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The "AEB Real Estate Monitor" is registered with The Federal Service for Supervision of Legislation in Mass Communications and Protection of Cultural Heritage, Certificate registration ПИ № ФС77-24458/ СМИ "АССОЦИАЦИЯ ЕВРОПЕЙСКОГО БИЗНЕСА: Обозрение рынка недвижимости" зарегистрировано в Федеральной службе по надзору за соблюдением законодательства в сфере массовых коммуникаций и охране культурного наследия. Свидетельство о регистрации ПИ № ФС77-24458 от 23 мая 2006

Frank Schauff
Chief Executive Officer,
Association of European
Businesses

Dear reader,

The end of December is approaching and now we may close the books on the year of 2014. It turned out to be quite a gruelling one. The conflict related to Ukraine shattered the confidence of many foreign investors. Many sectors of the economy were exposed to an unexpected new crisis. In particular, the real estate market failed to escape the challenge of the times. In the past six months, it has undergone numerous changes, notably in legislation which impede using or selling property. Price levels have also been unstable: exchange-rate fluctuations drive them down, but buyers have come into the market on a massive scale, aware that prices might rise in the short term.

The experts are predicting that 2015 will be a year of profound stagnation for the real estate sector, as well as for the economy overall. However, these are only forecasts and, as we know, they can be upset by unexpected, radical changes. Let us hope that 2015 will not match the negative analysts' expectations, and instead that the current situation will improve dramatically.

I would like to take this opportunity to thank those of our Real Estate Committee members who have been active in contributing to this publication and to the other activities of the Committee.

It is my hope that you will find this publication a useful resource, and that it will help you grow your business. I look forward to seeing many of you at our upcoming Real Estate Committee events.

On this note, let me wish you a merry Christmas and prosperous new year for 2015!

Dear friends and colleagues,

On behalf of the Real Estate Committee, I would like to introduce the 4th issue of the AEB Real Estate Monitor for 2014.

As we move towards the end of the year, it is clear that our industry faces serious and mounting issues and challenges resulting from heightened geopolitical tensions, the continuing slowdown in the economy and volatility in foreign exchange markets.

All real estate indicators are in the red zone not least in the office sector where vacancy rates have risen sharply to over 30%. In the retail sector, there has been a discernible decline in customer footfall and it is quite likely that New Year sales may be lower than expected. Even the logistic sector, which has remained resilient throughout the year, is now beginning to show signs of softening. Overall, the property market, across all sectors, is having to face up to weakening rental rates.

Sanctions and counter sanctions have not made it easy for European companies this year in Russia, but we need to ensure that our high quality products and services, our professionalism, integrity and transparency continue to serve, as best they can, the needs of the Russian business community.

Looking towards 2015, we anticipate that our industry will face one or two difficult and challenging quarters, but there are some indications that suggest that there will be the beginning of a recovery in the second half of 2015.

We are looking forward to working with you all and wish you a Merry Christmas and a prosperous New Year!

David Izett
Acting Chairman of the AEB Real Estate Committee,
Chief Operating Officer,
Cushman & Wakefield

Moscow market overview

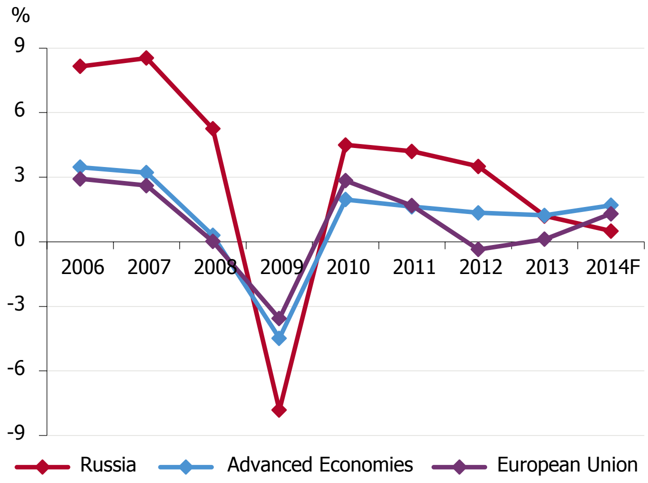
Capital market

This year has proven truly challenging for Russia. A falling oil price, continued conflict in Ukraine, sanctions, counter sanctions and a weakening ruble have heaped pressure on an economy that was already experiencing a cyclical slowdown. Consensus GDP forecasts, for example have been significantly revised down with little growth already expected for 2014. According to Oxford Economics, GDP growth for this year will be 0.5% having been revised down from original forecast of 3.1% in July 2013. (1 ▶)

Retail sales have come under significant pressure since the start of the year. The weaker ruble combined with rising inflation and falling wages are decreasing consumption power. Agricultural output and industrial production held up well in September, largely due to import substitution and both will provide support to GDP growth in Q3 2014. However, with capacity utilization already at 2007 levels, we doubt this dynamic can be sustained. (2 ▶)

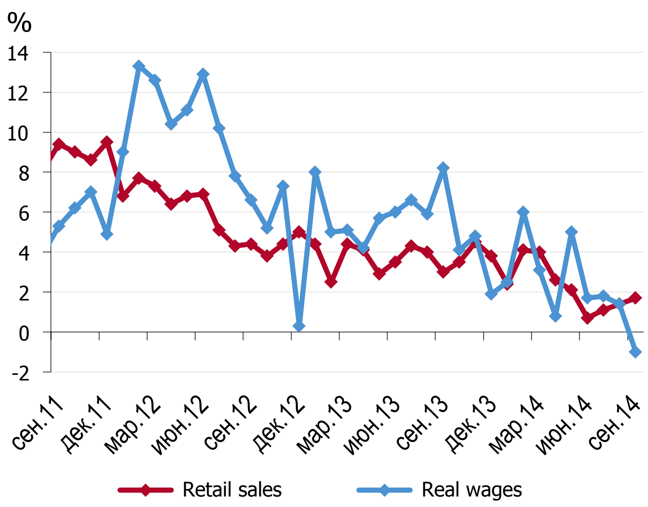
Despite these pressures Q3 proved to be surprisingly strong for commercial real estate investment. After a quiet summer, volumes reached USD1.5bn in Q3 2014, which is only 2% down on the same period last year YoY. On paper, these are an encouraging set of numbers, though year to date volumes are more sobering. Over, the first 9M of the year, total volumes amount to USD3.0bn, which reflects a decline of 40% YoY. We maintain our forecast of USD3.4bn in investment volumes for FY2014 though we should note that we do see some investment deals with Russian players in the pipeline which gives us some hope that there will be upside risks to our forecast. (3 ▶)

1 ▶ RUSSIA GDP VS PEERS



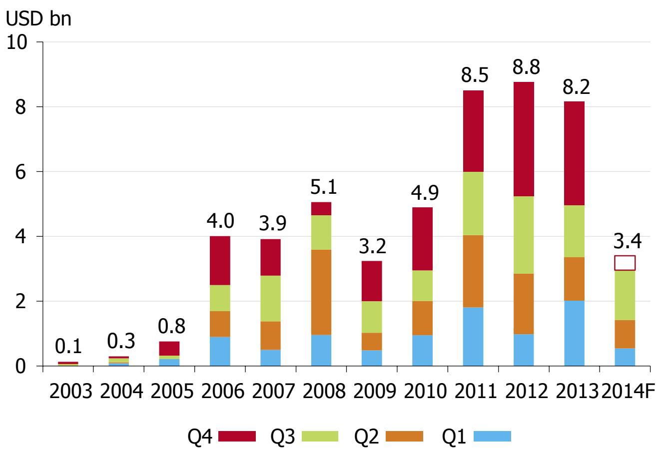
Source: Oxford Economics

2 ▶ RETAIL SALES VS REAL WAGES



Source: Oxford Economics

3 ▶ INVESTMENT VOLUME DYNAMICS

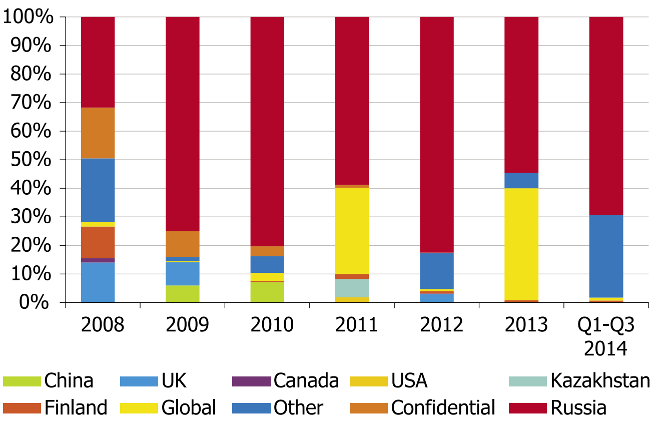


Source: JLL

Sources of foreign capital are beginning to change in our view. In Q1–Q3 2014 local investors continue to dominate the market, Russian players accounted for 69% of deals in Q1–Q3 2014 vs. 54% in Q1–Q3 2013. Given the tension between Russia and the West, we do not expect a significant pick up in western investment in the near term, however, we do expect that new sources of capital will develop, particularly from Asia and SWF's. We note for example, the recent acquisition of the Pokrovsky Hills residential complex by Qatar Investment Authority. (4 ▶)

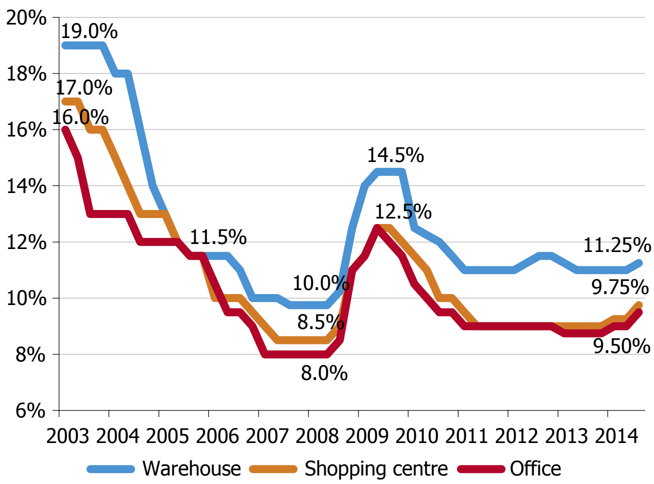
Capitalization rates have also reacted to the current market situation. In Moscow, for offices and shopping centres rates increased by 50bps to 9.50% and 9.75% respectively. For warehouses rates increased by 25bps to 11.25%. We maintain that we see risks to these numbers before year end. Since the start of the year we have predicted that any changes would more likely to be driven by external policy, rather than the local economy. Though the situation in Ukraine may have been difficult to foresee, it's impact is material. Until foreign perception improves and equity and debt markets normalize we see risks to these numbers. (5 ▶)

