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# URBAN REAL ESTATE MARKETS IN RUSSIA: THE CURRENT STAGE

by Olga Kaganova, CRE

*For international investors who are thinking about "windows of opportunity" in Russian real estate, it might be useful to systematically monitor the success of real estate reform and market activity in different Russian cities to identify the most promising places.*

**S**COPE OF PRIVATIZATION  
There is no doubt that urban real estate markets are quickly emerging in Russia due to the high turnover of privatized properties. But privatization itself exists unevenly across subsectors and geographical regions.

On average, more than 50 percent of the residential stock is already privately owned, varying from 30 to 95 percent in different cities. In fact, anyone who wished to obtain ownership in an apartment which he or she occupied has already done so early in the transition. Therefore, the share of privately-owned housing has been increasing slowly during the last three years (three percent in 1996).<sup>1</sup>

No national statistics exist about privatization of commercial and industrial buildings and premises, but indirect data indicate that the share of privately-owned properties may be high. For example, by the end of 1996, in St. Petersburg it was 25 percent.<sup>2</sup>

Because buildings and land are separately regulated,<sup>3</sup> privatization of the building stock has been proceeding without privatization of underlying land sites. Until 1995, almost no urban land was privatized for any commercial or industrial use. Only families had the right to obtain small plots for gardening or single-family homes. By November 1996, 2,927 enterprises across Russia obtained ownership titles to their sites, with a total land area of 36,500 acres, and land privatization applications for another 2,824 enterprises were processed.<sup>4</sup> This process is geographically uneven: a few cities and regions account for more than 50 percent of these purchases, and by December of 1995, 40 percent of regional administrative units had not even begun land sales to enterprises. St. Petersburg is the country's recognized leader in the privatization of commercial and industrial land. By April 1997, more than 1,500 privatized enterprises and businesses in the city purchased underlying land sites. *Table 1* demonstrates the

**Table 1**

Land Inventory for Ryazan and Chelyabinsk (as of July 1, 1996)		
Indicators	Ryazan	Chelyabinsk
Population (thousands)	537.2	1,111.1
<i>Land inventory</i>		
1.1 Area of documented tenure* of any kind (percent of total city area);	14.9	10.8
1.2 Area of documented private ownership (percent of total city area);	0.82	8.7
In particular:		
Area owned by families (for single-family homes or gardening)	0.38	8.6
Area owned by legal entities	0.44	0.1
1.3 Area of public lands leased out (percent of total city area);	11.4	1.8
In particular:		
Long-term lease (more than 15 years)	3.1	0.7 (both long-term and mid-term)
Mid-term lease (5 - 15 years)	7.1	
Short-term lease (up to 5 years)	1.2	1.1

Source: *Urban Real Estate Reform Indicators*, the pilot project of the Urban Institute in two Russian cities.

Note: \* The "documented tenure" means that land users have valid legal documents confirming their land rights. The absence of such documents usually means that a land user has been occupying a parcel for a long time (since obtaining the parcel during the Soviet era) and has not yet undergone the documentation process in correspondence with the current land legislation.

difference in land privatization policies in two provincial Russian cities.

Russian cities have practically not sold any vacant land to developers. As a result of delays in land privatization, the private land market for development is in an embryonic stage and there is a strong shortage of land available for market-oriented construction. Not surprisingly, land, which was privatized underneath enterprises, has experienced heavy market turnover. For instance, in Ryazan during the first half of 1996, 130 sale transactions happened with only 187 land sites owned by legal entities. This is 139 percent turnover rate per year!

Many cities, including Moscow, have declared their intention to develop a market of long-term lease rights for land rather than ownership rights.

Nevertheless, experience so far has indicated that land lease rights on public land are not transferable.

#### LOCAL AUTHORITIES AS ACTORS IN THE REAL ESTATE MARKET

Local (regional and municipal) authorities are major players in real estate. First, the state and municipalities continue to own a large share of real estate. As is clear from above, almost all urban land is publicly owned. Furthermore, local authorities are the biggest landlords for non-residential buildings and premises which they lease to private parties. Thus, by January 1996, St. Petersburg authorities held approximately 22,200 lease agreements for a total of approximately 62,060,500 square feet of space.<sup>5</sup> In the first half of 1996, Chelyabinsk city authorities held more than 700 valid leases; and authorities of Ryazan - more than 900 leases.

