

# **The Saint Petersburg Property Market 2010**





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KTI:  
Anastasia Nisenbaum  
Hanna Kaleva

Pöyry:  
Matias Johansson





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## Preface

The Saint Petersburg Property Market 2010 aims to satisfy the information needs of persons interested in the St. Petersburg property market. This report is a result of the ToiVe project, *Property Investment and Management in Russia*, which comprised a market study executed jointly by KTI Information Ltd. and Pöyry Building Services Oy.

The report provides a comprehensive overview of the St. Petersburg property market structure and practices. It contains in-depth analysis of data obtained from various sources, including interviews with key market players, market reports, property-related magazines and journals. The intent of the report is to present a neutral view of the market.

This publication is sponsored by nine companies that represent the Finnish property investment, development, management and finance markets. The sponsoring companies are Are, CapMan, Fatman, KIINKO Real Estate Education, Newsec, Nordea Bank, Oventia, REIM Group and SATO Corporation. In addition, Tekes (the Finnish Funding Agency for Technology and Innovation) provided financial assistance. The ToiVe team wishes to thank the sponsors for their support.

We also greatly appreciate the contribution of all specialists interviewed during this study. The names of the specialists are presented in Appendix 1.

The report is also available in PDF format at [www.kti.fi](http://www.kti.fi). We hope you find this worthwhile reading.

Hanna Kaleva, on behalf of the ToiVe project teams at KTI and Pöyry

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## I – General information

### 1.1 Basic facts about Russia and St. Petersburg

#### 1.1.1 General features

The Russian Federation (conventional short name: Russia; local long name: Rossiyskaya Federatsiya; local short name: Rossiya) is a transcontinental country extending over northern Eurasia. Russia covers an area of 17,075,400 square kilometers, approximately equivalent to one-eighth of Earth's land mass. The country is bounded by Norway and Finland to the northwest; by Estonia, Latvia, Belarus and Ukraine to the west; Georgia and Azerbaijan to the southwest; and by Kazakhstan, Mongolia and China to the south. The Kaliningrad Region is an exclave on the Baltic Sea bordered by Lithuania and Poland. It is also close to U.S. state of Alaska, along with Sweden, Turkey, and Japan. In fact, it is separated by relatively small stretches of water<sup>1</sup>.

#### 1.1.2 Population

In terms of population, Russia is the ninth largest country in the world with 141.8<sup>2</sup> million inhabitants. It is estimated that 73% of the population lives in urban areas. According to the Federal State Statistics Service, the two largest cities are Moscow and St. Petersburg with 10,563,038 and 4,600,276 inhabitants, respectively. Eleven other cities have a population of at least one million inhabitants: Novosibirsk, Nizhny Novgorod, Yekaterinburg, Samara, Omsk, Kazan, Chelyabinsk, Rostov-on-Don, Ufa, Volgograd, and Perm<sup>3</sup>.

Russia's 160 ethnic groups speak about 100 different languages, while Russian is the only official state language.

#### 1.1.3 Government and politics

Russia is a federation and a presidential republic. The President is the head of the state (Mr. Dmitry Medvedev) and the prime minister (Mr. Vladimir Putin) is the head of the government. The federal government is comprised of three branches:

- Legislative: The bicameral Federal Assembly, made up of the State Duma and the Federation Council
- Executive: Headed by the president
- Judiciary: The Supreme Court, Constitutional Court, Supreme Court of Arbitration and lower federal courts.

#### 1.1.4 Subdivisions

The Russian Federation consists of 83 federal administrative subdivisions that are grouped into 8 federal districts. Federal subdivisions constitute a sub-national level of the government, while federal districts are a level of administration of the federal government.

#### 1.1.5 Religion

Russian Orthodoxy is the dominant religion in Russia. According to a poll carried out by the Russian Public Opinion Research Center, 63% of respondents considered themselves Russian Orthodox, 16% stated as non-believers, 12% believe in God but do not practice any religion, 6% considered themselves Muslim, and 1% considered themselves either Buddhist, Catholic, Protestant or Jewish.

Russian Federation, Central Intelligence Agency



1 Numerical data presented in this section is obtained by the analysis of the documents of Federal State Statistics Service.

2 Federal State Statistics Service 1.10.2010; 139.4 million inhabitants – Central Intelligence Agency, estimation July 2010

3 According to the preliminary results of the population census in 2010, Perm has been excluded from the "Millionniki" list, the city's population reached only 956 thousand inhabitants.





### 1.1.6 Basic facts about St. Petersburg

St. Petersburg is located in northwest Russia on the Neva River, at the head of the Gulf of Finland on the Baltic Sea. Its location and proximity to European countries make it known as "The European Arch" of Russia. The first Russian Emperor Peter the Great founded the city in 1703, and it remained the capital of Russia for over 200 years. Today, St. Petersburg is one of the most actively developing regions in Russia. An advantageous geopolitical position, well-developed transportation system and diversified economy give the city great potential for economic growth.

The Northwestern Federal District occupies 9.9% of the total Russian territory; the population of the district is over 13 million inhabitants, which corresponds to 9.5% of the total population of Russia. St. Petersburg is the largest city in the region and the second largest city in the country, covering an area of approximately 1,439 square kilometers. The population density is 3,267.5 inhabitants per square kilometer, with a total population of 4.6 million inhabitants.

"St. Petersburg is the largest city in the region and the second largest city in the country"

## 1.2 Economic overview

### 1.2.1 The Russian economy

During the period 2003–2008, the Russian economy experienced significant growth with the annual gross domestic product growth rate exceeding 6%. However, the world economic crisis affected Russia to a larger extent than many other countries. The government of the Russian Federation had to control the depreciation of the national currency. A sharp drop in oil prices and metals created the need for the government to perform different actions for economic support. During the last months of 2008 and 2009, the Russian Federation had negative economic growth, a drastic drop in industrial production, outflow of foreign investments, high inflation, and increasing unemployment.

The situation started to change in 2010. An annual growth of 2.9% was recorded in the first quarter of 2010, in comparison with the same period in 2009. Improving industrial output, increasing exports, as well as growing consumer demand, were registered in the first quarter of the year. Government programs of more business-friendly reforms and the expected slow, but steady economy growth are considered to attract foreign investments to start flowing in again.

"An annual growth of 2.9% was recorded in the first quarter of 2010"

	Federal State Statistics Service								projections by IMF		
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
<b>GDP in nominal prices, RUR, bln</b>	10,830.5	13,243.2	17,048.1	21,625.4	26,903.4	33,258.1	41,444.7	39,063.6	44,841.8	49,318.1	53,305.2
<b>GDP growth rate, %</b>	4.7	7.3	7.2	6.4	7.7	8.1	5.6	-7.9	4.3	4.1	3.7
<b>International Reserves, USD, bln</b>	47.7	77.8	124.5	182.2	303	478.8	426	440.6			
<b>Trade Balance, USD, bln</b>	46.3	59.9	85.8	118.3	140.7	128.7	179.3	110.6			
<b>CPI, %</b>	115.1	112	111.7	110.7	109	111.9	113.3	108.8	106	105.4	105
<b>Retail Turnover, RUR, bln</b>	3,765	4,530	5,642	7,042	8,712	10,869	13,915	14,603			

### 1.2.2 Global competitiveness

Prior to the major economic crisis, the Russian Federation was showing continuous improvements with regard to its competitive fundamentals. Among the so-called BRIC (Brazil, Russia, India and China) countries, the deterioration of Russian financial market efficiency was one of the reasons it was the least successful in dealing with the crisis.

According to the Global Competitiveness Report released by the World Economic Forum, large market size and reasonable macroeconomic stability are seen as major strengths of the Russian business environment. However, weaknesses in institutional environment and business standards place Russia far below other European countries. The environment for protection of property rights, government favoritism in dealing with private sectors and the lack of government efficiency are perceived as the main threats. In the private sector, the level of ethical standards within private institutions lowers the ranking of Russia's competitiveness. Low levels of financial market sophistication and goods market efficiency contributed to the overall poor rating of the country's

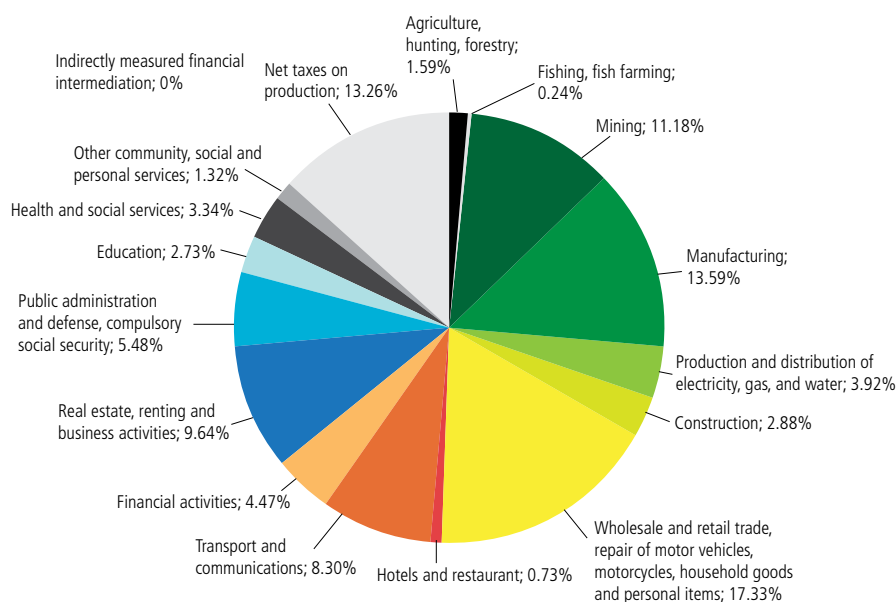
competitiveness. The study states high level of corruption and access to financing as some of the most problematic factors for doing business in Russia.

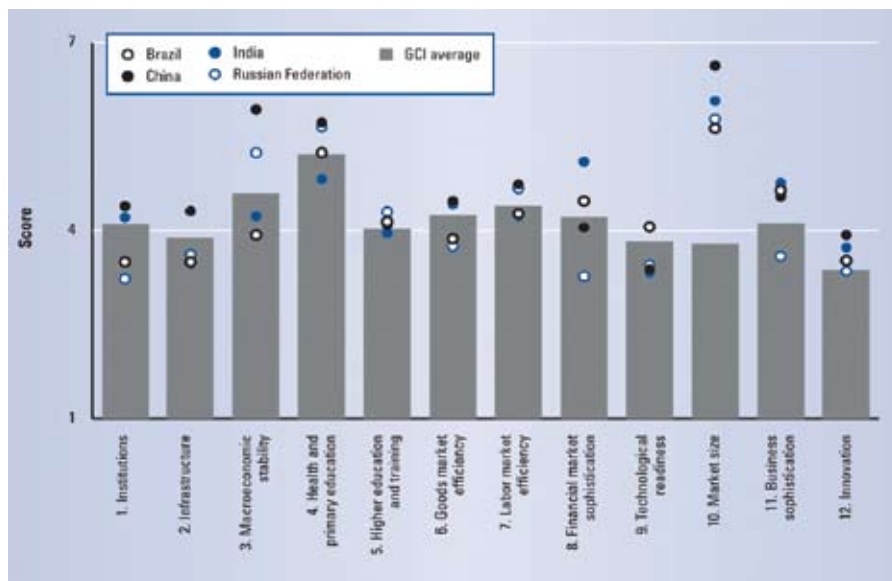
### 1.2.3 Corruption and bureaucracy

"Corruption is one of the key problems facing Russia as it seeks to grow out of its socialist past. High levels of corruption pose a serious threat to the establishment of democracy and the creation of a robust, market-based economy."<sup>4</sup>

