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Realizing Russia's Potential
PUTTING MONEY TO WORK IN RUSSIA
Panel Discussion

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St. Petersburg, Russia
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Moderator:

Veniamin Golubitsky, President, Renova StroyGroup

Panelists:

Artyom Golodnov, Senior Analyst, Goldman Sachs

Drew Guff, Managing Director, Siguler Guff & Company LP

Alexei Kalinin, Senior Partner, Baring Vostok Capital Partners

Natalia Khanjenkova, Managing Director for Russia, European Bank for the Reconstruction and Development (EBRD)

Irina Makieva, Vice-Chairman of the Management Board, Bank for Development and Foreign Economic Affairs (Vnesheconombank) state corporation

Stephen Peel, Managing Partner, TPG Capital

Ilya Ponomarev, Deputy Minister for Regional Development of the Russian Federation

Mikhail Semenov, Chief Executive Officer, Renova StroyGroup

Steven Wayne, President, Chief Executive Officer, Jensen Group

V. Golubitsky:

Esteemed participants, I would like to express my gratitude to you for choosing our topic from the wide selection that the Forum offers. I would especially like to thank those who have agreed to participate in our discussion today. I am proud to present to you our panelists, because we have gathered here some very interesting and influential people who are familiar with the given topic, not merely theoretically but through personal experience and the experience of the companies they direct and chair.

Stephen Peel is Managing Partner of TPG. This fund, with assets of USD 52 billion, needs no introduction to market insiders. As far as I know, TPG is currently actively seeking opportunities in Russia.

Drew Guff is Managing Director and founder of Siguler Guff. Besides this, he represents the direct investment fund Russian Partners, which manages assets of USD 10 billion. Forty percent of the fund belongs to Bank of New York.

Steven Wayne is founder and Chief Executive Officer of Jensen Group. Formed in 1991, it is especially pleasing to mention that Jensen Group has carried out more than 600 transactions in the Russian market in the interests of a wide circle of international investors.

Alexei Kalinin is a Senior Partner of Baring Vostok Capital Partners. BVCP is a company that specializes exclusively in Russia. It has recently launched its new fund, Baring Vostok 5, totalling USD 3 billion.

Many are very familiar with Natalia Khanjenkova, with whom we have been collaborating for a long time now. She is the Managing Director for Russia at the European Bank for Reconstruction and Development. As far as I know, Russia is today one of the bank's largest clients. I am not certain of the numbers. In my notes, I have EUR 2.9 billion across 74 projects.

N. Khanjenkova:

That was last year. Now, it is already more than EUR 20 billion across 700 projects.

V. Golubitsky:

I knew that I would make an error. It is my special pleasure to introduce Irina Makieva, Vice Chairman of the Management Board at Vnesheconombank. Irina oversees policymaking regarding support to Russian monotowns, and public-private partnership projects. Is this close to the truth?

I. Makieva:

The part about public-private partnerships is inaccurate. Currently, I am working on integrated regional development.

V. Golubitsky:

Integrated regional development is an important topic for the state.

Artyom Golodnov is a Senior Analyst at Goldman Sachs, specializing in transport infrastructure, construction, and real estate.

Lev Pukshansky, who due to a lack of space on the panel is sitting in the front row, is President of Terra Nova, which handles major public-private partnership projects in St. Petersburg. We will also be joined by Elena Nikolaeva, deputy to the State Duma, who works on issues of residential construction in Russia.

I will hand over to Artyom Golodnov, Senior Analyst at Goldman Sachs. He will give you a short overview of the real estate market in Russia and explain some of the challenges that await us there.

A. Golodnov:

I am an analyst at Goldman Sachs, specializing in the area of residential real estate, construction, and infrastructure. Over the last five years, I have observed the market grow, fall, and restore itself. It is an interesting market. It is of course not risk-free, but the risk profile in this area is well balanced.

If we are to speak of the fundamentals of this market, then first of all we must mention that Russia has a low level of housing provision. Housing provision here is just 23 square metres per person, whereas in developed nations this number is 40-

60 square metres. Another factor is that housing is practically uniform across the entire nation. Moscow and St. Petersburg stand out a little – there, the level of housing provision is a bit higher. This is unsurprising, since housing is clearly correlated to income level.

A low level of housing provision is just one part of the problem. The existing stock needs replacing. According to official statistics, about 100 million square metres of housing, or about 3%, have been deemed dilapidated and need to be replaced immediately. Approximately 200 million square metres of housing in Russia have an amortization level of more than 65%. That is, this is housing that needs to be replaced in the mid-to-long term. Besides this, 8% of housing (about 260 million square metres) was built before 1945, and the majority of this also needs to be replaced.

This same slide depicts another vital fact: half of all housing in Russia was built between 1971 and 1995. These are the so-called *Krushchevkas*, named in honour of General Secretary Khrushchev. This housing was built using the old technology of industrialized housing construction, and is of poor quality. Besides this, it is of a minimalist style: the kitchens and rooms are small. Nobody wants to live there. My compatriots present here understand me. Unfortunately, there was no other choice in the Soviet Union. This portion of housing likewise needs replacing.

I shall now say a few words on the topic of construction. Last year, new housing in Russia amounted to more than 60 million square metres. We are forecasting that the pace of annual growth will be 7–8% in the medium term. If Russia avoids macroeconomic shocks, then over the next 10 years, annual new housing construction should increase almost twofold. Housing provision for the population will increase to 26.5 square metres, which is still at a low level, but which indicates the ongoing potential of the market beyond 2020. This forecast is based on the assumption that housing taken out of circulation annually will amount to 1%. This assumption estimates the lifespan of the current housing stock at 100 years. Since the housing's quality leaves something to be desired, this assumption is also very conservative.

