



# RUSSIAN INVESTMENT IN US REAL ESTATE

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MANHATTIST.COM

## EXECUTIVE SUMMARY

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In January 2009, U.S.-Russian relations were at low comparable to the Cold War, due to unresolved issues and little confidence between Washington and Moscow, yet by the end of 2009, Russian real estate buyers become a growing presence in America's largest cities, and of particular note in Manhattan.



Russia's President, Dmitry Medvedev, following true to his predecessor's notion that Russia can only make meaningful plans for the future to the extent that it has control over the external sphere. For Putin and most of Russia's elites, sovereignty has meant being able to shape one's own destiny independently.<sup>i</sup> Yet, for a country that owes much of its quick rise from bankruptcy in 1999 to Putin's vision of profiting from increasing oil prices, it is not part of OPEC, and hence does not control the prices, which have since dropped. Highly dependent on natural gas for its economy, by the end of 2008, Russia was producing 12.4% of the world's oil (Saudi Arabia 13.1%), while it only possesses 6.3% of the world's reserves (Saudi Arabia 21.0%); Russia has more to gain than ever by diversifying commercial relations. Dmitry Medvedev has encouraged foreign investment outwards as means of establishing an international presence. As testament to this dynamic, foreign investors have begun buying the surplus US houses

in Manhattan, increasing to approximately 15 of which Russians are the largest contingent.<sup>ii</sup>

Manhattist seeks to understand this heightened demand, and given the role of elites in Russia's government, whether its continuation will have lasting benefits to both countries, both economically and politically. In the past year, the rise of sovereign wealth funds and international investors has grown in international economic importance, and one way in which they can reduce export risks is through investment in surpluses in the West. There exists political resistance to the presence of sovereign wealth funds and foreign investors in the recipient countries of the investments. One element of reform going forward is in developing partnerships and a regulatory system that allows these investments to operate. At the end of this research, Manhattist, offers recommendations on improved measures.

*“Many celebrities and financiers view the New York market as the optimal location for a long-term purchase.”*

## RUSSIAN DEMAND

Russia's elite tends to be the ones purchasing real estate in the United States. From the captain of the Russian World Champion hockey

team to Russian developers, Russian investors have been purchasing luxury properties in New York real estate.

Russia's richest man, Mikhail Prokhorov recently bought an 80% share in the NJ Nets basketball team and a 45% stake in Atlantic Yards, a real estate development in Brooklyn where the team will play in the future, for \$200 million. Russian fertilizer oligarch, Dmitry Rybolovlev, purchased Donald Trump's beachfront mansion in Palm Beach for \$95 million, which was the most expensive residential sale recorded in US history.<sup>iii</sup>

The trend has roots as early as 2008, when investor Len Blavatnik bought a Manhattan townhouse for \$50 million,<sup>iv</sup> was just down the street from his \$31.5 million townhouse he bought a few years previous.<sup>v</sup> In June 2009, financier Andrei Vavilov, who represents Penza in the Federation Council, bought an apartment in Manhattan's Time Warner Center for \$37.5 million. Following the trend, in early October of this year, the New York Observer reported a Russian investment fund purchased a penthouse on Manhattan's Central Park West for \$37 million.

Chelsea football club billionaire Roman Abramovich and billionaire Mikhail Friedman have cited the influx of their peers as reasons for purchases.<sup>vi</sup> Further, they view investment in the New York real estate market as long-term, “lower risk investment with a promise of U.S.-dollar earnings.”<sup>vii</sup>

US DOLLAR VS RUSSIAN RUBLE-2 YEAR CHART1



US DOLLAR VS RUSSIAN RUBLE-3 MONTH CHART1



*“The last few months, much of the investment trend has been correlated with the depreciation of the dollar versus the ruble.” viii*

The ruble has appreciated steadily against the dollar, meaning each ruble has more purchasing power when converted to US dollars. “We are seeing a huge uptick in activity since mid-September,” said Edward Mermelstein, a lawyer who specializes in real estate transactions for foreigners. ‘The way many look at the US right now is that it’s a bargain. All of a sudden in the last three months activity has picked up,’ explained Mermelstein.<sup>viii</sup>

Given exchange rate projections, Russian investments in US real estate have the potential to appreciate much faster than comparable investments made in US Dollars. The prices of two bedroom condominiums in Manhattan have remained stable and thus represent a good example for it is likely that the numbers will still be relevant upon publication. Manhattist calculates that an investment in such a property will likely yield an above 10% Internal Rate of Return with only 46.2% of the purchase financed at current rates, yielding an IRR of 14.05% .

