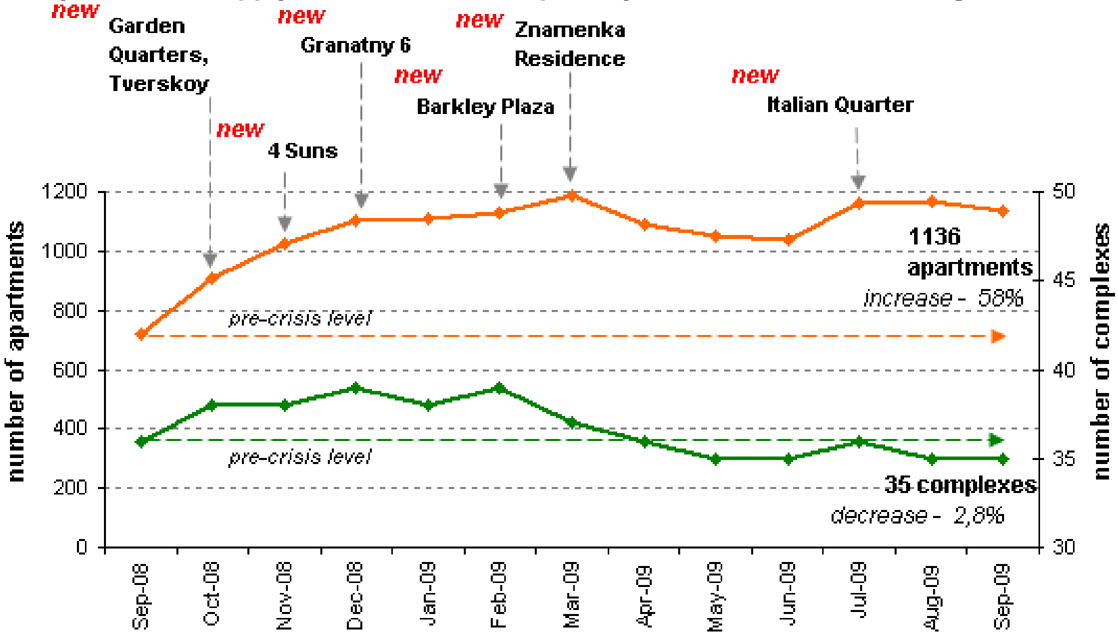
Crisis influence over the elite residential market of Moscow: 2009 year in review

Changes in market volume terms

A year ago, 720 apartments (in 36 residential complexes) were available in the primary elite residential market of Moscow. Currently, there're 1,136 apartments in 36 new residential complexes. Few new buildings are delivered, only one project, the Italian Quarter residential complex, was commissioned over the last 6 months. All in all, 7 new residential complexes were commissioned over the last year. In some new buildings in which apartments were available in September 2008 the primary sales had been completed. Among them are the following buildings: Khilkov per., 5; 1st Golutvinsky per. 11-15 and others.

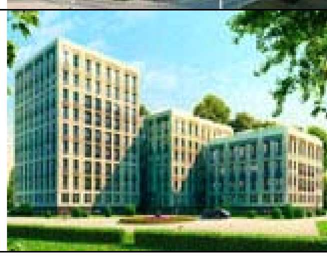
At the same time, the number of the available apartments has been growing during the whole year as such major projects as the Garden Quarters RC, the Four Suns RC and the Italian Quarter RC came into the market during the crisis. As the result, the supply volume grew 58%.

Dynamics of supply volume in the elite primary market of Moscow during the crisis



Source: data collected by Blackwood

Elite new buildings in which sales commenced during the crisis

Name	Address	Stage at the moment of beginning of sales	Photo
Tverskoy	3d Tverskaya-Yamskaya street 4-10	Active construction	
Garden Quarters	Efremova street 12/ M. Trubetskaya street 28	Preparation of site, demolishment of obsolete buildings	
4 Suns	B. Tatarskaya street 13	Beginning of active construction	
Granatny 6	Granatny lane 6, build.2	Beginning of active construction	