Second, because zoning regulation does not yet exist in most Russian cities, municipal authorities are heavily involved in land use control on a site-by-site basis. A private owner of a land site or a building must get permission from authorities for any proposed property development or redevelopment.

Finally, many officials are quite creative searching for their personal interests related to real estate and land development. Often, even strong conflicts of interest cannot be classified as illegal because of a lack

of relevant legislation. A typical example: a high-ranking municipal urban planner responsible for approving the type and parameters of land use at a land site has his own private business related to planning and design; when you apply for an approval of your project, you will be advised to order some work from his private firm; if you do not, your project will be stopped indefinitely. Instead of a step-by-step separation of private interests and public services, there is an opposite tendency that might be described as a mixture of "institutionalization of corruption" and "commercialization of government." This means creating special legal entities (usually municipal for-profit enterprises) that allow remarkable fees or commissions to be charged for the monopolistic performance of functions that should be the natural responsibility of municipal authorities (for example, providing good

quality titles for privatizing properties). Such municipal enterprises are functioning legally, and respectable companies deal with them because this may be the lone way to find a reliable counterpart on the authorities' side.

### **MARKETS FOR RESIDENTIAL, COMMERCIAL, AND INDUSTRIAL PROPERTIES**

There are a number of existing residential, commercial, and industrial properties available for purchase and rent, especially in big cities. In most cities the supply of existing and new homes is several times higher than the effective demand. The biggest problem for all three sub-markets consists of strong mismatches between location, size, and quality of the supply, and the requirements of effective demand.

For example, in larger cities, a remarkable portion of the apartments offered for sale is in multi-family prefabricated, concrete buildings constructed during socialist times in city outskirts. On the other hand, families that are able to buy apartments for cash (a workable mortgage system still does not really exist) want better quality and location. Some types of demand have not been met at all. For example, rental, residential, multi-family income property practically does not exist as a market type, though it certainly would find the demand, especially in larger cities and those with large communities of foreign professionals. Nevertheless, the housing market is active, reflecting two fundamental processes in the current transition stage of the Russian economy: 1). redistribution of wealth; and 2). large inter-regional migration.

Residential and office markets in the largest cities have two commonly distinguishable components - "Western quality" and "local quality." The former implies better construction materials, amenities, building design, and presence of professional property management (at least, for offices). In April 1997, average apartment prices in St. Petersburg varied in the ranges \$40-60/sq.f. for existing apartments and \$38-68/sq.f. for newly constructed ones (both ranges represent mainly "local quality"). In January 1997, average prices on "local quality" apartments in Moscow were \$85-133/sq.f.

### **INSTITUTIONAL INFRASTRUCTURE FOR THE REAL ESTATE MARKET**

The real estate market continues to be a cash market. Neither mortgage nor construction finance lending exist in any significant amounts. By mid-1996, only about 5,300 mortgage loans had been issued to

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home buyers across all of Russia. These loans were predominantly short-term (more than 60 percent were up to one year), with loan to value ratios around 30 to 50 percent, and an annual interest of 90 to 140 percent in rubles or 25 to 45 percent in USD.

Construction loans have been considered by Russian banks as highly risky business loans and they have been practically unavailable unless a borrower was controlled by a bank. In early 1997, the average interest rate on three month loans was 83 percent (nominal), and 113 percent (effective). Borrowing under such conditions creates negative leverage for developers, and they practically do not use bank loans. Such high interest rates on loans resulted from high inflation in previous years and, respectively, the high refinancing rate of the Central Bank of Russia. But the situation was improving, until the crisis of 1998: the annual CPI was 840 percent in 1993; 215 percent in 1994; 131.4 percent in 1995; 21.8 percent in 1996; and about 12 percent in 1997. The refinancing rate has dropped significantly from 200 percent in April 1995 to 28 percent in January 1997.<sup>6</sup> The crisis of 1998 is resulting in new, tremendous fluctuations in the refinancing rate.

The other reason why banks in Russia have not favored lending for businesses and real estate development is associated with state securities. During 1993 to 1995, yields on short-term state Treasury Bills and other federal bonds were very high. These types of securities have been considered so reliable that they absorb the biggest part of the banks' investment resources. It became a problem on a national scale, and since 1996, the reduction of yields on these types of securities has been a part of official state policy in the securities market.