ECONOMIC CONDITIONS

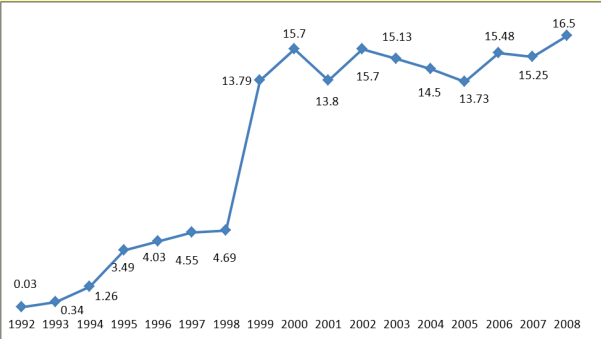
According to Manhattist calculations, the risk of currency change in 3-5 years is light to moderate. (refer to "International Currency Risk and Money Supply" report). Even though real estate is purchased in dollars in Russia, the only way to mitigate the effect of exchange rates in the long run is to have revenues and expenses in the same currency. Further, to hedge the risk of depreciation due to exchange devaluation, the investor must look at how the currency will do in the long run. The ruble is the only managed floating currency in BRIC countries. With an undervalued currency and little regulation, the ruble could move quickly in response to commodity prices. Particularly, the Russian economy is dependent on oil exports, so rises in oil prices could increase investment, increasing the exchange rate. However, the potential for a Russian political instability is

relatively high, causing uncertainty. It's likely that these risks have kept investors wary of the ruble.

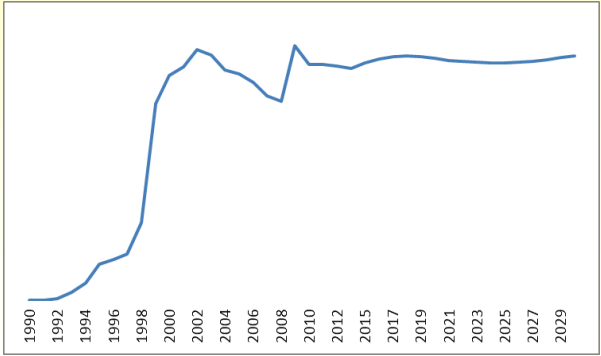
Yet, it is certain that since the end of the recession, supply of the USD has fallen steadily. Despite previous indicators of its weakness, the USD's role as the world's reserve currency (some 64% of the world uses it) helped it maintain its high rate. Some economies have begun supplementing their dollars with Euros (which accounts for 26.5% of reserve currencies), but the Euro does not have the convertibility of the USD that would make it a perfect substitute.

In essence, a smaller supply with a stable, if not growing demand of the Russian ruble in the currency exchange market will continue to steadily lead to the Rubble appreciating against the dollar.

BIG MAC INDEX: PURCHASING POWER PARITY



EXCHANGE RATE: LCU/US\$



The ppp plateau in 1998, and projections show that the latest fluctuations in currency have put the Russian/US ruble at an optimal appreciation point. (Data Source: Economic Intelligence Unit)

## MANHATTAN AND RUSSIA REAL ESTATE

When considering real estate as an option in an inflated economy, if there remains uncertainty in the direction of prices, real estate is attractive when it can be assured that the property will appreciate. One of the data points that demonstrate the liaison of appreciation and depreciation is the relationship between prices and replacement costs.

If a property is below replacement costs, then a builder could not construct the home at the same cost for the sales price of the property. This means that market conditions have limited the availability for new supply to enter the market, since homebuilders do not have an incentive to sell new homes at a loss. Considering the basic relationship between supply and demand, if supply becomes constrained, demand is then the most significant indicator of price. The last period of low real estate prices was during the savings and loan crisis (1986-1991), when some investors such as current billionaire Sam Zeill, managed to amass fortunes by buying undervalued properties through capitalizing on this dynamic. ix

One of the largest reasons that Manhattan's prices are down is due to unemployment. New York is the largest regional economy in the world, with a diverse economy, dominated by the business services, systems design, healthcare, consulting, finance, and media. It is the second largest city economy after Tokyo, and has an estimated 2008 GDP of \$1,406 billion. Further, the New York luxury market has historically appreciated at a rate of 8.2%.<sup>ix</sup> Those with enough capital willing to hold the properties through the cycle stand to profit the most.

Indeed, the recent sentiment to invest outside Russia can be understood considering Russia's Housing Industry has been left damaged by the worldwide credit Crisis, and without the necessary infrastructure to rebuild in the near future. The tightening credit market has made it more difficult for homebuyers to get a mortgage.