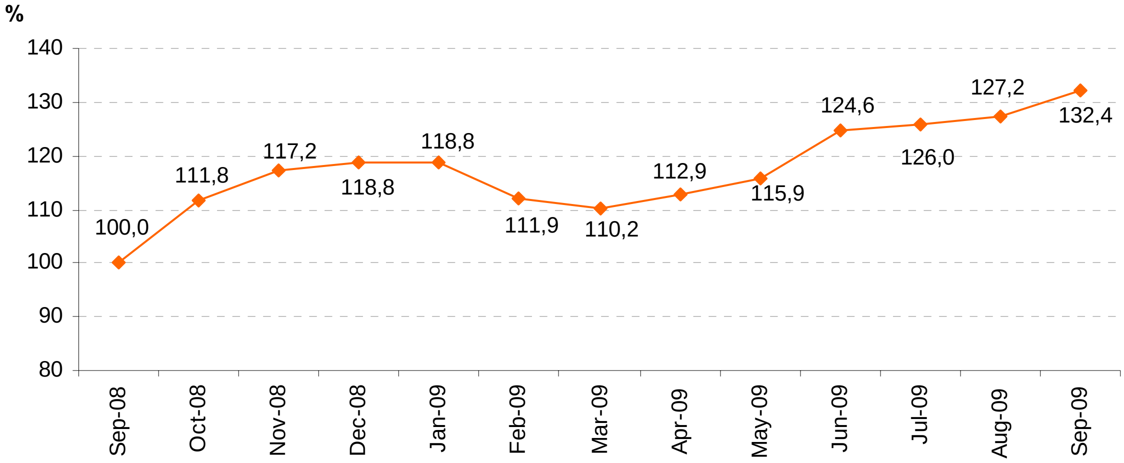
Name	Address	Stage at the moment of beginning of sales	Photo
Barkley Plaza	Prechistenskaya emb. 17-19	Delivered	
Znamenka Residence	Znamenka street 9/12	Reconstruction	
Italian Quarter	Dolgorukovskaya street 21	Foundation pit	

As far as the secondary market is concerned, a huge number of properties came into the market in October-December 2008 under the impact of the crisis. Subsequently, the supply volume declined in the first three months of 2009. Even though we saw sellers to become, as usually, more active in Q1 2009, we didn't observe any significant growth.

Starting from Q2 2009, the sellers thought twice before putting their assets for sale. Those landlords interested in raising funds quickly offered their assets at distressed prices. The rest of the sellers fixed the price level. Some sellers took their apartments off the market waiting for the price growth to resume.

All in all, the supply volume in the secondary market grew more than 30% over the crisis period.

Dynamics of supply growth in the secondary residential market of Moscow



Source: data collected by Blackwood

As far as new supply goes, its growth prospects remain limited. It was announced, once again, that the implementation of the Golden Island project, one of the best known up-market projects in the city center (over 200 thous. sq. m. of residential space), would be put off for 3-4 years.

In September, the Moscow government prohibited using lands in CAD for investment purposes; construction on these land plots will be funded through the city budget, possibly, to satisfy local municipal needs. Still, the construction of commercial residential buildings in the center which has already started will be completed.

Currently, the market is saturated and buyers can choose any kind of apartments to suit their needs. Of course, apartments with a good price/quality ratio are first sold, people are interested in high-quality apartments in prime location whose landlords are willing to offer big discounts.

As a result, the most attractive apartments are quickly sold out. However, the sellers seem in no hurry to bring into the market new properties which means that deficit of high quality residential space is unavoidable in the nearest future should there be no major changes in the market.

On the other hand, it’s still possible to find high quality up-scale apartments at a good price, and now is the best time to make a deal since the prices were substantially reduced during the crisis.