Another very important factor is that industrial construction (35 million square metres) comprises just over 50% of new housing. The remainder is individual construction. By this I mean dachas which are constructed by individuals and used only for a short time during the summer period.

To get a sense of what one million square metres is, take a look at the project of the St. Petersburg company Etalon Group. The project is called Jubilee Estate; its residential area amounts to approximately 700,000 square metres. Those 35 million square metres that are built every year are the equivalent of 50 such projects. For Russia, with its population, this is very little. Why is so little housing built? There are problems with its accessibility. How can we solve them? Two factors influence increases in housing accessibility and volumes of construction.

First of all, this is growth in the population's income. For the moment, the situation looks good: the Russian consumer is confident. You can see on the graph: employment is very high; unemployment in April of this year was 5.8%, which is very close to the historical minimum observed in Russia. People's level of confidence is at a high level and continues to grow. It is close to where it was before the crisis. The graphs show that, in recent times, the growth of salaries has accelerated. The growth of actual salaries was 12% in the first quarter of this year, which is once more the double digit growth we saw before the crisis.

The second factor in increasing access to housing is mortgage services. These are developing at a rapid pace in Russia. The volume of new mortgages increased by 75% in 2011. In 2012, we expect further growth of about 30%. We are seeing rapid growth, but it is growth from a low baseline. The penetration of mortgage services in Russia amounts to just 3% – that is, the volume of mortgages granted in Russia is 3% of GDP. This number is small not only in comparison with developed countries, this is a very low level compared to developing countries which are similar to Russia. In Eastern Europe, the average level of mortgages is 17% of GDP. In India, it is 7%, in China, 16%. Wherein lies the problem?

The main cause lies in high mortgage rates, which reach up to 11–12% for mortgages given in roubles. Although mortgage rates have never been so low in

Russia, their level remains high and prevents this sector from growing faster. Further decrease in mortgage rates should significantly increase demand for mortgages. This graph depicts the behaviour of mortgage rates in Poland. Starting from a point where the volume of mortgages, with interest rates of 7–9%, was 3% of GDP, by lowering rates to 2–4%, Poland managed to increase the volume of mortgages as a percentage of GDP to 20% in ten years. If rates continue to fall in Russia, therefore, we should see the same situation as in Poland.

Another problem that prevents the market from structurally growing faster is the fact that, in Russia, the population managed to amass ample capital during the economic boom of the 2000s. The level of bank deposits made by the population is double the level of loans. Aside from this, the majority of the population in Russia already has housing, acquired basically for free during privatization. On average, a family possesses 40 square metres of real estate, which in last year's prices amounts to around USD 60,000. People are using the sale of existing apartments to buy housing with a larger area.

If we concern ourselves with the question of why mortgage rates are high in Russia, then the first explanation we will come to is high inflation. Inflation in Russia, in recent times, has been significantly decreasing. The Russian government has done a very good job. If inflation continues to decrease, rates will fall. The second reason for high rates is the lack of cheap long-term capital. It is possible that pension fund money will become a source of such capital. According to our forecasts, assets managed by pension funds will increase from USD 80 billion in 2011 to USD 450 billion in 2020. If certain legislative changes are made, and pension funds are permitted to invest in infrastructure and housing projects, then their assets will be able to become a source of long-term money and support mortgage services.

This sector has two key problems. Firstly, sensitivity to the macro situation is high in Russia. In 2009, the largest developers' pre-sales fell by 50%. That is, people were seeing apartment prices falling, and there was a lack of confidence in employment, in tomorrow, and therefore people were putting off the decision to buy, which led to a strong fall in sales. Such a sensitivity gets in the way of making investment

decisions and entering the sector because its construction-investment cycle amounts to three to three and a half years. The second problem is the high level of regulation. In Russia, ground breaking happens on average two years after the purchase of land. A lot of permissions are required. The government has acknowledged this problem and is developing road maps to resolve it, to enable developers to start working a lot faster. This should lead to a decrease in risks and an influx of investment.

It is worth saying a few words about the degree to which the real estate sector is vital to the Russian economy. In Russia, the construction industry contributes about 10% of GDP; the residential construction sector accounts for 30% of that. Over the next ten years, the share of residential construction within the industry will increase to 36%, and residential real estate will comprise 3–4% of GDP. This is not an insignificant indicator, but, at the same time, we should not exaggerate its significance.

V. Golubitsky:

Artyom, thank you very much for this interesting presentation. It brings us to the discussion of an important topic. I must apologize that in my introduction I failed to mention my colleague, Mikhail Semenov, Chief Executive Officer of Renova SroyGroup, who is taking part in the discussion. Mikhail, my apologies.

In connection with what we have just heard, I would like to ask Stephen Peel a question: are there observable differences between the Russian real estate market prior to the crisis and today, and what should an ideal project look like for you to be ready to enter the market?