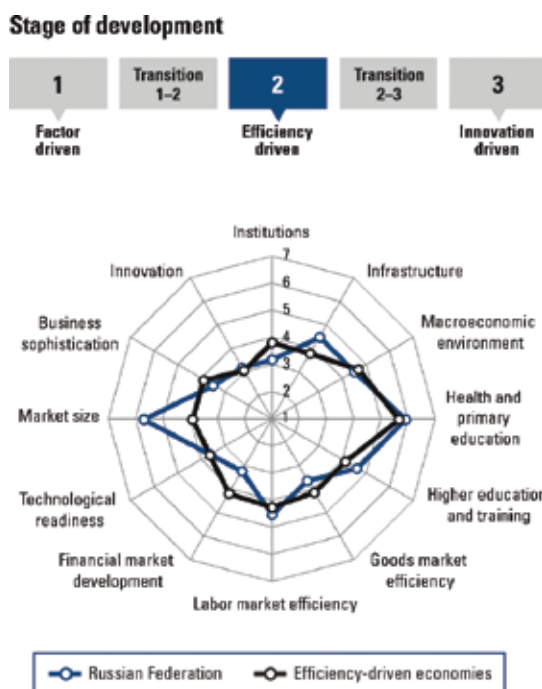
"High level of corruption and access to financing are the most problematic factors for doing business in Russia"

GDP by sector of economy, Rosstat, 2010

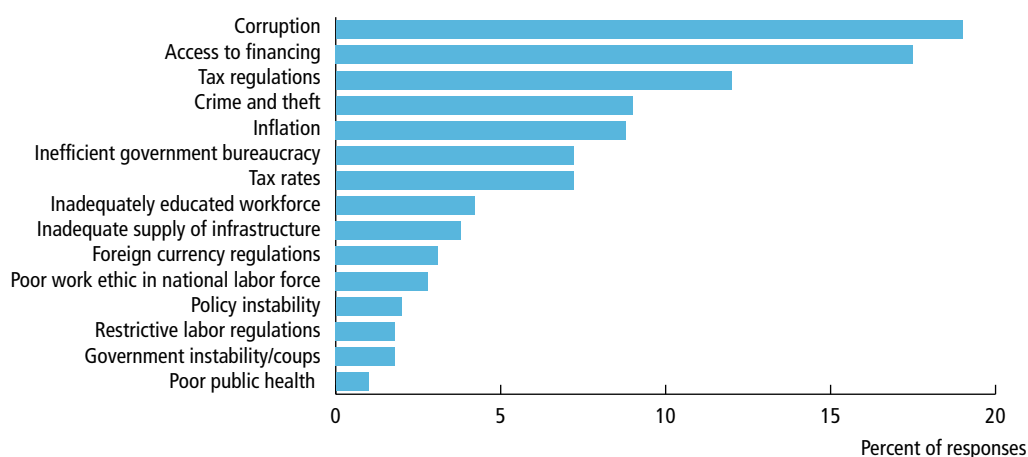




Competitiveness comparison of the Russian Federation to the countries in transition 2-3, Global Competitiveness Index 2009-2010



The most problematic factors for doing business in Russia, Global Competitiveness Index 2010-2011

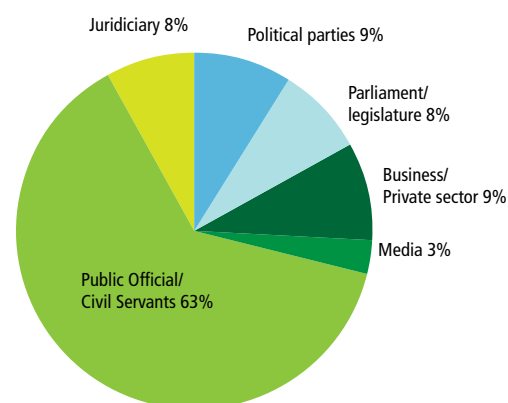


RANK	REGIONAL RANK	COUNTRY / TERRITORY	CPI 2010 SCORE	90% CONFIDENCE INTERVAL		SURVEYS USED
				LOWER BOUND	UPPER BOUND	
56	1	Turkey	4.4	4.0	4.8	7
62	2	Croatia	4.1	3.7	4.5	8
62	2	FYR Macedonia	4.1	3.7	4.5	5
68	4	Georgia	3.8	3.0	4.7	7
69	5	Montenegro	3.7	3.1	4.3	5
78	6	Serbia	3.5	3.1	3.9	6
87	7	Albania	3.3	3.0	3.6	6
91	8	Bosnia and Herzegovina	3.2	2.8	3.5	7
105	9	Kazakhstan	2.9	2.2	3.7	8
105	9	Moldova	2.9	2.7	3.2	6
110	11	Kosovo	2.8	2.7	3.1	3
123	12	Armenia	2.6	2.5	2.8	7
127	13	Belarus	2.5	2.1	3.1	3
134	14	Azerbaijan	2.4	2.1	2.7	7
134	14	Ukraine	2.4	2.1	2.6	8
154	16	Russia	2.1	1.9	2.3	8
154	16	Tajikistan	2.1	1.7	2.5	7
164	18	Kyrgyzstan	2.0	1.8	2.3	7
172	19	Turkmenistan	1.6	1.4	1.8	3
172	19	Uzbekistan	1.6	1.5	1.7	6

Russia is perceived as a highly corrupt country. In the Corruption Perceptions Index (2010), Russia was ranked 154th along with Cambodia, Central African Republic, Comoros, Congo-Brazzaville, Guinea-Bissau, Kenya, Laos, Papua New Guinea, and Tajikistan. Among the countries in the region (Eastern Europe and Central Asia), Russia was classified as 16th out of 20.

According to the Transparency International Organization, the level of corruption in Russia has hardly improved over the past two years. Government efforts to combat corruption by setting up a presidential commission and an adoption of the package of anti-corruption legislation have not had much effect since no effort was made to reform the bureaucracy. The Russian Federation was ranked 123rd along with Uganda and Uruguay in the report *Doing Business 2011*, a joint research of The International Finance Corporation and The World Bank. According to the sub-national research in 2009, Moscow and St. Petersburg are the cities with the poorest performance within the sampled Russian cities. Kazan, the capital of Tatarstan, is the city with the fastest improving environment for the entrepreneurs. High level of bureaucracy is the main reason for the Russian low ranking in the Global Index. In terms of construction permits, Russian Federation was classified as 182nd out of 183.

Sectors most affected by corruptions, Global Corruption Barometer 2009



The excessive role of the government in the economy and business sector increases the problem of corruption. According to a study by Transparency International, 22% of the respondents consider current government actions to be effective, while 52% of the respondents see them as ineffective. Nonetheless, it is important to note that these actions are just the first steps of the long-term anti-corruption battle.

#### Ease of Doing Business, Main Indicators, Doing Business 2011

Starting a Business	Procedures (number)	9
	Time (days)	30
Dealing with Construction Permits	Procedures (number)	53
	Time (days)	540
Registering Property	Procedures (number)	6
	Time (days)	43
Getting Credit	Strength of legal rights index (0-10)	3
	Depth of credit information index (0-6)	5
Protecting Investors	Extent of disclosure index (0-10)	6
	Strength of investor protection index (0-10)	5.0
Paying Taxes	Payments (number per year)	11
	Profit tax (%)	9.0
	Labor tax and contributions (%)	31.8
	Other taxes (%)	5.7
Trading Across Borders	Document to export (number)	8
	Time to export (days)	36
	Documents to import (number)	13
	Time to import (days)	36
Enforcing Contracts	Procedures (number)	37
	Time (days)	281
Closing a Business	Recovery rate (cents on the dollar)	25.3
	Time (years)	3.8
	Cost (% of estate)	9

### 1.2.4 Transparency

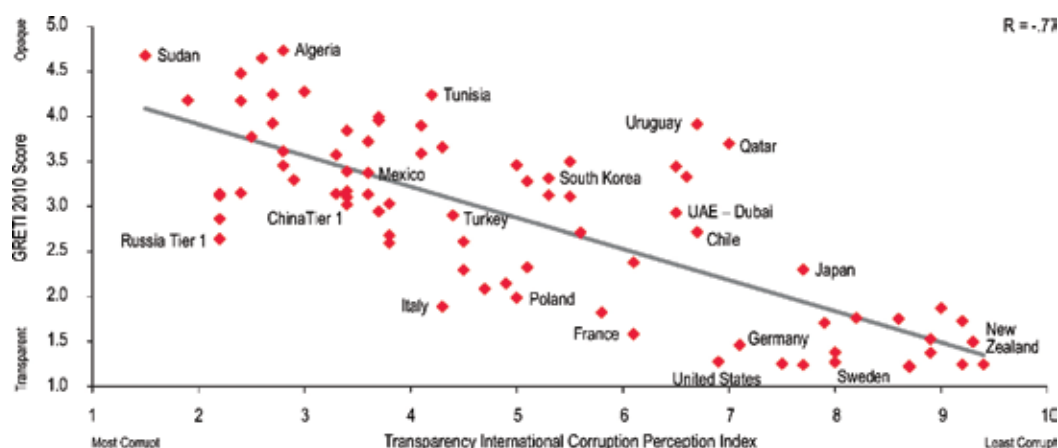
The Russian economy can be characterized as semi-transparent, along with the overall business environment, political risk and financial/accounting systems. According to Jones Lang LaSalle Global Real Estate Transparency Index 2010, the Russian real estate market is semi-transparent. A survey of the Russian real estate market revealed differences in transparency between Russian cities. Moscow was ranked 31st in the Index, St. Petersburg – 35th, the so-called “Millionniki” cities (cities with over one million people) only achieved 43rd rank<sup>5</sup>. The transparency improvements across all Russian cities have stalled as a result of the severe real estate downturn. Players were forced to concentrate on their

survival rather than improvements; both Moscow and St. Petersburg showed slight positive score change, 0.04 and 0.02, respectively.

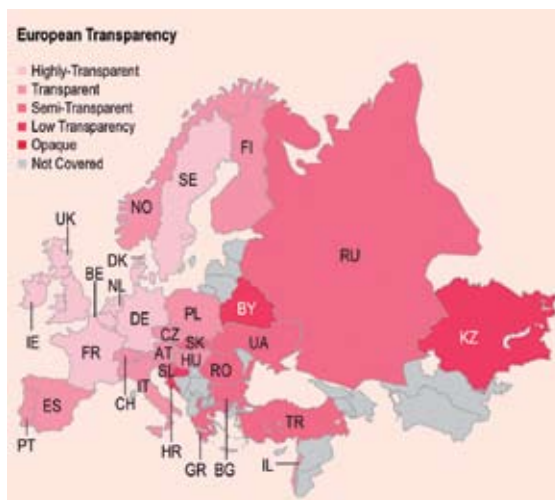
### 1.2.5 Property market information

Property market information is essential for all the players operating in the market. The availability of information facilitates the investment decision-making process for both existing and new players. Reliable information on both own holdings and the market in general is also essential in managing and benchmarking the performance of property investments, as well as in communicating the performance to various stakeholders.

Correlation between Transparency and Corruption, Global Real Estate Transparency Index 2010 (JLL)



<sup>5</sup> In total 81 markets were included to the index.



Measurement and benchmarking of property investment performance is complicated in immature markets due to the shortage of transparency and available information. Russian real estate investment markets are comparatively young. This can be partly seen as an explanation for a relatively limited supply of market information available on the market. Also, tradition and cultural issues affect Russian players' attitudes towards transparency.