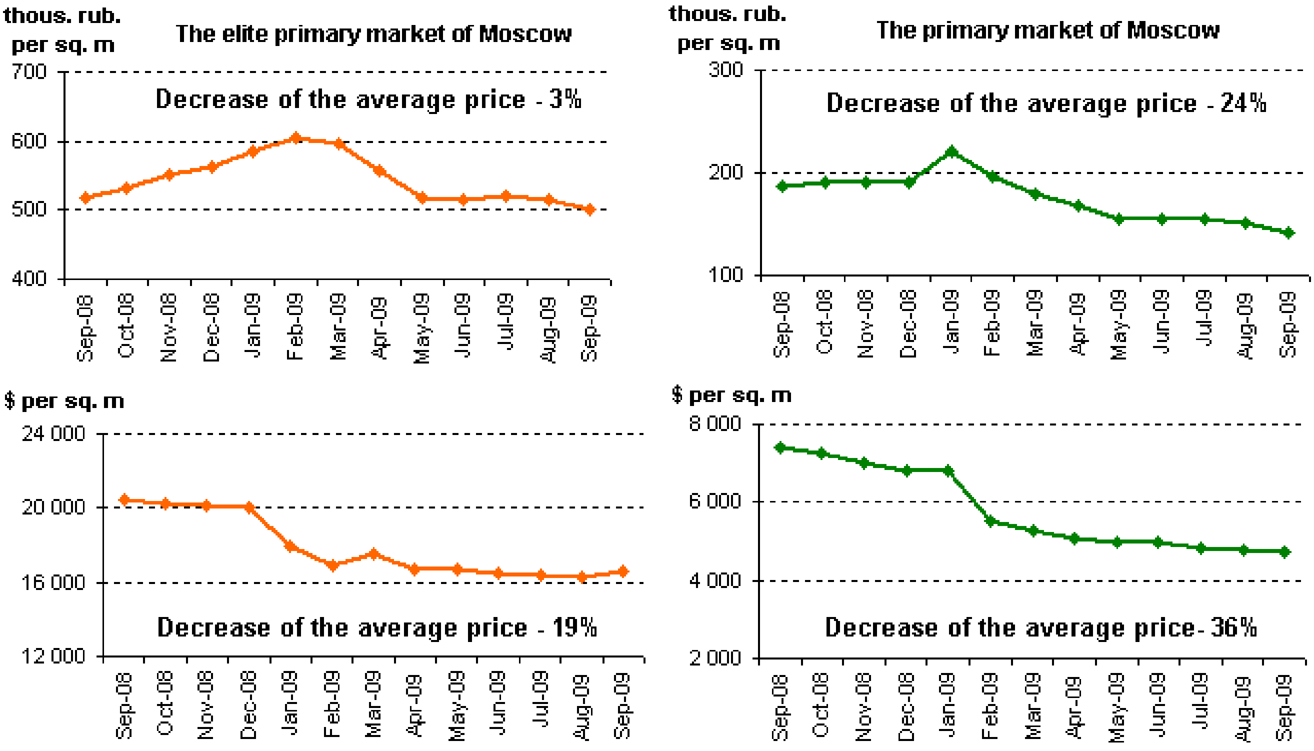
Changes in price level

The prices of elite residential properties were growing rapidly before the crisis. In September 2008, the average price in the elite primary market reached $20 490 per sq. m.

Under the influence of the crisis, the average price level in the market of elite new residential buildings declined 19% from the peak level reached in September 2008 amounting to $16 600 per sq. m. at the end of September 2009. The prices fixed in rubles saw a 3% decline.

The price reduction in the primary market of Moscow in the whole was more considerable: 35% for the prices fixed in dollars and 24% for the prices fixed in rubles.

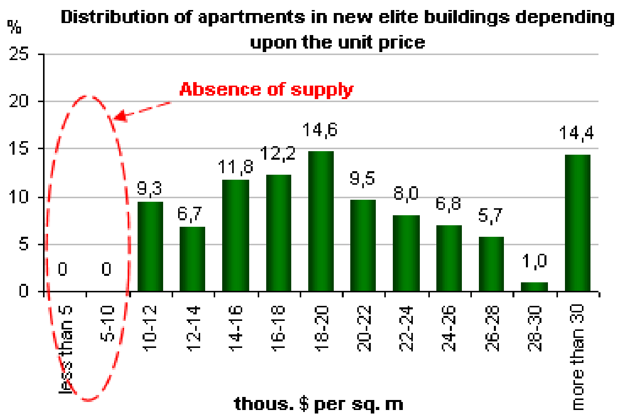
Price dynamics in the primary residential market during the crisis