S. Peel:

So, what has gone on since the crisis? Obviously yields have come back in, the market has become somewhat more efficient, but it is still less liquid than pre the 2008–2009 crisis. Yields are still higher, bank lending is available, but more expensive. I think the big surprise you have got is that the amount of foreign

investment in the market is dramatically reduced. I think that foreign direct investment into real estate pre-crisis was about 70% of the total investment levels, today it is about one third. I think those are the big surprises when you look at what has happened to big investment flows pre and post crisis. My take on Russian real estate, and there are many more experts here but from an outside observer and somebody who has done one major investment project in Moscow, there are still plenty of people like us who are in the deal business. We like to invest, we invest for the medium term, we have reasonably expensive capital, we find opportunities where we can buy cheap and hopefully create some value with our partners and sell within a three to five year period. There are plenty of people both domestically and internationally who will do that, take that risk, manage that, and have capital for that. There is very little, as the gentleman from Goldman Sachs said, long-term capital for Russian real estate. And for the market to work efficiently, we need to find ways of attracting more long-term institutional investment capital into the market. That comes from a number of sources. Traditionally, they can come from pension funds both domestic and international. So, there can be a natural growth in Russian pension funds, but anything the government administration can be doing to stimulate growth in pension funds, pension savings, and pension assets will be very good for real estate markets and infrastructure markets. I think the domestic market is going to have to lead the international market. That is key, obviously high net worth capital flight has been an issue. High net worth investors should be key participants in long-term real estate markets in Russia. And then the development of more sophisticated instruments, RITs, master limited partnerships, instruments that have created securitized long-term assets for investors in other markets should be applicable in Russia and should be something that people are looking to develop to create this end long-term takeout pool for real estate.

V. Golubitsky:

Thank you, Stephen. With regard to the mention of the role of government, I would like to ask Drew Guff the following question: what, from your perspective, does the

Russian government need to do to make involvement in this market more attractive? Also, please address the earlier question about the ideal project: how do you imagine it in Russia? Do you have any comments?

D. Guff:

Thanks. The biggest or most important thing that the Russian Government could do is to attack the problem and the issue that our colleague from Goldman Sachs mentioned in page 13 of his presentation which shows how many days it takes to get construction permits and how many days it takes to get a building built. Time is the enemy of good returns in investing. The following are generally what is known in this market: you know your costs; there are enough construction firms and enough construction history so you know your people; you know what your cost is per square metre; and you know what your rents are roughly going to be or you are willing to take the risk of guessing what your band will be. The uncontrollable part of it, which I think has scared off a lot of money from investing in real estate in Russia, is the time it takes to get your project done. So, there are administrative means to shorten that. It has been addressed at the presidential level, it can definitely be addressed at every mayoral level, and you can speed the process for things that are more important or not to a certain city or town or region. Something like an ombudsman, for example. If I were king or tsar, I would create a green corridor for projects or things that are important. Either socially important, infrastructurally important, monetarily important for the city, and give those deals an easy pass or a green light. As Stephen said we are all in the deal business more than projects. Projects are vague; projects are some sort of form of interesting fantasy, but a deal is what eventually everybody wants to have because that is how they will make money in the end. If you make money you will come back again and again. So as I said, I would give an easy pass or green light to certain projects. I will speak a little bit about just one thing that we have already done in the city of Moscow. We built the first Tier 3 data centre to serve the high-tech needs and the information technology needs of major users. So, it is everyone from Gazprom to Sberbank to

small cloud companies, everyone today needs modern infrastructure for IT. It is a critical need. Getting those up and running quickly is important, and getting power and electricity is also important. Another key area is utilities, electricity in particular. I would focus on specifically days to construction, days to permitting, it is something where there are KPIs, Key Performance Indicators, and you can score your government bureaucrats on that. Then there is the qualitative side, whether you are in India or even Belarus, there are people who will meet tech company executives, move them through the visa process. Most foreign companies need visas to come in and out of Russia and create for them again a sort of easy pass green corridor where you can come in, you are made to feel welcome, you come in, you go to Skolkovo, you go to your data centre, you go to IBM's facilities and it is a qualitative improvement in making Moscow, Skolkovo, and Russia a really attractive tech centre. The one big competitive advantage Russia has right now in the whole sphere of technology is IT. I have been on two panels so far talking about innovation in IT. The enthusiasm that big global corporates have for Russian programming is extremely high. So, there is a natural advantage that can be used further to stimulate construction in and around the IT sector.

V. Golubitsky:

Thank you, Drew. Our discussion is called 'From Skolkovo to Other Projects'. I would like to ask Steven Wayne the following question: how do you rate the potential and the attractiveness of the Skolkovo project? It includes a large segment of office real estate, but has a residential segment as well. We already discussed this topic at MIPIM (*Le marché international des professionnels de l'immobilier*) in Cannes. At the same time, I will ask a question about business in Russia as a whole: what are your perceptions about profitability; what kind of profitability are you expecting?

S. Wayne:

Thank you. Let me just maybe start off by saying that I am not such an expert in technology nor the Skolkovo project, so I cannot say so much about the specific project itself, but I can say some things about how it is viewed. We went out last year and we raised about USD 160 million just for investments inside of Russian real estate. It is interesting for us. We are not allocators that get a bunch of money and then say here is where we put it and then we look for the best deals. But, we go out and find investors that specifically want to come into Russia and specifically want to come into Russian real estate. I would say maybe just to borrow an analogy from Mohamed El-Erian who runs PIMCO's liquid portfolio, he said investors right now are looking for the least dirty shirt. I would say unfortunately for us, and I consider myself at least 45% Russian, I think we kind of have the dirtiest dirty shirt. But, I guess as a value investor I look at it and I say screw the dirt. Let us look at the shirt. The shirt costs USD 100. I am a value guy, a developer, an active manager, I realize that I may look a little bit silly when I take the shirt home if it smells or is dirty, but if I do the work that it takes to wash it, in a week or a day, I will have a clean shirt, and because it was dirty and smelly I paid a lower price. Beating this analogy to death, I think we are the dirtiest dirty shirts. But, actually I see this as an opportunity and something that is great for those people in the market willing to not only overlook the dirt and look at the price of the shirt and then look at the shirt itself. The things that we looked at this morning: massive undersupply and massive under equity. I would say an educated populous with extremely low debt levels. The Russian debt to GDP ratio is 13% and in the United States it is 104%, and this does not include corporates and then the personal debt levels. I see these things as massive opportunities, and I would say similar to Drew, I would be remiss if I did not actually address the dirt. If I were going to talk about a little bit where people need to improve things – in terms of the managers, we need to attack the dirt and get rid of it. What Drew pointed out I would say is one of the things that I would also point at as one of the biggest difficulties is this massive pipeline in terms of getting permissions. It is the same thing that I always argue to United States investors, 13% debt to GDP versus 104%. It is a massive dislocation. The same thing here as you

are seeing in the United States and Canada you can get it in 30 days and here it is 700. That is twenty times, it is too much. So, this is the kind of dirt, it seems that these things are hard, but in my opinion these things should be easy. I would say we have a beautiful shirt, we need to clean the dirt off it, but I think for the people who can look beyond the dirt on the shirt it is a huge opportunity.