The main sources of market information include property consultancies and property press. Consultancies' market data is usually produced as a side product of their core services and, as such, has the potential for subjective and biased reporting. In addition, differences in methodologies affect the market reports produced. Market figures sometimes vary significantly, depending on the source. This can be very confusing particularly for a newcomer to the market. Currently, there are no independent, neutral information service providers.

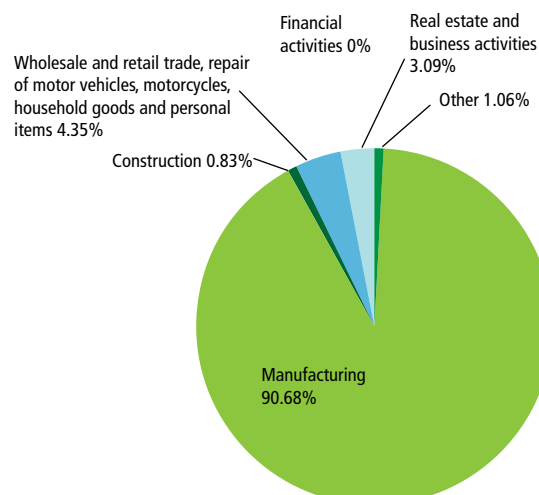
Furthermore, the low level of transparency is complicated by the unwillingness of the players to disclose financial details of their activities to the public. Holding unique market information is considered a competitive advantage.

However, it is important to mention that Russian and foreign companies have different positions regarding openness. International companies who have entered the market tend to open financial information more than the Russian companies. This is mainly a result of differences in mentality and patterns of doing business. There are, naturally, also big differences in the needs for information between local and foreign players, the former group being "insiders" in the market, and the latter group having to start research from scratch. As a consequence, the increase in the number of foreign and other types of new players increases the need for neutral information.

Despite of the differences in behavior patterns, perception of the availability of property market information is the same among Russian and foreign companies. Interview participants of the current study were united in the opinion that there is a lack of reliable information available in the market.

"Market figures sometimes vary significantly, depending on the source"

Foreign investment by sector of economy, St. Petersburg, Rosstat

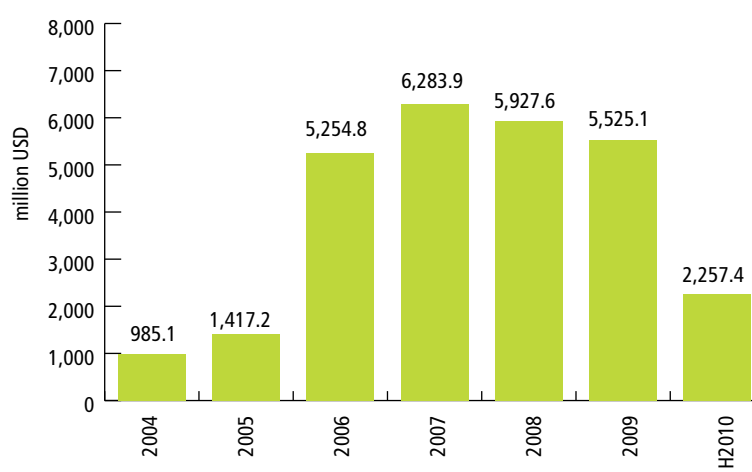




#### Availability of market information

	SOURCES	ASSESSMENT OF QUALITY	COMMENTS
INVESTMENT RETURNS	N/A		
RENTS - COMMERCIAL	PROPERTY CONSULTANCIES	VARIED	Differences in definitions, lease terms, currencies, affected by quality of space.
RENTS - RESIDENTIAL	REALTY AGENCIES / PROPERTY CONSULTANCIES	VARIED	The term "Rental Residential" is normally referred to the market of the private investors (individuals), rather than of the professional investors. The latter segment is not being researched by the consultancies agencies.
OPERATIONAL COSTS	N/A		Due to the prevalence of gross rents in the market, information on the operational expenses is not considered of highly importance.
VACANCY RATE	PROPERTY CONSULTANCIES	VARIED	
YIELDS	PROPERTY CONSULTANCIES		The number of transactions is low; yields are not typically published.
TRANSACTIONS	PROPERTY CONSULTANCIES	COVERAGE VARIES	The number of transactions is low.

#### Volume of foreign investment in St. Petersburg, Rosstat, Committee for the Economic Development, Industrial and Trade Policy



#### Main Economic Indicators, St. Petersburg, first half 2010, Committee for The Economic Development, Industrial and Trade Policy

Gross Regional Product	4.4%
CPI	105.4%
Unemployment rate (registered unemployment)	0.87%
Foreign trade turnover increase (1st quarter 2010)	Foreign trade turnover 57%
	Export 170%
	Import 46.5%
Industrial Production Index	Industrial Production Index 108.3%
	Car manufacturing 235%
	Metallurgy 142.7%
	Production of other minerals 121.6%
	Chemical industry 121.2%
Housing construction	128.4%
City budget (Revenues)	124.1%
Retail turnover	3.8%
Real wage increase	5.1%

### 1.2.6 Economic outlook for St. Petersburg

According to the Committee for The Economic Development, Industrial and Trade Policy, St. Petersburg's economy showed a steady recovery in the first half of 2010. The growth rates were varied in different economic segments, however, a few exceeded the pre-crisis levels. Gross regional product growth was 4.4%. The Industrial Production Index totaled to 108.3%: the car industry showed the best results (235%), and metallurgy (142.7%). The volume of the foreign investment in the first half of 2010 reached 2,257.4 million US dollars, 1.5 times more than in the same period in 2009. More than 90% of the investment went to the manufacturing industry. Furthermore, registered unemployment rate (as a ratio of the number unemployed to the size of economically active population) decreased from 1.1% in late 2009 to 0.87%, and real wages increased by 5.7%.

Reduction of the interest rate for mortgages contributed to the increase of residential construction during the first half of the year, amounting to 28.4% compared to the same period in 2009. A total of 338 apartment houses were completed, increasing the housing stock by almost a million square meters.

## II – Institutional framework for property investment

### 2.1 Legislation

#### 2.1.1 Forms of commercial activities

Foreign investors can carry out commercial activities in various forms: representative offices, branches and Russian legal entities.

Both representative offices and branches of a foreign company are considered as parts of foreign companies, and special laws and rules are applied to the activities of such entities. Foundation of a permanent establishment, in the form of one of the Russian legal entities, will help to avoid these differences. As a result, the company can operate in the Russian market in accordance with the same laws applied to domestic companies.

The most common forms of legal entities in Russia are limited liability companies and joint stock companies. Other legal company structures (e.g., partnerships, where participants are liable for the company's obligations with their property) have not earned much popularity in Russia.

"The most common forms of legal entities in Russia are limited liability companies and joint stock companies"

#### 2.1.2 Property ownership

In Russia, the rights for the land and the building are separated. The existing land lease determines ownership of the building or right to construct. In addition to the traditional rights of real estate recognized in Russia, (i.e., ownership rights, rights to lease, rights to pledge, servitudes) there are certain rights that are not recognized by other countries' legislation, including, for example, rights to perpetual (unlimited) use of a land plot; rights to lifetime inherited possession of a land plot; and rights to free-of-charge short-term use of a land plot.

Certain types of rights to real estate may be held only by subject to rights given to certain groups. The subjects of rights can be divided into two groups: private, i.e., individuals and legal entities, and public, i.e., the Russian Federation, the subdivisions of the Russian Federation and municipalities.

The registration of ownership of land is performed by entering data in the State Land Cadastre. Buildings and

"In Russia, the rights for the land and the building are separated"

constructions are additionally described and registered in the system for state technical registration of objects of city-planning activities.

Investment activities are regulated by the Russian Federation Constitution as well as by several codes, federal laws and other regulatory legal acts. In addition, the authorities of individual administrative subdivisions of the Russian Federation can adopt special laws and legal acts. While investing in a particular Russian Federation subdivision, it is important to be aware of the particularities of its legislation.

A new legislative basis regulates investments into the state-owned real estate located in the territory of St. Petersburg. Potential types of assets to invest in include: (a) land plots for new construction; (b) unfinished construction projects; and (c) buildings and constructions to reconstruction. Land plots or real estate facilities in St. Petersburg are sold to investors either through tenders (auctions/competitions) or granted for designated use, depending on the type of the property.

#### 2.1.3 Land

Only land registered in the State Land Cadastre can be purchased or sold. An agreement of the transfer of rights must be in writing. Generally speaking, both residents and non-residents may acquire real property. However, certain restrictions apply to foreign individuals, foreign legal entities and companies with more than 50% of equity held by foreign investors. Non-residents may not own land plots located on the territories close to the state borders or agricultural land. Only lease rights are permitted for these types of land.

Land in the Russian Federation is used in accordance with its approved designation. The category of a land plot may be changed only in accordance to a certain procedure established by the federal law, "On Transfer of Land or Land Plots From one Category to Another". Land in the Russian Federation can be divided into seven categories according to its designation: agricultural land; settlement (community) land; land for industry, energy sector, transport, communications, radio broadcasting, television broadcasting, informatics, land for maintaining space activities, defense and security land, and land of other special designations; land for specially protected territories and objects; forest fund land; water fund land; and reserve land.

It is important to mention a simplified procedure of leasing state-owned land plots in the St. Petersburg area for



investment projects. Land plots are granted for the purposes of preparing necessary city planning documents, determining the possibility to build, developing design documents, as well as for further construction. Land plots are granted

through an open tender for a lease period of six years. If the investor succeeds to complete the construction within the agreed term, the land plot may be granted for a 49-year lease or maybe purchased by the investor.

### Development of Land

A number of steps should be passed when developing the land in Russia. In practice it might take longer than expected, due to the necessity to get the approvals of different authorities: one to two years (purchased land plot), and three to four years (leased land plot) before the construction can be started.

#### Land development process

Sequence of steps	Authorities to be dealt with
Rezoning of the land plot, if its initial designation differs from the designation required for the constructing the desired type of real estate	Clearance from the Health and Epidemiology controlling body "Sanepidnadzor" Environmental expert from the Federal Service for the Environmental, Technological and Nuclear Supervision "Santekhnadzor"
Connection to the public utilities (electric power, heating, water supply and sewage, gas, etc.)	The technical specifications are provided by the organizations responsible for public utility networks
Design and survey investigation	An authorization from the local executive body
An authorization to implement an investment project for construction of real property	An authorization from the regional executive body
Construction project documentation	A construction project agreement to be concluded with the local architecture and town planning authorities. An agreement with the organizations responsible for public utility networks
Examination of the construction project in terms of compliance with the sanitary regulations	"Sanepidnadzor" clearance
Construction permit	The local executive body
Registration of the construction project	The local architectural and construction supervision authority "Archstroynadzor"
An architectural authorization is required to perform ground works	The local architecture authority
The construction works must be performed by a duly licensed construction company	
A permit to commission the project	A compliance with the project documentation inspection to be performed The local executive body
PIB/BTI measurements	Project Inventory Bureau/Bureau of Technical Inventory
Commission of the project	
Registration of title to real property	

Local authorities as well as the state executives are responsible for managing state-owned property. These entities cooperate with the investors by, for example, providing information on available investment projects. The following web portals contain information about investment activity in St. Petersburg and Leningrad Oblast.

#### Web portals containing information on investment activity in St. Petersburg

Authority name	URL	Language
The Administration of St. Petersburg	<a href="http://www.gov.spb.ru">www.gov.spb.ru</a>	Russian
The Property Fund of St. Petersburg	<a href="http://www.property-fund.ru">www.property-fund.ru</a>	Russian/English
The Committee for Investment and Strategic Projects	<a href="http://www.st-petersburg.ru">www.st-petersburg.ru</a>	Russian/English
Investment Administration	<a href="http://www.stateinvest.spb.ru">www.stateinvest.spb.ru</a>	Russian
The Property Fund of Leningrad Oblast	<a href="http://www.leofi.ru">www.leofi.ru</a>	Russian

## 2.2 Taxation

The tax system in Russia differs markedly from tax systems in Western European and North American countries, which creates additional need for further studies on all the particularities of the tax system for newcomers to the market. The Tax reform was started in 1998 and has been going on ever since. Apart from all the advantages at a national level, the Tax Reform also decreased the difference between Russian and other European tax systems.

