WINTER OLYMPICS AND FOOTBALL WORLD CUP BOOST INFRASTRUCTURE SPEND AS RUSSIAN ECONOMY GROWS

Russia is the largest country in the world, encompassing 9 time zones and bordering 18 other countries. However, it is worth noting that it is very much a European country with 80% of the population living to the West of the Ural Mountains in 'European Russia'.

Russia has historically been proudly independent, culturally, politically and financially and this financial independence has played to Russia's advantage during the credit crunch. Although the economy suffered a downturn as a knock on effect of the wider global problems, the underlying economy is in a strong position and is well placed to support economic recovery while Russia's debt-to-GDP ratio of 8.5% is the lowest of any major country. The Russian economy has shown consistent growth of between 4.3 - 4.6% since 2010 and the World Bank is expecting that Russia will have a zero budget deficit by 2012-13.

"Russia suffered less than most during the economic downturn and is strongly placed for economic recovery with a huge increase in construction activity in the years ahead. Russia is hosting a number of major sporting events including the 2014 Sochi Winter Olympics and the 2018 World Cup which will see billions spent on sporting venues and a multiple of those billions spent on infrastructure upgrades. Retail and residential schemes are all due to see increased spending and a recovery in the commercial offices sector is also expected." **Tim Robb - Location Leader, Russia**

The banks

Due to tight regulation and limited international business most Russian banks were not directly affected by 'toxic debts' or the shoring up of financial institutions which were deemed to be 'too big to fail'. The state-owned giants Sberbank and VTB are such dominant forces in the Russian market that this year has seen the withdrawal of several major international retail banks including Barclays and HSBC, while VTB has created an Investment banking division that has secured the vast majority of current privatisation and fund-raising mandates.

Employment

Unemployment in Russia is steadily falling and currently stands at 5.5%. Salaries in June 2011 were approx 3.8% higher than a year earlier however with inflation running at close to 9%, earnings in real terms are well down. Nevertheless the average Russian is earning more money in real terms today than before the crisis started.

The rise in earnings has seen an increase in consumer spending and the Russian appetite for consumer goods, branded clothing and the latest technology means that there is still a demand for new shopping malls and retail outlets in and around the main centres of Moscow and St Petersburg. The government's support for new technology has promoted an impressive 4G wimax network and mobile phone reception on underground trains in Moscow and St Petersburg.

Funding

The global credit crisis resulted in many international investors withdrawing from the Russian market. Foreign Direct Investment (FDI) fell by 41% in 2009 and by 13% last year. As a result, a series of projects across the country remain unfinished, and many new schemes were shelved before they even started. Across Moscow this funding withdrawal is evidenced by the numbers of multi-storey concrete and steel frames which have been erected and then left, with no other work carried out for the last 2 years.

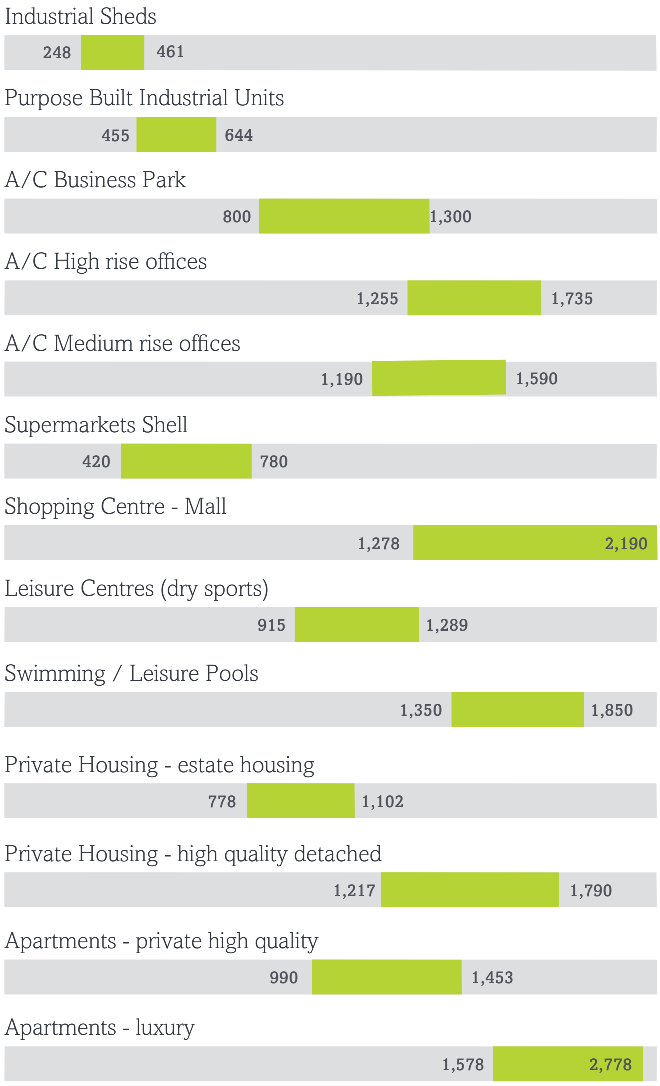
However, FDI in the first half of this year was almost 30% higher than the same period of 2010. In the last 12 months, funding of state projects has also increased. Government investment through Sberbank and VTB into many of the stalled commercial office and residential schemes has seen some of them restarted. This has led to higher growth than forecast with the level of investment increasing by 5% in the 4th quarter in 2010 compared to a year earlier, well up on estimates.