V. Golubitsky:

Since the topic of discussion has turned to the quality of laundry and dry cleaning services, I would like Mikhail to say a few words about public-private partnership projects from the position of the Russian investor. I know that there is experience of cooperation in such projects with foreign investors. How do they assess the situation? Are we talking about just laundry or is there a wider angle of scrutiny?

M. Semenov:

Our company is considering integrated regional development projects as well as simply opportunistic projects. We not only communicate with investors interested in the Russian market, but also look abroad to Eastern and Western Europe. We are an international company, and therefore assess not only Russian but also foreign opportunities. Abroad, the level of profitability is insufficient for us. We have become accustomed to Russia's fortune. We are attracted by the profitability that we see here and that is absent in European projects. Because of this, it is important to understand who has come and for what reason. If an investor has come to do business and wants to make a profit, then there is no place better than Russia in the immediate area. We reach this conclusion by analysing 30 to 60 projects per month. Interaction with foreign investors shows that the focus is gradually shifting from the insufficiencies and complexities of the bureaucratic process to the essence, the fundamentals. I am grateful to Artyom above all for his fundamental message. If we turn our attention to what is happening in Russia with the supply and demand of economy housing, we will discover huge opportunities. I am very happy that I can participate in the implementation of these opportunities. I want as many investors as

possible to take a look at the situation not from above or from the side, but having submersed themselves in it, so that they can have the chance to make a comparison. What happens after that is their choice. If they are willing, for the price of a little discomfort, to get a solid discount and make some money, then they are in the right place.

V. Golubitsky:

Thank you. I will ask Natalia Khanjenkova a question. You are a conduit for investors to the Russian market; you have banking experience, and a wider, nearly political, mandate. How do you perceive calls for affordable housing from the middle class? Are there Russian projects of this kind in your portfolio? With whom and how do you collaborate, besides in Moscow and St. Petersburg?

N. Khanjenkova:

You are completely correct. For us, Russia is one of our priority markets, and a third of our annual investment is carried out in Russia, including in the sector under discussion. Considering our mandate, regional development is the most important thing for us, even if we do work in Moscow and in St. Petersburg as well. Therefore, we are considering projects in the regions. We are a development institution, but at the same time we are also a bank, and our partners know perfectly well that a banking approach to any project is important for us. We correlate profit with risk; the greater the risk, the greater the profit we have the right to expect.

A question was asked here: what it is an ideal project for investors and banks? In the projects that we implement in Russia, the risks and challenges are often related to land ownership rights. We consider many projects that ultimately remain frozen because we can see no clear rights to the land. A well projected cash flow is very important. The mention of an existing, huge demand was correct. But it must coincide with a projectable level of profitability.

The prospects for residential construction are related to the development of mortgage services. It is comforting that they grew by 30% last year. Although their penetration is still low, we are noticing a pattern of growth.

As far as commercial real estate is concerned, we do not always find potential clients confident that, in the end, there will be demand. Because of this, we are searching for anchor residents and anchor tenants, so that at least a minimal cash flow may be assured.

Regarding infrastructure: without certainty that its issues will be solved, we cannot finance a project. There are two approaches here: either clear agreement with local authorities, or the private investor takes on these challenges themselves, but then how money flows work becomes an important issue. It is also important that the initial investment comes from the sponsor's capital, with supporting credit relied on afterwards.

It is an integrated approach to the solution. Last year, we, together with our partners joined the Ecodolie project, not as a creditor, but as an investor. We find this project attractive because infrastructure issues have been agreed with the local authorities, and because it is a regional project. The first constructions are in Orenburg and Obninsk. The project encompasses not only residential real estate but also social facilities. At the moment, we are seeing a demand for integrated solutions. Advanced construction techniques and energy efficiency were also important. We can observe herein both a commercial approach and our mandate to support anything related to energy efficiency in Russia. We are interested in working in this sector; we have the experience and are assessing the risks rationally enough.

V. Golubitsky:

Thank you, Natalia. We have heard the perspective of the European bank; it would now only be right to hear Irina's opinion. As a development institution and a bank, how does your organization view such integrated projects? What is happening here in the market, and what emphases do you pay attention to?

I. Makieva:

I would like to support Natalia in her point that, at present, it is important not to focus solely on residential construction and the residential and non-residential real estate markets. I would emphasize things somewhat differently.

The first things that strike me as promising are the approaches to integrated development of individual areas. Currently, substantial work is being done on developing clusters in the Russian regions. Many countries have already conducted similar work; for us this is also nothing new. In the coming years, there will be particular emphasis on this topic. In the near future, a list of clusters that will receive high priority support will be confirmed; these will be innovative clusters. But in terms of integrated regional development, it is not just large-scale enterprises and educational institutions that will be built in these clusters. We will also be building residential real estate and social infrastructure, and it is precisely in these areas that investors are most anticipated.