Russia's mortgage market is still very small with respect to its economy, only 2.5 percent of GDP in 2008. Most real estate transactions are done in cash and paid in full with US dollars. Only 14 percent of homes were bought using mortgages in 2007, while only 26 percent of purchases of newly constructed apartments were aided by credit. Mortgage growth will most likely continue to be stunted, due to higher interest rates, falling real estate prices and the credit crisis.<sup>x</sup>

While the rigid distinction between viable sources of income is laudable, especially in light of the last decade in the mortgage market in the US, it is creating precarious conditions for those seeking high-end properties. Many of the construction projects that started before the 2008 have stopped. Russia's credit crisis, coupled with its dependence on oil have left Russia's real estate unable to mature.

To Medvedev's credit, he has begun emphasizing modernizing of Russia.<sup>xi</sup> But after a decade of oil-fueled growth, Russia GDP will decrease by 8% this year due to oil prices.<sup>xii</sup> The decline in world oil prices has hit Russia hard, since natural gases account for about 65% of Russia's export revenues, and the government is dependent on taxes from its sales for more than half of its revenues.<sup>xiii</sup> While currently, oil prices remain high enough to sustain some public spending, it may not be enough to meet salary increases or pensions, since real wages are falling. Unless Russia can diversify economic returns, conditions render Medvedev's revitalization ambitions difficult

## POLITICAL REFORM

As a fast growing economy, many US companies are interested in investing in Russia, but find maneuvering the political system difficult. Political tensions are not the only potential pitfall when it comes to US investment in Russia; legal discrepancies are

a threat as well. US companies consistently worry about the potential failure of the Russian justice system to uphold investors' rights. "Medium-size companies—and I mean big medium-size companies—still have concerns about the rule of law," says Andrew Somers, president of the American Chamber of Commerce in Moscow. "So that's a competitive disadvantage for Russia. And

*After a decade of oil-fueled growth, Russia GDP will decrease by 8% this year due to oil prices, rendering the government unable to spend on infrastructure.*

until they straighten it out, it will continue to be.<sup>xiv</sup> Foreigners in Russia have the same rights as local companies and individuals, with one main exception: they cannot own plots alongside national boundaries.<sup>xv</sup>

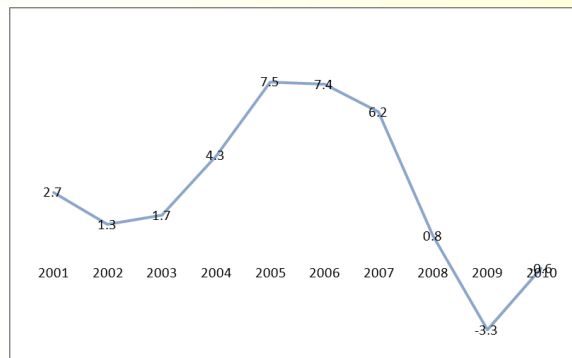
Deepening Bilateral commercial relations will mean a stabilizing element in Russia's relations with the West. While there has been backlash to sovereign wealth funds investing in domestic sectors, with concerns including relative lack of transparency over investment strategies, concern over possible political intervention and potential large-scale market moves. Manhattist proposes that a

by the US will have to account both Russian actions and domestic politics.

The first involves facilitating peaceful nuclear U.S.-Russian cooperation. In the aftermath of the conflict between Russia and Georgia, the Bush administration withdrew the 123 agreement from Congressional consideration. Approval of the agreement will be necessary if RosAtom, the

Russian atomic energy agency is to go forward with its plan to store nuclear waste from third-country reactors. It will also be required if U.S. companies are to engage in civil nuclear projects in Russia,

RUSSIAN CENTRAL GOVERNMENT FISCAL BALANCE (%GDP)



relationship based upon individuals providing economic leverage to both countries, could actually increase transparency and improve political relations.

Further, the two have mutual interests in improving economic and diplomatic relations. While Russia faces a declining population, it hosts a sizeable portion of the world's billionaires, who further have highly disposable income (almost 80%). However, Russia lacks international economic negotiation power, since it is not part of major geographic or industry organizations such as the World Trade Organization (WTO), European Union, or OPEC. Mutually assured commercial interests stand as an entry way into political stability, and they have both stated mutual interests in transnational issues of terrorism and climate change.

