RUSSIA: WHAT COMMERCIAL PROPERTY TYPES WILL ATTRACT INVESTORS IN 2021?

The Russian economy is recovering from its sharpest contraction since the global financial crisis, caused by the Covid-19 pandemic and a sharp drop in the oil price. According to the latest projections of the Central Bank of Russia, the country is on track to grow by nearly 4 percent in 2021. At the same time, there is growing concern regarding rising inflation. Amid this uncertainty, real estate is likely to remain a popular investment for people in Russia. However, as the descriptions of this article imply, there has been a shift in demand: While earlier private equity had mainly flown to housing, in the previous year commercial property was in demand even among private investors. The author explains what should be borne in mind by those looking to buy in this sector. Red.

In 2020, the level of investment in Russian commercial property was comparable to 2019: offices, logistics, hotels and retail assets lured about 2 billion US Dollar in total. But while the market volume remained almost unchanged despite the crisis, the structure of investment was markedly different from what we have seen in recent years: explosive demand for logistics assets made up for the flagging interest of investors in office and retail assets (see figure 1).

Foreign capital remains scarce

The share of investments in logistics reached 30 percent in the total structure of transactions, whereas in five recent years this was between 10 and 15 percent. Analysts saw a similar trend during the crisis of 2014, for example, when the share of investments in logistics skyrocketed to 25 percent.

As for the distribution of investments by the origin of capital, Russian investors remain dominant in the market – only about 11 percent fell on foreign capital in the total volume of transactions in 2020 (see figure 2).

From a geographic point of view, a significant amount of investment is still concentrated in the Moscow region – in 2020, the share of transactions here was 78 percent. St. Petersburg and regional transactions accounted for comparable volumes of 230 to 240 million US Dollar each (see figure 3).

The crux of the matter is that quality logistical assets offer investors long-term and hedged rental flows, a relatively low entry cost versus other segments, and a liquid rental market that is in high demand during crises. These advantages are now further amplified by an explosive growth in the logistics market on account of changing consumer habits during the global pandemic.

Warehouses are the main beneficiary of 2020, but in the future investments in this sector will keep on growing. This conclusion can be made if we look at developed markets and compare Moscow with European megacities such as Paris or London. One can readily see how far behind the Russian capital is in terms of total storage space. With a much larger population, Moscow has twice as few logistics facilities.

Not by logistics alone

Therefore, we may expect that the demand for storage facilities will be precipitated by the integrated development of retail and companies supporting the entire supply chain of online turnover, including logistics companies delivering products within the "last mile" as well as those engaged in the storage and distribution of orders. In 2020, companies from these sectors accounted for more than 50 percent of all logistics transactions.

Yet logistics properties alone are not the only liquid segment for investors. Even though some companies are switching to remote or flexible working, quality office assets in prime locations historically remain an immensely popular segment for investments. Offices are perhaps the only market sector that has demonstrated maximum resilience to all the market crises of the last 15 years.

The office market was quite stable in during the pandemic, even though the lockdown caused fears that the vacancy rate may surge. But unlike previous crises, by 2020 the market was short of quality office space, which motivated companies to hold back on lease terminations.

As a result, a slight contraction of demand helped keep vacancies at the level of 8 percent against a background of low volume of newly commissioned space. For comparison, the highest vacancy rate was recorded in 2014, when more than 14 percent of office space was vacant.

Stable office sector

In turn, the low vacancy allows landlords to keep rental rates at the current level, unlike 2014, when many owners of office centers were forced to abandon the rent peg to the US Dollar, which resulted in sinking rental flows for many developers.

The explosive growth of the co-working segment (by dozens of percent a year) also raises the appeal of offices to investors, which means that various types of office space will remain attractive. Working from home is inconvenient for many employees and in case of big teams this practice often proves inefficient.

But perhaps the main change that 2020 brought to the market was the luring of new non-core and private investors to real estate, rather than the redistribution of demand. Earlier, commercial property had been a closed sector dominated by large companies because of the higher entry cost compared to the housing market, for example.