4 ▶ INVESTORS BY ORIGIN



Source: JLL

5 ▶ PRIME YIELD DYNAMICS



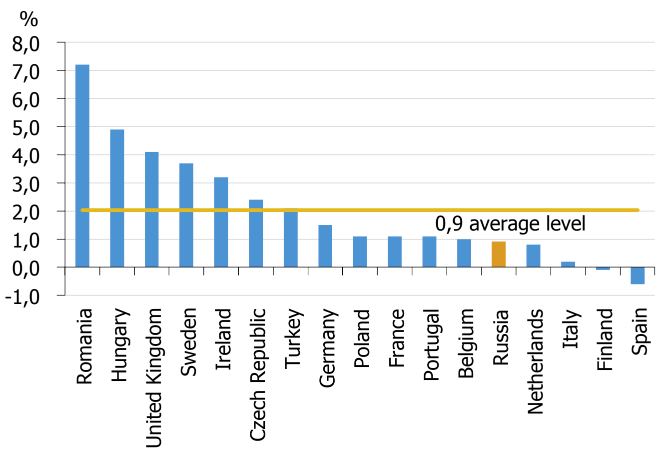
Source: JLL

Retail

Through the third quarter the retail sector has continued to be affected by the macroeconomic turbulence. Retail turnover growth is under pressure due to GDP downgrades, ruble volatility, stagnant wage growth and more expensive credit. Retailers have already started to feel the pinch due to weakening consumption dynamics. Consequently, retailers are being forced to revise expansion plans and some have even closed their stores. Foreign retailers do, in our view, continue to see the potential of Russian retail market even if they have put their development plans on hold for the time being. We should note that even despite the economic uncertainty, some brands have continued to expand. (**6** ▶)

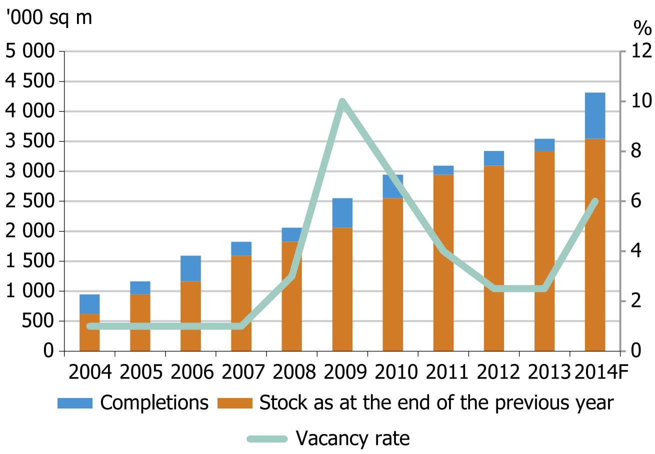
We anticipate 2014 completions will reach the level of 1.7–1.8m sq m in Russia. The level of new deliveries over the first three quarters of this year has almost equaled 2013's level (850,000 sq m) and reached more than 840,000 sq m. We have seen a significant increase in retail supply in Moscow by the end of 9M2014 to 3.8 m sq m. The majority of completions for 2014 are expected in Q4; another five shopping centres with total GLA of over than 450,000 sq m. If all announced projects will be opened on time, the volume of new retail space will exceed 750,000 sq m, which would hit the highest ever level of annual completions. (**7, 8** ▶)

6 ▶ RETAIL SALES GROWTH FORECAST, 2014



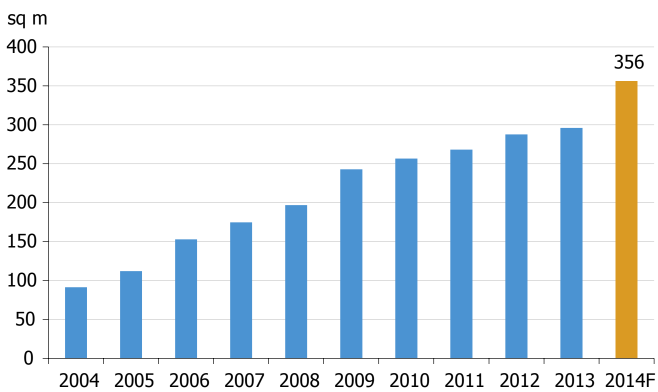
Source: JLL

7 ▶ MOSCOW COMPLETIONS



Source: JLL

8 ▶ STOCK PER 1000 INHABITANTS IN MOSCOW

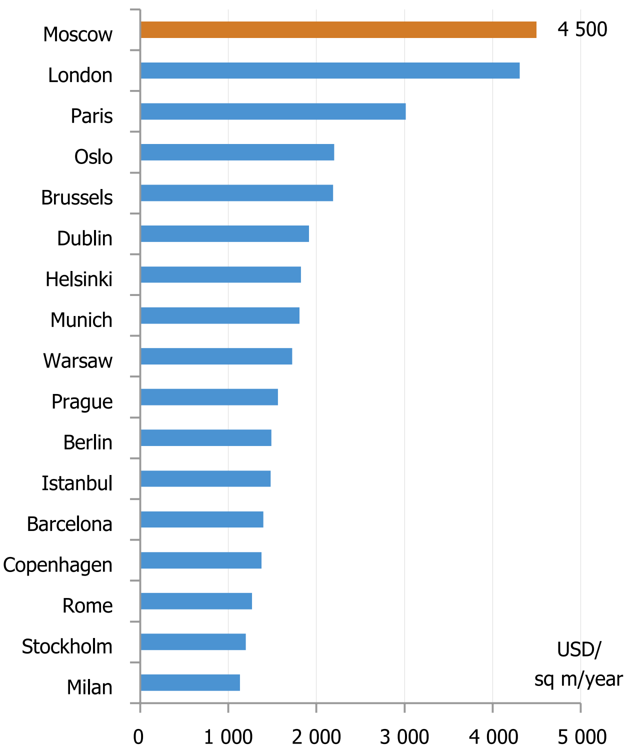


Source: JLL

Vacancy rates in Moscow shopping centres have come under pressure, increasing from 3.5% to 6% in Q3 2014. Rather counterintuitively, base rents generally remain unchanged, though that's not to say tenants are not pushing for discounts. For the moment, developers, in turn, are ready to consider alternative commercial terms. For example, in newly constructed shopping centres they offer to peg the rent to the lower bound of turnover rent for the short-term (3–12 months). Given the economic situation we do anticipate significant pressure on both rents and vacancy rates, particularly in lower quality shopping centres as we go into 2015. (9 ▶)

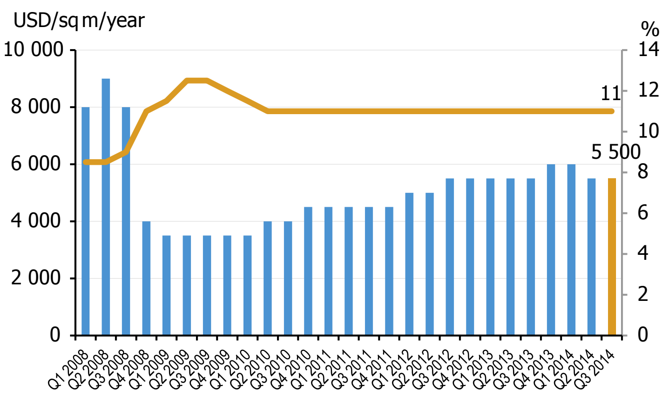
The Moscow street retail market has, of course, been impacted by the economic uncertainty. In Q1–Q2 rents fell in both prime and secondary streets. In Q3 rents for both markets have stayed at the same level as in Q2 though tenants are increasingly pushing for better terms. The vacancy rate remained stable in the prime retail corridors in Q3 2014, in secondary corridors this figure increased marginally from 16% to 17%. Further vacancy dynamics will depend on the willingness of landlords to negotiate the terms with tenants, which are reviewing their development plans now because of the economy. (10 ▶)

9 ▶ EUROPEAN PRIME SC RENTS



Source: JLL

10 ▶ MOSCOW STREET RETAIL RENTS AND YIELDS



Source: JLL

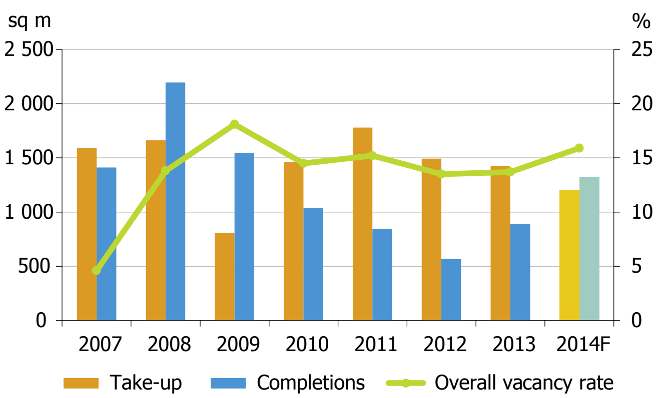
Office

A five-year record level of quarterly completions was seen in Q3 – almost 0.5m sq m of new office space entered the market, around 85% of which was located outside the Third Transport Ring (TTR). By the time of delivery, half of the total volume of new supply was already pre-leased or purchased. (**11**)

This year, the volume of new deliveries of office space could reach 1.3m sq m, which is 50% higher than the total amount of completions in 2013. Moreover, Class A premises will comprise almost a half of new supply in 2014 totaling to approximately 660,000 sq m – the highest level ever seen in the market.

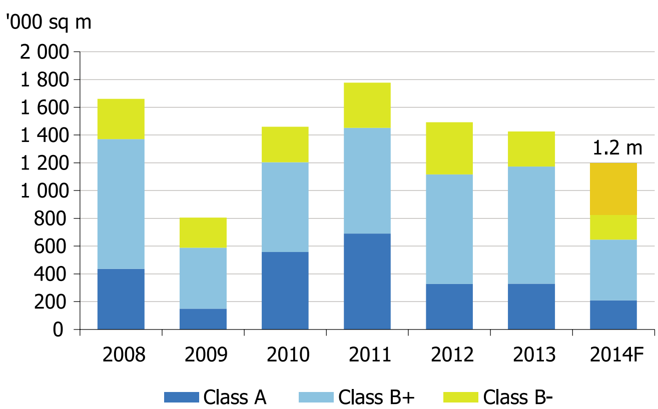
Over 9M 2014 occupier activity was 21% lower YoY with take-up volumes at 826,600 sq m. Demand for office space in 2014 has been affected heavily by the deterioration of the Russian economy and ongoing political uncertainty. In the current environment tenants become more cautious in their decisions to buy or to lease new office space, which is reflected in the increased share of renewals and renegotiations of lease agreements in deal structure this year. The volume of transacted space for FY 2014 is estimated at 1.2m sq m implying a 16% YoY decrease. (**12**)

11 COMPLETION DYNAMICS



Source: JLL

12 TAKE UP DYNAMICS

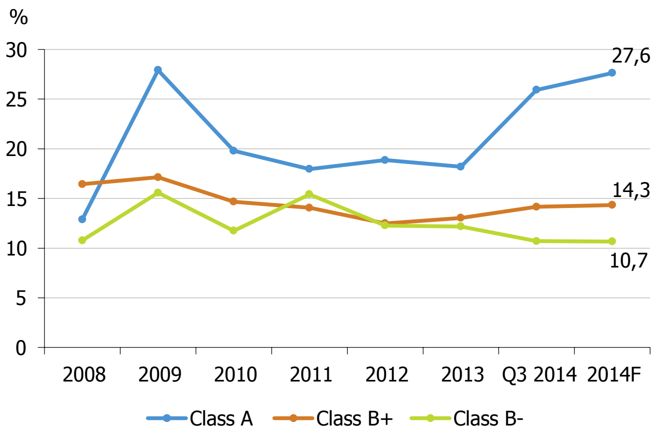


Source: JLL

By the end of Q3, about 15.5% of quality office space in Moscow was vacant compared to the 14.8% level seen in the previous quarter. In view of ongoing growth in supply coupled with the moderate demand for office space, the vacancy rate will keep growing throughout the rest of the year and is likely to reach 15.9% by the end of 2014 compared to 13.7% seen in 2013. In Moscow City the overall vacancy rate could potentially reach 40% following the completion of OKO MFC by the year end adding another 110,000 sq m of new office space to the total stock in the area. (**13** ▶)

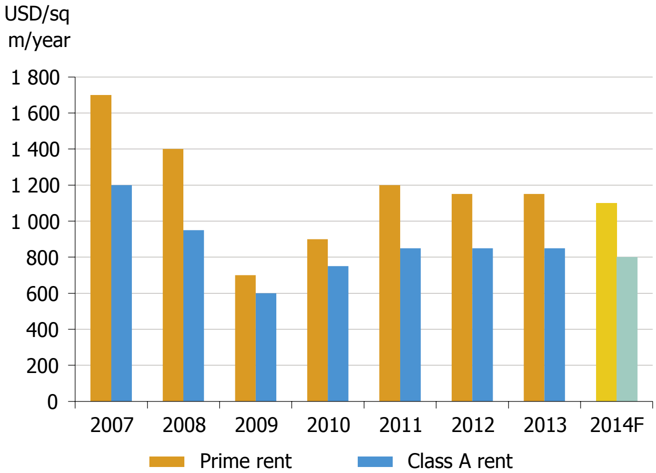
Rents are expected to remain under pressure throughout Q4 assuming no improvements in macro environment. Putting aside the current uncertainty on the market, we believe that over the longer term rents will move in line with GDP growth reflecting the underlying state of the economy. (**14** ▶)

13 ▶ VACANCY RATES



Source: JLL

14 ▶ RENTAL LEVELS



Source: JLL

Warehouse and Industrial

SUMMARY

In the Moscow region during the first 9 months of the year, 940,000 sq m of quality warehouses were delivered – a record volume for the market. This indicator is 15% lower than the average index for 2008–2013. For the first 9 months of 2014, 500 thousand sq m were purchased and leased compared with 780 thousand sq m the year before. The vacancy rate increased by 4% and made up 7%.

