Radius GROUP

Time to Upgrade Your Warehousing or Manufacturing Footprint in Russia?

Don't let a crisis go to waste.

In 2014 and 2015 the Russian economy faced a perfect storm of low oil prices and geopolitical turmoil. The result was a steep recession, with GDP falling by almost 5% and a severely devalued ruble pushing down consumption of imported goods and services by almost 30%[1].

The depth and severity of the crisis has hit companies hard, causing many international players to reevaluate their Russia strategy. Some have elected to slim down their retail networks and scale down their expansion plans or, like GM, to drastically reduce their presence in the country.

Other multinationals, however, see today's tough conditions as a strategic opportunity. After all, with the world's fifth largest economy by purchasing power parity[2], and ranked ninth by population[3], Russia is still a hugely significant market in European and even global terms. Retail sales of $640 billion in 2015 and 148 million potential consumers mean Russia is, in the words of consultancy AT Kearney, "too big and important for retailers to ignore."[4]

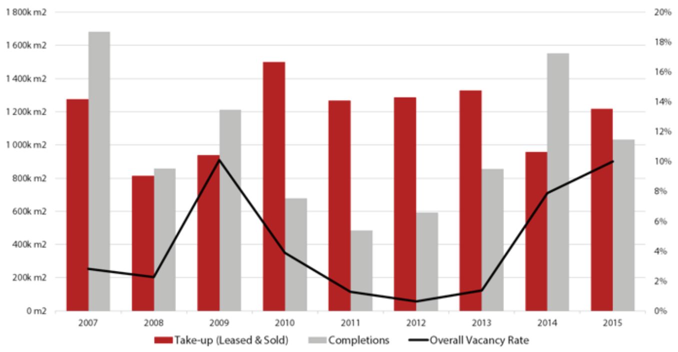
Over the last year, the real-estate infrastructure companies need in order to serve Russian markets has become dramatically cheaper and more accessible. As speculative real-estate construction projects started before the crisis come on-line, they have struggled to find occupiers.

For the warehouse and logistics real-estate sector, vacancy rates in the Moscow area have risen to 10%, their highest since 2009. True vacancy rates could be as much as 15%, if 'hidden vacancies' - unused properties still under lease - are included. This is a dramatic shift in a region with a structural shortage of industrial space. In 2012 and 2013, vacancy rates in the area hovered below 2%, and developers could not build fast enough to meet demand. Today the vacancy level in Moscow is over 800,000m2, the highest in the market history for the region. As a result, overall rents have fallen by around 30%, well below levels recorded during the 2008 financial crisis. That number includes renegotiations: rents for new leases have fallen even further. Companies looking for manufacturing or distribution space can currently rent premises at rates lower than those necessary to stimulate the development sector to construct new facilities.

1 Source: OECD
2 Source: World Bank
3 Source: World Bank
4 Source: Global retail expansion, an unstoppable force. AT Kearney 2015

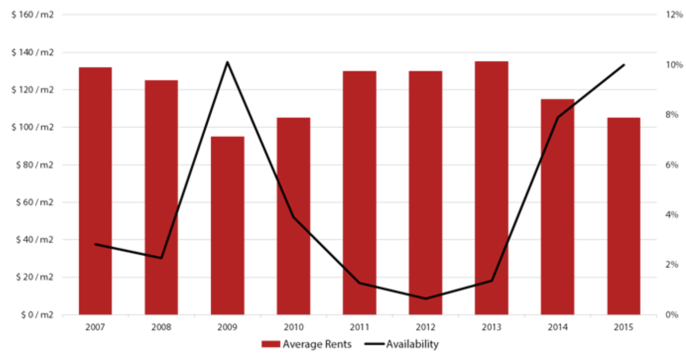
WAREHOUSE COMPLETIONS, RENTS AND VACANCY RATES, MOSCOW AREA

KEY MARKET INDICATORS



Source: JLL, December 2015

RENTS* & VACANCIES



* includes the rental costs on renegotiations and renewals

Source: JLL, December 2015

Three real-estate opportunities for 2016

The current condition of real-estate markets creates significant opportunities for companies operating in Russia. That is especially true for any company looking to develop the sophisticated supply chain infrastructure that modern markets and efficient operations require. The nature of those opportunities depends on the organization's chosen response to the economic crisis:

Opportunity #1

Maintain functionality while reducing fixed costs

Tough market conditions mean companies with existing facilities in Russia have been able to renegotiate leases on favorable terms, or to take advantage of additional capacity in the market – and commercial flexibility – to re-configure their operational footprints to better suit their current and anticipated future needs.

Since 2009, for example, US agricultural equipment maker John Deere, has operated one of its four global strategic spare parts depots alongside a machinery manufacturing operation in a 76,500m2 facility outside Moscow. In 2015, John Deere reconfigured its existing operations into a reduced footprint of ~ 50,000m2, while simultaneously relocating its Russia HQ from central Moscow to the same facility. The change has allowed John Deere to maintain full functionality while enjoying increased operational efficiency at a dramatically reduced Russian real-estate cost.