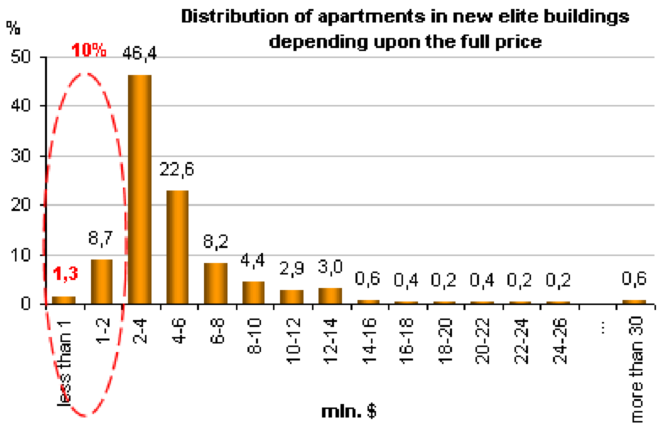


Source: data collected by Blackwood

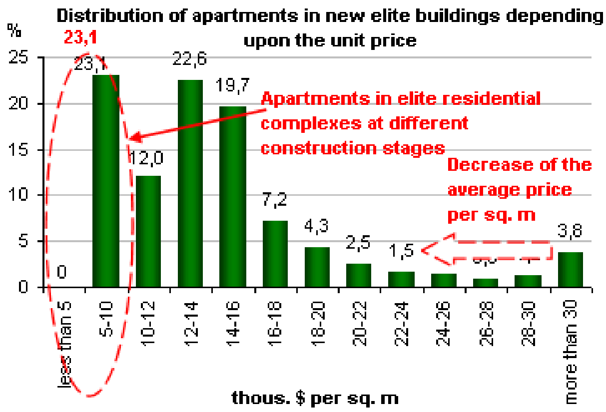
Before the crisis, elite supply constantly shifted into higher price segments due to the ongoing price growth. The price in the primary market were minimum $10 000 per sq. m., and the share of apartments below 1 mln. was as little as 1,3%. At the same time, only low liquidity apartments in residential complexes at an initial construction stage were offered at the lowest prices.

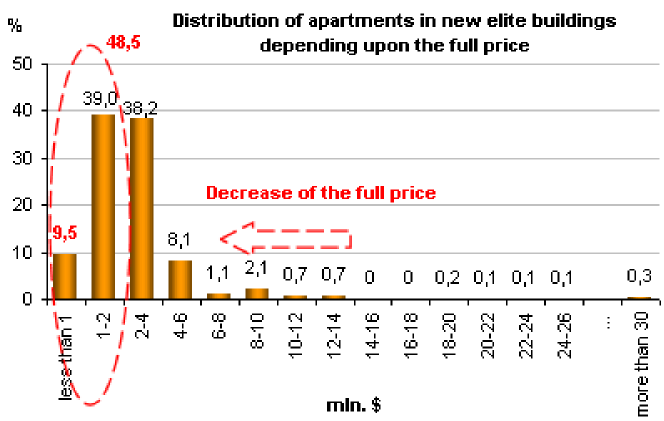
September 2008





September 2009



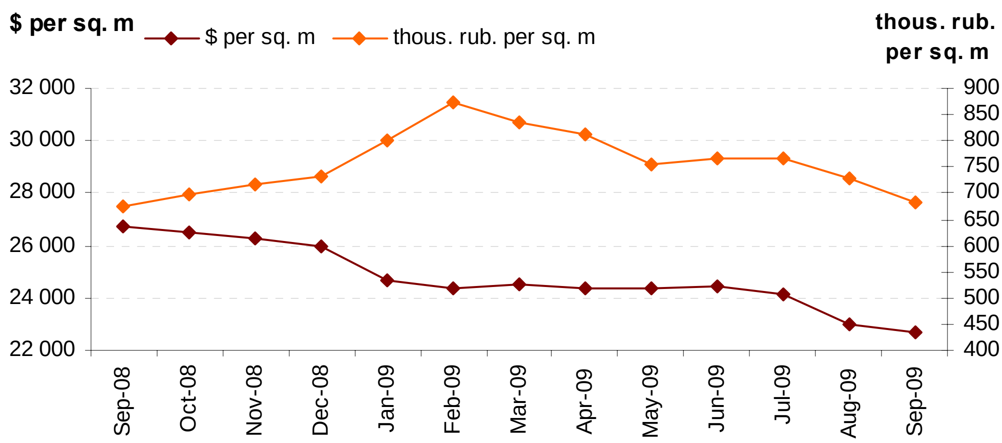


Source: data collected by Blackwood

Under the impact of the crisis, apartments in high-quality elite residential complexes close to completion came into supply, their price being below $10 000 per sq. m. As an example, we can cite the Shokolad RC (from $7 800 per sq. m.) and the Four Suns RC under construction (from $6 700 per sq. m.).