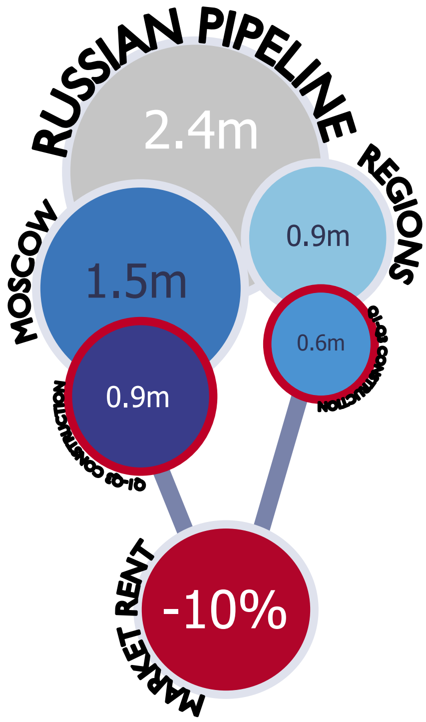
The average rental rates for Class A projects decreased in Q3 2014 to the level of $115—125$ per sq m per year*. We observe the price segmentation in the rental rates depending on the direction, quality of the project and developer.

In the regions in the first 9 months of 2014 supply increased by 590,000 sq m. This is also a record volume for the market. The absorption level during this period reached 225 thousand sq m of warehouse space, which is almost 60—70% higher than the average indices for 2008–2013. A slight compression in rental rates is observed. (**15 ▶**)

CONSTRUCTION

In the first 9 months of 2014, more than 940,000 sq m of new warehouse space was delivered, with more than 380,000 sq m being delivered in Q3. The leading warehouse property, delivered in 2014, is PNK-Severnoye Sheremetyevo (158,000 sq m). Despite the rise in vacancy rates, we are not observing a decline in construction volume. According to our forecasts, total new supply in

15 ▶ MAJOR INDICATORS



Source: Cushman & Wakefield

16 ▶ MOSCOW NEW CONSTRUCTION*, 2014

Project	Highway	Distance, km	Total area '000 sq m	Delivery quarter
PNK - North	Rogachevskoye	27	157,85	Q1, Q3
South Gate Industrial Park	Kashirskoye	27	120,00	Q3
Dmitrov Logistic Park	Dmitrovskoye	30	69,30	Q2
Bykovo Technopark	Novoryazanskoye	19	68,42	Q2,Q3
PNK - Chekhov II	Simferopolskoe	50	30,27	Q2
PNK - Chekhov II	Simferopolskoe	50	113,31	Q4
Nikolskoye Logopark	Rogachevskoye	35	104,97	Q3
Sever II Logopark	Leningradskoye	30	99,56	Q4
Sofyino Technopark	Novoryazanskoye	32	84,97	Q4
South Gate Industrial Park	Kashirskoye	27	48,00	Q4
Nova Riga Logopark	Novorizhskoye	25	67,38	Q4
Sherrizon-Nord LP	Leningradskoye	16	62,20	Q4

Source: Cushman & Wakefield

* Rental rates are denominated in US$ per sq m, per annum, triple net

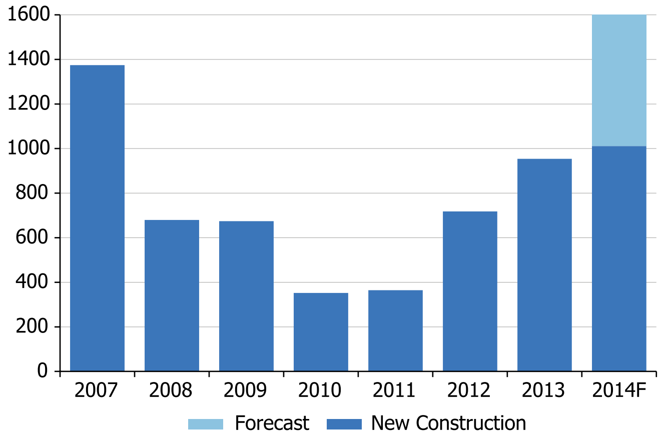
2014 will reach 1,5–1,6 million sq m: in the North-West – 400,000 sq m; in the South-East – 340,000 sq m; in the East – 260,000 sq m).

In the regions, the supply increased by 590,000 sq m. 250,000 sq m of Class A warehouse space was built in St.Petersburg. According to announced developer plans, more than 900,000 sq m of new warehouse space will be built till the end of 2014 outside the Moscow Region. (**16, 17, 18, 19 ▶**)

DEMAND

In Q3 2014, the total volume of quality warehouse deals in the Moscow Region reached 200,000 sq m. 54% of these deals were property sales transactions. Tenant activity was

18 ▶ NEW CONSTRUCTION IN THE MOSCOW REGION ('000 SQ M)



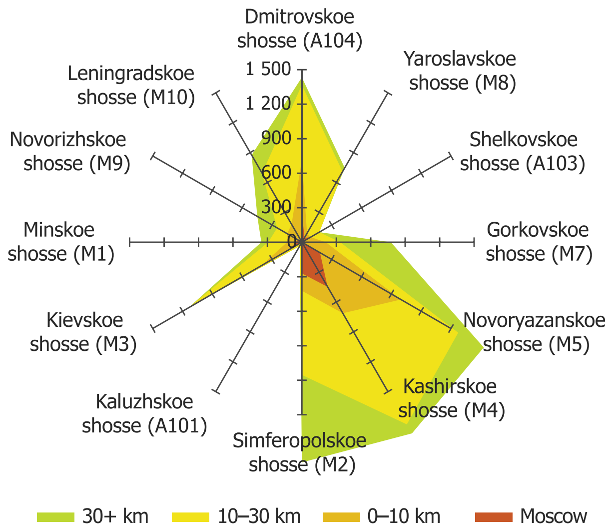
Source: Cushman & Wakefield

17 ▶ NEW CONSTRUCTION* RUSSIA EXCEPT THE MOSCOW REGION, 2014

Project	Region	Total area '000 sq m	Delivery quarter
Armada Park	St. Peterburg	78,88	Q3
Samaratransavto	Samara	61,00	Q3
Tolmachevo Logopark	Novosibirsk	45,30	Q1
Osinovaya Roscha	St. Peterburg	45,00	Q3
PNK KAD	St. Peterburg	43,32	Q3
Logocenter Kuban	Krasnodar	38,40	Q2
Logocenter	Chelyabinsk	33,72	Q1
a2Logistic	Rostov-on-Don	33,19	Q2
a2Logistic	Rostov-on-Don	66,43	Q4
PNK KAD	St. Peterburg	23,48	Q4

Source: Cushman & Wakefield

19 ▶ NEW CONSTRUCTION IN THE MOSCOW REGION ('000 SQ M)



Source: Cushman & Wakefield

20–25% lower than the average 2008–2013 levels.

The average deal size in Q3 increased 50% compared with the beginning of the year and reached 15 thousand sq m (at the end of 2013, the average deal size was 18 thousand sq m). In 2014, demand is driven by logistics companies (30% of the lots in 2014), production companies — 29% and retail chains — 19%.

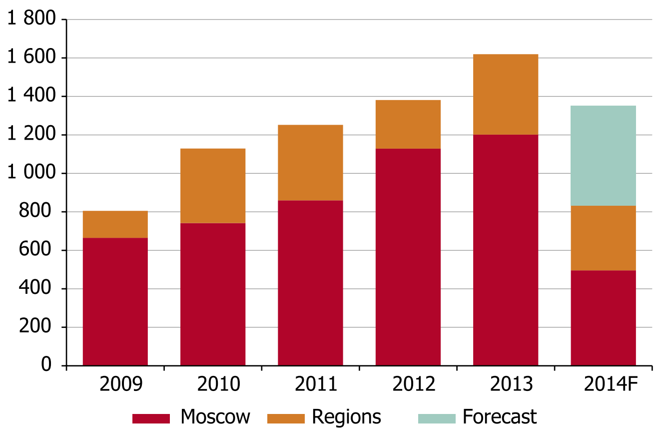
In the regions in Q3 2014, take-up was more than 150,000 sq m. This figure is twice higher than in 2008–2013. Sales transactions account for 16% of the total take-up. The average deal size in 2014 is 14 thousand sq m. Retail tenants were the most active on the market (58%). (20 ▶)

RENTAL RATES

By the end of Q3 2014, the average rental rate* in the Moscow Region for Class A space was within the $115—$125 range. We observe segmentation of rental rates, depending on direction, quality of the project and developer. For example, in the North-West direction, 20—30km from MKAD, average rental rates are $110—$115, in the South — $120—$125, the South-East — $100—$110, and the South-West — $130—$135, at the same distance from Moscow.

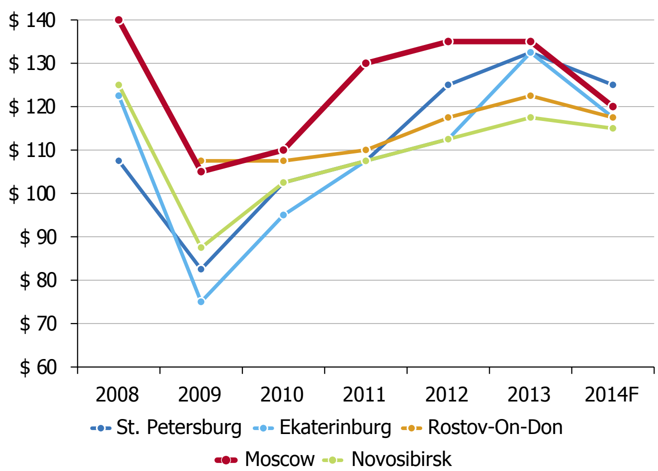
From the beginning of 2014 there is a trend of decline in US Dollar rental rates in the regions. The largest decline was observed in Ekaterinburg and St. Petersburg to $115—$120 and $120—$130 respectively. The share of headline rents in rubles is growing in regional projects. (21 ▶)

20 ▶ TAKE UP, '000 SQ M



Source: Cushman & Wakefield

21 ▶ RENTAL RATES IN MAJOR RUSSIAN CITIES CLASS A



Source: Cushman & Wakefield

* Rental rates are denominated in US$ per sq m, per annum, triple net

TRENDS

We expect that by the end of 2014 the total yearly take-up volume will be 30–40% lower than the 2013 results. The new construction outlook will be at 1.4–1.6 mn sq m. We forecast further increase in vacancy rate in the Moscow region.
The high vacancy rate will be the determining factor for the Moscow region market in 2015, tenants will have the opportunity to lease ready-to-move space, it will allow tenants of warehouse space to implement their projects in the short and medium terms, without construction risks and with the favorable commercial conditions.