As part of its Russia restructuring efforts, Adidas has purchased outright the distribution center in the South of Moscow that it had previously leased. Adidas was able to acquire the 120,000m2 building at a relatively low price from a landlord in need of capital, a less costly option for the sportswear company than its previous $US denominated long-term lease contract.

Opportunity #2

Upgrade existing real-estate infrastructure at historically low rental values

Companies are looking for operational efficiency improvements as well as cost reductions in order to maintain the profitability of their Russian operations. High quality, well designed and energy efficient warehouses and manufacturing facilities have an important role to play here, and some companies are taking advantage of lower real-estate costs to shift their activities to better premises.

As one example of this "flight to quality", French DIY and gardening retailer Leroy Merlin relocated its Russian e-commerce fulfillment operations to a new, high quality, BREEAM certified building South of Moscow.

Low rents, flexible lease arrangements and the availability of long term leases denominated in rubles rather than dollars mean that such upgrades can often be made on more favorable terms than those in place for older, less appropriate facilities.

Opportunity #3

Expand functionality and improve operational efficiency at historically low investment costs

Some companies, particularly ambitious retail players, are accelerating their investment and expansion plans, using the crisis to secure new property at costs that would have been unthinkable before the crisis.

Low cost food retailer Lenta, for example, has announced plans to open up to 40 new outlets across the country[5].

Leroy Merlin says it is supporting its 34 stores in 17 Russian cities with the development of a 100,000m2 national distribution center South of Moscow near the Domodedevo Airport, the largest single user retail distribution center in the history of the Russian Federation at the time of investment.

According to its public announcements, French retailer Auchan invested €138 million in Russia during 2015, and the company has announced plans to invest a further €195 million (18 billion rubles) in 2016 to build 10 new hypermarkets and 40 new supermarkets in Russia, together with associated supply chain infrastructure. The company also has plans to develop a new 100,000m2 distribution center, scheduled to open in 2018[6].

5 AT Kearney retail development report, as before
6 Source: International Supermarket News

Maximizing return in any investment climate: quality and compliance are key

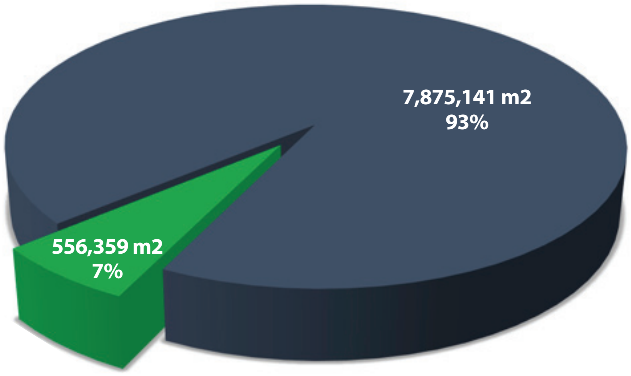
Whatever the business case for changes to their Russia supply chain footprint, some key considerations will help companies to achieve the best long-term value from the decisions they make today

Existing buildings

Even around Moscow, Russia's industrial property markets remain relatively immature. Moreover, the high cost of capital puts pressure on the margins of property developers, leading many to emphasize low construction costs over the longevity, operating performance, or even legal and regulatory compliance of buildings.

As a result, international companies – especially those looking for class A accommodation built to international standards and owned by reliable landlords – can still find it difficult to access the property they need. Detailed due diligence is essential, therefore, and this should include not only the construction and condition of buildings, but also the quality and availability of utilities and the business practices of developers and landlords.

Moscow Market Class A Warehouse Supply



BREEAM[7] certified premises as a fraction of total Class A industrial space

New construction

If an organization cannot meet its needs from existing stock yet has access to suitable capital, the crisis has also created extremely favorable conditions for new construction. The Ruble has lost more than half its value against the dollar since 2013. At the same time, construction investment has slowed dramatically, creating capacity in the market. Moscow was identified as the world's sole "cold spot" for construction in 2015, according to analyst Turner and Townsend.

