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=DJ FOCUS: Russian Property Developers Look To Regions

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MOSCOW (Dow Jones)--Russian property firms are pushing out of Moscow and St. Petersburg as the twin capitals become cramped and the government seeks to rejuvenate the country's increasingly affluent regions, industry participants say.

Real estate has become one of the hottest sectors in Russia, thanks largely to the huge inflow of petrodollars and a countrywide dearth of quality properties from apartments to offices to warehouses.

Moscow and St. Petersburg - which together house around 15% of Russia's 150 million people - have enjoyed the lion's share of activity. But as land plots become more difficult to find, developers are diversifying into prosperous regional capitals, where competition is less fierce, potential gains are bigger and state-led redevelopment is generating additional appetite for new projects.

"At the moment, there's demand for quality properties in almost every region in Russia," said Yevgeny Kolodkin, vice president of London-listed OAO Sistema Hals (HALS.LN), part of conglomerate AFK Sistema (SSA.LN).

"We see most long-term potential in cities of over a million people, coastal resorts and areas of natural or historic interest."

When deciding which areas to target, Sistema Hals generally weighs up demand, the competitive environment, local salaries and economic growth, Kolodkin said.

Russia's economy is expanding by around 7% a year and the regions are currently the biggest beneficiaries, boasting wage growth well in excess of Moscow and St. Petersburg.

And while those two cities remain the favored destination for Russians seeking their fortunes, the promise of a better life has also tempted migrants to the warmer climes of Krasnodar and Rostov-on-Don in the south and the oil-rich regions of Tyumen and Yamalo-Nenetsk, where monthly salaries are now among the country's highest. Sistema Hals' regional exposure is limited to around 15% of its \$2 billion portfolio, although it plans to increase this to 30% in the medium term.

Existing regional developments include shopping centers in Tatarstan's capital Kazan and a health spa in the Black Sea resort of Sochi, which is undergoing a \$12 billion facelift ahead of the 2014 Winter Olympics.

Regional expansion isn't without its pitfalls. Success can depend particularly on the ability of developers to build fruitful relationships with local governments.

"The major risk of going to the regions is that they are run by different administrations. Just because you're successful in Moscow or St. Petersburg doesn't mean you can necessarily transfer this," said Tim Millard, a partner at property adviser Cushman & Wakefield in Moscow.

Others say a lack of reliable information, problems in sourcing raw materials, and poor transport access to remote areas can complicate expansion.

But these problems aren't serious enough to deter the majority of the big property firms.

"There's a growing focus on the regions," said Kim Iskyan, joint head of research at brokerage UralSib. "The fact is that there's not much space left in Moscow and St. Petersburg."

The retail market in those two cities is rapidly maturing. Prime office segment yields in Moscow are set to fall to 6.8% in 2010 from 9.5% last year, adding to the lure of the regions, according to investment bank Renaissance Capital.



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Returns can also be bigger as regional properties are appreciating from a lower base, UralSib's Iskyan said. Residential property prices doubled in Moscow and St. Petersburg last year, but have since stagnated, while regional prices climbed 10% in the first quarter of 2007 alone, according to official data.

"The regions will repeat the pattern of Moscow," agreed Victor Szalkay, a spokesman for residential developer PIK Group (PIKK.RS), which raised \$1.9 billion at its London IPO in May, Russia's biggest real estate placement to date.

Over the next two or three years, PIK will double the number of regional cities in which it operates from the current seven and expects to benefit from a less intense competitive environment. "Regional competitors lack resources," Szalkay said.

Indeed, of the nine Russia-focused property developers - four of which have together raised \$3.7 billion through share offerings this year alone - all are based either in Moscow or abroad.

Another reason to look further afield is the ongoing overhaul of the country's Soviet-era roads, schools, hospitals and housing, much of which is crumbling after years of neglect, experts say.

President Vladimir Putin pledged in April to raise spending on regeneration, while the government plans to inject \$7.5 billion into the regions by next May from a new investment fund created from the country's oil windfall.

"The current accent on infrastructure projects is creating huge opportunities for developers," said Anton Avdeyev, who heads the Moscow office of Finnish property consultants Reim Group.

Major state-led drives include a scheme to farm casinos out of cities and into four regional gaming zones, large-scale road-building projects in the south and far east of the country, and technology parks expected to generate 75,000 new jobs in regional cities, including Nizhny Novgorod and Yekaterinburg.

In addition, the government is striving to roll out affordable housing under a program headed by First Deputy Prime Minister Dmitry Medvedev, in which private firms will receive some funding from the government.

One such project is a 100,000-hectare site in the southern Russian city of Volgograd that's being developed by AFI Development (AFID.LN), a subsidiary of Israeli conglomerate Africa Israel Investments Ltd. (AFIL.TV) that so far has less than 5% of its portfolio outside Moscow and St. Petersburg.

Similar partnerships are being employed to build a toll road from Moscow to Novorossiisk and are planned to help implement an upgrade of sewerage plants in Rostov.

"These kinds of programs are important both socially and commercially as they allow for the creation of public-private partnerships that secure the interests of business while promoting important social goals," said AFI spokesman Alexander Chernov.

Company Web sites: <http://www.sistema-hals.ru/english>

<http://www.pik.ru>

<http://www.africa-israel.com>

<http://www.reimgroup.com>

<http://www.cushmanwakefield.com>

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