I would like to tell you about a few of the projects our bank is working on. They are integrated regional development projects. In the Kaluga Region, with the participation of Vnesheconombank, the Kaluga Region Development Corporation has been established; it is operating successfully. We are implementing two projects there, which are creating 16,000 jobs. If there are jobs, then there is a demand for housing construction. Looking at Siberia, we can observe the shining example of the Kemerovo Region and the construction of the satellite city Lesnaya Polyana, in which 95% of the housing is occupied by young families. This has been done without damaging the environment. Another example is the regional development that is taking place in anticipation of the forthcoming events in Vladivostok in September of this year.

Vnesheconombank enters into an agreement for integrated development with a particular region. Further on, we will assess the degree to which the entire Vnesheconombank group can affect the development of any particular region. This includes VEB ENGINEERING, VEB CAPITAL, our sister banks, the Agency for Strategic Initiatives, and the Russian Direct Investment Fund. We approach the

region in an integrated manner, synchronizing our activity, which helps the VEB group to work effectively. At the end of last year, we signed a four party agreement between the Ministry of Economic Development, the Agency for Strategic Initiatives, the nongovernmental organization Delovaya Rossiya, and Vnesheconombank. We agreed to work together on implementing a new industrialization strategy that should lead to the creation of 25 million jobs. This is a large-scale project that will implement the cluster approach to integrated regional development. These are the main trends that I wanted to tell you about.

V. Golubitsky:

Thank you, Irina. I would like to ask Alexei Kalinin a question. In many countries, the housing market is an indicator of the state of the economy. What do you think: does the housing market in Russia act as a driving force of development, and do you have any interest in this market in terms of your experience with Baring Partners?

A. Kalinin:

We represent the Baring Private Equity International group in Russia and the countries of the CIS. This is a large group that works in all developing markets. In addition to Baring Vostok, it includes Baring Asia, and Baring India. GP Investments works in the South American market. For these reasons, we have the opportunity to compare and observe our colleagues' experience in the real estate projects that they implement in their markets.

Our first experience in real estate consisted of investment in two projects. One was a low rise construction which Natalia already mentioned. The second was related to the Etalon Group, the IPO of which took place just over a year ago. This was the goal of our investment. Both investments were fairly successful; we like the sector.

I would like to share our thoughts about the state of the markets. The crisis had a negative effect on this sector. Essentially, profitability fell by half. Cost of production for construction is growing steadily, while the average price of housing fell in 2009.

The price in roubles has today almost reached pre-crisis levels, but the cost in dollars has not yet been restored.

However, there are also positive aspects. In particular, the land market has become more accessible; its overheating in 2007–2008 was a limiting factor. Today the quality of proposals has improved and the projects are developed to a greater extent, especially in the areas of required permits and installation of technology. Meanwhile, prices have remained at the same level as before the crisis. Another factor is the end consumers. They have become more demanding of developers. The problems we were observing before and after the crisis – cheated investors, margin calls that were being issued in the sector because there was too much credit – led to the consumer becoming more discerning, more careful in choosing who to work with. This invigorates the situation in the sector as a whole because, here, the crisis works like a forester.

The next slide is related to profitability. We have the opportunity to observe various markets. The slide depicts EBITDA-profitability along the horizontal axis and company growth trends along the vertical axis. Three of the largest Russian public companies are highlighted in blue: PIK, LSR, and Etalon, and there are four examples of foreign companies that work in developing markets, including a Chinese company, and a Brazilian company that works in the low-rise construction market in South America. What do we observe, and what conclusions can we draw from this graph concerning profitability in Russia? It is at the same level as other developing markets, but the growth pattern lags substantially behind. This is related to our demographical problems.

If we take a look at the pattern of development for developers in China or South America, then we see that we have something to aim for. As for demand for housing, the government has done a lot recently. Demand is being stimulated; mortgage rates are falling. This is happening because the Agency for Housing Mortgage Lending (AHML) programme has begun to work (although it is still fairly complicated in a procedural sense). Another interesting programme is one being offered by Sberbank. This is the 10-10-10 programme, which offers credit to

developers on favourable terms, and allows mortgages to be taken out even under unfavourable conditions: for 10 years, at 10% interest, and with a 10% down payment. This is similar to what we are seeing in other developing markets. The role of mortgage services is still small. The share of initial acquisitions which involve a mortgage contract is only 12–14% (in America this is 80–85%). We are developing the Obninsk project in conjunction with Sberbank; there, mortgage credit accounts for 60% of new acquisitions. For Russia, this figure is fairly high.

V. Golubitsky:

Once more, there was mention of the role of government, as well as of low-rise construction. We should turn to Elena, President of the National Agency for Low-Rise and Cottage Construction (NAMIKS). Our colleagues were discussing the issues that get in the way of day-to-day investor activity in Russia. You are the author of a law on public–private partnership that is dedicated to cooperation between the state and the investor in integrated regional development projects. What can you tell us about this law, and of the state’s influence on such development?

E. Nikolaeva:

I would like to begin by saying that the situation is changing dynamically. You mentioned the low-rise construction sector. I will remind you that in 2007 no such sector existed in residential construction. It was considered to be redundant; the thinking went that residential construction should primarily be high-rise. Since 2007, the situation and structure of the new housing sector changed drastically. This led to the current situation wherein 56.5% of new housing is low-rise. Over the course of a few years, significant changes took place in housing policy due to the active involvement of the business community, which has an interest in seeing this sector develop. We removed barriers to access and implemented changes in legislation that levelled the playing field between the low-rise and high-rise construction sectors. Large integrated regional development projects were also launched, in

which one of the criteria was the percentage of new low-rise construction, including on land belonging to the Russian Housing Development Foundation.

Low-rise proved its worth. Such critical aspects as project completion timeframes and the ability to implement projects in stages, led to these projects turning out to be more profitable for investors. Because of this, large funds, including Ecodolie, began with low-rise construction.