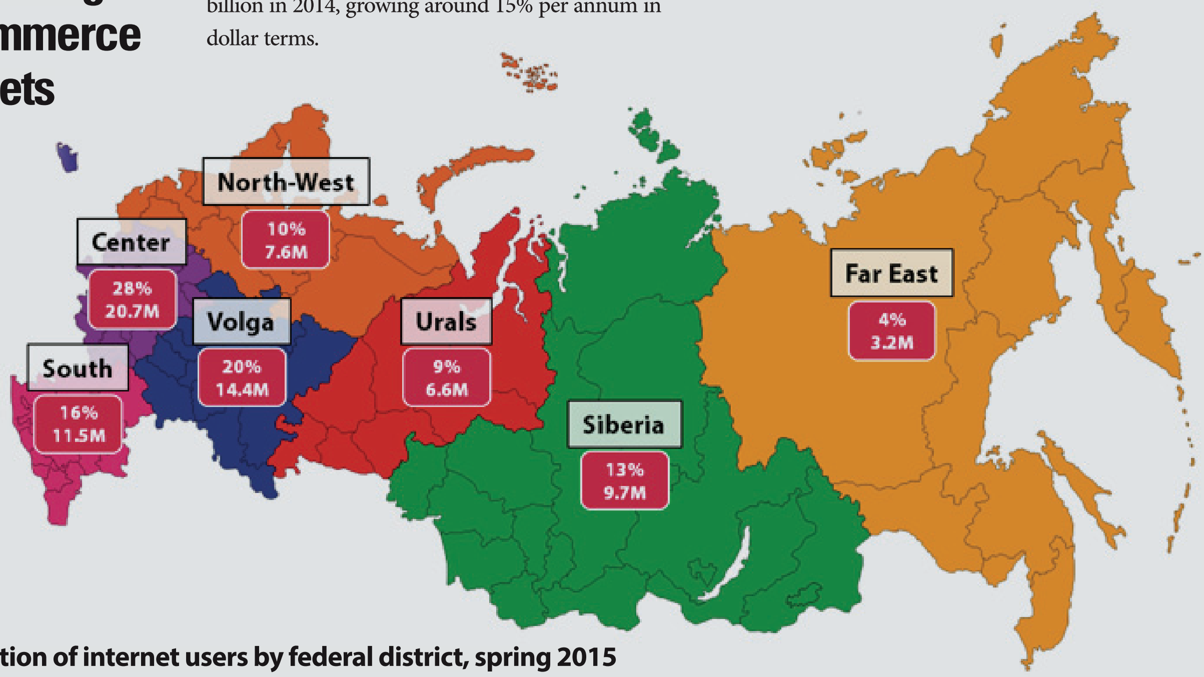
As the result of these two trends, land and construction costs have fallen significantly for international firms. At $550 per m2, average construction costs (excluding land, infrastructure and pre-development costs) for large distribution facilities in the Moscow area are now around 40% cheaper than similar facilities in the US for example[8].

Radius Group Customer Case Example

Investing to capture greater share of growing e-commerce markets

In September 2011, Russia overtook Germany as the country with the largest number of internet users in Europe[9]. Even so, internet penetration is still growing at over 10% a year, with around half the adult population using the internet daily in 2015. The Russian e-commerce market for physical goods reached $14.5 billion in 2014, growing around 15% per annum in dollar terms.

In 2015, UK apparel company Next brought online a dedicated e-commerce fulfillment center in Russia, its first outside the UK. French sporting goods retailer Decathlon, meanwhile, is supporting distribution to both retail stores and e-commerce customers from a single, multi-channel facility.



Distribution of internet users by federal district, spring 2015

Source: East-West Digital News. http://www.ewdn.com/e-commerce/insights.pdf

7 Building Research Establishment Environmental Assessment Method: the world's leading sustainability assessment method for masterplanning projects, infrastructure and buildings.
8 Source: Turner and Townsend International Construction Survey 2015
9 Source: East West Digital News

Comparative construction costs per m2, Russia and US

PROPERTIES	MOSCOW, RUSSIA RUR	USD @ 62.37	SEATTLE, USA USD
Industrial			
Warehouse/factory units – basic	34 000p.	$550	$740
Large warehouse distribution centre	35 000p.	$560	$960
High-tech factory/laboratory	90 000p.	$1 440	$4 000

Source: Turner & Townsend – International construction market survey 2015

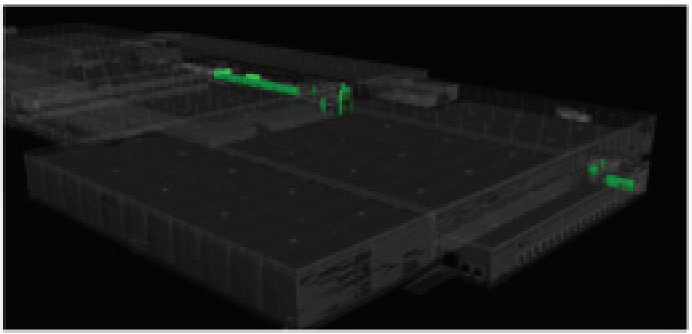
Over and above the 'normal' demands of delivering a large construction project within time, quality and budget constraints, developing property in Russia comes with its own challenges, which should not be underestimated. Key considerations include securing utility capacities, development permissions and construction permits for connecting all necessary utilities to the land site; managing the cost and timing of establishing such utility connections, and ensuring reliable, cost effective long-term utility supply. In addition, it can be hard to ensure – and document – compliance with appropriate fire safety, security and environmental performance standards, especially when working with contractors unfamiliar with internationally accepted construction practices.

