SOANE

CAPITAL

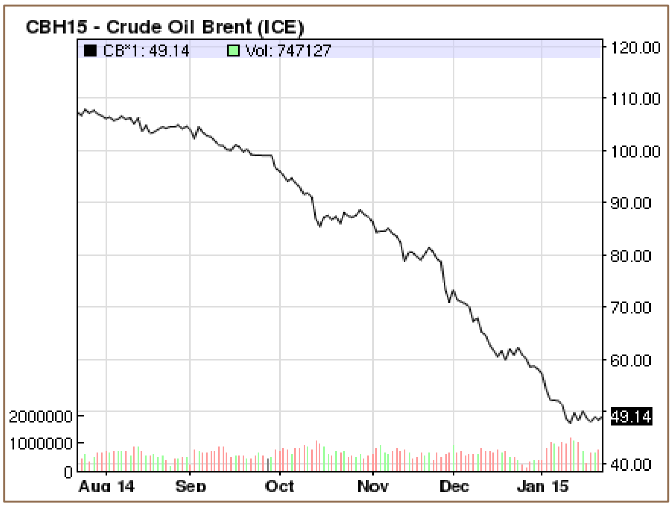
Money out of Moscow

The consequences of the Russian economic crisis on London's luxury residential property

Introduction

As discussed in the previous 'Soane Speaks' articles, since 2008, private money has sought safety in the form of real estate assets for the preservation of wealth. In the right jurisdiction, property is considered a safe investment that irrespective of volatility within global financial markets, will still exist and uphold value. At present this statement is particularly pertinent for wealthy Russian individuals, who, according to numerous property and financial professionals, are increasingly determined to extract their capital out of Moscow in the wake of the recent Russian economic crisis.

In January 2015, Russia's credit rating was cut to 'junk' by Standard & Poor, underscoring the dramatic economic deterioration in the largest global energy exporter. The downgrade was yet another setback to the Kremlin, already buffeted by wild gyrations in the value of the Rouble and strict western sanctions, imposed after the State annexed Ukraine's Crimea region. Consequently, this has shut large Russian corporations, alongside key Pro-Putin individuals and some of Russia's richest, out of global capital markets. Not to mention the impact of collapsing oil and gas prices, which make up more than 50% of Russia's budget income and approximately 65% of the nation's exports. In December 2014, Russian banks faced a surge of withdrawals as the Rouble plunged to record lows. Despite many failed attempts by the government to tackle the currency freefall, such as the 17% emergency interest hike in December 2014, Russia's financial system is weakening and therefore limiting the central bank's ability to transmit monetary policy. The Russian central bank still holds plentiful reserves of approximately $360bn, however the combination of falling oil prices, the Rouble collapse and western sanctions is rapidly eroding them. As a consequence of the current Russian economic crisis, the number of Russians looking to extract their wealth out of Moscow and preserve it within safe assets such as real estate is believed to have accelerated.



The Russian Attraction to London's Luxury Property

Of all the world's cities, London is considered to retain the most established luxury residential property market. London was home to the most UHNWIs last year, more than any other global city and this is projected to still be the case in ten years' time. According to Prime Resi, the prime central London market is led by Middle Eastern and Asian purchasers. This is widely considered a consequence of the substantial levels of capital growth within the expanding nations of India and China. Nevertheless, over the last couple of years, Russian buyers have become a major force and are now positioned within the top five purchaser groups. Situated halfway between Moscow and New York, London attracts luxury property investment from wealthy Russian individuals due to its easy access to global financial markets, preferred time zone, politically stable environment, mature property market and the excellent education on offer.

Russian interest within luxury property has traditionally been associated with owner occupancy. However, as commercial ventures within illiquid Russia come to an abrupt stop, wealthy Russians are viewing prime London residences as an attractive investment and a secure, tangible asset to preserve wealth. This may offer some explanation as to why a top-end London estate agent, since the beginning of the Rouble decline, has identified a 10% upturn in enquiries from Russian individuals all looking to purchase London residences. More specifically, residences positioned within the super-prime and prime areas of Mayfair, Belgravia, Knightsbridge and Chelsea, which comprise three metre plus ceiling heights and prestigious garden square views. The Russian desk at Knight Frank identified similar trends through analysing the company's web traffic. They declared that the number of Russians viewing prime London residences was 13% higher in November 2014 than the same month in 2013. This figure was up 9.5% from October 2014, a tendency that disregards previous years when web traffic has traditionally declined over the final quarter. In addition, one of London's fastest growing estate agencies highlights that pre-economy crisis, roughly one in five of their high net worth clients were Russian, however at present this sits at approximately three in five.