If we want to discuss the development of affordable housing policy in Russia as a whole, we should identify a few problems. The first is the large variation across the regions, which means it is impossible to approach them in a uniform manner. There are regions where from the outset investment is very attractive (Moscow, Moscow Region, St. Petersburg, and Krasnodar Territory). After that come those regions where cluster-based policy is being actively developed (Kaluga Region, Ulyanovsk Region, Kemerovo, and a series of other regions). Then there are depressed regions, with cities where not one house has been built in 15–20 years.

Recently, I was in Mednogorsk, a monotown in Orenburg Region. In 17 years, not a single house has been built there. People are living in buildings that were erected by German captives. Yet there are absolutely no problems with commencing construction in Mednogorsk. If even one investor wanted to start building, he could begin tomorrow. The governor will fawn over him.

We spoke of a road map that was born during the discussion with Vladimir Putin at the Istrinsk conference. The President's first executive order on his inauguration day dealt with the development of residential construction and the reduction of administrative barriers. The government has already begun to prepare a corresponding federal standard. The standard includes a series of very important points: a curtailment of procedures and their clarification so as to attenuate the 'imagination' of civil servants tied to local elites who are already building in a particular region. But this is not solely a problem of civil servants; this is a struggle for projects, investments, and profit. Currently, a unique situation has arisen for investors: a change of elites and a change of power are taking place practically in

every region. This means that old connections are being disrupted, and you will have the opportunity to move into the regions.

V. Golubitsky:

Elena, the fact that everything is changing in Russia might not be the best news for investors...

E. Nikolaeva:

Everything is changing for the better because real competition is being created. And therefore, wherever the more efficient investor chooses to go, he will encounter the best conditions. Secondly, we have finally agreed that integrated regional development means higher profits for the investor, which is possible only in a clear administrative environment. The increase in profitability is tied in with the necessary removal of additional risks and additional burdens within the cost per square metre which previously existed in Russia – historically, road construction, installation of infrastructure, social facilities have all been included in the cost per square metre. Not a single country in the world has this. Now, national and regional leaders have come to the understanding that these are different processes, and that the integrated development of a region demands synchronization between tangible residential development projects and natural monopolies, road construction, and the creation of social infrastructure. Therefore, the cost per square metre will decrease, while demand stimulated by AHML and other instruments is actively growing.

The third point is the absence of an integrated legal framework that can ease additional burdens through public–private partnership. By means of this mechanism, profitability can be increased in the places where it is lacking. To do so, we must use existing models and development institutions such as Vnesheconombank. We are actively working on public-private partnership legislation which stipulates in which instances the government enters such projects and for what segments it is prepared to create additional opportunities, including the construction of social infrastructure.

Currently, we are implementing pilot projects in Khanty-Mansiysk and Astrakhan to demonstrate to investors and the country's leadership how the chief models of public-private partnership work in areas unusual for Russia. It is customary in Europe to use public-private partnerships to create social facilities such as hospitals, schools, and nursery schools; here, the situation is still absurd. We only have budget financing, and we do not understand very well how this works.

The situation with transport projects is analogous. The legislation has the approval of all the federal government agencies, which is extremely important. It was a long process. At the moment, it is being refined; we will come back to it in the autumn session to open up new opportunities for investors in public-private partnerships under transparent conditions, stipulated not just on the regional level but the federal level as well. This legislation will become an additional stimulus for increasing profitability and attracting investment.

I shall make another point – the entrepreneurial community itself is having a significant influence on the development of this sector. For as long as business did not unite and begin to advance its interests systematically and in an integrated manner – as long as it continued to do so intermittently and differently in each region – it would come up against serious barriers. Whether they were erected consciously or not is immaterial. Today's situation boasts entrepreneurial initiative that is supported by the country's leadership. The understanding has dawned that an influx of investment, some of which is Western, makes this market more comprehensible and civilized.

We are paying attention to the increase in demand, but this is still a very complicated challenge. If we do not change our approach to the housing and public utility sector, then in 10 years, according to experts' estimates, 45% of housing stock in the Russian Federation will become unsound. So, it is important to speak of good stock carefully.

In summary, various options emerge: development of new cities; development of areas around cities; and large projects such as 'New Moscow', 'New Tambov', and 'New Lipetsk'. These are the possibilities of integrated regional development

through novel approaches to creating a living environment. In Russia, the consumer is changing qualitatively, and is no longer searching solely for square metres. Now he requires a social and cultural environment, leisure facilities, and proximity to work. Without the mechanisms afforded by public–private partnerships and without the cooperation of business and the authorities, we will be unable to accomplish this; in this sense, I am cautiously optimistic.

V. Golubitsky:

It is good that you are cautious but an optimist. As for social burdens on the cost per square metre, when will they be removed? As soon as the law is enacted?

E. Nikolaeva:

This mechanism allows regions to finance social facilities in a new way. I hope that the pilot projects give each regional authority the opportunity to determine its position. Under this integrated regional development, we are already implementing solutions in which investors are freed of the social facilities burden.

V. Golubitsky:

I think this is a topic for discussion. It is good that the State Duma recognizes this, and perhaps the laws will reflect this, but this is not quite the case on the ground yet. Let us now get questions from the audience.

M. Grin:

Mikhail Grin, Director of the Russian National Agency for the Development of Housing Funds for Social and Commercial Lease. In the topic outline it says ‘From Skolkovo to...’, without any further details. In the case of Skolkovo, we have a definite area which has a boundary. The successful programme to improve the living conditions of service personnel showed us that when we do something in a focused way – when all the conditions are clearly stipulated, like a business plan – the project bears fruit. Therefore, it is important to declare which areas will be

subject to these projects, as well as the anticipated number of cinemas, theatres, roads, and finally jobs. This is the shortest way. Otherwise we simply create good general conditions which might lead us nowhere. This question is for Elena Nikolaeva and for you, Veniamin, since you are the Chairman of Skolkovo.