Among the most important changes, the tendency to reduce tax rates should be mentioned. Another important achievement is the recent establishment of a precise list of tax violations: the penalties can be imposed only for violations stated in the list.

Despite the recent improvements of the tax system, there are a number of drawbacks that still exist. Poor organization of Tax Authorities, together with the lack of legal knowledge among the employees is one of the downsides. In addition to the inherent complex nature of the Russian taxation system, the undergoing reform can sometimes lead to confusion and difficulties in understanding the taxation rules. And last but not least, the drawback of the current Tax System is dependent on taxation of the corporations. This is due to the relative insignificance of tax payments received from the individuals compared to companies.

Tax Reform, Beiten Burkhardt Rechtsanwälte (German Attorneys-at-law) 2009-2010

Tax reduction	Income tax	Individual income tax	Residents 13%
		Tax on income received as dividends	For the residents: 9%
			For non-residents: 15%
	VAT		18% (long-term goal up to 16%)
	Corporate Profits Tax	For most revenue	20%
		Tax on profits in the form of dividends	Dividends among Russian companies: 9% to 0%
			Dividends between a Russian and a foreign company: 15%
Tax on turnover		Cancelled	
Cancellation of a large number of the Tax Concessions that leads to the development of normal competition in the market. At the same time a number of concessions have been preserved on the regional level. Partially at the regional level there is a general liberalization of tax rules, aimed at compensating companies for losses from the elimination of concessions.			
Tax control (though establishing the rules for exercising tax control)	Rules for registering taxpayers through assigning them taxpayer identification numbers (INN)		
	Rules for indicating special codes of reason for tax registration (KPP) for separate subdivisions		
	Rules regulating audits conducted by tax authorities		
	Rules for obtaining information on taxpayers' activities		
	Mandatory pre-trial procedure for appealing decision to hold (to refuse to hold) a party tax liable		
Tax violations	Establishment of a precise list of tax violations for which penalties may be imposed		
	Reduction of the amount of penalties for many of the tax violations		
	Allowance of an extrajudicial procedure for penalty charging		
	Given a delay in considering the issue of imposing penalties tax authorities lose the right to collect the penalties from the taxpayer		
	All ambiguities of legislation are construed by a court as being in favour of the taxpayer		
Gradual raise of fiscal load on wage pool by increasing the aggregate rate of social contributions			

### 2.2.1 Corporate Profit tax

Corporate Profit tax is a federal tax. The rate is different for domestic and foreign companies. The permanent establishment of a company makes it deemed domestic, thus allowing it to follow all the rules applied to Russian companies. If a company does not have a permanent establishment, tax rates might be higher; the difference will also depend on the treaties between the Russian Federation and the company's country of origin. Corporate tax rate varies between 0% and 20% depending on the form of income.

There is no separate Capital Gains Tax in Russia. A capital gain from a sale is tax-free for individuals who owned the asset for more than three years. In case the ownership period is shorter, capital gain is subject to taxation according to personal income tax rules, and the tax rate is 13%. As for companies, regardless of the period of the ownership, capital gains are considered as corporate income and are taxed according to corporate profit tax legislation.

"No separate Capital Gains Tax in Russia"

### 2.2.2 Value Added Tax

Broadly speaking, the Russian value added tax (VAT) system follows the EU system. Standard VAT rate is set at 18%, with an exception of specific food products and goods for children; the rate for these types of products is 10%. The tax base can be divided into three groups:

- Sales revenue
- Goods and services used for company's own needs
- An import of goods to the customs of the Russian Federation

Objects of taxation are:

- Compensated transfer (sale) of goods, performed works and rendered services
- Gratuitous transfer of goods, services and works. Market value is used for tax base calculation
- Performance of construction and installation works for one's own use
- Import of goods to the customs of the Russian Federation

There are a number of actions that are not considered as realization and are not the objects of taxation. Among those, the following examples can be mentioned: any transactions with the currency and transfers of property of an investment nature (contributions to the Charter Capital). One important exception closely related to real estate investment is the transactions with land plots or parts of thereof. Rental payments in Russia are subject to VAT.

As a general rule, VAT to be paid is calculated as the difference between VAT on taxable turnover and deductible VAT. The main types of input VAT, subject to a deduction by the purchaser are VAT on production expenses and VAT on acquired or constructed fixed assets. At the same time, VAT on the following types of activities are generally not deductible: VAT on non-production services, VAT on expenses pertaining to the production of goods, performance of works and rendering of services which are not charged VAT.

### 2.2.3 Corporate Property Tax

The permanent domestic establishment of all movable and immovable property by Russian and foreign companies are subject to taxation. Foreign companies that are not performing activities in the Russian Federation but do have, however, immovable property located on Russian Federation Territory are subject to taxation. Land plots are not taxed. The taxation base is calculated on the average book value of the taxable property. The depreciation of property is deducted from the initial book value. The rate of the corporate property tax may not exceed 2.2% and is determined on the regional level.

"The corporate property tax rate may not exceed 2.2%"

Laws of many constituent territories of the federation, stipulate tax concessions in relation to property created or acquired for the implementation of an investment project. Normally such concessions, which might result as a reduced tax rate or tax exemption, are provided for the duration of the payback period of an investment project.

### 2.2.4 Personal Income Tax

Personal income tax is levied individually at a flat rate of 13%. This refers both to earned income and capital gains. A special tax rate of 35% applies to lottery and gambling wins.

Employers act as an agent, obliging to deal with the personal income tax of their employees. This increases the amount of tax payments and improves the tax-payment culture of Russian population. Some years ago it was not unusual to pay so called "black" wage to the employees in order to avoid taxation.

## 2.2.5 Unified Social Tax

From 2001 until 2010, the employers paid Unified Social Tax on salaries and wages of the employees. The rate is regressive and depends on the amount of the gross salary; the highest rate is 26%, and the lowest amount to be paid is 2% of the gross salary plus 104,800 roubles (2,655 euro). From 2010,

the Unified Social Tax has been replaced by separate contributions to a Pension Fund, Social Insurance Fund, Mandatory Medical Insurance Fund and territorial mandatory medical insurance funds of the Russian Federation. For 2010, the rate has been preserved at a level of 26%; however, from 2011 it will be raised up to 34%.

Taxes, Source Beiten Burkhardt Rechtsanwälte (German Attorneys-at-law) 2009-2010

Tax / Tax Level	Tax Rate	Note
Corporate Profits Tax	0%	On income of Russian organizations in the form of dividends given compliance with the several legislatively established conditions
	9%	On income in the form of dividends paid by Russian and foreign companies to Russian companies
	15%	On income in the form of dividends paid by Russian companies to foreign companies
	10% <sup>6</sup>	On income of foreign companies from freight of vessels, planes, other mobile transportation means and containers, provided that the foreign company's activities do not create a permanent establishment in Russia
	20% <sup>6</sup>	On other income (aside from those mentioned above) of foreign companies from sources in Russia, provided that the foreign company's activities do not create a permanent establishment in Russia
	15%	On income from state and municipal securities (there are some exceptions)
	20%	On profit of Russian companies and foreign companies whose activities create a permanent establishment in Russia (2% to the federal budget and 18% to the regional budget) as of 01.01.2009
Value Added Tax (VAT)	18%	For most goods, works, and services
	10%	For certain food products, children's goods, periodic print publications and domestic and foreign produced medical goods
	0%	In relation to exported goods, works (services) directly associated with the shipment or transport of goods placed under the customs regime of international customs transit, and certain other goods (works, services).
Corporate Property Tax	<2.2%	Not more than 2.2% of the residual value of the taxable property according to accounting data
Personal Income Tax	13%	Special rate applies to lottery and gambling wins (35%)
Social Tax	34% <sup>7</sup>	A regressive rate from 26% to 2% plus 104,800 rubles

<sup>6</sup> Unless otherwise provided by international agreements.

<sup>7</sup> The rate is valid from 2011.

## 2.3 Market practices

### 2.3.1 Investment practices

The short market history, as well as specific features that deal with the way the market has developed, has resulted in some peculiarities regarding property investment practices. Compared to the most Western property markets, the Russian market is quite development oriented. Most players' strategies are based typically on "develop and sell" objectives. Institutional-like, long-term approach to property investment is still rare.

Consulting services are widely used by investors and developers in transaction processes. At the same time, the local investors very much rely on their own experience and market knowledge. Market presence of new players, like foreign investors and development companies, has made the role of advisors even more important. Prior to a deal, international companies usually require thorough due diligence analysis. Russian companies are more flexible in this sense, and the required level of due diligence can be performed internally.

"Institutional-like,  
long-term approach to  
property investment is  
still rare"

Among the main differences of local and foreign investors, one should mention the length of the decision-making process. Local investors can be characterized as more risk-tolerant than foreign investors. Market knowledge is based on their experience, making it possible to make decisions in short time frames.

Conversely, international investors are more risk-averse and need thorough research and analysis in order to invest. This can be partly explained by the lack of market knowledge. The other reason is the type of capital for the investment. Foreign funds, typically backed by institutional investors, have to follow certain decision-making procedures, which often require thorough analysis and reporting, as well as various committee meetings and organizational decision-making layers to make final decisions. Differences in decision-making procedures can lead to significant differences in length of the process, varying from only couple of weeks with regard to local investors, to several months when international players are considered.

Prior to the economic crisis, the constantly rising market created the conditions for many of the property-related companies to invest in developments where the projects were hopefully sold upon completion. Decisions on speculative development are normally based on the overall market situation. The shortage of high-quality commercial premises, as well as the lack of tenants' trust for developers manifested in as the unwillingness to sign agreements on uncompleted premises, are relevant drivers for starting construction processes without any pre-lease agreements. In the retail sector, however, due to the high importance of the location characteristics, negotiations are started and pre-lease agreements are made with the anchor tenants at an early stage.

The timing of sales of a speculative development project depends primarily on the developer's strategy and its financial stability, and can be performed at any stage of the development process. The developer-investor's strategy is typically to stay as an investor upon the best possible offer.

### 2.3.2 Rental practices

The immaturity of the market is the main reason for the lack of established, widely used leasing practices. Market participants tend to adjust to varying lease conditions, while lease contracts are usually subject to negotiations. However, as the market develops, patterns of rental practices are gradually established.

"There are no  
established, widely used  
leasing practices"

The leasing process is normally done in-house. Most of the owners have large leasing departments. The involvement of agents is always welcome by landlords; however, exclusive brokerage rights are rare. The practice is varied in different property sectors. In today's "tenant" market, it is not rare that the landlord pays the broker's fee, however, traditionally the service user is the one who covers this cost. Brokerage fees typically vary from half a month's to one and a half month's rent.