Two issues could improve relations, first proposed by the Brookings Institution, and expanded upon here by Manhattist, but the timing of when to move

much as their European competitors do. RosAtom has said to see this as an activity worth tens of billions of dollars.<sup>xvi</sup>

Further, Russia would benefit from investing in a more stable source of revenue for its country other than oil. Faced with the scientific evidence of global warming, already, major energy companies such as Shell and BP are turning to renewable energy and lower carbon releasing energy sources such as natural gas. Shell has even endowed a sustainable development department at the University of Qatar. Currently, Russia faces difficulty with supplying its natural gas. Ukraine continues to face internal political turmoil and tense relations with Moscow. This creates conditions in which Ukraine and Russia could fall into a crisis in Crimea or over the supply of Russian natural gas to Ukraine.<sup>xvii</sup> Despite high world energy prices, Russian gas and oil production hit a plateau in 2005, registering little or no annual increase since then. Getting and developing new oil and gas fields

is arduous and costly. Further, for the time being, the price of gas is linked to and well below the price of oil. OPEC is well managed and has been growing its revenues for over 3 decades.

The second recommendation is facilitating the entrance of Russia into the World Trade Organization. In September 2009, U.S. officials indicated that the U.S. government would not press for Russia's accession into the World Trade

Organization. However, stability of Russia is in the both parties favor. As rapidly developing countries become highly productive, they tend to run trade surpluses, accumulate wealth and gain influence, it is then better if Russia can do so by participating in international dialogues, and by diversifying economic returns away from an overreliance on oil, with its ensuing conflicts and instability.

## CONCLUSION

The steep decline of US housing market between 2006 and 2008 is a crisis that the Obama administration inherited, and substantial economic headway would be a domestic and international benefit. The US subcabinet dialogue on US-Russia economic relations launched in April 2008 was a beginning, but there is substantial room for improvement to address mutual interests of nuclear threats, economic stability and climate change.

Russia and the US have incentives to relieve tensions and need a senior-level push to make progress. The subject requires federal attention, and as Brookings contends, may benefit from launching a high-level business dialogue.

The oversupply of US luxury real estate presents an opportunity to extend Russia's international presence, diversify economic returns.

<sup>i</sup> Gaddy, Clifford and Andrews Kuthhin, Putin's Plan, The Washington Quarterly, Spring 2008, 1.

<sup>ii</sup> Reed, Brinton, Russian and Chinese investment into the US Real Estate, The Arginsky Consulting Group, March 2009.

<sup>iii</sup> "Russia's outward investment." Deutsche Bank Research. 30 April 2008. Available online at:

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<sup>iv</sup> <http://www.themoscowtimes.com/business/article/387728.html>

<sup>v</sup> <http://www.guardian.co.uk/world/2008/jul/18/donaldtrump.usa>

<sup>vi</sup> <http://www.nuwireinvestor.com/articles/russian-investors-seek-real-estate-deals-in-the-us-53316.aspx>

<sup>vii</sup> <http://www.themoscowtimes.com/business/article/387728.html>

<sup>viii</sup> <http://www.nuwireinvestor.com/articles/russian-investors-seek-real-estate-deals-in-the-us-53316.aspx>

<sup>ix</sup> Manhattist calculations using data from [http://www.trulia.com/real\\_estate/New\\_York-New\\_York/market-trends/](http://www.trulia.com/real_estate/New_York-New_York/market-trends/), accessed November 24, 2009

<sup>x</sup> Property wire

<sup>xi</sup> Dmitry Medvedev's Building Project, The Economist November 28<sup>th</sup>, 2009, 57.

<sup>xii</sup> Dmitry Medvedev's Building Project, The Economist November 28<sup>th</sup>, 2009, 57.

<sup>xiii</sup> Congressional Research

<sup>xiv</sup> [http://www.businessweek.com/globalbiz/content/jul2009/gb2009075\\_785215.htm](http://www.businessweek.com/globalbiz/content/jul2009/gb2009075_785215.htm)

<sup>xv</sup> <http://www.thompsonhine.com/publications/publication1606.html#4024>

<sup>xvi</sup> Pifer, Steven, Reversing the Decline: An Agenda for U.S.-Russian Relations in 2009, Policy Paper, Number 10, January 2009.

<sup>xvii</sup> Pifer, Steven, Crisis Between Ukraine and Russia, CPA Contingency Planning Memorandum No. 3, July 2009, 1.

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## About Manhattist

Manhattist is a real estate firm that serves clients in purchasing luxury properties. Our unique model of membership packages provides comprehensive service possible to our clients. We are committed in helping our clients every step along the way. In addition to current appraisal and valuation of an investment property, we provide services such as conducting global market analysis, seeking unique opportunities, to providing personalized strategies and performing in depth due diligence.

At Manhattist, our research and advisory division is built to give you an insightful view into the dynamics and developments of global real estate markets. Our research cover almost all aspects of influencing factors in the real estate industry, ranging from market demographics, public policy issues, global economic environment to trend subjects.

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