The information infrastructure for the real estate market is strongly underdeveloped and the

information that exists is not always reliable. First of all, sale and rental prices are often not reported in order to avoid taxes (see below). Usually the asking prices are what is available through real estate periodicals or brokerage companies. Second, the volatility of many market parameters is incredibly high—(this is typical for such an emerging and unstable market as in Russia). For example, interest rates on loans for the same types issued at the same time may vary by 10 or more percent inside of one bank. Third, information which is typically obtainable from property managers in mature markets (operating expenses, vacancy rates, etc.), is, as a rule, not available because property management as an industry does not really exist yet. Finally, information held by public agencies (such as number of registered sale transactions) is not available in some regions and cities for various reasons.

The professional infrastructure for real estate is growing and institutionalizing very rapidly. Especially successful is the development of real estate brokerage and appraisal, and on a more limited basis - real estate management. The Russian Society of Appraisers (RSA) provides a good illustration of the institutionalization process. The RSA was created in 1993, and by November 1997 had about 2,390 members at 76 regional chapters. The first training course was offered in the summer of 1993 in St. Petersburg and Moscow. It was sponsored by the World Bank and the Eastern European Real Property Foundation (NAR/USAID creation). By the end of 1996, about 10,000 people completed different courses in appraisal. Currently, the RSA is publishing the monthly *Information Bulletin* and *Appraisal Issues*, a quarterly journal. It has also published more than 20 books and brochures, including four textbooks translated from English.

Professional real estate institutions repeat many features typical of the institutionalization of the real estate industry in the U.S.: development and maintenance of professional standards; training for members of professional organizations; sharp competition among different professional organizations; lobbying interests of the profession and the industry, etc. What is probably different from the American experience is: 1). a high level of bureaucratization, at least in the leading professional organizations (which is not surprising, given the long history of Russian bureaucracy); and 2). the orientation of many organizations toward corporate memberships rather than individual ones. Membership in leading professional organizations

is not affordable for ordinary practitioners and small companies.

## INVESTORS IN THE POSITION OF DEVELOPERS

Income properties in operational condition that would be worth acquisition, practically do not exist in Russian cities. Thus, real estate investors immediately find themselves in the position of developers dealing with either new construction or reconstruction. A special study conducted in St. Petersburg<sup>7</sup> in the fall of 1995 indicated that Russian and foreign investors had different concerns about their developers' role. Foreigners saw two major obstacles for their participation in reconstruction projects: 1). an absence of long-term property rights during the reconstruction period; and 2). several uncertainties concerning a project's economic feasibility. The absence of property rights results from a common practice: Russian cities allocate land sites for the construction period only (on a short-term lease, for instance), with the local authorities' obligation to grant a long-term lease upon completion of construction. Also, an ownership title on a building constructed with private financing has been obtainable only upon completion of the building. Clearly, such property rights are not mortgagable, and, by American standards, they are legally not sufficient.

The economic uncertainty usually contained two components. First, the costs of connections to off-site utilities typically were not known before a formal commitment was made by a developer (to make the commitment requires time and money). The cost of utilities connections had been dictated almost arbitrarily by monopolistic providers of centralized systems (such as electricity, heating, gas, sewer), which were municipally owned or already privatized. In 1993 to 1995, such "infrastructure exactions" imposed on developers made up 20 to 50 percent of the total development costs for housing projects in many Russian cities. Second, the standard provision in land lease agreements stipulated the landlord's (municipality's) right to increase ground rent "in correspondence with legislation," without negotiations with the tenant. Such uncertainties prevented an evaluation of economic feasibility and stopped many foreign investors.

The study found that Russian investors were less sensitive to legal rights on land per se, yet the impossibility of using land rights to secure loans was also important for them. They too complained about the heavy burden of "infrastructure exactions."

Since 1995, the conditions for real estate development have been improving. Authorities in most cities have recognized the problem of unfeasible requirements of utility providers and have been trying to improve the situation. Now they also better understand the idea of economic feasibility. The issue of property rights during the construction period has been actively discussed and was partly addressed by the federal government in 1997. Some local governments are beginning to grant long-term rights on vacant land from the very beginning of the development process.

The issue of new approaches to providing utilities for urban development and redevelopment in Russian cities and towns will be a hot topic for years. In particular, the potential market for implementing modern technologies for local utilities systems should be huge.

### THE SHADOW ECONOMY AND REAL ESTATE

The real estate sector is involved in the shadow economy mainly through tax evasion. The underreporting of sale prices is common in transactions among individuals. Technically, to underreport the price is not difficult because such sales are often "double cash" transactions: no loans, no bank transfers - just a briefcase of bills going from one to another or, in the best case, through a deposit with an escrow agency.