		Office	Retail		Warehouse	Rental Residential
			Shopping centers	Street retail		
Lease length	Short-term (months)	11 m	11 m		11 m	up to 11 months with the right for prolongation
	Long-term (years)	3 years	Anchor:10 - 15	3 - 5	3 - 10	
			Other: 3 - 5			
Payment conditions	Currency	USD/EUR/RUR				
	Prepayment	1 m	1 m	1 m	Class A: 3 m	½ - 1 m
					Class B: 1 m	
	Deposit	1 - 2 m	1 m	1 m	1 - 3 m	1 m
Type of rents		Gross		Net	Gross	
		VAT, electricity, IT incl. or excl.	VAT, electricity, IT excl. or incl.	All expenses are excl.	Fixed OPEX incl.	Electricity, water supply, Telephone expenses incl. or excl.
Rent increase	Fixed rent	Fixed rent 2 - 3 y				Demand related
	Fixed increase	RUR: 10%	3% - 7%	Fixed increase	3% - 5%	
		USD/EUR: 4% - 5%			step rent	
	Indices		LIBOR/HICP by foreign developers	CPI by Rosstat		
Fit-out		Landlord	Tenant: fit-out costs	Shell&Core areas: landlord	Internal areas: tenant / landlord	Furnished apartments are more common, but unfurnished premises are also available
			Landlord: external works and common areas	Internal areas: tenant	Shell&Core areas: landlord	

## Lease length

Among the most distinctive features of the Russian market are the short-term lease contracts. Previously, this type of contract was widely used in the market. The development of the market and constant increase of the presence of the international players brought international standards to the market, and today both short-term and long-term lease contracts exist.

Short-term contracts are 11-month rental agreements that can be found in all property sectors. Registration of the contract is not required, which is considered as a main advantage by the players. The high level of bureaucracy makes the registration process time-consuming, and, therefore, neither the tenant nor the landlord wants to deal with it. Short-term agreements are more attractive to small- and medium-sized companies, in particular, as a measure to ensure

flexibility and avoid additional obligations. From the landlord's point of view, short agreements provide possibilities for flexible rent increases in the rising markets. Upon termination of these 11-month agreements, they are often renegotiated and continued with updated terms. Long-term additional "side" agreements are sometimes used in the commercial property market to guarantee the long-term lease intentions. In the rental residential market where private owners dominate as landlords, short-term contracts can also be used for taxation reasons.

On the other hand, long-term contracts offer the landlord certainty in cash flow during the lease period. Likewise, from tenant's point of view, longer contracts provide more security for financial planning.

## Rents

The lack of stability of the Russian ruble has led to foreign currencies being widely used in pricing. Rents are not an exception. Rents can now be denominated in the US dollar, euro, or the Russian ruble.

The rapid development of the market created the conditions for the landlords to be able to increase rents on a yearly basis. After the market downturn, the situation

"Short-term contracts are 11-month rental agreements"

"Rents can be  
denominated in the  
US dollar, euro, or the  
Russian ruble"

has changed drastically. According to Jones Lang LaSalle, there are two common practices in the market. Rents can be fixed for two to three year periods or renegotiated annually. The high volatility of the market explains the reluctance of applying indices for rents adjustment. The use of different currencies in rent denomination is another reason.

The economic downturn also affected landlords' attitude towards rental deposits. Previous pre-payments varied from two months to half a year, depending on the market segment. Today, the landlords on average require a deposit of one or two months.

Gross rents are prevailing in the market. The trends associated with triple-net rents could have been observed a couple of years ago, but the financial crisis bounced it back to the initial stage. The definition of a "gross rent" also varies in the market. Property maintenance costs are always included in the gross rent, while the expenses for electricity, IT, cleaning services are normally excluded. VAT is another item typically not included in the base rent. At the same time, there are examples in the market gross rent that includes all possible expenses. The lack of established rental practices in the market affects the way information is presented in the consultants' market reports. Rental levels can be presented either per month or annum, including or excluding VAT, and denominated in any of the used currencies.

### 2.3.3 Asset and property management (Pöyry)

Property management in the St. Petersburg market refers usually to management of the company's own property portfolio. External property management contracts are a rarity in the market, which has led to some confusion in the terminology. Among domestic market players, control of one's own assets is typically not handed over to others, mainly due to the lack of trust towards service providers.

"External property  
management contracts  
are a rarity"

Consequently, there is neither much demand nor supply for property management services, and companies providing these services are usually of foreign origin, working with foreign clients. For international investors, the lack of property management services may be one significant obstacle for market entry. To overcome this, most investors have established offices for managing their property portfolios.

Having the need to set up management naturally increases property investors' overhead and risks. This is particularly important in the current situation when the property portfolios of most investors are small. The cost of maintaining a property management function is relatively high when compared to outsourcing this function to an outside service provider, responsible for a bigger portfolio, owned by multiple investors.

### 2.3.4 Property maintenance (Pöyry)

Property maintenance in St. Petersburg still holds many characteristics that have been inherited from the Soviet business organization. Maintenance is typically an internal function, and maintenance staff is located on-site. Although some companies already combine internal staff with external

"Typically, maintenance  
staff is located on-site"

specialist services, the process of transferring to outsourced services is only beginning. This is one of the dominant features of the property maintenance sector.

Typically, the maintenance of a property remains in the hands of the developer or it is taken over by the owner. Similarly to property management, in property maintenance outsourced services are more typical among the international companies. The use of outsourced property maintenance is somewhat more popular than property management. The practice has been also adopted by some Russian companies. Business centers and retail chains have been among the first companies to outsource, but also many state-owned or state-affiliated companies, such as banks, have moved in this direction.

At the moment, market practices in St. Petersburg are definitely moving towards the Western practices. Preventive maintenance and different flexibility enhancing solutions, such as rotating or centralized maintenance and mobile maintenance units, are becoming increasingly popular. In addition to all the international companies, many local maintenance companies also provide these services. All the same, the primary target group of these new services is international property owners and users, not the local



companies. Outsourcing and preventive maintenance and off-site staffing, in particular, is still to gain popularity among the Russian enterprises. According to the estimates gathered from the interviews, less than 10% of those Russian companies that have outsourced their property management have introduced off-site maintenance.

In the context of the interview conducted for this study, many property owners in St. Petersburg questioned the economic rationale of outsourcing. The common argument was that the cost of technical staff is so low that outsourcing is not a profitable option. On the other hand, service

"Flexible solutions are gradually replacing permanent on-site staff"

providers in the sector claim that outsourcing can ensure reliable staffing, provide better skilled professionals and still earn savings up to 20% on any property. The question is hard to evaluate from outside.

However, on-call maintenance, staff banks and other flexible solutions are gradually replacing permanent on-site staff. Although this may not lead to the predominance of outsourcing in maintenance in the short term, it is certainly increasing demand for these services. One feature of this is that, according to many maintenance companies, clients are slowly beginning to experiment with outsourcing by transferring the maintenance of individual functions to external suppliers.

Another typical characteristic of the market is that advertised service supply of maintenance companies may exceed actual supply capacity. As a result, care must be taken to ensure the company is capable of actually providing the service and the staff offered.



### III – Players in property investment market

The Russian market is quite specific when it comes to distinguishing between different categories of market players. Due to distinctive features of the market development, most of the local companies now operating in the market perform a variety of activities. It is common practice for a single company to offer a full range of services, from concept development to brokerage and management services, to acting as an investor. This can be explained by the earlier stages of the market development when there were not many companies providing property-related services. Furthermore, this determined that most of the potential investors established subsidiaries specializing in real estate. It is therefore often impossible to draw a clear line between different types of market players and distinguishing their multiple and simultaneous roles within the market.

"A single company commonly offer a full range of services"

#### 3.1 Ownership structure

##### 3.1.1 Domestic investors

Different types of domestic companies invest in the real estate market of St. Petersburg area. Powerful national corporations tend to diversify their portfolios either by investing in existing properties or by establishing subsidiaries for property development, and they often also rent out premises to tenants in the market. The corporations can typically be categorized as long-term investors and/or owner-occupiers. Traditionally, involvement of the Russian banks in the market was also an illustration of owner-occupancy. For corporations, capitalization rates or other typical investment measures are not considered as crucial parameters for decision-making when the property is purchased or developed for their own use. A property for company's own use is considered a safe long-term investment the value of which is expected to rise gradually. At the same time, the practice of assessing the profitability of investments based on their ability to generate income is becoming more common even among the state-owned companies in cases when they invest in premises to be rented out.

Among the Russian corporations, Gazprom and its different business entities and affiliated companies should be mentioned as significant property market players. Banks

such as VTB, St. Petersburg, Bank Petrovsky and many others belong to the other group of owner-occupiers.

Property companies are another type of domestic investors. Apart from investing, they typically deal with development and property management of real estate assets. Furthermore, the development companies quite often also act as investors in the market.

The number of listed domestic property companies is limited, compared to the number of companies operating in the market. LSR Group, Systema-Hals, Glavstroy (a construction subsidiary of Basic Element) and Bank St. Petersburg are some of the listed domestic property market players.

##### 3.1.2 International investors

St. Petersburg is the second area of interest of international investors after Moscow. Rapid development of the Moscow's property market led the investors to seek better investment opportunities, and St. Petersburg used to be their second option. The real estate downturn drastically affected this decision and extremely high risks played a crucial role in the cancellation of many significant entry plans.

The slow continuous recovery of the rental market has started to regenerate new demand from international investors. In addition, a government policy encouraging foreign investors further stimulates the arrival of new foreign players. The main interest towards the St. Petersburg area comes from the Nordic countries; Finnish companies, in particular. The main reasons are geographical proximity and a common history.

"The main interest towards the St. Petersburg area comes from the Nordic countries"

ICECAPITAL, SATO, EKE Group are a few examples of Finnish investors active in the market. Listed foreign companies investing in the market include Sponda Plc, Raven Russia Limited and Technopolis Plc. The other foreign property investors mentioned during the interviews were the Chinese, Korean, Israeli, and European companies.

The lack of high-quality income generating properties used to determine the tendency to invest in development projects. Today, property development is associated with high risk, further preventing the entrance of new international investors.

### 3.1.3 Investment funds

According to the Federal Law on Investment Funds, two types of investment funds can be distinguished: unit investment trusts and joint stock investment funds.

The low activity of Russian institutional investors such as pension funds and insurance companies – which are only starting their activity in real estate markets – explains the fact that only foreign institutional investors are invested in the existing investment funds.

The Jensen Group, the primary St. Petersburg fund management company and their associated Russian Real Estate Fund II L.P., has attracted institutional and private investors from Europe and Northern America. It was closed with a total of 89 million US dollars of committed equity in May 2010. Evli Property Investments commenced its first Russian real estate fund on St. Petersburg property market. The fund emphasized business premises in Russian real estate market. The fund is currently invested in three properties in St. Petersburg area, including two office properties and a logistic center.

ICECAPITAL is another Finnish fund management company investing in the St. Petersburg market with a focus on the rental residential properties.

East Capital Private Equity announced that the East Capital Russian Property Fund was to be closed in June 2010, with no investments being made. Moscow, St. Petersburg and "Millionniki" cities were the target areas for this investment fund.

Unit investment trusts became a very popular form of investment activity during the 2000s. A vast variety of asset management companies managing open-ended and closed-ended unit investment funds are present in the market. TKB BNP Paribas Investment Partners should be mentioned as an example of a joint venture active in the market. Svinin & Partners (part of Okhta Group Holding), BFA Asset Management, PAN TRUST (part of PAN Investment Company) are examples of local companies managing unit investment funds investing in commercial property.

### 3.1.4 Institutional investors

Russian pension companies and insurers have not been active in the market. International institutions are not likely to make direct investments in Russia either. A few real estate investment funds investing in the market are the only sign of the presence of international institutional capital.

Russian banks in some instances play the role of "institutional" real estate investors. High-risk margins offered by the real estate markets naturally attract financial institutions to real estate as an alternative investment asset class. This is normally achieved through the establishment of subsidiaries specializing in real estate development or

management. Participation in the equity structure enables banks to get control over the managerial decisions, which diminishes the risks inherent to the property market. As an example, VTB Development's development portfolio currently contains five major commercial real estate projects. Another example is Bank St. Petersburg, which develops an office property for both owner-occupancy and for realization in the open market.