Leisure and sport

This rise in government spending is clearly evident in the leisure and specifically sports sectors. There are several key events driving the development of both stadia and associated infrastructure across western Russia in the next 10 years. These include heavy investment in Kazan in the Republic of Tatarstan, which is hosting the 2013 Summer Universiade, (the University Olympics), the 2015 World Aquatics Championships and the 2017 Confederations Cup.

Work is also underway in the South at many of the venues for the 2014 Sochi Winter Olympics. With a total development cost of approximately US$10.85 billion, the work includes a mountain complex, the construction of several sports complexes as well as the main Olympic Stadium and an Olympic village and broadcasting centre.

Indicative costs per m² in Russia (€ per m²)



Note: The costs shown above are based on the Study of International Building Costs which EC Harris carried out during the 1st quarter of 2011. The figures represent typical guideline ranges of 'built' costs that a client could expect to pay and are based on cost per m2 data provided by EC Harris sources 'on the ground' in Russia. Note that the figures are based largely on prices payable in Moscow and St Petersburg.

Costs are given in € per m² of gross floor area, measured to the internal face of the external walls.

Note that the figures exclude land costs, professional and legal fees, etc and VAT, which should be added to the costs in this study. VAT is currently 18% on construction projects in Russia.

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Russia is also spending $10 billion on hosting the 2018 FIFA World Cup. The development includes the construction of eight new 45,000 seat stadia across western Russia, upgrades to stadia in Moscow and St Petersburg and use of some of the Kazan and Sochi facilities. Infrastructure improvements will form a considerable proportion of the investment with US$1 billion being spent on the stadia and US$9 billion being spent on infrastructure.

Partly as a result of the major sports events taking place, Russia's 2010-2015 transport infrastructure development programme is expected to see an investment of approx US$450 billion over the next 5 years. The difficulty of raising that kind of money means that the government has taken steps to secure funding, such as the re-introduction of road funds. The latest infrastructure spending plans come as a follow up to the 2008 programme to improve the country's transport infrastructure which was severely cut due to tight budgetary constraints. Some analysts estimate the cost to upgrade Russia's ageing infrastructure at over $5 trillion over the next 15 years.

The property market

Unlike the leisure sector the corporate real estate fit out market is dominated by private capital from international companies who have recognised the potential in the growing economy and investments in Russia, and by Russian companies with international interests or western influenced business plans. Companies from the oil and gas sectors, IT, electronics and investment banks are all expanding their operations to capitalise on Russia's growth. The market is buoyant at the moment with many companies looking to expand their current operations.

An improving economy has resulted in strong demand for office accommodation, particularly in Moscow and recent figures from Jones Lang LaSalle indicate that take up of office space in Moscow in the first half of 2011 was the second highest in Europe, second only to Paris. Completions are currently low but the current office pipeline remains high with some 2.5 million m² in the pipeline for completion in the next three years. Rental costs for prime space reached US$1200 per m² in the 2nd quarter of this year, up 20% on the first quarter.

One of the major challenges for international companies wanting office space in Russia is finding commercial developments constructed to meet their quality expectations and the environmental requirements identified in their corporate governance. There is therefore often a gap between the client requirements and the availability of suitable base build developments.

Residential

The demand for residential properties in Moscow and St Petersburg is keeping resale and rental values similar to the costs of residential property in London. As a result of attractive returns on residential developments, the banks are also re-funding and restarting many residential schemes in both Moscow and St Petersburg. Due to the scale of public housing and the limited availability of land, the redevelopment of existing dilapidated housing stock is a massive undertaking, and there are several large schemes starting across the country. The Moscow authorities have approved a five year program to erect 12.7 million m² of housing space by 2016 including some 3.8 million m² which will be financed by the city budget. The planned volume to be put up by private investors - 8.9 million m² - is included in 500 investment contracts which have already been drawn up. The city's investment in the whole program will amount to approx US$24 billion. Part of the programme includes the demolition of 413 blocks of obsolete 5-storey housing whose 1.6 million m² will be replaced with modern units.