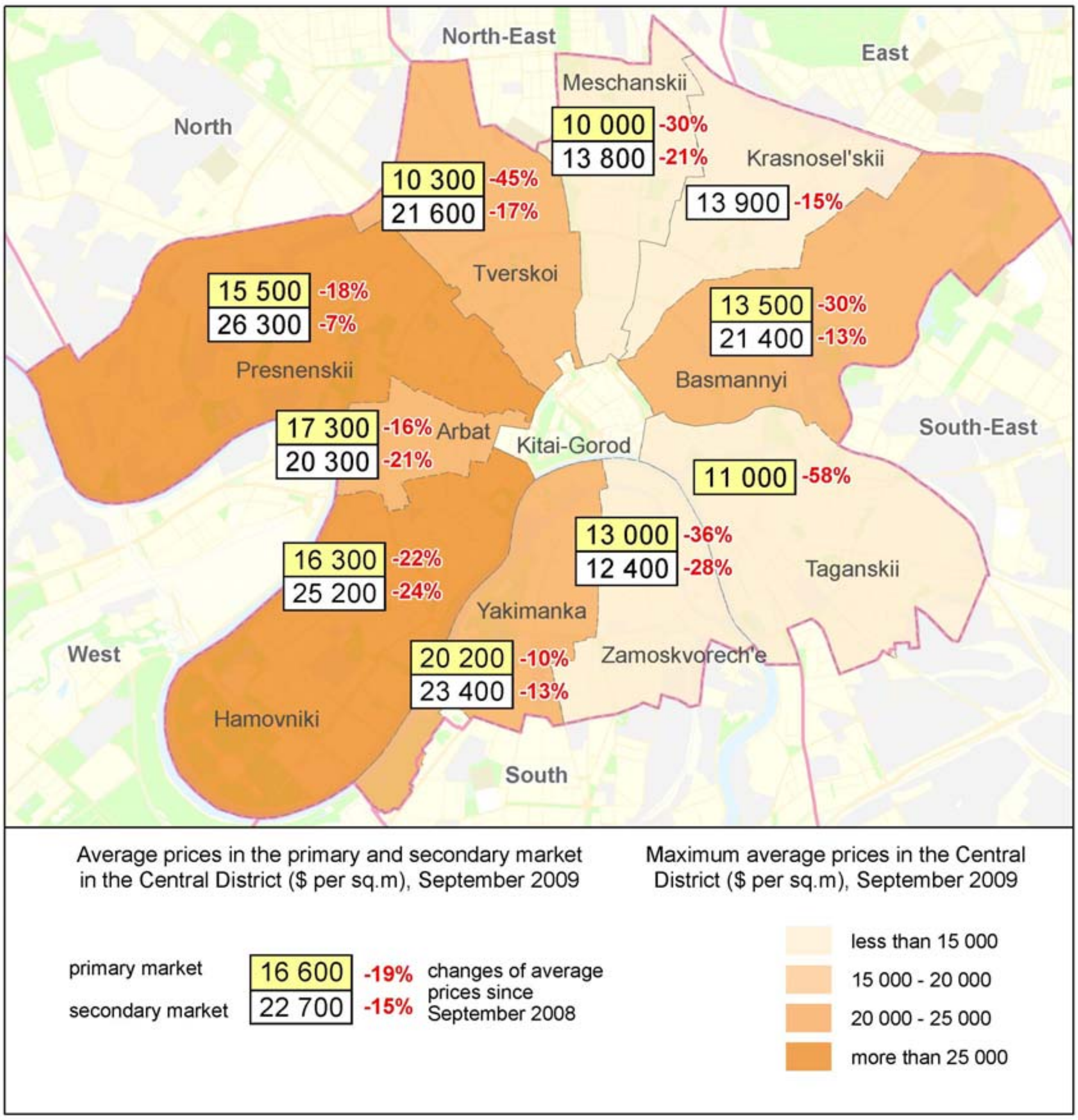
As for the secondary market, the crisis influence was less pronounced. The asking prices fixed in dollars declined 15% reaching $22 700 per sq. m.