## 3.2 Real estate service sector

### 3.2.1 Development

Local and international construction and development companies operate in the market. Local players include pure construction and development companies, developer-investors, and development subsidiaries of Russian corporations. An enormous number of local construction companies operate in the market. Local developers used to specialize in a particular real estate sector; many of them have recently expanded their activity to other sectors. Actual construction is either performed by subsidiary or subcontracted to an external construction company.

"An enormous number of local construction companies operate in the market"

The office sector is dominated by developer-investors Holding Imperia and the Management Company Teorema. Holding Adamant is a market leader in the retail segment. RBI, LenSpecSmu, LE and Stroitelny Trest are the main participants in residential development, and mainly sell the apartments for owner-occupancy. VTB-Development is an example of a development subsidiary of a Russian bank, whereas Glavstroy is a construction holding company that is part of the Russian investment company Basic Element.

The number of international companies active in the property development has increased in recent years. The most active players include Renaissance Construction, YIT, NCC, ENKA, Bovis Lend Lease and SRV.

### 3.2.2 Property management (Pöyry)

The fact that companies specializing in total facilities management control a majority of the property management sector reflects the development of this branch in St. Petersburg. Most of these companies have either started by providing services to affiliated companies and later expanded to external parties, or have followed international companies entering Russia. This history can be seen also in the fact that both of the two biggest property management companies in St. Petersburg have strong international backgrounds.

As the number of international investors active in St. Petersburg is still comparatively low, it is not expected that the supply in managing agent or managing contractor services is going to grow significantly. The lack of supply of these services is a particular characteristic of the St. Petersburg market and affects the operations of many companies in the market.

Among asset management companies, the foreign players Aberdeen Property Investors, Amplion Asset Management, Ovenia and London & Regional Real Estate Asset Management should be mentioned. However, these companies are either just starting their operations in the St. Petersburg market or are just serving very few clients currently.

There are a number of big local property management companies. The biggest, Adamant and Senator, only manage the properties they own. Other big companies in the market are Best, MTL, Becar and VMB Trust, but many of these limit their services to only business centers, or business centers and retail space. International property management companies include M+W Zander, who have entered the market with Raiffeisen bank and have become well-established in Russia, and two Finnish companies, Ovenia and REIM.

### 3.2.3 Property maintenance (Pöyry)

The biggest property maintenance companies in the market are Finnish, although the market does have many Russian suppliers as well. While international property management companies usually are quite specialized and may provide only a part of the maintenance services needed in one property, e.g., concentrate on technical systems, the local companies have quite a different approach. The Russian companies

"The Russian maintenance companies usually provide a full range of services"

usually provide all property maintenance services themselves, and many of them have also extended to facility services, such as reception and cleaning.

Many property management and maintenance companies in St. Petersburg have started off by managing business centers or retail space owned by their parent company. This background can be seen from their customer portfolio as well. Practically all companies still concentrate on either business centers or retail space.

In logistics and industrial premises, the supply is much more limited and, especially in industrial space, Finnish companies have a strong representation. This does not mean that they would have a dominant position in maintaining industrial premises; rather this highlights the rarity of outsourced maintenance in the industrial sector. Most of the industrial premises in St. Petersburg are still owned by large domestic enterprises that have not moved towards outsourcing in maintenance.

Although it appears that all types of properties have a number of potential suppliers available, it is important to notice that in many cases the location of the property may rule out many of the suppliers. Most suppliers are operating in only a few locations and may not be able to expand their operations to other areas easily. A significant problem in this respect is severe traffic congestion, which makes very difficult to provide reliable service in a wide geographical area.

The location of the property may rule out many of the suppliers"

All of the big domestic companies providing property management services also provide property maintenance services. Other companies, with roughly the same service supply, but in a more restricted scale, are IB Group, Super Service and Praktis. Local companies that have specialized in only property maintenance are in the minority. Only two, Sistema and Top Service, were identified. However, there probably are a big number of small companies operating in the market.

International suppliers of property maintenance are not many, but they control a significant portion of the outsourced market. The biggest companies are M+W Zander, YIT Service, Tekmen and Are. Compared with M+W Zander and YIT Service, who are able to provide a full service portfolio, Tekmen and Are are quite specialized companies. Both of these companies have specialized in installation of HVAC and industrial machinery, but also provide maintenance services for these systems.

### 3.2.4 Advisory, brokerage, valuation and transaction services

Real estate advisory is a well-established activity in St. Petersburg. The supply of different types of advisory services accelerated rapidly in recent years because of the increased liquidity of the market and entry of new players. Nowadays, a mixture of domestic realty agencies and big global companies can be found in the market.

The emergence of domestic real estate agencies gave start to the advisory activity. From being mainly real estate brokers, the agencies expanded their activities to offering advisory, research and valuation services. Prior to the entry and expansion of the global consultants the local firms held the biggest share of the market. The entry of international players boosted the growth of the market share of the global advisory companies, such as Colliers International, Knight Frank and Jones Lang LaSalle. Jones Lang LaSalle entered the market by opening a local office in St. Petersburg, while Knight Frank and Colliers International entered the market through the purchase of the local companies. CB Richard Ellis has organized their operations through cooperation agreements with a local player. In St. Petersburg Maris Properties, "in association with CB Richard Ellis," represents the network. Cushman and Wakefield perform their activities in the market from the Moscow office. Other local brokerage and consulting companies have also become parts of global networks, like NAI – Becar Realty Group, BNP Paribas – Astera Group, and others. As the most active local advisory companies ARIN, Praktis CB and Best Commercial Real Estate should be mentioned. Advisory and brokerage services are also offered by a vast variety of local realty agencies. Furthermore, global business consultancy firms, such as Ernst & Young, KMPG and PricewaterhouseCoopers also offer real estate specific services in the market.

### 3.2.5 Financing services

Russian banks are the main players in property financing. State-owned banks are the most active players in this sector. Sberbank and VTB are to be named. The biggest Russian private bank crediting the real estate market is Alfa Bank.

"Banks have shown a high level of loyalty to the developers"

During the economic downturn, a high number of distressed asset sales were expected in the market as a result of developer's inability to settle their debts. Banks have, however, shown a high level of loyalty to the developers attempting to restructure debts. The establishment of property companies has been another solution in the existing situation – banks, however, tend to avoid it due to the lack of experience in the market.

International banks offering corporate lending services include UniCredit, Raiffeisen, Nordea, City Bank, SEB and Aareal Bank.

Real estate has always been considered as a highly risky asset among Russian financing institutions. The real estate market downturn has strengthened this perception further. Nowadays, practically no debt financing is available for development projects. Banks deal only with lending capital against the income generating properties. The lending conditions are often harsh allowing the banks to offset inherent risks.

## IV – Property sectors

### 4.1 Office sector

#### 4.1.1 Market

St. Petersburg is far behind European cities in terms of office stock. It has the lowest office supply in Europe compared to other big cities. St. Petersburg's history has determined the current structure of the office segment. High industrialization of the city during the Soviet times explained the lack of demand for office space, resulting in poor supply. The situation started to change only in the last decades.

Currently, the office stock can be divided into the three main quality groups: modern office space, lower quality offices and inferior space used as offices. According to different experts, total stock of the space used as offices is around 7–8 million square meters, whereas supply of modern office space slightly exceeds 2 million square meters.

"There are three main quality groups: modern office space, lower quality offices and inferior space used as offices"

Geographically, modern office space is concentrated in the central parts of the city. Location characteristics of the office centers delivered in 2009 indicated increased interest of developers to the decentralized areas; however, in 2010 new office centers were completed mainly in the central areas of St. Petersburg. Despite predictions of office demand being reallocated from the city center to suburban areas, central location remains of the highest interest to tenants.

The economic downturn has affected the demand for office space. The time lag inherent to the construction industry resulted in oversupply of the office space and hence high vacancy rates. The development activity has drastically slowed down.

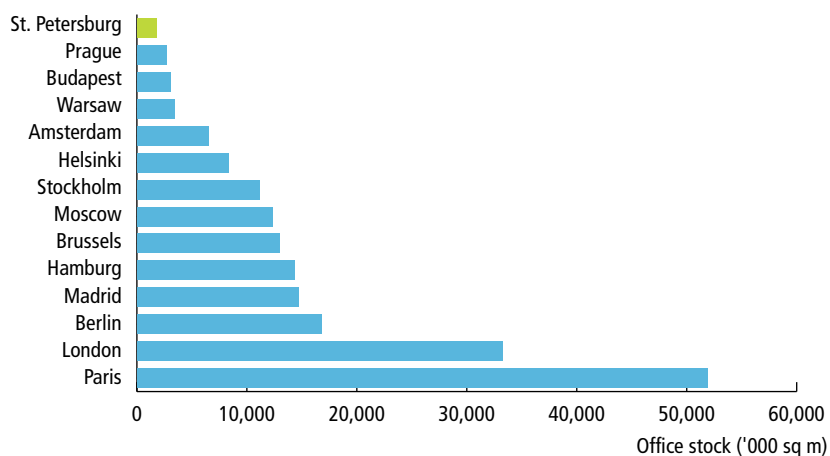
Regardless of recent slow but steady recovery of the rental market, today the vacancy rates remain the highest in St. Petersburg compared to other European cities. Rental rates have stabilized but remain at the low level. According to different expert estimations, about 200,000 square meters of new office space will be completed by the end of 2010.

Nevertheless, the potential for the continuous economic growth of St. Petersburg area, together with insufficient office stock, speaks towards room for high volumes of construction and an increase in the office stock.

#### 4.1.2 Players

Historically, development companies were the main investors in the office segment. Their share of the market remains the largest. Traditionally, banks play a significant role as owner-occupiers. In addition to growing interest to real estate as an

Office space in European cities, Jones Lang LaSalle



	Colliers	Knight Frank	JLL	CBRE	Astera	GVA Sawyer	NAI Becar
Total Stock (ml sq. m)	1.37	1.46	1.78	2.01	2.34	1.43	1.81
A class	367,900	358,200	404,230	456,600	537,050	361,000	481,000
B class (B+)	1,003,300	1,100,200	1,375,020	1,553,000	1,797,950	1,064,000	1,325,000
Distribution between classes	27/73	25/75	23/77	23/77	23/77	24/76	27/73
Vacancies							
A class	26%	27.9%	32.2%	18%	22%	31.3%	5%-25%
B class	17%	14.6%	19.1%	15%	10%	15.3%	10%-30%
Forecast							
Completions 2010 area (sq. m)	170,000	≈200,000	>150,000	>200,000	226,421	150,000 - 170,000	290,000 - 320,000

investment asset, the financial crisis resulted in higher involvement of banks in the market. Recent tendency of powerful national companies to move their headquarters to St. Petersburg creates another group of owner-occupiers. Foreign investors are currently not as active as was expected, due to high risks of investment in development projects and the lack of core properties.