Crowdfunding platforms offering private investors the opportunity of collective investments in commercial assets are rapidly

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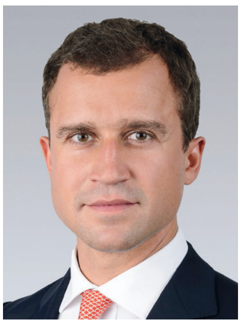
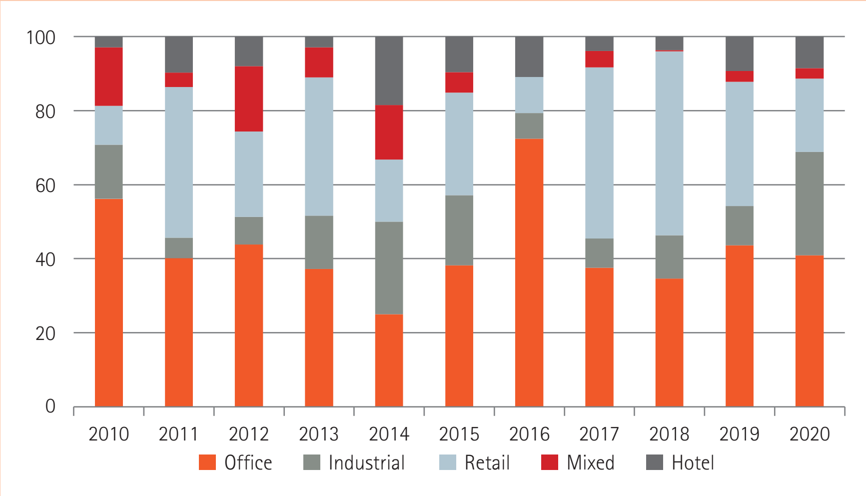
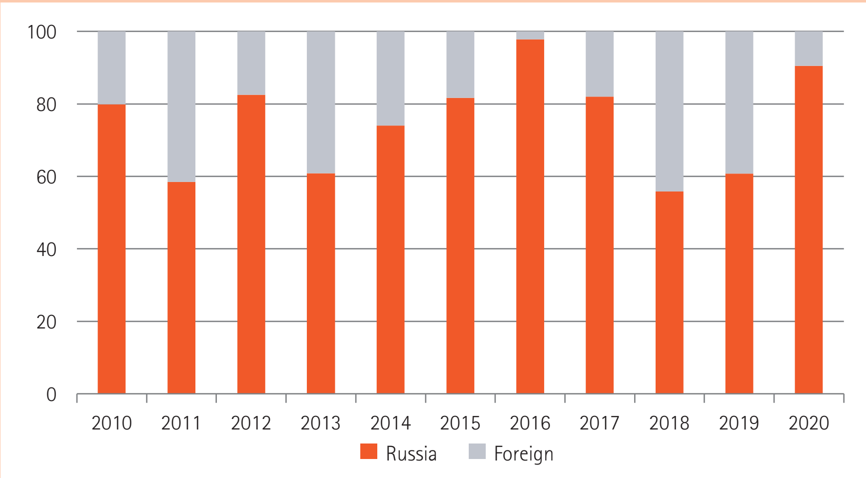


Figure 1: Distribution of investment by segment (in percent of transaction volume)



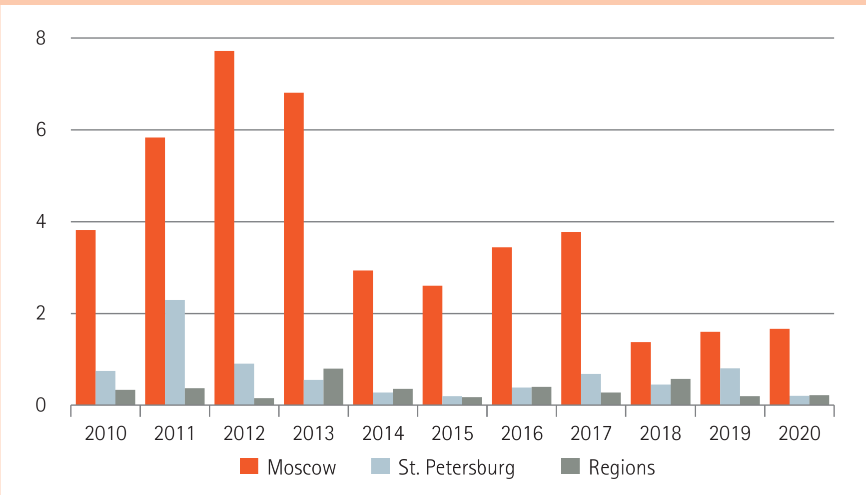
Source: Colliers Russia

Figure 2: Distribution of investment by source of capital
(in percent of transaction volume)