In this situation, most developers will postpone new projects, which will lead to decrease of new construction in 2015.

In the regions, the high demand for quality warehouse space remains stable. The 2014 absorption level will be 50–70% higher than the average levels for 2008–2014. The decrease in rental rates will stop in most regions. The volume of new construction will be at 0,8–1 mn sq.m. (**22, 23 ▶**)

22 ▶ RENTAL RATES IN MAJOR RUSSIAN CITIES CLASS A

City	Avg base rental rates, USD / annum		Avg leased area, sq m
	min	max	
Moscow	$115	$125	10,000–15,000
St. Petersburg	$120	$130	2,000–10,000
Ekaterinburg	$115	$120	5,000–10,000
Samara	$110	$120	3,000–5,000
Kazan	$90	$100	3,000–5,000
Rostov-On-Don	$115	$120	3,000–5,000
Krasnodar	$110	$120	3,000–5,000
Novosibirsk	$110	$120	2,000–5,000

Source: Cushman & Wakefield

23 ▶ LEASE TERMS IN MOSCOW

		class A	class B
Net Rent Rates	$/sq m/year	115–125	105–115
Operating Expenses	$/sq m/year	30–40	15–25
Utility Charges	$/sq m/year	10–12	10–12
Yearly Rent Indexation		CPI–3%/ 3.5%	8–10%
Minimum Lease Term	years	5–7	1–5
Contract Security	months	3–6	1–3
Advance Payment	months	1	1
Contract Currency		USD/RUB	RUB
Minimum Lease Area	sq m	3,000	500

Source: Cushman & Wakefield

Hospitality – Moscow hotels in Q3 2014

Average occupancy across all market segments of Moscow hotels in Q3 2014 demonstrated a slight 4% decrease (66%) as compared to the same period of 2013. During Q3 2014 both Dollar and Rouble ADR (average daily rate) decreased (15% and 4% respectively) amounting to 201 US Dollars/7,168 Roubles. RevPAR (revenue per available room) nominated in US Dollars decreased by 20% and amounted to 130 US Dollars. RevPAR nominated in Roubles decreased by 7% and comprised 4,674 Roubles.

The **upscale segment** demonstrated a negative trend compared to Q3 2013. Dollar RevPAR dropped by 18% (188 US Dollars), while RevPAR nominated in Roubles – by 7% (6,734 Roubles). Such a result was reached by a 6% occupancy decrease (62%) and a 11% fall of Dollar ADR (303 US Dollars), while Rouble ADR remained unchanged, amounting to 10,841 Roubles.

Business hotels did not show better results in January–September 2014. Thus, US Dollar RevPAR decreased by 25% (109 US Dollars), which was composed of a 6% occupancy drop and a 18% fall of ADR nominated in US Dollars (167 US Dollars). The Rouble RevPAR decreased by 15% (3,911 Roubles) in line with a 7% ADR drop (5,985 Roubles).

A certain decrease of ADR and RevPAR was observed in the **midscale segment**, while the overall occupancy remained unchanged (72%). Both ADR and RevPAR nominated in the US Dollars dropped by 19% amounting to 131 US Dollars and 94 US Dollars respectively. The Rouble ADR and RevPAR decreased by 8% (4,680 Roubles and 3,376 Roubles).

It is necessary to point out that the extreme fluctuations of the US Dollar against the Rouble had a significant impact on further declines in the Dollar equivalent. As the US Dollar in January–September 2014 went up against the Rouble by 15.4% (comparing to the corresponding period of 2013), the Dollar figures showed a stronger decline than the Rouble.

An absolute gap in RevPAR between market segments has changed and demonstrated the following results:

• The variation between the upscale and midscale segments comprised 94 US Dollars/3,358 Roubles compared to 114 US Dollars/3,594 Roubles in the same period of 2013.

• The difference in RevPAR between upscale and business hotels slightly changed to 79 US Dollars/2,823 Roubles vs. the Q3 2013 results (85 US Dollars/2,681 Roubles). (24 ▶)

HOTELS OPENED IN Q1 2014:

• A new Raikin Plaza hotel opened in Moscow on Sheremetievskaya Street, 6/1 in the end of January 2014. The 54-room hotel offers a restaurant, a lobby bar, a conference room, a gym, a beauty salon and underground parking.

• A 4-star Intourist Kolomenskoe business hotel opened in March 2014 on Kashirskoe Highway, 39b. The hotel offers 259 rooms, a restaurant, four conference halls for 170 people, ground and underground parking.

• Renaissance Moscow Olympic Hotel located on Olympiyskiy Avenue, 18/1 was under Marriott management until mid-December 2013. In the end of April 2014 a 4-star hotel was re-opened after reconstruction under Azimut Hotels & Resort management and offers 486 rooms, seven restaurants, a bar, 16 conference halls, a business center, a banquet hall, a fitness center and parking.

• A new Hilton Garden Inn Moscow New Riga hotel opened at the end of March 2014 in Kostrovo village, 50 km away from MKAD on Novorizhskoe Highway. The hotel offers 164 rooms, a restaurant, seven meeting rooms, a business center, a fitness center, sports and children's playgrounds and a summerhouse with BBQ.

• A hotel, known as Marco Polo Lesnoy, started to operate under Heliopark Hotels & Resorts brand in the beginning of April 2014. Heliopark Lesnoy is located in Solnechnogorskiy area, Peshki village. The hotel offers 137 rooms, restaurants, conference-halls, a swimming pool, a sports ground and parking.

HOTELS OPENED IN Q2 2014:

• A new Mercure Baumanskaya hotel opened on Baumanskaya Street, 54, Moscow in May 2014. The hotel offers 47 rooms, a restaurant and parking.

HOTELS OPENED IN Q3 2014:

• Nikolskaya hotel is now being operated by Starwood Hotels and Resorts starting August 2014. The hotel is now called The St. Regis Moscow Nikolskaya. The hotel offers 210 rooms, three restaurants, two bars, a lounge area, three conference halls, a banquet hall, fitness and SPA centers with a swimming pool.

• A new 4-star Gallery Voyage hotel opened on Avtozavodskaya Street, 23, bld. 16, Moscow, at the end of August 2014. The hotel offers 560 rooms, a restaurant, conference halls, a fitness center, a sauna, a swimming pool and parking.

• A new Gorod hotel opened in the building of Kievskiy Railway Station in Moscow at the beginning of August 2014. The hotel offers 22 rooms, a lounge area and a

24 ▶ HOTELS OPENED AS OF OCTOBER 2014 IN MOSCOW AND MOSCOW REGION

Name	Room number	Address	Class
Moscow			
Four Seasons Moscow	180	Okhotny Ryad Street, 2	5 stars
The St. Regis Moscow Nikolskaya	210	Nikolskaya Street, 12	5 stars
DoubleTree by Hilton Moscow – Marina	270	Leningradskoe Highway, 39, ldg.. 1	4 stars
Azimut Moscow Olympic (former Renaissance Moscow Olympic) – rebranding	486	Olympiyskiy Avenue, 18/1	4 stars
Intourist Kolomenskoe	259	Kashirskoe Highway, 39b	4 stars
Raikin Plaza	54	Sheremetievskaya Street, 6/1	4 stars
Gallery Voyage	560	Avtozavodskaya Street, 23, ldg.. 16	4 stars
Mercure Moscow Baumanskaya	47	Baumanskaya Street, 54	3 stars
Gorod	22	Kievsky Railway Station	2 stars
Total: 9 hotels	**2088**		
Moscow Region			
Radisson Blu Airport Sheremetyevo	391	Moscow Sheremetyevo Airport	5 stars
Hilton Garden Inn New Riga	164	Novorizhskoe highway, Kostrovo village	3 stars
Heliopark Lesnoy (former Marco Polo Lesnoy) - rebranding	137	Solnechnogorsky area, Peshki village	3 stars
Total: 3 hotels	**692**		

Source: EY database, open sources, operators' data library. The developer of the project is Vipservice CJSC supported by RZHD public company.

• Hilton Worldwide announced the opening of DoubleTree by Hilton Hotel Moscow – Marina located on Leningradskoe Highway, 39, bldg.1, Moscow, in the middle of September 2014. The 270-room hotel offers a restaurant, a lobby bar, 10 conference halls, fitness and SPA centers with a swimming pool, a beauty salon and parking.

• The Carlson Rezidor Hotel Group opened Radisson Blu Hotel Moscow in Sheremetyevo Airport, Moscow region, at the beginning of September 2014. The hotel offers 391 rooms, two restaurants, a lobby bar, a 200-square-meter conference center, 47 meeting rooms and parking.

HOTELS OPENED IN OCTOBER 2014:

• Four Seasons Hotels and Resorts opened Four Seasons Moscow hotel on Okhotny Ryad Street, 2, Moscow, on October 25th, 2014. The hotel offers 180 rooms, two restaurants, two bars, a café, five conference halls, two banquet halls, fitness and SPA centers with a swimming pool and parking.

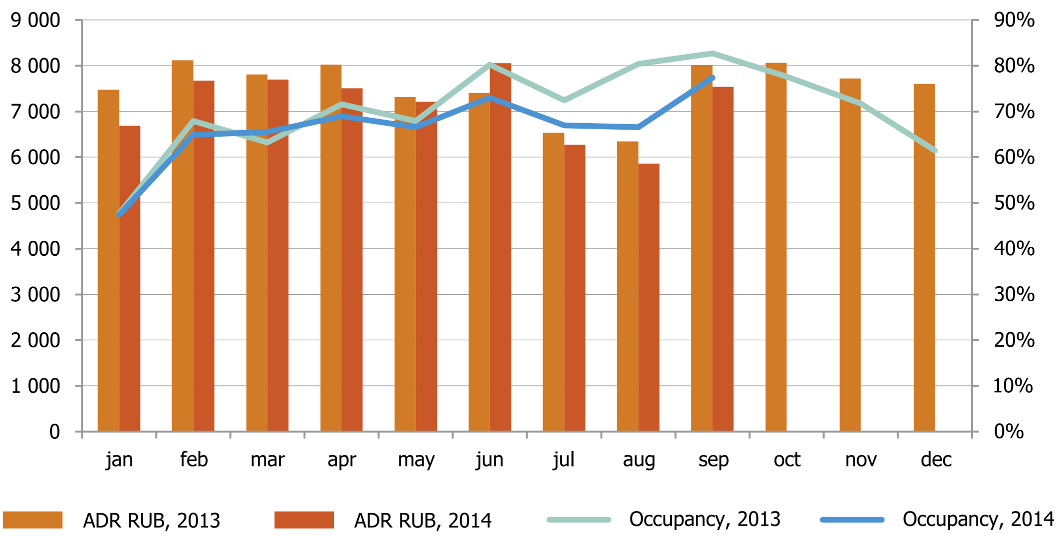
We expect the following hotels to open in 2014: (**25, 26, 27, 28, 29, 30 ▶**)