Residential price dynamics in the secondary market during the crisis



Source: data collected by Blackwood

Average prices of elite residential properties in Moscow by sub-districts in CAD, September 2009



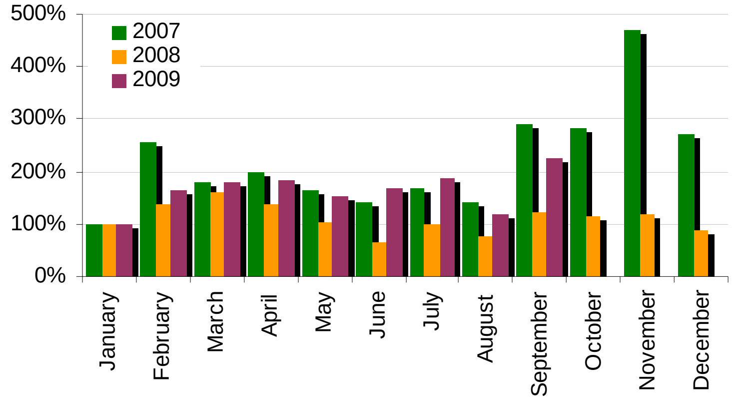
Source: data collected by Blackwood

During the crisis, the sellers didn't only reduce the prices in the price lists but also applied an individual approach to each buyer offering discounts, installment plans, gifts, organizing PR events, etc. The discounts available in the secondary market were smaller. Currently, the amount of discounts and other additional bonuses has decreased considerably. Still, we should say that all these measures taken by the sellers proved quite efficient and helped them attract buyers in times when demand for residential space remained at a critically low level.

Crisis influence over demand

The buying activity started to go down in autumn 2008. This reaction was typical for investment buyers who postponed purchases expecting the market to hit the bottom. Demand among people buying residential property for their own needs remained virtually unchanged. The only difference is that today, people are more focused on properties close to completion.

Dynamics demand* in the market of upscale residential property, %



** - incoming requests processed by Blackwood's experts, January of the corresponding year - 100%*

Source: data collected by Blackwood

However, many potential buyers adopted a wait-and-see approach due to the unstable market situation. The market saw the lowest buyer activity in late 2008 – early 2009.

Demand commenced to grow since the beginning of 2009. The number of incoming requests was nearly as high as in 2008 which served to prove that the demand in the elite segment remained stable. The crisis, despite all its negative impact, expanded possibilities of potential buyers: when sellers were willing to make discounts, buyers could buy a high-quality apartment for less money. Besides, the market saw deferred demand in early 2009. Some buyers believed that the market had already hit the bottom, other buyers still took a wait-and-see approach postponing deals, therefore, the demand often remained unrealized.

It's worth mentioning that the buyer activity didn't decrease with the start of the vacation period. The main factor attracting buyers over the first six months of the year was the price and possible discounts, demand characteristics in terms of location and quality of apartments remained practically unchanged.

The demand continued to recover in Q3 2009. In this case, we can speak about gradual recovery of investment demand. The buyers who were initially attracted by the discounted prices considered an option of buying a new apartment. However, it's still too early to speak about the global trend: buyers choose apartments in new residential buildings very carefully. The key factors are: degree of completion, adherence to the construction schedule, developer's credibility, discounts or special terms.

