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B2B: How Political Instability Will Affect Investment in Russia

By Tim Millard

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Recently I was asked the following three questions by a client:

Your view on the geopolitical and economic situation and outlook in Russia.

Consequences of the first point for a) real estate investment markets and b) real estate bank financing.

Consequences for the local vs. international investors.

As I felt that quite a few people may be wondering the same things I thought I would share my answers as follows:

1. Inherently uncertain! My working assumption is that there is too much at stake in terms of economic damage for there to be significant further escalation. I continue to expect (hope for) steps towards stabilisation which will therefore allow the European Union to water down or abandon the next round of sanctions. The sanctions that are already with us are likely to stay in force for an extended period of time.

This would mean that the economy would return to its pre-crisis path, after a period of lost activity, sometime in early 2015. A lot of goodwill has been squandered on both sides, and trust levels are therefore very low — this means that there are significant downside risks. This is particularly the case as the end game for Russia is not clear.

Although I am inclined to the above scenario there is the possibility that the Ukraine situation will accelerate a process in Europe of diversifying gas supplies and reducing reliance on Russia. In the longer term this has the potential to be very damaging. The declining oil price could also start to have a very significant impact.

2. Real Estate investment markets are likely to mirror the broader economy. Once again we are seeing a divergence in expectations between buyers and sellers and therefore in the absence of some degree of distress we are unlikely to see any transactions. Potential sellers have no incentive to part with their assets when pricing must clearly have moved away from its last peak. As commercial real estate is a forward-looking asset, potential purchasers require stability — it does not matter at what level but they do not want to risk buying into a falling market. Buyers will also therefore largely be waiting to see when stability has returned to the market. This means an understanding that rents are stable with some opportunity for growth and that there is a clear understanding of market cap rates. The only question is how long this will last and this will depend to a large extent on external factors — not least the availability of debt.

Investment will be affected by the availability and cost of debt and the affect will be significant. New debt will become scarcer, more expensive and on less favourable terms. This will slow activity in the market and will inevitably push yields out.

We will not be able to identify the moment when the investment market starts to return until after the event. However, I do not expect that genuine arms lengths transactions will be visible in the market until at least the second half of next year.

When the momentum starts, though, I expect it to gather pace and potentially reasonably quickly. There is plenty of interest in the Russian story waiting for the right conditions to invest.

3. Depends entirely on the respective attitudes towards risk. Ordinarily in times of stress in the market local investors understand the risks better and are therefore more active. In addition, under current conditions local investors may have less opportunity for investment overseas and less options as to where to put this money. There is a belief that Russian money returning home will be a significant factor in the market but we have not seen it yet.

However, international investors are likely to have a lower cost of capital and the next few months may therefore represent a very good buying opportunity.

Another point worth making is that development finance will become even rarer than senior debt. I therefore expect a large slowdown in the starting of new construction and this will lead to a constriction in supply starting two to three years from now. It is well worth once again looking at the supply patterns from 2008 onwards as I expect a similar patter this time around (see below). I therefore firmly believe that it is a good time to be starting developments, assuming starting construction in 12-18 months from now — as you will be delivering into a thinner market (and there will have be an opportunity for the overhang of supply in the case of the office sector to have been reduced) and will therefore have an inbuilt competitive advantage. This is largely true for all sectors but quality of the product and location remain of vital importance.

Those were my answers, although I have also heard a number of different views. While I am writing I would like to say this:

Sometimes the deluge of negative news is so unrelenting that you inevitably get overwhelmed by it. However, perhaps a broader perspective or even a completely new way of looking at things can throw up some interesting insight. What if the times that we are living in now, in Russia, actually represent a glorious opportunity? What if we were to look back at this point from the future and wish that we had had the courage or inspiration to do the unexpected? For those of us, like JLL and me, who are committed to this market these perhaps are exciting times!

In all sectors there are supply increases this year meeting softening demand...if you are in Russia for the long haul (and you should be, shouldn't you?) is now not the time to tie up your real estate needs for the medium term or to pursue that investment opportunity? You will probably be very glad that you did!

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