25 ▶ FUTURE HOTELS ANNOUNCED FOR OPENING IN MOSCOW AND MOSCOW REGION IN 2014

Name	Room number	Address	Class
Moscow Region			
Four Elements Borodino Club	160	Minskoe Highway, 100 away from MKAD	5 stars

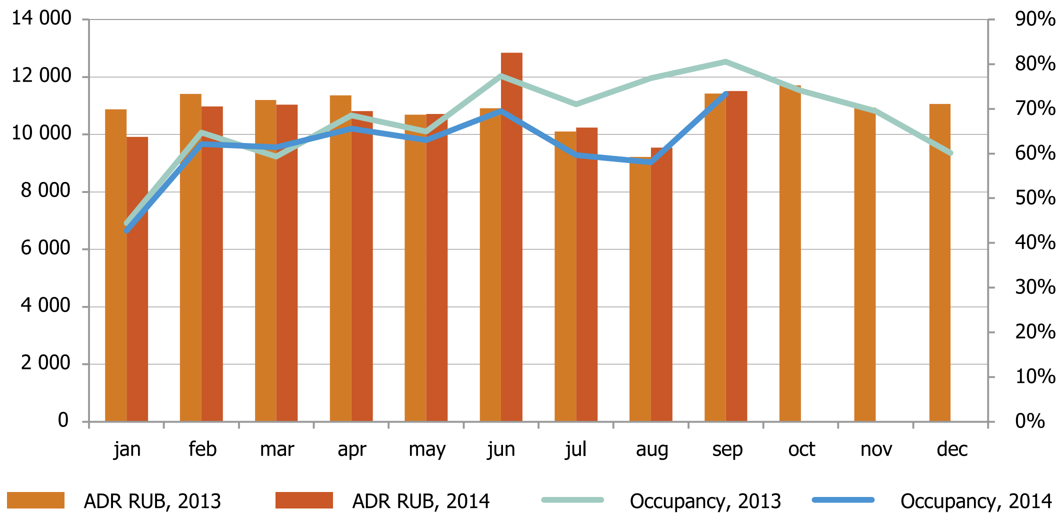
Source: EY database, open sources, operators' data

26 ▶ AVERAGE MARKET ADR (RUB) AND OCCUPANCY DYNAMICS, 2014 VS. 2013



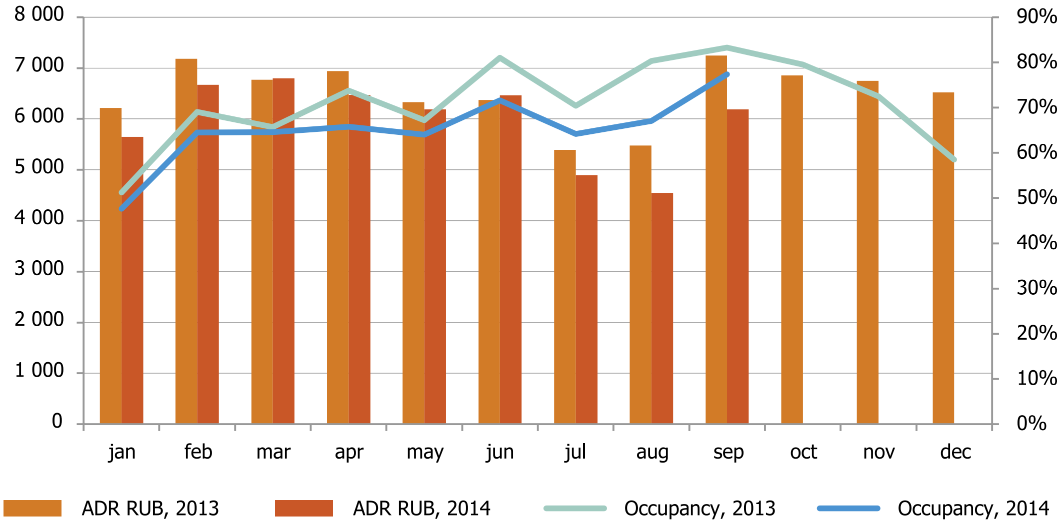
Source: EY analysis

27 ▶ 5-STAR HOTELS: ADR (RUB) AND OCCUPANCY DYNAMICS, 2014 VS. 2013



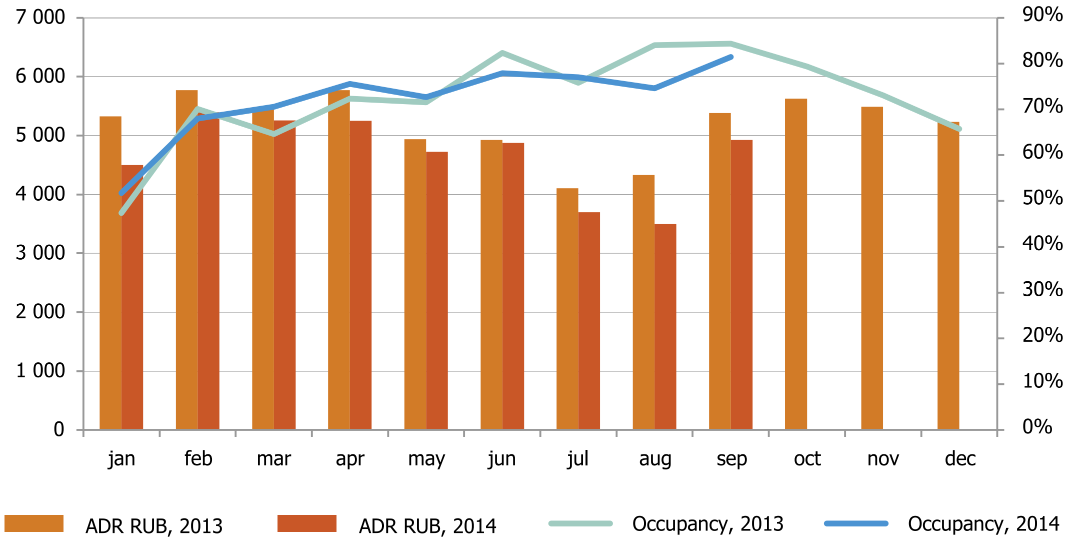
Source: EY analysis

28 ▶ 4-STAR HOTELS: ADR (RUB) AND OCCUPANCY DYNAMICS, 2014 VS. 2013



Source: EY analysis

29 ▶ 3-STAR HOTELS: ADR (RUB) AND OCCUPANCY DYNAMICS, 2014 VS. 2013



Source: EY analysis

30 ▶ OPERATIONAL INDICES DYNAMICS

	January - September 2014 (US Dollars/Rubles)	January - September 2013 (US Dollars/Rubles)	January - September 2014 / January – September 2013, %	2013
5 stars				
Occupancy	62%	68%	-6%	68%
Average daily rate (ADR)	303 $ / 10,841 RUB	342 $ / 10,798 RUB	-11 % / 0 %	343 $
Revenue per available room (RevPAR)	188 $ / 6,734 RUB	230 $ / 7,277 RUB	-18 % / -7 %	231 $
4 stars				
Occupancy	65%	71%	-6%	71%
ADR	167 $ / 5,985 RUB	204 $ / 6,437 RUB	-18 % / -7 %	205 $
RevPAR	109 $ / 3,911 RUB	145 $ / 4,596 RUB	-25 % / -15 %	145 $
3 stars				
Occupancy	72%	72%	0%	73%
ADR	131 $ / 4,680 RUB	162 $ / 5,112 RUB	-19 % / -8 %	164 $
RevPAR	94 $ / 3,376 RUB	116 $ / 3,683 RUB	-19 % / -8 %	118 $
Average				
Occupancy	66%	70%	-4%	70%
ADR	201 $ / 7,168 RUB	236 $ / 7,449 RUB	-15 % / -4 %	237 $
RevPAR	130 $ / 4,674 RUB	164 $ / 5,004 RUB	-20 % / -7 %	165 $

Source: Smith Travel Research, EY analysis

Moscow housing market

In October we have observed an almost 10% decrease in demand for high-end luxury apartments. This is a repeat of what has been seen in the June–July months of this year. This tendency is in accordance with the trends regarding the moving habits of families – most of the potential tenants have families and tend to plan their relocations before the start of the school year.

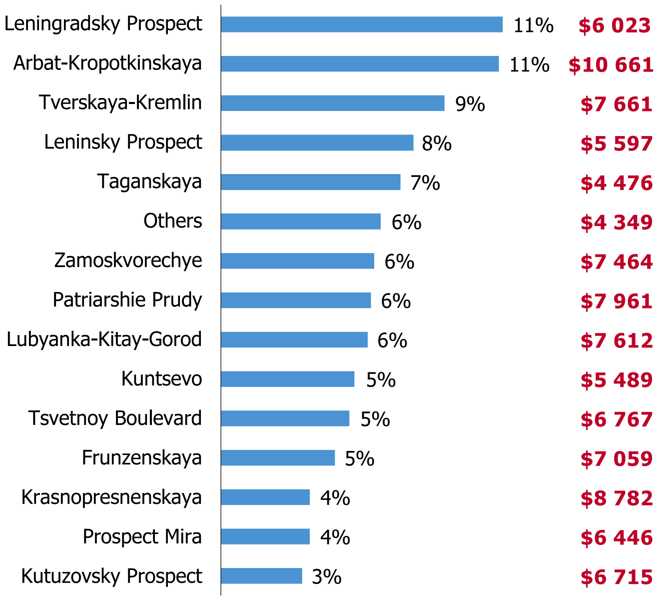
REVIEW

In October, it has been observed, the amount of high-end luxury apartments available for rent has increased by 2%. It appears to be an increasing trend that is leading to an over saturated market of high-end apartments in Moscow. This is especially true with apartments priced at $7,000 a month or higher. The market for apartments at budgets that high appears to be reaching a period of stagnation. (31 ▶)

As of previous, the most highly valued properties, comprising almost one fourth of the market, are situated in the Arbat-Kropotkinskaya area. On average, the rent balances out to $10,660 per month. This is 35% higher than the average value for high-end luxury apartments throughout Moscow. Although, it has been observed that the owners of such apartments are willing to allow for a 5–15% decrease in the initially proposed asking price in the process of negotiation.