Two Definitive Markets

While many experts have documented a significant upsurge in wealthy Russians purchasing prime central London residences, Bloomberg suggests something slightly different. They propose that only Russia's Oligarch population, who amassed momentous wealth through the fall of the Soviet Union in 1991, are currently purchasing and after spearheading a boom across the capital, the majority of Russian buyers have now disappeared from the market. Reinforcing Bloomberg's proposal, a top London estate agent has observed an approximate 70% year on year drop in Russian individuals registered as interested in purchasing prime central London residences. Providing a further view was the London based estate agent Alyesford International, who suggests that due to the nation's current economic crisis "Russian buyers have been virtually eliminated overnight". Nevertheless, one property professional who advises Russia's wealthiest on the buying of central London residences, proposes that at present two definitive categories of Russian buyers exist and that each market is performing entirely differently. The first market, which encompasses residences in excess of £20m, is considered to be solid and stable, as Russia's Oligarchs continue to invest in luxury residential property in an effort to preserve their wealth in the wake of the current Russian economic crisis. The second market however, which comprises sub-£5m residences has witnessed a substantial decline of Russian purchases.

The stability associated with £20m plus luxury residential market is believed to be due to a significant percentage of Russian Oligarchs retaining considerable amounts of wealth within offshore bank accounts and therefore only have a proportion positioned in Russia. However, this is not the case for individuals associated with sub-£5m purchases, who typically have the majority, if not all of their wealth situated in Russia, a country currently in economic meltdown. In an attempt to reduce the internal financial pressure on investment-starved Russia and counteract the collapse of the Rouble, Russian state-controlled banks have limited and in many cases for large depositors prohibited withdrawals. As a result, for the individuals unfortunate enough to have almost all of their wealth within Russia, extracting money out of the country in current economic crisis and into safe jurisdictions such as the United Kingdom, is at present a near impossible assignment. Whereas the Russian Oligarchs who retain substantial wealth within offshore bank accounts in safe jurisdictions are seemingly able to continue to make expansive property purchases. It is important to mention that whilst retaining significant amounts of wealth in offshore bank accounts may present an invaluable passageway for capital flight into safe jurisdictions, this is not necessarily possible for all of Russia's wealthiest. The western sanctions have targeted more than one hundred individuals close to the Russian leadership, as well as key decision-makers, forbidding them to enter the U.S. and E.U member states and freezing their assets in those countries. An asset freeze affects not only individual bank accounts and shareholdings, but also economic resources such as property. Therefore, the western sanctions for a number of blacklisted Russian Oligarchs has prevented new capital, despite being held outside of Russia, from entering the UK and at the same time blocking the use of capital already on UK shores.

Irrespective of being in the most severe economic crisis since the 1998 meltdown which witnessed Russia default on its national debt, the nation's Oligarch population that do not appear on the sanctions list, seem largely immune to the demise of the Rouble and tumbling oil prices. While in the most part due to possessing such momentous wealth, purchasing prime central London luxury residential property for approximately 40% more than before the Rouble collapse seems largely immaterial to these select and exclusive group of purchasers. This is alongside the recent Stamp Duty Land Tax (SDLT) reform, which now stipulates purchasers of a £20m luxury residence to pay an additional 65.3% (£913,750) in tax. On the other hand, wealthy Russian property purchasers recently received some favorable news, somewhat of a rarity at present. As a result of the Conservative party obtaining in excess of the 326 seats needed to form a majority administration in the

May 2015 General Election, the proposed plan by Labour to introduce a 2% annual mansion tax for residences worth in excess of £2m was eliminated. Nonetheless, such recent increases in the costs of purchasing and retaining luxury residential property in the UK, firmly accentuates the desire among Russia's wealthiest to position their capital in secure assets situated within safe jurisdictions.

What does the Future Hold for Russia?