Rents on commercial properties often have two components: one "official," shown in a lease agreement and subjected to the Value Added Tax, and the other, unofficially paid separately in cash. By the estimates of Moscow brokers, in the summer of 1996, up to 90 percent of all commercial leases had such double rents.<sup>8</sup> Even without discussing the ethical problems for appraisers, double rents complicate the appraisal of income properties. Obviously, two values may be considered: one based on the formal rent, and the other - at a real rent which includes the informal component. The market value of the property should be somewhere in the interval between these two values and should depend on the level of transferability of informal components of rents when the property is sold. But it might be very difficult, if not impossible, to predict transferability of such informal components of rents.

Interests of the organized crime in real estate have at least three forms. The first involves laundering illicit incomes through investments in real estate. Most likely, such investments are not across regions

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of the country, but instead concentrated in some particular cities.

The second form, widely present in big cities, involves a "protection racket" for the owners or tenants of commercial properties. Charges imposed by organized crime may even be formalized in writing through a "protection agreement." It appears that the process of protection racket in real estate has reached some stabilization. Areas of such cities as Moscow and St. Petersburg have been divided between clans. These clans have established relations with property owners, managers, or tenants, and provided protection from other clans. The alternative for property owners and managers is to elicit protection from the organized crime, i.e. to hire private security. In any event, protection of or from the organized crime adds to the cost of renting a commercial space. So, when preparing to rent a space for business in Russian cities, it makes sense to ask directly whether a protection is included already in the rent rate.

The third form is an informal control of the organized crime over some particular properties. Such control may restrict the real rights of a formal, legal owner of a property in different ways. The owner may be not allowed to change the use of the property, or to change a manager, or to sell the property, or anything else - it depends on the nature of what may be denoted as a "criminal's partial interest" in the property. So, an acquisition of an income property in Russia requires an especially careful due diligence that the property is not loaded with such types of interests.

No reliable data exists on the prevalence of the shadow and criminal practices or the magnitude of consequences in real estate, and this might be a subject for a special study. However, the shadow economy as a whole and the organized crime are considered as serious problems in current Russia.<sup>9</sup>

### CONCLUSION

Despite many bureaucratic restrictions, the lack of market infrastructure, and the shortage of investment resources, urban real estate markets

in Russia have been growing almost explosively. In the first stage, emerging real estate markets predominantly involved the market turnover of existing buildings and premises. While the amount of privatized commercial and industrial land is increasing, and vacant land is becoming available, the market is entering the next stage where new construction and reconstruction will play an important role, creating a tremendous niche for real estate investors.

Another positive process for investors is competition among Russian regions and municipalities for attracting private investments in local economic development and reconstruction of their cities. Cities that will be first to offer an attractive "investment climate" for investors of regional, national, or international scale will gain a real advantage over competitors. For international investors who are thinking about "windows of opportunity" in Russian real estate, it might be useful to systematically monitor the success of real estate reform and market activity in different Russian cities to identify the most promising places.

Some strategically important tendencies in the evolution of urban real estate in Russia have not yet been revealed; and they should also be under close scrutiny by potential investors. Some unclear strategic questions are:

- What level of suburbanization should be expected in Russian cities?
- What scale and types of retail properties would be vital in Russian cities?
- Given the organized crime interests in some subsectors of real estate, which subsectors would be best for foreign investors?

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8. As I assume, such double rents should be less common in "business centers" with foreign tenants and more formal "Western style" management.
9. Russian governmental sources attributed 25 percent of GDP of the Russian Federation to the shadow economy in 1996 and 40 percent in 1997 and consider this as a threat to the country's economic security. The organized crime in Russia is also considered as a threat to the national security interests of the U.S. (see "Russian Organized Crime. Global Organized Crime Project" - Center for Strategic and International Studies, Washington, 1997).

## ABOUT THE AUTHOR

**Olga Kaganova, Ph.D., CRE**, is a research associate at the Urban Institute. She has been providing technical assistance on real estate reform in Russia, Moldova, Hungary, and Bulgaria as part of USAID and World Bank projects. She also has made land appraisal, feasibility and market studies for private and public clients, consulted on property acquisition in Russia, and consulted with the governments of several Russian cities on improving the investment climate. Dr. Kaganova is a founding member of the Russian Society of Appraisers and she has published numerous articles in professional and academic journals and books in the U.S., Western Europe, and NIS.