Throughout this year we have noticed an increasing interest in properties for rent in the areas surrounding Leningradskiy prospect. In October the demand has risen to almost equal that of the demand for properties in the Arbat and Kropotkinskaya area. However, note that the average price for renting an apartment in Leningradskaya area is half the price ($6,000 monthly rent) in comparison to the most highly valued Arbat area. (32 ▶)

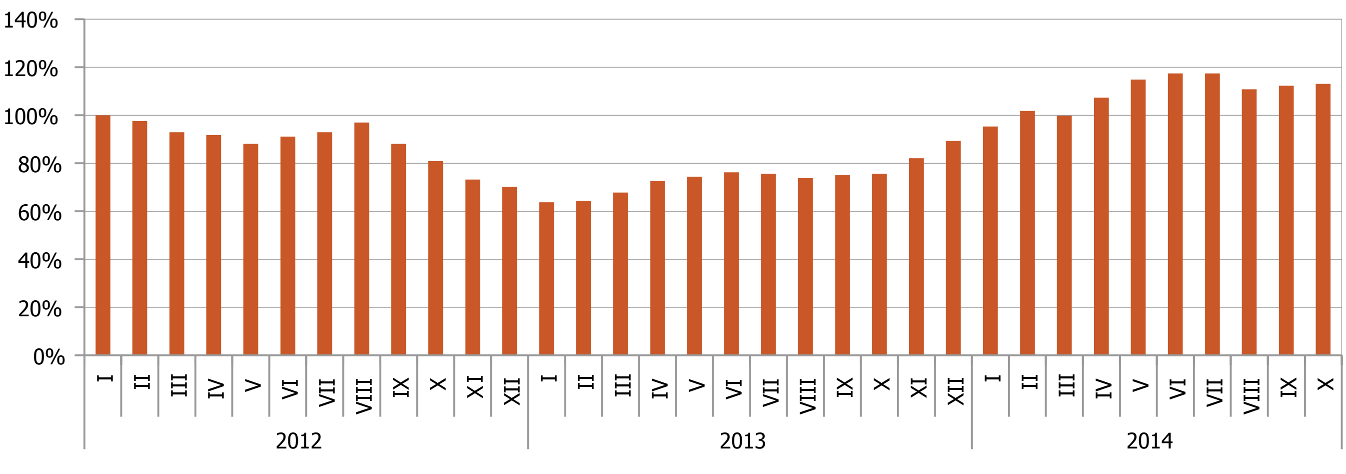
32 ▶ TERRITORIAL STRUCTURE OF SUPPLY IN THE RESIDENTIAL RENTAL MARKET OF MOSCOW (FIRST HALF OF 2014)



% - The share of the area in the structure of supply
$ - The average price per apartment per month in the given area

Source: Intermark Relocation

31 ▶ DYNAMICS OF THE SUPPLY OF MOSCOW'S PRIME RENTAL MARKET (JANUARY 2012 – 100%)



Source: Intermark Relocation

St. Petersburg market overview

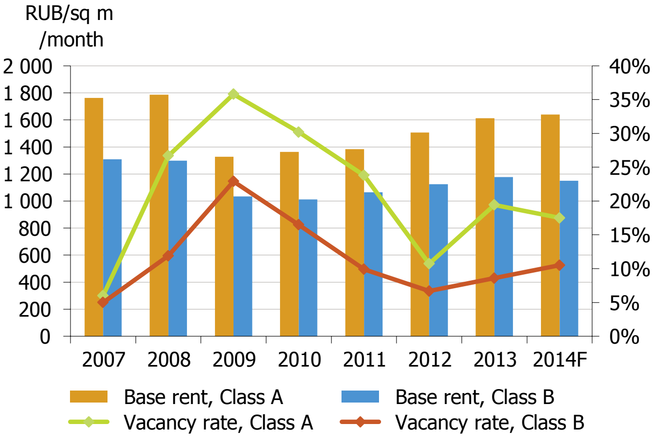
Office

Completion levels in Q3 2014 were the lowest quarterly result on record. In the third quarter 38,845 sq m in four office buildings were completed. Total modern office stock amounted to 2.552m sq m, which corresponds to 495 sq m per 1,000 inhabitants. Moskovskiy District secured the second place in terms of quantity of office space and it will hold the leading role in 2015–2016 in terms of new office space delivered to the market.

Net absorption levels in Q3 2014 were 38,480 sq m, which is 20% less than in the third quarters of 2009–2013. Moskovskiy District of St. Petersburg showed the highest results in terms of net absorption (30,850 sq m). It is also the leader during the Q1–Q3 2014. The transfer of Gazprom and its affiliate companies to St. Petersburg is the main reason for the leading role of Mining and Exploration in leasing deals structure. The market is highly dependent on the future transfer of Gazprom to St. Petersburg.

The average vacancy rate decreased in Q3 2014 from 12.2% to 12.0%. In Q3 2014 rouble rents slightly increased by 0.8% in Class A and fell by 1.9% in Class B. Average rental rate is equal to 1,640 roubles per sq m/month (including VAT and OpEx) in Class A and 1,170 roubles in Class B. Due to weakness of rouble, dollar rents in Class A segment slightly decreased by 1.3%, in Class B fell by 4.5%. (**33** ▶)

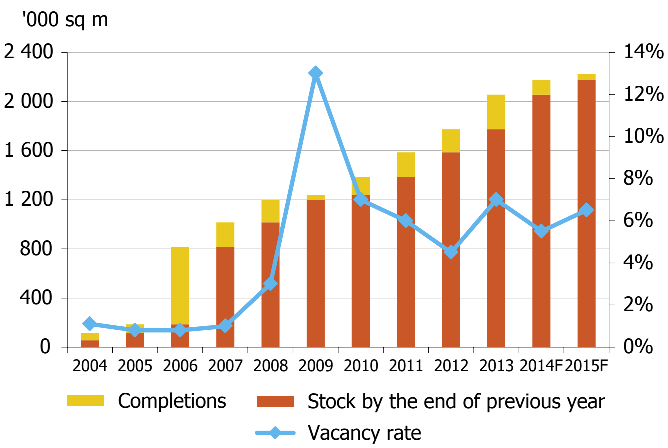
33 ▶ OFFICE MARKET BALANCE



Source: JLL

Shopping centre

34 ▶ SHOPPING CENTRE STOCK AND VACANCY RATE DYNAMICS



Source: JLL

According to the results of the first nine months of 2014 the size of the St. Petersburg retail market amounted to 2.098m sq m of quality retail space. (**34** ▶)

Two shopping entertainment centres with the total leasable area of 41,740 sq m were delivered to the market in 2014, both of them were commissioned in Q3 2014. This is the lowest volume for the last three years. Two shopping entertainment centres with a total leasable area of 77,250 sq m will be delivered to the market by the end of 2014. In Q3 2014 the vacancy rate in St. Petersburg SECs remained at 5.5%.

In Q3 2014 prime base rental rates for retail gallery space in quality shopping centres remained stable at USD2,000/ sq m/year (rents exclude VAT and OPEX). Along with this, during the quarter there were small rental rate changes for some tenant profiles. Retailers are increasingly pushing to renegotiate lease terms due to rouble weakness and the uncertain economic and political situation. In some cases developers are ready for compromises.

Street retail

In Q3 2014 we observed the prime rental rates decreasing on the main St. Petersburg street-retail corridors. The reduction was due to rouble weakness in July–September 2014. There was no common dynamic of rouble rental rates in Q3 2014, we saw rental rates growth in some locations, and rates decline in the others. In Q3 2014 the upper border of the prime rental rates was equal to USD3,100/sq m/year (without OpEx and VAT). Retailers prefer to focus on existing stores rather than driving growth through expansion. Given the current macroeconomic environment, the efficiency of each particular store becomes more and more important for retailers.

Warehouses

Total leasable area of 199,450 sq m of new warehouse space were delivered to the market in Q3 2014, this is the highest quarterly result for the last six years. Consequently the total volume of quality warehouse space was equal to 2,242m by the end of September 2014. 187,600 sq m of new quality warehouse space is planned to be delivered to the market by the end of 2014. If all announced projects are completed, the total volume of completions in 2014 will exceed 400,000 sq m, that is slightly less than the highest figures of 2007–2008. The share of owner occupied warehouse complexes is almost 50% in the future completions (till the end of 2015).

In Q3 2014 net absorption reached 142,060 sq m. This is the highest quarterly result since 2007. Total take-up in Q3 2014 reached 200,990 sq m, which is 60% more than in Q3 2013. The majority of the deals were built-to-suit deals. Retail companies held the leading position in terms of demand in Q1–Q3 2014 (48%).

In July–September 2014 vacancy rate increased to 4.0%. In Q3 2014 the asking rental rates decreased to USD120–125/sq m/year (without OPEX and VAT).

Hot Topic:

Lease of "future" property: is the cautious approach justified?

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Tair Suleymanov
Associate, Dentons, St. Petersburg

Almost two years have passed since the Highest State Arbitration Court of the Russian Federation ("HAC") issued Plenum Decree No. 13 dated 25 January 2013. This decree gave a new interpretation of RF Civil Code rules regulating lease arrangements, inter alia, allowing the execution of legally binding (for lessor and lessee) lease agreements for real estate where ownership title will be acquired by the lessor at a future date, i.e., so-called "future" properties.

Despite the unofficial "judge-made law" status of this decree (RF law does not recognize judicial precedents as a source of law, although lower-level state arbitration courts must comply with the HAC's position unless, in view of the merging of the HAC with the Supreme Court of the Russian Federation, the Supreme Court officially provides a different interpretation), business and its advisors seem to tend towards a conservative approach and treat this new opportunity for structuring lease relations with great caution, despite the advantages this opportunity gives.

In circumstances where the number of top-quality leasable areas (especially in class A business centers, premises complying with "green building" standards, etc.) is limited but the demand for such areas is more or less constant, both lessors and lessees may be willing to agree legally binding long-term arrangements for a property to be acquired by the lessor in the future, e.g., after its development.

Historically, the combination of preliminary and main (long-term or both short-term and long-term) lease agreements have been used in order to achieve the aforesaid effect. However, this structuring approach has always been subject to certain legal and tax risks related, in particular to the following:

- the execution of the main lease agreement cannot practically be forced;
- the legal status of any payments under a preliminary lease agreement is ambiguous, and consequently there is a risk of the provisions of a preliminary lease agreement regulating such payments being declared invalid;
- there is a risk that lease payments for actual use of leased property before the main lease agreements enter force may not be recognized as expenses;
- other risks related to compensation of inseparable improvements in the event of non-execution of the main lease agreements.

In a nutshell, the concept offered by the HAC provides for the following: the main lease agreement executed between the parties before the lessor has registered ownership for the leased real estate properties, as required under Russian law, is valid and has legally binding effect for the parties to such agreement, even though the agreement has not been registered in accordance with Russian law when necessary. Therefore, such agreement leaves no room for any of the parties to later insist on a change in the terms of an executed agreement (e.g., after construction of the leased property has been completed), unlike structuring options involving a preliminary lease agreement.

This means that a lessor and lessee have more comfort in terms of payments under such agreements, may use the wide range of securities for performance of their mutual obligations offered by Russian law, may actually start lease relations after the leased property is commissioned in accordance with Russian law, and their position is much less risky from the civil law and tax standpoints.

The argument commonly used by critics of the "future" property lease concept that this new concept does not have a legally binding effect on third parties (i.e., other than the lessor and lessee) is similarly applicable to the old structuring approach (preliminary and main lease agreements) and therefore cannot be considered a solid reason for not using the "future" property lease concept. Another area of concern is state registration of "future" property lease agreements in cases required under Russian law. There are doubts that the registering authorities are likely to register lease agreements for properties which do not officially exist. However, the HAC's interpretation does not provide for such an agreement to be submitted for state registration immediately after its execution. "Future" property lease agreements may be submitted for state registration after the leased properties have been duly commissioned, passed technical and cadastral registration, and the lessor's ownership of such property is registered. In such case a "future" property lease is no different to regular property lease agreements, and it is very unlikely that the registering authorities would have legal grounds to refuse registration of the agreement.

To summarize the above, we can conclude that the "future" property lease concept may be more beneficial and comfortable for long-term structuring of lease relations for property to be acquired in the future. We are already aware of several cases where this new structure was used, including one where the property (premises) should be acquired by the lessor upon the completion of a complex investment project and use of the old structuring option would not provide a sufficient level of protection of the lessee's interests. Therefore, we believe that the "future" property lease concept may be viewed as a worthy instrument for structuring lease deals to the benefit of all parties.

Hot Topic:

International hotel chains in Russia – 2015

Angelika Normann
Senior Manager, Hospitality & Leisure Advisory Services Leader, EY

According to the annual EY research of the international hotel brands' presence in Russia, in October 2014 there were 137 hotels under international management with a total room stock of 31,485 keys operating in the region. Therefore, over the last year 37 new hotels under international management were opened, while there were 100 hotels with the total room stock of 24,823 keys operating in Russia in October 2013. More than half of the existing room supply is concentrated in Moscow and St. Petersburg (57%), followed by Sochi (13%), the Moscow Region (5%), Ekaterinburg (4%) and other locations.