As things stand, Russia's GDP is estimated to shrink by at least 5% in 2015. Inflation has soared to 15%, the Rouble is trading near record lows, consumer and business sentiment is on the decline and companies continue to be shut out of key financial markets in the U.S. and Europe. Escalating violence in Ukraine could lead to new international sanctions and there's little sign of a significant rebound in world oil prices. Much will depend on how fast Russia burns through its foreign currency reserves. Last year Russia spent $134b trying to prop up the Rouble, bail out struggling companies and contain the economic crisis. Many experts believe that Russia's surplus funds could keep the nation afloat for another two years, even if oil prices stay at current levels and the conflict in Ukraine continues. According to a statement made by Russian Finance Minister, Anton Siluanov, Russia is suffering losses at a rate of about $40 billion per year as a result of the western sanctions. Furthermore, the Russian economy is also suffering losses at a rate of $90–$100 billion per year from the drop in oil prices. Nevertheless, what does this all mean for the luxury prime central London residential market? According to the Russian Desk at Savills, luxury prime central London property investment from Russian individuals will remain minuscule as recession looms over Moscow and western sanctions endure. Unfortunately for Russia, the U.S. State Department recently suggested that U.S sanctions against Russia have no end in sight. A year after Russia annexed the Ukrainian peninsula of Crimea, State spokesperson Jen Psaki stated that there are no plans on lifting the sanctions that began because of the Kremlin land grab, "We reaffirm that sanctions related to Crimea will remain in place as long as the occupation continues. The United States continues to support Ukraine's sovereignty, territorial integrity and right to self-determination". In addition, European Union leaders have agreed of late that the economic sanctions imposed on Russia, due to expire in July 2015, will stay in place until a Ukraine peace deal is fully implemented, effectively extending them to the end of the year if need be. The Russian Government has seemingly accepted such decisions, as Alexey Ulyukaev, the Russian Minister for Economic Development proposes that the sanctions already implemented are going to stay for a long time, however, he does not expect new sanctions to be imposed.

Conclusion

As a result of the current economic crisis in Russia, which has seen a dramatic decrease in the value of Rouble and oil price, wealthy Russian individuals are increasingly determined to preserve their wealth within tangible assets and safe jurisdictions. London is widely considered to retain the most established and secure property market and offers wealthy Russian individuals access to key global financial markets alongside a politically stable environment. As commercial ventures within Russia come to a sudden stop, wealthy Russians are viewing prime central London luxury residences as an attractive investment to preserve wealth. Whilst many property professionals have identified an increase in the number of wealthy Russians purchasing or registered to purchase prime central London residences, Bloomberg suggests that at present, only Russia's Oligarch population are purchasing, with the majority of Russians buyers dropping completely out the market. Reinforcing this belief, one property adviser's states that two markets exist and at present each are performing entirely differently. The £20m plus London residential market is considered stable, due to Russian Oligarchs retaining substantial amounts of wealth within offshore bank accounts. Therefore, these individuals are able to continue to make expansive property purchasers, amid the economic crisis in Russia. However, the sub-£5m London residential market has seen a substantial decline of Russian purchasers, as state-controlled banks limit and in some cases prevent client withdrawals in an effort to reduce the internal financial pressure on investment-starved Russia and counteract the collapse of the Rouble. Although retaining significant amounts of wealth within offshore bank accounts may present an invaluable passageway for capital flight into safe jurisdictions, this is not necessarily possible for all of Russia's wealthiest. The western sanctions, introduced as a result of the annexation of Crimea, have targeted more than one hundred individuals close to the Russian leadership and prevented them from entering U.S. and E.U member states alongside freezing their assets in those countries. Therefore, for a number of blacklisted Russian Oligarchs, the western sanctions have prevented new capital, irrespective of being held outside Russia, from entering the UK and into safe and tangible assets, whilst also blocking the use of capital already of UK shores. The economic future for Russia looks bleak, as inflation reaches 15%, GDP is estimated to shrink by at least 5% by the end of 2015, and Russian companies continue to be locked out of key financial markets. Both the U.S and E.U. have confirmed that western sanctions will endure for as long as Russia continues to occupy the Ukrainian peninsular of Crimea, with the possibility of new sections should violence between the two nations increase. Consequently, Russian investment within luxury central London residential property will remain diminutive as the majority of wealthy Russians face the near on impossible task of extracting money out of the Russia and into secure assets within safe jurisdictions.

The next 'Soane Speaks' article will discuss the consequence on the UK luxury London residential market, specifically on house prices and market liquidity, following the Conservative parties majority win in the recent UK General Election 2015.