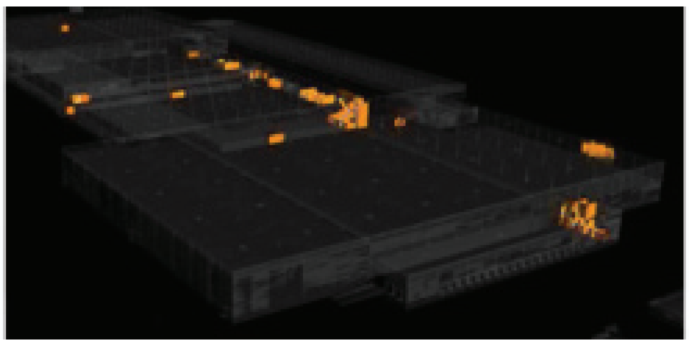
Pick the right partner

For companies looking for build-to-suit accommodation, a growing understanding of the requirements of international customers has produced a new breed of property developer able to deliver high-quality properties. Demand for such properties has also been driven by investors, who understand that a longer lasting, higher value asset is a safer investment warranting a lower return on capital. For tenants, that means lower rents, lower cost of operations, lower energy consumption and lower maintenance costs while enjoying greater operating efficiencies that high quality facilities allow.

Technology has helped too. Advances in computer-aided design and project management tools have transformed the transparency and efficiency of the construction processes, allowing designs to be optimized, problems to be identified early and progress against plan to be monitored in real time, greatly reducing construction risk.

Digital tools accelerate construction, reduce errors and increase transparency





10 Source: Deloitte
11 Source: Moscow Times

Radius Group Customer Case Example

Localizing manufacturing networks

Russian markets will increasingly be served by products manufactured or assembled there. In part, this reflects a tendency for many companies to shift manufacturing activities closer to the point of consumption, in order to improve flexibility and cut transportation costs. But policy decisions are also playing a role. The government's Pharma 2020 strategy, for example, aims to encourage local manufacture of 50% of medicines by the end of this decade[10 11].

In 2014, German medical products manufacturer Hartmann Group established a 20,000m2 co-located manufacturing and distribution facility outside Moscow. The project was designed and built to Hartmann's exacting German standards yet fully aligned to Russian regulations. The healthcare company took the facility on a 15-year lease. For Hartmann, the early establishment manufacturing capabilities at its Russian subsidiary was a strategic priority, allowing it to develop the skilled labor force it will need as production in the country is ramped up.

Radius Group Customer Case Example

Decathlon National Distribution Center 32,000 m2

South Gate Industrial Park, Moscow

On completion of the project, which was handed over on time and on budget, the client project manager, with 20 years of experience in Russia, said he has never seen such a high level of construction quality.

South Gate Industrial Park is a 144ha, 653,000 m2 site 30km south of Moscow and adjacent to the key M4 and A107 roads. South Gate houses distribution, manufacturing and office space for more than 15 international companies.

French sporting goods retailer Decathlon had very demanding requirements for its Russia distribution center, which supports its national store network as well as e-commerce operations in the country. The company partnered with Radius Group to develop a dedicated facility at South Gate Industrial Park.

The warehouse space includes the highest specification fire suppression system in use in Russia today. Built to ESFR25 (Early suppression, fast response), standards, the system is fed by a dedicated, on-site pump house with a main supply pump and two backups, one powered by a diesel engine in case of electrical supply failure. The whole installation is further backed up by South Gate's own pump house, which uses an identical three-pump system.

High specification fire suppression system at the Decathlon national distribution center

Takeaways

- The economic crisis is forcing companies to revisit their Russia strategies
- They have three basic options: (1) withdraw, (2) retrench or (3) expand
- For companies with a long term commitment to Russia, cost reductions and an easing of capacity constraints have created create a unique window of opportunity to acquire industrial real-estate
- Quality remains an issue, with a lack of familiarity with international construction standards and business norms
- Global industry leaders like John Deere, Auchan, Next, and Leroy Merlin are taking advantage of the crisis to acquire high quality supply chain assets at historically low cost, supporting their increased investment in the Russian market.

About Radius Group

Our mission is to design, build, finance and operate the finest warehouse and manufacturing real-estate underpinning Russia›s modern supply chain, thus strengthening our customers› global connectivity with Russian consumers and building trust.

We treat our customers as a community of enterprising people and organizations with unique skills, capabilities and goals. Our community's opportunity to thrive increases in an atmosphere of trust and when decision-making is oriented toward the long-term. We aim to do the right thing by treating every customer relationship and requirement as an opportunity to enhance trust and build something great.

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