It is planned that by 2020 the number of hotels under international management will increase by 147 new properties (30,126 rooms). Thus, if all of the announced hotels do open, by 2020 the number of hotels under international management in Russia will amount to 284 hotels (61,611 rooms) in 55 locations. In this case, by 2020 the share of Moscow and St. Petersburg will decrease to 48%, Sochi – to 8% due to growth of branded hotel supply in the Moscow Region (7%) and Nizhny Novgorod (3%). Furthermore, the first branded hotels are planned to open in such locations as Anapa, Arkhangelsk, Barnaul, Belgorod, Cheboksary, Kemerovo, Khabarovsk, Kirov, Naberezhnye Chelny, Nizhny Tagil, Novokuznetsk, Novorossiysk, Pereslavl-Zalessky, Rostov-on-Don, Saransk, Stavropol, Togliatti, Tomsk, Ufa, Ulyanovsk, Vladivostok, Zelenogradsk.

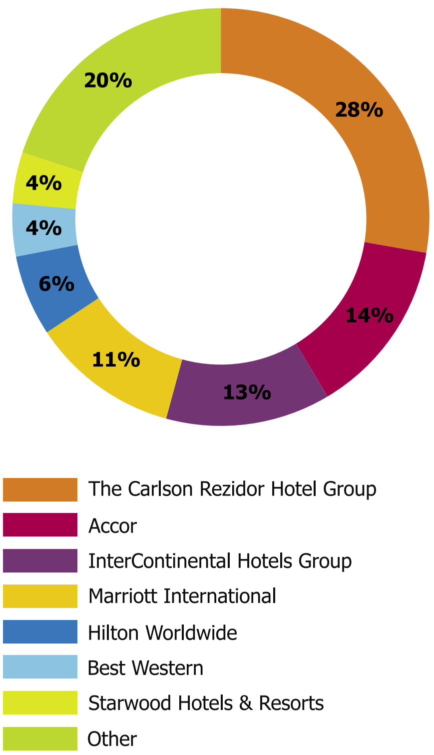
Nowadays the geography of international hotel operators' footprint is expanding due to a number of international-scale events held in Russia:

- APEC Summit in Vladivostok, 2012;
- World Summer University sport games in Kazan, 2013;
- Winter Olympic Games in Sochi, 2014;
- Formula-1 race in Sochi, 2014;
- FIFA World Cup in Russia, 2018.

For instance, 18 hotels (3,829 rooms) under international operation entered the Sochi market during 2012–2014, eight of them opened (1,462 rooms) in 2014. Today the hotels under international brands are located in 33 cities and towns of Russia. By 2020 this presence is planned to extend to 55 cities and towns. Russia remains primarily a business tourism destination for both foreign and internal tourists. As Moscow and St. Petersburg are the largest business centers of the country, they stay on top of the international hotel chains' 'target destinations' lists.

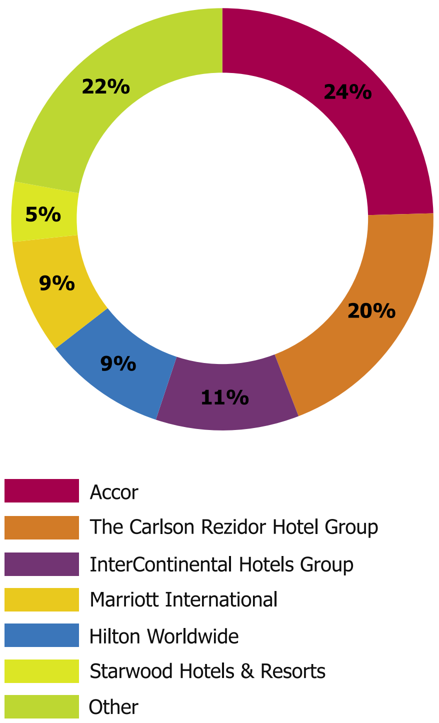
The total branded room stock available in Russia as of October 2014 (i.e. 137 hotels, or 30,126 keys, in 33 locations) is operated or franchised by 23 international hotel chains currently presented in the region. The biggest market share (66%) is divided between The Carlson Rezidor Hotel Group, Accor, InterContinental Hotels Group and Marriott International. The graphs below demonstrate the actual and projected footprint of hotel operating companies in Russia. (**35, 36** ▶)

35 ▶ SHARE OF HOTEL OPERATORS – DISTRIBUTION OF EXISTING ROOM SUPPLY, RUSSIA (AS OF OCTOBER 2014)



Source: hotel operators' data, EY analysis

36 ▶ SHARE OF HOTEL OPERATORS – DISTRIBUTION OF FUTURE ROOM SUPPLY BY 2020, RUSSIA (INCLUDING EXISTING ROOM SUPPLY)



Source: hotel operators' data, EY analysis

Furthermore, development of the Russian hotel operators and their presence on the international market should be noted. Generally, national hotel brands hold a significantly smaller proportion in most countries' markets (except the U.S.), than hotels under international management. A similar trend was observed in the Russian market: currently the portion of hotels under international brands (137 hotels) is almost twice as much as those under national management (72 hotels).

Nevertheless, Russian hotel operators borrowing international experience, continue their development, and open new hotels both in the regional market and abroad. The largest Russian hotel chains are presented by Azimut Hotels, Amaks Hotels & Resorts, Heliopark Hotels & Resorts, Intourist Hotel Group, Cronwell Hotels & Resorts, Korston Hotels and others.

HOTEL CHAIN AFFILIATIONS – MAIN BENEFITS

It is a prevailing opinion among hotel developers and owners – both local and foreign – that a global chain affiliation is an indispensable component of a hotel's success. Moreover, recently banks and other lenders have begun to recognize the key role of management in hotel business by providing more favorable terms to developers with an appropriate chain affiliation. Institutional, financial, and other passive investors, that view hotel assets as attractive investment targets, also typically prefer to "separate bricks from the brains" and purchase managed hotel properties where they do not have to be involved in operations. This applies not only to future owners (seeking hotel concepts and operating projections development), but also for existing hotel owners who admit that they "have squeezed the maximum" out of their properties as independent hotels and are now looking for global chains to assist in boosting performance even further.

Despite the demonstrated tendency towards global chain affiliation, hotel owners should not disregard the independent operation option. Without advocating for either option, below are the main benefits an owner may anticipate from global hotel chain affiliation. (**37 ▶**)

37 ▶ MAIN BENEFITS FROM GLOBAL HOTEL CHAIN AFFILIATION

Benefit	Comment
Recognition	Recognizable hotel brand is perceived as a quality guarantee
Property status	International brand allows to raise property status
Safety	Foreign tourists prefer to stay in hotels under well-known international brands in «unsafe» countries
Global booking system	Opportunity of booking via different electronic channels, search simplicity, booking without intermediaries
Integrated marketing	Integrated marketing allows brand promotion cost reduction due to the hotel's presence on operator's website, in booking systems, catalogs and brochures
Loyalty programs	Guests who join chain's loyalty program are motivated to choose hotels of this brand due to various benefits and discounts for regular guests
Level of service	Common service standards, management systems and staff training unification in chain hotels result in a higher level of service than in independent hotels
Stability in crisis time	Chain hotels are more sustainable to crisis for a number of reasons: more stable demand from loyal guests, efficient occupancy management due to several global reservation systems; highly skilled professionals with working experience under unstable economic conditions
Lower costs	Hotel chains guarantee lower costs of consumables, engineering maintenance, advertising and marketing costs due to the large purchase volume and costs distribution among all the hotels in chain
Investors' risk decrease	International brand lowers risks and provides great advantage when selling a property and granting a bank loan

Source: EY analysis

Hot Topic:

Russian real estate laws: top changes 2014

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Valentin Borodin
Partner, Real Estate Practice, Brandi Partners

From the beginning of 2014, the laws of Russia in real estate, construction and land matters have been significantly changed affecting the interests of many Russian commercial real estate market participants. This article outlines the most important changes adopted or entered into force in the current year.

1. LARGE SCALE AMENDMENTS TO THE LAND CODE OF RUSSIA RELATING TO THE ISSUES OF ACCRUAL, TERMINATION AND EXERCISE OF RIGHTS TO LAND PLOTS AS WELL AS OTHER SIGNIFICANT CHANGES

These amendments are primarily introduced on the basis of Federal Law No. 171-FZ dated 23 June 2014 On Amending the Land Code of the Russian Federation and Certain Legislative Acts of the Russian Federation (Law No. 171). They constitute a reform of the Land Code of Russia and affect the interests of all real estate market participants (investors, developers, owners), in particular, of those acquiring rights to the public lands for construction. The reforming, in particular, relates to:

• current ways of acquiring rights to public lands;
• special cases of acquiring rights to public lands;
• setting easements and new ways of acquiring rights to public lands;
• conditions of public land lease agreement.

Apart from the above mentioned amendments introduced by Law No. 171, a number of important amendments to the Land Law of Russia have been also adopted on the basis of Federal Law No. 234-FZ dated 21 July 2014 On Amending Certain Legislative Acts of the Russian Federation. In particular, this federal law details the standards on land protection and state monitoring of lands, introduces the standards determining and regulating the procedure for municipal land control and sets the definition and the purposes of common land control.

2. AMENDMENTS TO THE CIVIL CODE OF RUSSIA WITH REGARD TO LAND MATTERS

Based on Law No. 171, the important amendments have been also introduced this year to the Civil Code of Russia, which significantly affects the interests of lessees of public land plots carrying out construction works at such plots. Thus, the Civil Code of Russia is supplemented with article 239.1 providing for termination effect of the public land plot lease agreement entered into following the results of auction. In particular, the right of the lessor (state or local authority authorised to dispose of a land plot) to take legal action demanding forced sale of the facility under construction located at such plot through public bidding is provided for.

3. AMENDMENTS TO THE URBAN PLANNING CODE OF RUSSIA

The important amendments in real estate have been introduced this year to the Urban Planning Code of Russia on the basis of Federal Law No. 224-FZ dated 21 July 2014 On Amending the Urban Planning Code of the Russian Federation and Certain Legislative Acts of the Russian Federation (Law No. 224). In particular, Law No. 224 sets new tools for providing owners with land plots for integrated urban development or cultivation of the areas previously built-up subject to construction of low-income housing at such land plots and sale at a fixed price determined following the results of the auction. In addition, Law No. 224 provides for two new types of agreements: an agreement on area urban development for low-income housing construction and an agreement on integrated area urban development for low-income housing construction and determines the requirements to such agreements as well as the procedure for entering into such agreements.

4. CHANGES IN THE TAX LAWS OF RUSSIA ENTERED INTO FORCE IN 2014

Among the most important changes in the tax laws of Russia entered into force in 2014 and affecting the interests of many real estate market participants, the following ones should be noted:

• Transition to cadastral value in taxation of entities' property with regard to certain real estate facilities from 1 January 2014.

The legal framework for such transition is Federal Law No. 307-FZ dated 2 November 2013 On Amending Article 12 of Part One and Chapter 30 of Part Two of the Tax Code of the Russian Federation. Amendments introduced by this federal law affect the interests of the owners of office and trade centres as well as of the owners of non-residential premises designated for offices, retail facilities, public catering and consumer services facilities. Thus, from 1 January 2014, the property tax with regard to such facilities is calculated on the basis of real estate cadastral value but not on the basis of net assets value. For this purpose, the maximum rates of property tax with regard to real estate facilities, the tax base of which is determined as a cadastral value, are set at the federal level. Thus, for Moscow the rate may not exceed 1.5% in 2014, 1.7% in 2015, and 2% in 2016 and thereafter. For other constituent entities of Russia the rate shall not be more than 1% in 2014, 1.5% in 2015, and 2% in 2016 and thereafter.