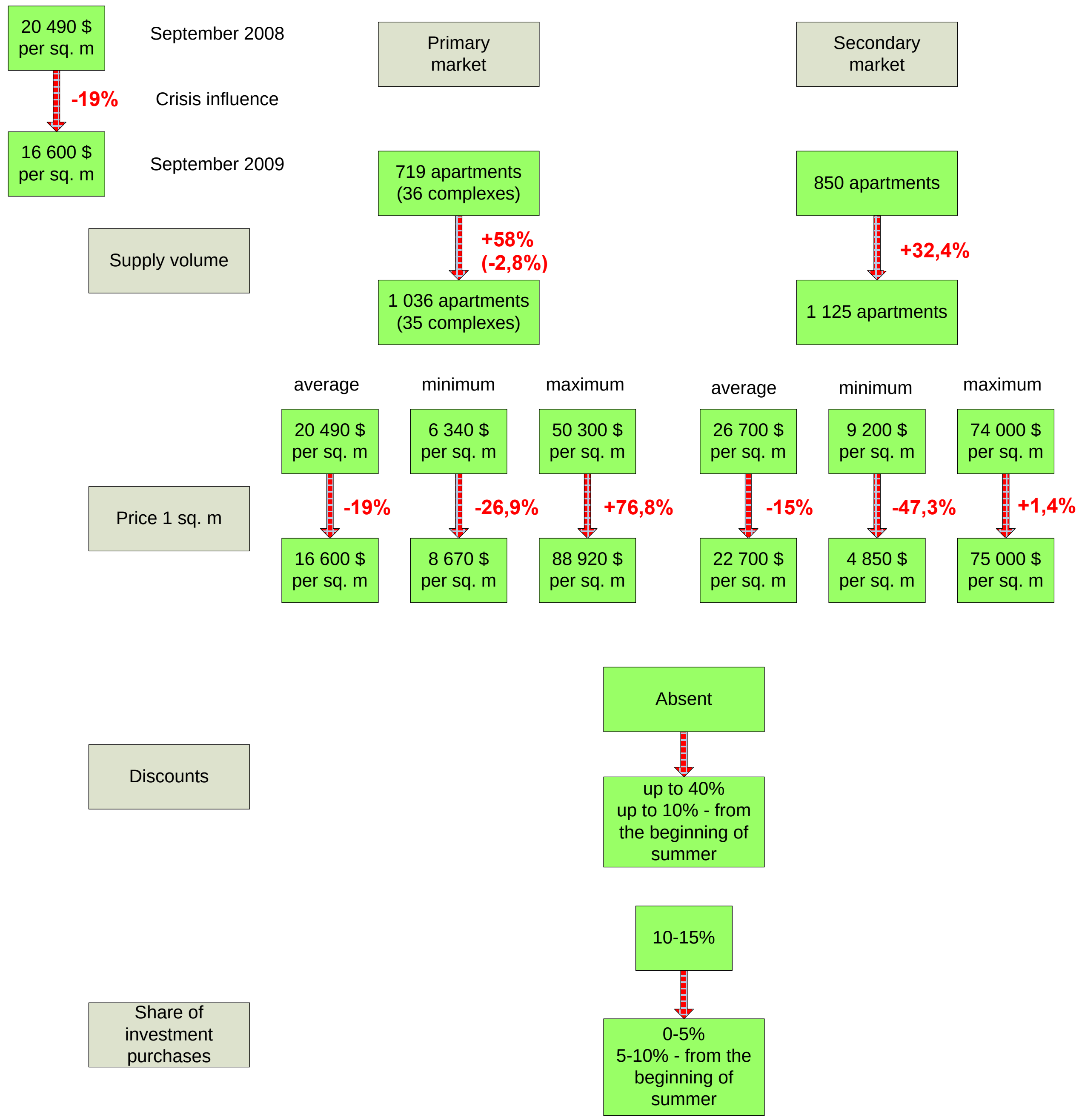
All in all, the buyers' requirements remain high, both in terms of the house itself (favorable location, developed infrastructure, state-of-the-art engineering systems, service and maintenance, etc.) and in terms of the apartment (thought-out interior zoning, superb viewing characteristics, high-quality repairs in case of secondary apartments).

The demand pattern in terms of budgets looked as follows in Q3 2009: apartments worth up to $2 million enjoyed the highest popularity (70% of demand) while prior the crisis, their share was not more than 50%. The number of incoming requests for the priciest apartments (over $5 mln) grew from 3% to 6% in Q3 2009 which shows that the buyer activity in different segment of the elite residential market is intensifying.

Conclusions and forecast

The elite residential real estate market analysis showed that the crisis did affect this segment. Please, see blow how the crisis changed the elite residential market indexes.

Crisis influence over the elite residential market indexes



Source: data collected by Blackwood

Since the beginning of summer, the market has been showing signs of stabilization: the demand for real estate began to recover and price decline decelerated. The situation didn't change much in autumn. Today we may assume that the market will hardly see any sharp correction in the nearest future, it will continue to stabilize till the end of 2009, with a seasonal drop in activity in December-January, and then market growth will resume in early 2010.

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