V. Golubitsky:

In Skolkovo and in Ekaterinburg, we have major academic projects, but I am not entirely certain who should declare what. It seems to me that we are speaking more of the market. Acquire something, and later through a dialogue with the authorities clarify what kind of preferences there are, and what opportunities. I believe Elena spoke of this. These are all public–private partnership projects, where the roles of the partners, the government (whether regional or federal), the municipality, or the investor are clearly defined. This is the case in Skolkovo as well. In the cases where these roles are defined, everything is clear. The whole problem is that, generally, there was no definition, and therefore I asked Elena to speak about public–private partnership legislation. The rules of this game were not stipulated, and every investor played at his own risk, while the regional legislators invented new laws. Where it was possible to successfully lobby for a normal law, these relationships began to work out. How will they work following the legislation framework? This question is for Elena.

E. Nikolaeva:

You are absolutely correct. The model situation is spelled out in the legislative framework, which provides investors with guarantees that if they enter large projects under these rules, the government will perform its obligations. Second, what seems important to me is that, with Skolkovo, it is possible to work out unique models precisely by virtue of special legislation without additional barriers, and to approach the creation of an entire, smart city in a whole new way. In the future, this experience will have to be replicated, based upon public–private partnership legislation.

V. Golubitsky:

Thank you. We have another question.

S. M. Kotwani:

Sammy Manoj Kotwani, President, Indian Business Alliance. I would like to know whether Russia is experiencing a crisis. Yes or no? Is Russia experiencing a recession?

E. Nikolaeva:

I think that there is a crisis in Russia, just as in the rest of the world, but our authorities' response was so strategic and of such quality that in the real estate sector, certainly, we feel the effects of the crisis the least. Unprecedented methods of support were employed. These methods allowed us to calmly negotiate our way through the crisis. We learned a lot during this crisis; it played a cleansing role.

V. Golubitsky:

Let us ask the investors that work in this market. For example, what does Steven think?

From the audience:

Let me continue this thing: for the last six months Russian GDP has been falling. In any country once the GDP has been falling for six months, it is understood that we are in recession. In this time of recession, please tell me what will happen to salaries? Again, what will represent what you are saying, and where will the property market go from there?

D. Guff:

The Russian economy is not in recession. The Russian economy has numbers that would make any European country really envious, but the Russian economy is not

the locomotive of the world economy. The Russian economy is farther back in the number of cars on the train. The Russian economy is highly geared to global demand because global demand affects commodity prices. Commodity prices are very important to Russian GDP which is still largely export-dependent, especially dependent on hydrocarbons. The fear that anyone who invests in Russia or is a friend of Russia has, is that it is going to follow a spiral if Europe has a meltdown. The biggest fear, the biggest risk for any real estate investor is what is happening in Europe right now. Your point is incredibly well taken because the real estate market will depend in large part on what happens in the next six months in Europe. To that extent, we should all be rooting for a German bailout of Greece, Spain, and Portugal. That would be the best thing that could happen for the overall economy, and so Russia's role in the G8, G20, and everything else should really be geared towards growth – growth in the BRICS and growth in the developed world. But Europe will play a really important factor in the overall success or not, of Russia. The other problem affecting the real estate market and the general investment market right now is that the world is in a risk 'off' mode. When things get nervous, the emerging markets get hit much harder than any of the developed markets. People pull their money out of risky places, even China. Look what is happening in India. India is seriously in recession. People used to talk about the 'R' falling out of the BRICS, now people talk about the 'I' falling out of the BRICS. India is, for foreign direct investment, a disaster zone right now. Comparatively speaking, Russia looks pretty good. Russia has a lot of advantages it can use to reinforce its place within the BRICS. I would say the other fear is that there is a withdrawal of money from emerging markets and that also is not going to happen until there is more stabilization in the global economy. But, I would say that the concrete steps that have been taken in general in Russia over the past year or two for direct investment have been better than anything we have seen in the past ten years.

S. Wayne:

I think this could turn into a Drew admiration society, but I basically think the exact same thing. I think the economy is booming – with maybe two other nuances. First, look at the corporates. The corporates are crushing it in Russia right now. Like Abbott Labs, their second highest sales in the world are in Russia. The car industry here grew 23% last year, and was the fastest growing car market in the world, including China. China was higher in terms of the number of units sold, but in terms of growth rates it was 23% here. You cannot be in a recession and have a car market which is the second biggest capital thing that you purchase growing 23%. I would say just looking at the corporate PNLs, they are growing incredibly quickly. Unemployment in St. Petersburg, for instance, I know it is not the country, is 1.4%. So, I would say the economy is booming, but maybe just the nuance, the place where there is a crisis and recession is capital markets. If you take Western Europe and the United States, they have very weak economies. Germany is sort of like the proud child of Europe right now, their economy is growing 1.2% per year. But, at the same time they have extremely strong capital markets and the same in the United States. Here we have high growth, but our capital markets are incredibly weak. These are pernicious effects, especially on the real estate market. Maybe, if I could just comment on one other thing, I do not want to get too long winded here. But, the slide that Alexei shows where our publicly traded property companies are growing at compound annual growth rates of 10%, in my opinion this is super misleading. I do not think this reflects the growth in residential demand. I think this basically reflects the capital markets. I know those companies, they were over leveraged, they could not get any financing. And if you cannot get financing in real estate, you not only cannot buy, you cannot exit. I think if you look a little bit more granularly, it is hard for people to buy. Most people who purchase residential real estate in St. Petersburg today, they come very close to purchasing the whole value of the apartment with almost no finance, and it is 3% of GDP. These are the kinds of things, like 3% of GDP is the mortgage market. The average in Europe is 52%, so it is one seventeenth. I think we really have to keep these things in mind when we talk about the capital markets. So, I think it is booming, but on the other side – and

maybe this will be my last point, sorry about this – in 2009 our economy shrank 7.8%. The next year it grew 4.7%. In the world this was the biggest difference. So, 7.8% down, it was a 12.5% difference in one year and I would say this shows the susceptibility of our economy to the capital market, but it also shows, in my opinion, the underlying strength.