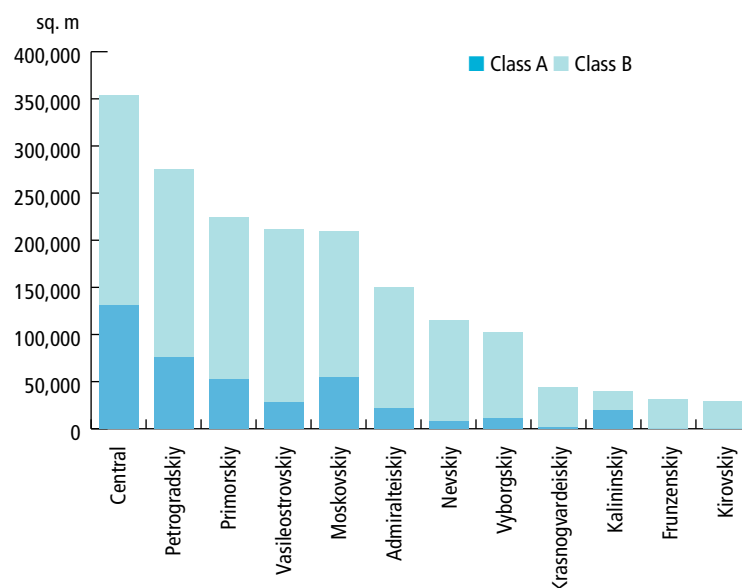
The biggest local and foreign investor-developers whose portfolios mainly consist of office property include Holding Imperia, Management Company Teorema, Renaissance Development, Russian Real Estate Investment Company (Ruric), EKE, Technopolis and Sponda Plc. Among the most active investment funds are EVLI Property Investments Ltd. and Jensen Group, even though they are small by international standards.

"Foreign investors are currently not as active as was expected"

#### 4.1.3 Rental practices

Rental practices in the office market vary. The terms of rental agreements can differ notably depending on the tenant. Short-term contracts of eleven months prevail in the market. However, tenants occupying large spaces more often require long-term agreements, with terms up to ten years.

Geographical distribution of office space A&B classes, St. Petersburg Jones Lang LaSalle





"The rents are typically gross in most of the multi-tenant office buildings"

Instability of the Russian ruble results in rents to be denominated also in euro and US dollars. The rents are typically gross in most of the multi-tenant office buildings. Net rents started to become more popular, but this tendency was stopped by the economic downturn due to the increased competition for tenants and need to offer better service. Due to widespread gross rents, operating expenses are typically not transparent. According to consultants' market reports, operating costs vary from 60 to 130 US dollars per square meter, per annum, depending on the quality of the building. Annual rent increase rates in the office sector vary depending on the currency: typically 10% for rents denominated in rubles, and 4% – 5% - in euro and US dollar.

## 4.2. Retail sector

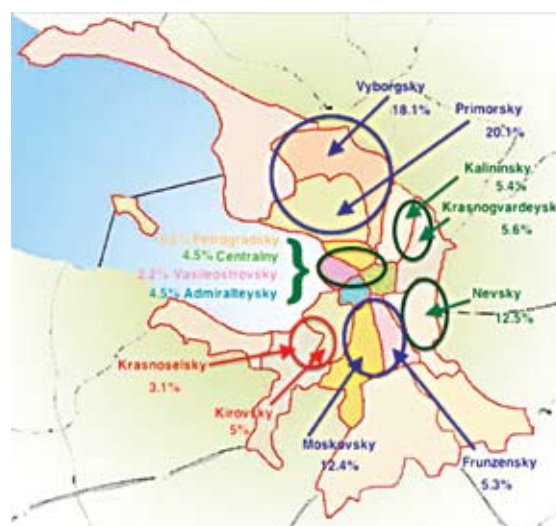
### 4.2.1 Market

Retail property market in St. Petersburg is considered to be the most developed. The existing supply can satisfy the demand, but the quality of the stock varies. According to the experts' estimates, St. Petersburg has one of the highest provisions of retail space per capita among the cities in Russia. However, the supply of retail space is not evenly distributed throughout the city. A little less than half of the total shopping center stock is concentrated in three administrative districts: Primorsky, Vyborgsky, and Moskovsky.

"Retail property market in St. Petersburg is considered to be the most developed"

The overall outlook for retail remains clearly more positive than for offices. This applies to both rents and vacancies, but not to new development. Only two new retail facilities were put into operation during 2009, which was the lowest level of annual stock increase in the St. Petersburg retail market. Projections for the completions in 2010 are quite promising; over 200,000 square meters in four major shopping centers are due to be put into operation by the end of the year. Decline in personal income during 2009 had a significant

Geographical distribution of retail space in St. Petersburg, retail facilities with area more than 4,000 sq. m, Colliers International

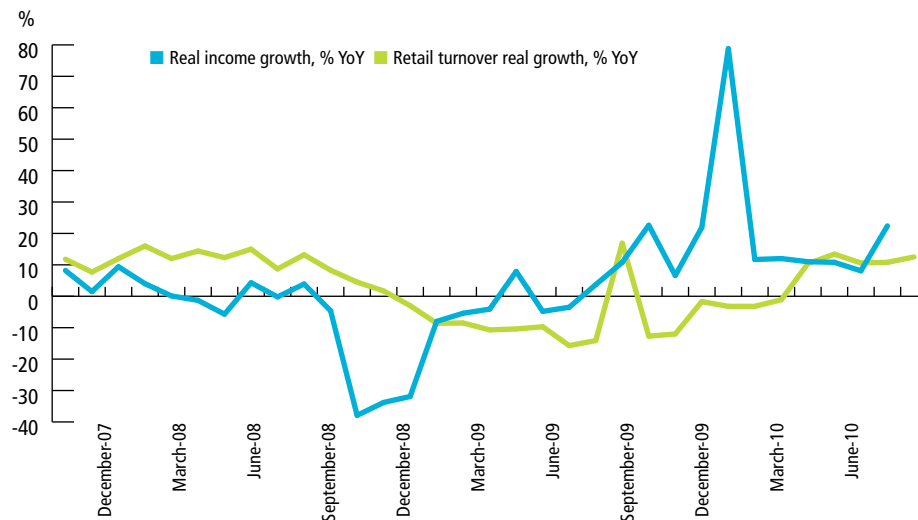


Major retail development projects in St. Petersburg, 2010-2011

	GBA (sq. m)	GLA (sq. m)	Developer
2010			
Galeria <sup>8</sup>	200,000	93,000	Briz
Leto	113,890	80,000	Sistema-Hals
Nevsky Center <sup>9</sup>	97,000	42,700	Stockmann
Balkanskiy II	29,957	20,485	Adamant
Nikolaevsky Passage	13,000	6,700	Nevskie Bani/Krona
Zvenigorodsky	6,743	3,660	Adamant
2011			
City Mall, Phase 3	71,091	18,100	Macromir
Osinovaya Rosha	39,556	19,400	Adamant
Kupchino	24,830	15,200	RTM Development
Dal'	22,155	18,000	Donk
DLT	33,240	9,200	Mercury Group
Iskra	28,000	21,000	Skeyls

<sup>8</sup> The opening of the shopping center is announced for 25 November.  
<sup>9</sup> Nevsky Center department store was opened on 19 November.

Retail turnover and income dynamics, St. Petersburg, Jones Lang LaSalle, Rosstat



impact on retail turnover. As a result, some operators had to decrease their presence in the market, while the others, more successful ones, continued the extension of their market share. Retail turnover started to grow again in March 2010, which is an indirect sign of the reviving consumer demand.

The lack of new completions during 2009 and first half of 2010 smoothed the impact of the decrease in demand. High quality retail assets in good locations remain fully occupied. At the same time, vacancy rates in shopping centers with poor concepts and transport accessibility can reach 40%.

#### 4.2.2 Players

Local investors and property companies, development companies and owner-occupiers comprise the main investor groups in the St. Petersburg retail sector. The number of foreign investors is limited to a few players. Adamant Holding, who currently owns and manages 21 shopping centers, dominates the St. Petersburg shopping center market. Macromir Holding is another Russian investor specializing in retail real estate. IKEA Group is an active player in the Russian market with its shopping center chain MEGA. There are currently two super regional MEGA shopping centers with total GLA exceeding 250,000 square meters in the St. Petersburg area. Institutional investors are underrepresented in the sector. The owners of high street retail are not publicly announced, with most of the premises being owned by private

investors.

Russian retailers are the biggest occupiers in the market: Lenta, X5 Retail Group (retail chains Karusel, Pyaterochka, Perekrestok), O'KEY, etc. Foreign retailers active in St. Petersburg include Metro Group, Auchan, S Group, Kesko Group, Kingsfisher and Stockmann. Most of the local retailers typically own their premises, whereas the own vs. rent strategies of the foreign retailers varies.

#### 4.2.3 Rental practices

Rental agreements are normally longer in the retail than in the office market. Fixed terms are commonly applied in the retail market. Anchor tenants in the shopping centers typically have leases up to fifteen years. Other tenants have shorter leases, from three to seven years. Short-term rental contracts are also common, however, the practice of additional long-term agreements is applied in order to guarantee the long-term landlord-tenant relationship.

The tendency of wider use of turnover leases in 2009 proved out to be only temporary. Fixed rents prevail in the shopping center segment. Moreover, the landlords tend to be more flexible with regard to the rental deposit. During the economic recession, rental discounts have become a common practice in the new shopping centers as well as in the less successful ones. Operational expenses are typically included in the rent, and there are significant differences in operational expenses between landlords, and they can also

Shopping centers segment in St. Petersburg, a comparison table of the figures by different consultants, Summer/Fall 2010<sup>10</sup>

	JLL	Colliers	Knight Frank	CBRE	Astera	GVA Sawyer	NAI Becar
Stock, ml sq. m	1.3*	3.9	3.8	3.2	4	4.2	3.4
Vacancies	9%	<10%	8%	10%	15-20%	11% - 13%	2% - 7%

\*Modern quality shopping centers with area exceeding 10,000 sq. m are included in the analysis; DIY, hypermarkets and furniture centers are excluded.

<sup>10</sup> Significant difference in figures is explained by difference in methodology applies, i.e. JLL includes only modern shopping centers with the area exceeding 10,000 sq. m.



vary by the tenant type. According to the estimates of Colliers International, OPEX vary between 45-55 US dollar for anchor tenants and 80-150 US dollar for other tenants per square meter, per annum. The practice to denominate rent in euro, US dollars or Russian rubles remains the same.

"Rental agreements are normally longer in the retail than in the office market"

### 4.3 Warehouse sector

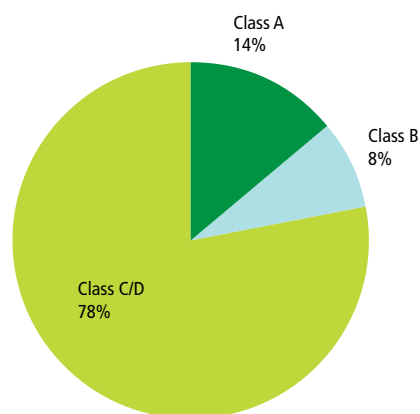
#### 4.3.1 Market

Despite the fact that St. Petersburg lies on one of the main transport corridors, connecting northern Europe and Russia, the logistics property market is in its stage of early development. The market is characterized by the lack of high-quality warehouse space. The expansion of international manufacturers to St. Petersburg, the development of the retail market, as well as the improvements in infrastructure has led to an increase in demand for high-quality warehousing and logistics properties.

"St. Petersburg lies on one of the main transport corridors, connecting northern Europe and Russia"

Despite active construction in recent years, the market is dominated by outdated space. According to the City Committee for Real Estate Inventory and Valuation (GUION), the total warehouse stock amounts to 6.8 million square meters while, according to the estimations of the consulting companies, high quality warehouse space of "A" and "B" class amounts to only 16% – 22.5% of the total supply.