It should be noted that the extremely adverse effect of transition to cadastral value in taxation of the entities' property with regard to the above mentioned real estate facilities is a significant increase in the property tax for many owners of commercial real estate facilities both in Moscow and in other cities of Russia.

• Change in the date of determining VAT base in real estate sale from July 1, 2014.

Now, the tax base is to be determined not as of the date of state registration of ownership transfer but as of the date of real estate transfer under a transfer and delivery certificate. The legal framework for such innovation is Federal Law No. 81-FZ dated 20 April 2014 On Amending Part Two of the Tax Code of Russia.

5. CHANGES IN THE PLEDGE LAWS ENTERED INTO FORCE IN 2014

On 1 July 2014, Federal Law No. 367-FZ dated 21 December 2013 On Amending Part One of the Civil Code of the Russian Federation and Invalidating Certain Legislative Acts (Provisions of Legislative Acts) of the Russian Federation (Law No. 367) introducing large scale amendments to the Civil Code of Russia in pledge relations entered into force.

As to real estate matters, Law No. 367 has set certain peculiarities for mortgage. Thus, according to the adopted amendments, a real estate mortgage may be recognised as an independent obligation, e.g., it is accrued, exists or is terminated regardless of the underlying obligation. That means that invalidity of the underlying obligation (for example, loan agreement) does not result in termination of mortgage and vice versa. Real estate mortgage is independent and encumbrances the owner's property. It should be noted that from 1 January 2015, in the course of reforming the civil laws, it will be possible to determine the obligations secured with a pledge (including mortgage) by specifying the pledge of all owner's property or a part thereof as well as to describe pledged property in any way that allows identifying the property as a pledged property as of the date of enforced seizure, including by specifying the pledge of all owner's property or a certain part thereof.

It should be also noted that, according to the amendments, the rules for mortgage agreement state registration will not apply to mortgage agreements entered into after 1 July 2014. However, the rules for necessary state registration of a mortgage as a restriction to the rights to a real estate facility remain in force. These amendments are aimed at eliminating ambiguity of agreement registration and right restriction resulting therefrom.

6. AMENDMENTS TO THE ADMINISTRATIVE OFFENCES CODE OF RUSSIA

Among the most important amendments to the Administrative Offences Code of Russia (the Administrative Offences Code of Russia) in 2014 affecting the interests of real estate market participants, the following ones are worth noting:

• The fines for misuse of farming lands are increased

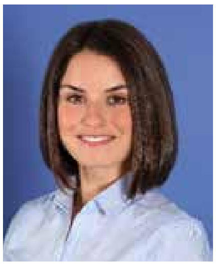
The framework for such increase in the fines is Federal Law No. 6-FZ dated 3 February 2014 On Amending the Administrative Offences Code of the Russian Federation, according to which a fine for misuse of farming lands is charged currently taking into account the cadastral value of a land plot.

• It is planned to increase significantly the fines for unauthorised land occupation

Such increase in the fines is provided for in Draft Law No. 510495-6 On Amending the Administrative Offences Code of the Russian Federation being under consideration of the State Duma. In case such draft law is adopted, the fines for unauthorised land plot occupation may be increased 20 and more times. This draft law also offers to set increased fines for persons that have occupied farming lands. In addition, the fines for misuse of lands as set in article 8.8. of the Administrative Offences Code of Russia may be increased. For this purpose, the fines will be calculated on the basis of the cadastral value of a land plot.

Hot Topic:

Hotel Franchising in Russia and the CIS



Olga Fazullina
Manager, Hospitality & Leisure, KPMG

As the market matures, more investors are showing a willingness to get into hotel management and to structure their own professional teams. Representatives of major hotel chains operating in the Russian market claim that in recent years more owners have been requesting franchising agreements and not management contracts. The majority of international hotel chains in Russia and the CIS are still not ready to entrust the management of hotels under their brand to investors with no related industry experience. That said, the degree of strictness applied in reviewing investor profiles varies from one hotel company to the next; for example, Marriott International Inc. accepts the franchising model only if the management company that will run the hotel is on the list of Marriott's approved companies. Wyndham prefers to expand its presence in the region by opening hotels under its brands in collaboration with known-in-the-market Russian and international third-party operators, while Intercontinental Hotel Group, Accor and some other chains are prepared to consider entering into franchise agreements with less experienced owners.

The majority of franchise agreements in Russia and the CIS are signed for budget/midscale brands, such as Hampton by Hilton, Holiday Inn Express, Days Inn, Novotel, and Courtyard by Marriott. It is very unlikely that hotel chains would entrust to individual investors the management of their top brands (Ritz Carlton, Sofitel, Planet Hollywood, W, etc). This can be explained not only by the reputational risks involved in such a move, but also by the higher margins that luxury hotels generate for management teams.

Each hotel company has its own strategic priorities in terms of the geographical location of their managed/franchised properties, and not all markets in Russia and CIS are equally attractive for brands. The majority of companies agree that the most promising CIS countries in terms of development are Azerbaijan, Kazakhstan, Georgia, Armenia and Ukraine (as soon as the current geopolitical situation stabilises). Attitudes vary among hotel chains when it comes to entering new markets. Some are ready to expand into unexplored locations only through franchises, due to the lower operational risks franchise agreements provide; however, some chains are prepared to manage properties in such destinations to ensure that the brand's reputation and standards do not suffer under local management. Countries such as Uzbekistan, Tadzhikistan, Kyrgyzstan and Turkmenistan are of interest for hotel operators primarily in terms of getting established in the capitals of these countries.

In Russia, hotel companies are interested in significantly expanding into regional cities. As the targets of hotel companies in terms of the number of operating hotels in regions grow, smaller cities are becoming more interesting for brands. Regional cities have a cap that can be achieved for ADR, consequently there is a business rationale for developing mainly midscale and budget brands in such destinations. The potential margins of such properties do not always motivate hotel chains to take full responsibility for operations; in addition, paying a fee to engage a hotel chain to run the property will not necessarily bring added value to the owner. Thus franchising represents the most optimal method for brands to develop in regions.

HOW MUCH DOES IT COST?

Key issues to consider during the property franchising decision-making process is fee structure and amounts to be paid. Some structures differ from operator to operator; we have consolidated the general conditions an investor may come across in the majority of franchise contracts. Most of the figures are confidential; for convenience we cite some ranges.

A typical fee structure involves:

• An initial fee payable by the franchisee on the execution of the Franchise Agreement associated with the initial granting of rights and costs incurred by the franchisor. Its aim is to cover the operator's initial costs, (i.e. from reviewing the site, market potential analysis, evaluation of the hotel's plans/existing layout). The initial fee typically takes the form of either an amount based on the hotel's room count or a fixed amount. This fee is sometimes non-refundable.

• The royalty fee is a recurring fee the franchisee pays to the franchisor, and covers the use of a trademark and a trade name, as well as continuing franchise services. The fee is typically based on room revenue and usually varies between 4 and 5 percent of gross room revenue. Some operators add 2 percent of F&B revenue to room revenue.

• The technical services fee covers the brand's costs during the provision of ground support to the franchisee development team related to the design and development of the hotel. A technical service agreement (TSA) ensures that after a project has been completed it complies with brand standards and is operationally efficient. Technical fees usually range from USD500 per room for rebranding projects to USD1,000 for greenfield projects.

• The marketing fee covers an operator's various promotional activities related to increasing brand awareness among the target audience and developing new brand initiatives. The fee, which is usually based on gross room revenue and sometimes on total revenue, typically ranges between 2 and 3 percent of room revenue or 1 and 2 percent of total revenue.

• The reservation fee covers costs associated with an operator's reservation system, such as central office operations, respective personnel, and all distribution-related fees. Rates and the way they are calculated vary between different operators and depending on which systems they use. Rates may be charged as a percentage or a fixed amount charged per booking, depending on the brand.

• The loyalty fee is part of a franchisor loyalty programme. Often the fee is calculated as a percentage of total revenue generated by loyal guests, and typically ranges from 3 to 5 percent.

Depending on the operator and project there may be additional system and technical support services provided by the hotel chain and related fees stipulated in a contract. Another common requirement, cited by all hotel chains, is that the general manager of a property must be approved by the brand. Some franchisors offer extra services for franchised properties. IHG, for example, provides staff outsourcing services for such key hotel positions as revenue manager or general manager, as well as hotel performance support (several visits per year, assistance on reviewing marketing/sales plans and strategies etc., in order to maximise owner profit).

THIRD-PARTY OPERATORS – EXTRA BENEFITS OR EXTRA COSTS?

Another option for managing a hotel property is to attract a third-party management company which specialises in providing such services for hotels. A professional third-party management company can benefit inexperienced owners who do not wish to be involved in the hotel's day-to-day operations, and engaging such a company does not necessarily mean in practice having a three-sided arrangement between the brand providing the franchise, the management company running the hotel, and the owner. Third-party management companies are able to more objectively advise owners on whether they should brand their property – some hotel projects may not obtain any added value by having an international brand name; however, having an experienced management team in place, whose remuneration is linked to hotel performance, will most likely benefit the owner.

Such third-party companies generally work with a number of hotel chains and brands and may propose a number of options to owners suitable to each project. When suggesting a brand, they tend to be more interested in the potential performance of a project than in promoting a particular hotel chain. During the construction phase, the third-party management company can help owners avoid unnecessary costs and align a property to the standards of several brands if a brand has not been chosen. Investors that plan to operate a number of properties, and are unsure about committing to a particular brand, would be better suited working with one third-party operator that manages their properties under various brands, or no brands at all. This would also allow the management company to cluster some positions, and thus improve the operational efficiency of the managed hotels.

The combined fees of a third-party operating company and the franchise fees for the brand will most likely equal or exceed those of signing one direct management contract with a hotel company. However, such a dual structure gives extra flexibility to owners, since the terms of management contracts with third-party companies are usually shorter than those with hotel chains (10–15 years, vs. 20–25). In addition, management contract termination clauses are usually less stringent, and if an owner is not happy with the brand or management company it is easier to replace one of them rather than terminate the direct management contract with the hotel chain. In such cases any negative impact on the hotel's day-to-day operations will be minimal and the investor will incur fewer losses.

A number of international companies operate hotels in Russia and CIS, including Interstate Hotels &Resorts. The company was the first to establish in the region and has the biggest portfolio of brands and hotels under management (13 properties, with over 4,000 rooms). Hotel chains are keener to entrust upper-scale brands to international management companies (Interstate Hotels & Resorts, Sophos Hotels, Vienna International) when signing franchise agreements. However, local competitors are also gaining in terms of both experience and in the number of properties they manage. Companies such as BS Hospitality management and IFK Hotel Management currently operate properties under the brands of one hotel company (Hilton and Louvre Hotels, respectively); however, IFK in a recent interview with us stated that to become more competitive in the market it plans to expand in the near future its portfolio of brands.

CONCLUSION

In order to arrive at a conclusion on the expansion of franchising in Russia and CIS, we analysed operator pipelines in terms of the number of franchised vs. managed hotels. No specific trend appears to unite all brands operating in the market or clearly demonstrates that franchising has become a development priority for all hotel chains. Some hotel companies are more proactive in implementing this structure than others, but, that said, an overall increase in the number of franchised hotels in the market pipeline can be observed.

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