Source: Colliers Russia

Figure 3: Geographical distribution of investment transactions (in billion USD)



Source: Colliers Russia

developing. Before, commercial property was mainly the realm of banking structures, but now asset owners themselves are willing to "package" their assets as REITs and sell shares to private investors in these investment vehicles. These shares are in ever higher demand: the interest from private equity is being whipped up by the higher yield of commercial property in comparison to bank deposits or bonds as well as by better manageable risks compared to the stock market.

Newbie investors are not always lucky

The corona crisis resulted in a significant influx of both private equity and large institutional investors to the commercial real estate market. The latter once specialised in assets from other segments; yet the unstable economic situation is motivating investors to diversify their assets. Logistics is the hit of the year by a large margin. It is logistics that has attracted a number of companies that have traditionally invested in offices and housing.

Despite the upsides of commercial property, for some investors 2020 proved unsuccessful. These are mainly investors who were too aggressive in their debt financing strategy as well as in self-defeating relationships with the portfolio of current tenants in the long-term outlook the market does not forgive such unbalanced and aggressive strategies.

Street retail shows its potential

Another attractive asset for investors is street retail premises in Moscow and Saint-Petersburg which are currently in ever higher demand. This partly has to do with the recent growth of housing prices; as a result, the yield of housing rent is coming close to the yield of bank deposits and does not seem attractive, especially because further growth of housing prices won't be steep.

The yield of commercial premises on lower floors reaches 10 to 12 percent in rubles, whereas the yield of housing rent is in the range of 4 to 5 percent. What's more, the tenant of street retail premises is more stable than the renter.

This is why some who used to invest in the purchase of residential units last year switched to street retail. Yet it should be noted that this redistribution is not dramatic, since it is investors with the average check varying between 10 and 30 million rubles (about 100 000 to 300 000 euro) who have shifted towards this segment.

Risk appetite needs to be considered

The main demand falls to the share of small premises let out to small tenants from the retail sector. While this year retail has sagged by 15 to 30 percent in terms of sales and cash flow, the adjusted yield of such lots remains higher than the yield of housing investments.

It's also important to take the appetite of investors for risk into account: conservative investors will be interested in the yield of 4 to 5 percent per annum, given the high liquidity of residential units. As for the liquidity of commercial premises, it is limited in comparison with residential units. In our estimation, both investment options – in residential units and commercial premises – will keep developing in the mid-term and long-term outlook depending on investor's goals.

We should not also forget that Investments in a ready rental business is one of the most booming markets and they will always be in demand among investors. The average amount of a single deal in the investment market tends to be sinking of late: whereas the average investment deal check was 3 billion rubles or higher a short time ago, now it is in the area of 1 billion rubles.

In the meantime, we see a tendency towards the growing number of deals and acquisition of investment-grade property. With the average amount of a transaction going down, the market remains robust, offering exciting opportunities for acquisition of quality highly liquid assets with an attractive yield. The rental business offers a number of advantages – it is liquid, allows access to leverage, the investor can work with a cash flow which is indexed on a regular basis. The asset type normally directly defines the investor's format: this can be both a private investor and a large institutional investor who looks either at large assets or at asset portfolios.

The return on rental business investments is 8 to 10 years; the yield is roughly 10 to 12 percent per annum; the rental flow is annually indexed – normally by the annual ruble inflation rate. The rental flow and indexation are guaranteed by the rental agreement called to protect the interests of both landlord and tenant.

If the market is falling and tenant's business is unable to cover the rent or bring rental income, the parties either renegotiate new terms or the owner changes the tenant for a new one. In this situation it is asset liquidity that plays an important role.

Asset with a regular cash flow

Acquiring an asset, the investor gets a regular cash flow that yields more than bank deposits. The given income is indexed with time, providing its owner protection in the form of immovable property as well as flexibility in terms of its possible use and future liquidity.

The downside is that a tenant can move out, so the matter of quality and liquidity of the premises as well as demand for it on the market is important. One of notable upsides for those investing in rental business is that the given type of investing allows using the premises as collateral for raising extra bank financing.