Warehouse stock distribution between the classes, St. Petersburg, Jones Lang LaSalle, GUP "GUION"

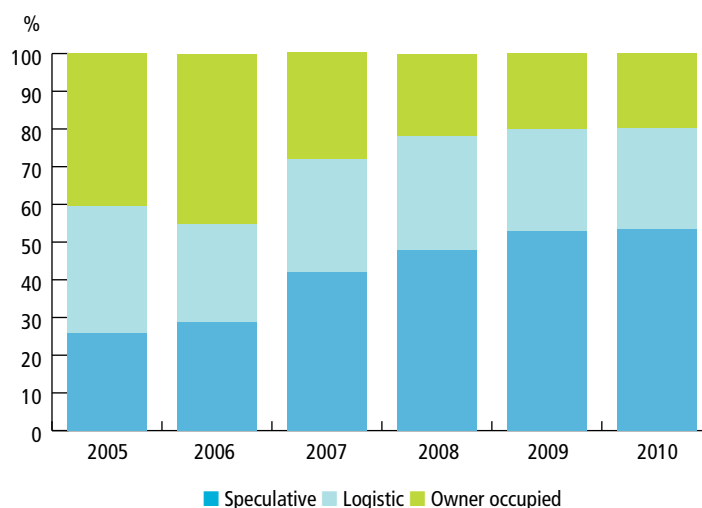


The economic downturn affected the warehouse segment significantly. Previously, undersupply of quality warehouse space and the growing demand were the two main characteristics of the segment. This caused interest from the developers' side and hence resulted in high volumes of construction. In 2009, due to a decrease of goods turnover, as well as cargo transportation, the demand decreased drastically. The vacancy rates in 2009 were recorded at a level of 40%.

Slowed down activity of the developers in the warehouse sector resulted in the lack of new warehouse space delivered to the market in 2010. Low level of new completions, together with the steady recovery of the potential tenants' economy, has resulted in decreasing vacancies. Favorable leasing conditions are the reason for tenants' migration.

The market is expecting very few completions in 2010 and the beginning of 2011. According to different sources, up to 80,000 square meters of warehouse space will be delivered by the end of the year, which is only one-third of the completion volumes of the previous years.

"The economic downturn affected the warehouse segment significantly"



Warehouse segment in St. Petersburg, a comparison table of the figures by different consultants, Summer/Fall 2010

	Quality warehouse		Class A		Class B		Completed q1-q3 2010 sq. m
	Total Stock sq. m	Average Vacancy rate	Stock sq. m	Vacancy rate	Stock sq. m	Vacancy rate	
JLL	1,512,180	14.4%	989,640	n/a	522,540	n/a	17,900
Colliers*	1,120,000	24%	n/a				22,000
Knight Frank	1,657,000	n/a	952,000	21%	705,000	23.5%	3,000
CBRE	1,484,000	n/a	977,000	35%	507,000	18%	60,500
Astera	≈1,774	n/a	≈1,189,000	n/a	≈585,000	n/a	76,000**
NAI Becar	1,240,000	20% - 25%	≈719,200	n/a	≈520,800	n/a	n/a
* Speculative warehouses and logistic facilities are included in the analysis							
**C class is included in the analysis							

### 4.3.2 Players

Owner-occupancy is very common in large manufacturing properties. Heavy machinery, including military equipment, production of aluminum alloys, shipbuilding yards, aerospace, and other industries are present in the St. Petersburg area. Most of the world's car manufacturers have recently established plants in St. Petersburg. Noted recent demand for the light industrial business sector will diversify the ownership structure in the industrial property market.

The ownership in the logistics sector is widespread with occupiers, property companies, individual investors, developer-investors, property funds and foreign players. Raven Russia Ltd. has been very active in the market in recent years despite the drastic downturn of the market.

EPI Russia is an example of foreign capital invested in the St. Petersburg warehouse market. MLP Russia, Interterminal Group of Companies and Management Company Teorema are among the major warehouse space owners. VTB Development has a project of an industrial park in its portfolio.

Despite the high vacancy rates since the beginning of 2009, the logistics property market has a great potential due to the lack of quality space that is attracting both local and foreign investors.

### 4.3.3 Rental practices

Due to the heterogeneity of both the available stock and the user needs, rental practices vary in the warehouse market. Rents are typically gross, with fixed operating expenses included in the rent. According to the advisors estimations, operational expenses vary between 25 and 45 US dollars per square meter, per annum. Lease period is normally from three to 10 years, however, short-term contracts of eleven months are also available. Rental increases are normally agreed between the tenant and the developer and highly depend on the applied currency terms. A practice of 3 to 5 percent annual rent increase has evolved in the beginning of 2010. Euro, US dollars and Russian rubles are used in rent designation.

## 4.4 Rental residential property market

### 4.4.1 Market

There are some fifty thousand residential buildings in St. Petersburg, with the estimated total area of over 110 million square meters. The number of apartments is estimated to be around 1.88 million apartments.

The Russian residential market differs significantly from other European countries, and the St. Petersburg market is not an exception. A communal residence either in regular apartment dwellings or in special communal buildings (so called “Obshezhitie”) is the CIS countries’ phenomenon<sup>12</sup>. It started during the Soviet times and has remained till today. There are over 118,000 communal apartments that are about 10% of the total residential area. Residential area in the communal buildings (“Obshezhitie”) reaches 1,287,900 square meters. The government of St. Petersburg strives to solve this problem by introducing different target programs and providing subsidies to low-income families.

“A communal residence  
is the CIS countries’  
phenomenon”

Half of the total residential area is municipal housing. Individuals and companies own one-fourth of the residential stock. In terms of the number of buildings, more than half are privately owned. Ownership of the occupied residential properties became possible only within the last twenty years when the process of privatization was initiated. The share of housing cooperatives reaches 15% of the market stock.

The lack of residential space supply and positive net migration determine constant demand for housing in St. Petersburg. After the dramatic decline of commercial property values, residential real estate became the most attractive sector to the developers. A more positive view regarding residential real estate from developers’ point of view can be explained by the shorter payback period strengthened by the constant demand for homes.

### 4.4.2 Players

The city of St. Petersburg is the major player in the rental residential housing. So called “ZhilKom-Servis” agencies (Housing Communal Service translated from Russian) act as the property management organizations on behalf of the government of St. Petersburg. According to the estimate of GUION, about half of the total residential area is municipal housing.

The small private investors, mainly individuals, own a significant part of the rental apartments. Their investment portfolios normally consist of several apartments; the process

Target programs of the Government of St. Petersburg 2007 - 2011

A legislative act on the St. Petersburg housing certificates	Subsidies to low-income families with residential space provision lower than approved minimum
A legislative act on the exchange of a communal apartment for non-communal apartments that allows each family may have one of its own apartment	Subsidies to the low-income families, occupying such premises
	Priority of the communal apartments occupiers to use advantages of other programs, such as “home for youngsters,” “home for the employees of the public sector,” “long-term mortgages,” etc.
	Assistance in purchase of available rooms in the apartment by setting lower prices depending on the place in the waiting list (so called residence conditions improvement)
	Swaps with the purpose of single-family accommodation
Changes to the legislative act on the realization of residential property owned by the City of St. Petersburg	
Changes to the legislative act “Affordable Housing for Youngsters”	Subsidies to young families, or an option of getting non-interest loans
Changes to the legislative act “Housing for the Public Sector Employees, i.e., Education, Public Health, and Social Services Sectors	Cost prices for the apartments for the public sector’s employees
Changes to the legislative act “On Long-Term Mortgages” 2002 –2012	Subsidies of 30% of the apartment price for citizens on the waiting lists for a purchase of a new apartment if they obtain a mortgage

<sup>12</sup> A communal apartment (kommunalka spelled from Russian) is a shared apartment, where two or more families share a bathroom and a kitchen.

being known as the “second-hand rent”. This group of investors creates the main competition to so-called professional residential investors. The rental residential market has not been a long-term investment target for local property companies or any other types of professional investors. Owner-occupancy became a more attractive option since the start of the privatization process. As a result, the number of companies operating in the rental residential market is very limited. Today, high potential of the market has attracted foreign professional investors, such as SATO and ICECAPITAL, purely concentrated on the rental residential market. The Jensen Group is one of the few local professional players in rental residential market. They manage investment funds investing in rental residential market.

#### 4.4.3 Rental practices

In the private rental residential market, rental practices vary. Lease-term is normally eleven months. Short-term contracts are not subject to registration; hence, both the landlord and the tenant can avoid bureaucracy issues. Property owner can also avoid taxation by not registering additional rental income.

The scarce number of professional players determines the lack of established rental practices in the professional rental residential market. Short-term contracts are prevailing in the market. International practice of lease “until further notice,” as for instance in Finland, has not been evident in the St. Petersburg market. However, landlords normally offer the option for lease extension.

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Jones Lang LaSalle

Colliers International

Knight Frank

Maris Properties in association with CB Richard Ellis

Astera

NAI Becar

GVA Sawyer

## APPENDIX 1 – Interviewed Specialists

Interviewed specialist	Position	Company name
Charles L. Voss	Managing Director	Aberdeen Property Investors St. Petersburg
Kari Sundqvist	Director, International Operations and Business Development	ARE
Kyle Patching	Managing Partner	ARIN
Mikhail Troshkin	General Manager	Austrian Office Park Development LLC, Tilman Kraus
Pavel Filippov	Managing Partner	Avanko Capital
Sergey Volchenkov	Associate	Avanko Capital
Vladimir Sergunin	Associate Director, Investment Services Department	Colliers International
Julia Sheveleva	Economic Research Manager	Finnish-Russian Chamber of Commerce
Mikhail Igoikin	Head of the Analytical and Market Modeling Department	GUP "GUION"
Sergey Gribovsky	Deputy General Director	GUP "GUION"
Mikko Söderlund	Managing Director	IBI Invest LCC, SRV
Liudmila Gurtovaya	Head of the Valuation Department	Institute of property management and appraisal (INUPEK)
Anna Rezhepp	Associate, Capital Markets	Jensen Group
Ekaterina Kolokolova	Sales and Leasing Manager	Jensen Group
Andrey Rozov	Head of the St. Petersburg Branch	Jones Lang LaSalle
Veronika Lezhneva	Senior Analyst, Economic and Strategic Research Group	Jones Lang LaSalle
Nikolay Pashkov	Director, Professional Services	Knight Frank
Oleg Gromkov	Head of the Research Group, Commercial Property	Knight Frank
Kari Paajanen	Managing Director	LR Management, London & Regional Properties
Alexander Moskvitin	Commercial Director	Management Company "Adamant"
Kirill Shishkov	Chief Executive Officer	Management Company Teorema
Kirill Akinshin	Head of the Consulting and Valuation Department	Maris Properties in association with CBRE
Natalia Kireeva	Market Research	Maris Properties in association with CBRE
Denis Lola	Project Manager	NAI Becar
Svetlana Lezhneva	Head of the Marketing Department	NAI Becar
Julia Panova	Clients Manager	PAN
Yury Zaretzky	General Director	Peterland
Andrei Hitrov	Managing Director	Transway North-West LLC, EKE
Galina Zhivova	Property Manager	REIM Group
Tatiana Bogdanova	General Manager, Russia	REIM Group
Staffan Tast	Regional Manager	SATO
Jan Svojavolja <sup>13</sup>	Marketing Director	Senator
Marita Koskinen	Business Development and Purchasing Director	Prisma LLC, SOK
Brets Prietnieks	Head of the Security and Technical Department	Stockmann
Pavel Ljulin	Technical Manager	Stockmann
Tarmo Hiltunen	Managing Director	Tekmen SPb LLC, Lemminkäinen
Ivan Tretyakov	Chairman of the Board of Directors	Vector Group
Alexander Grishin	General Director	VMB TRUST
Alexander Olkhovsky	Member of the Board of Directors	VTB Development
Alexander Parshukov	Head of the Investment Department	VTB Development
Peter Forssell	Real Estate Development Director	YIT Lentek
Antti Kivelä	Business Development Manager	YIT Peter JSK, YIT
Sebastian FitzLyon	Chairman	Zinovieff Group



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Fax: +358 20 7430 131  
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