V. Golubitsky:

Thank you, Drew. Thank you, Steven. Thank you, Elena. We have put together such a diverse panel that I made an error and did not let Lev Pukshansky speak. He is from Terra Nova, a company that works on integrated projects.

L. Pukshansky:

Thank you, Veniamin. You sat me opposite the panel, but this will not save you from my comments. I shall approach this topic from an unexpected angle. The international financial system has a significant structural problem, and I think that this structural problem is related to the fundamental problem of financial theory. It is no secret to anyone that the existing financial theory made a serious error, at least in terms of calculating risks related to subprime loans. Risk allocation, which is the largest corpus of current financial theory, was conducted incorrectly, and its conclusions turned out to be incorrect.

From my perspective, there is one more error that is related to the topic we are discussing, that is, the appraisal system. I agree with what Mikhail Semenov was saying. The main risk that exists in any business is the risk of demand. All other risks are secondary. Let us examine the fundamental difference in demand between developed economies and the Russian economy. From my perspective, it is simply day and night. These are absolutely different principles. Steven spoke of Russian assets as if they were dirty shirts. But, you in the developed economies have no demand, and will not have it for a very, very long time. The main problem is overproduction. Nobody needs what these respected Western companies are

producing. Development, development: no one needs it, not in Europe, nor in America.

Elena said that 45% of our housing will, after some time, be put out of commission. Of course it is bad that people's roofs have holes. But it is a colossal opportunity for development. Imagine: 45% of a nation with 150 million inhabitants!

I have been participating in similar discussions with foreign and Russian companies for already – it seems to me – an eternity. Initially, the foreigners were lecturing us on what a proper, investment-friendly, Russian product should look like. The Russian companies listened attentively, agreeing... That was 15 years ago. Today, foreign companies continue lecturing us on what a proper product should look like, from simplified books. In your business schools you have simplified books, as well as books that are better. In the meantime, Russian companies have long since been talking about real business, and Russian authorities have long since been undertaking real measures.

The fundamental difference is that demand in Russia still exists; it is long-term and fundamental. If there is basic discrimination in the world, then it is the discrimination of the rating agencies. Look at how comfortably they have set themselves up: all the rating agencies are in developed economies. And they came up with such things as 'sovereign exposure' and 'municipal exposure'. They give their own countries the highest rating; other economies are rated lower and lower and lower. This means that the money that they invest in our economy will be a priori subject to higher interest rates. Besides this, because of the price of money, our own cost of production becomes greater when we come to your markets. This, in my opinion, is daylight robbery.

The basis of all ratings appraisals is statistics. I was watching the first presentation by my esteemed colleague. It contained interesting and important numbers. But the table showing the delay before ground breaking killed me. I cannot agree with you that in America, architects complete their plans in two months, while in Russia it takes two years just to break ground. The devil is always in the detail. If you have in mind the time from the project's announcement to the commencement of ground

work, then, of course: we love to announce everything early in Russia. But, believe me that not one American architect has ever completed any plan in two months. And, if you had in mind that this is our bureaucratic apparatus which takes these two years away from us, then I cannot agree with you. I volunteer as the head of the largest association of developers in our country. Nobody takes two years to approve anything.

There is of course a range of problems with integrated regional development, and I wholeheartedly agree with every word that Elena said about how our business should not take on functions which are not appropriate for it. Business completely subscribes to this opinion, but unfortunately not every participant of the process is of the same mind. When I am in St. Petersburg, I am often told that, well, you have projects with this or that level of profitability, so share some of it, but do everything yourself. From my perspective, this is a fundamentally incorrect position. Due to the input of abnormal economic schemes, we get distorted construction in the output.

Russia has everything required for integrated regional development. There is demand, and there are interesting regions. On the level of political will, the government is making steps in the right direction. We need the correct vector, a unified effort. I can provide a practical example. The company I head has for a few years now been involved in the largest integrated development site in St. Petersburg. This is the alluvial area in the Gulf of Finland. The total area of the project is 476 hectares. The main thing is our will as the macro-developer of this project, and the will of our partners. I am very happy that one of our partners will be the Renova group, and that its representatives are the President and CEO. Thank you very much.

V. Golubitsky:

That was a pleasant turnaround! We really did sign an agreement with Terra Nova. This is the largest project in St. Petersburg, and we already entering the first stage. It is an integrated regional development project, a really large project.

I. Makieva:

Since they have not yet switched off the lights, I would like to announce that our bank established the Development prize, which will be awarded by the President of the Russian Federation at next year's St. Petersburg International Economic Forum. One of the proposed categories is for integrated regional development. Please send nominations to the bank during the year. The best projects will be selected, and the decision will be confirmed by the Supervisory Board which is chaired by the Prime Minister. I invite you to the award ceremony for this prize here a year from now.

V. Golubitsky:

Thank you. In that case, we are already checking in. I want to thank all our colleagues. The discussion was very interesting and dynamic. It was both helpful and interesting. Thank you very much.