The official government forecast is that 63 million m² of housing will be completed in 2011, 8.4% up on last year. Housing output is forecast to continue to grow, by 6.3% in 2012 followed by rises of 6.0% and 11.0% in the following two years. While the forecast looks assured, the pace of housing construction in Russia has slowed significantly this year; the 15.3 million m² of housing built between January and May 2011 was almost 7% down on the same period of 2010.

Retail

Retail sales were up by 4.8% in the first half of 2011 and retailers are starting to regain confidence. Occupancy rates in the most recently opened shopping centres in Moscow are higher than for some time and stand at 60-80%, well up on the 40% occupancy of the previous two years.

Investment in shopping centres picked up considerably in Moscow during the first half of 2011, after 2 years of frozen or abandoned developments, and demand for shopping centre space is expected to continue to be strong. However, developments in the retail sector are likely to be hindered in Moscow by restrictions on construction projects in the city centre. Development is also likely to be slowed by new requirements for shopping centre developers to build transport infrastructure around the centres they develop on the Moscow Ring Road. Nevertheless the growth of the Moscow shopping centre market is forecast to continue with 14 centres planned to be delivered in 2011-12.

Materials

Some indication of the uplift in construction activity can be gained from the growth in cement consumption, which rose by 10% in 2010 with a further 12% growth expected in 2011. The latest figures represent a bounce back from the 20% cut in consumption in 2009.

There are challenges in all sectors when meeting international standards, not the least the fact that many multinationals have their own design standards and environmental policies to which their projects must conform. Due to the costs and logistical difficulties in setting up manufacturing bases in Russia, some key materials requested by international clients are often unavailable in Russia. Where the client chooses to import the relevant material, the costs and time associated with bringing in non-certified materials can be prohibitive. For items of mechanical or electrical plant, customs duty has to be paid and the item needs to be fire safety certified. In addition to these costs, transportation to site can be very expensive due to the size of the country. Overall these costs can add up to 50% to the cost of the plant and can add weeks to the programme.

Russia is a huge country where most of the development, investment and construction is in the western ‘European’ region. However, labour is rarely a problem as the construction industry depends on workers migrating from distant countries including Tajikistan, Kazakhstan and Turkey. As a result there is a large low cost labour force.

Forecasting

Because of the wide economic fluctuations, forecasting construction tender prices in Russia can be problematic. Construction inflation peaked in mid 2008 at 15% then dropped to a low of 4% in mid 2010 but now has levelled off at around 9%. However, based on the increased demand within the Moscow market and the large number of significant government projects (not least the Winter Olympics and the World Cup), there will be pressure on available resources resulting in higher prices. This will be particularly acute for the large scale international contractors who have the experience and capability of delivering international standard venues that meet either the IOC or FIFA expectations.

Economy and construction - Russia at a glance

	2010	2011*	2012*
Economy generally			
Real GDP growth (%)	4.5%	4.0%	3.8%
Consumer price inflation	6.9%	8.7%	7.8%
Producer Prices	3.5%	6.0%	7.5%
Household consumption	3.0%	5.7%	
Gross fixed capital formation	6.1%	-0.6%	
Average salaries per month	US$732	US$833	
Unemployment rates (%)	7.2%	5.5%	5.0%
Capital Investment - annual & change	6.0%	2.7%	
Foreign Direct Investment % change	-13.2%	29.8%	
Exports - annual % change	31.5%		
Imports - annual % change	29.4%		
Industrial output	8.2%	5.3%	
Construction Industry			
Total construction output	-6.4%	7.9%	1.1%
Construction industry as % of GDP	4.9%	4.8%	4.7%
Employment rate - annual % change	-0.5%	4.0%	2.9%
Cement production - annual % change	6.4%	20.9%	
Brick production - annual % change	-0.6%	4.8%	
Housing completions - annual % change	1.8%	8.4%	6.3%
Building materials costs - % movement	1.8%	8.3%	

*2011 and 2012 are forecast figures

Contact

Tim Robb
Location Leader, Russia
e tim.robb@echarris.com

Paul Moore
Cost and Technical Research Leader
e paul.moore@echarris.com

w echarris.com/research