MDM Bank

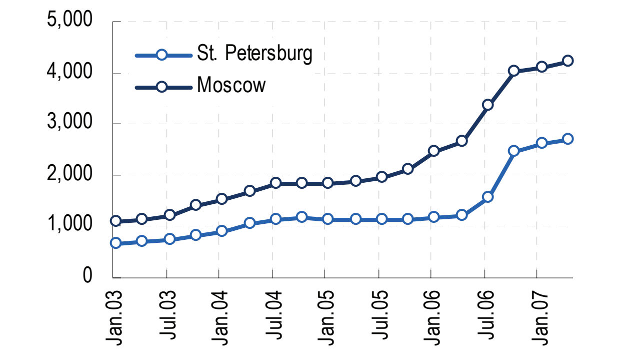
ARSAGERA

ST. PETERSBURG RESIDENTIAL REAL ESTATE: TIME TO MOVE IN

REAL ESTATE SECTOR | Monday, April 16, 2007

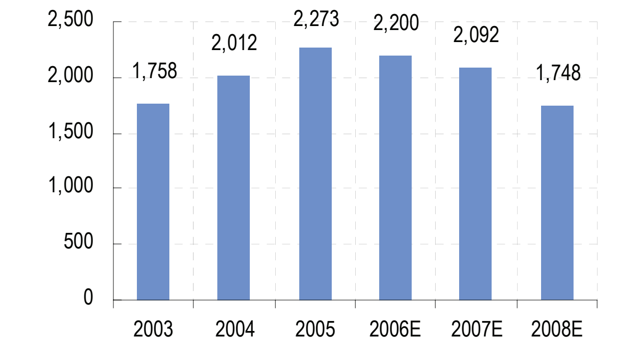
Analyst: Elena Afonina e-mail: Elena.Afonina@mdmbank.com Tel: + 7 495 795 2521

St. Petersburg residential prices lagging Moscow's, USD/sq m



Source: Arsagera Asset Management

Residential real estate construction to decline, '000 sq m



Source: St. Petersburg Property
Note: based on existing projects pipeline

A unique real estate play. Arsagera Residential Construction Fund, a closed-end RTS- and MICEX-listed fund, represents a defensive investment in the dynamic St. Petersburg residential real estate market. A unique vehicle that offers upside and protection from ongoing volatility in global markets, the fund has posted a 98% return since its December 2005 market debut.

Promising macro environment. The favored-city status of St. Petersburg and its above-average rates of economic growth suggest that demand for residential real estate will remain robust in Russia's second city. For St. Petersburg, and for Russia overall, the potential for increased demand for housing, stemming from growth of disposable incomes and the proliferation of the mortgage market, which is still in its infancy, represents a long-term value driver.

Supply squeeze notable. We believe that an unusual confluence of circumstances has resulted in a significant mispricing of St. Petersburg residential real estate. Misguided legislation has led to the total paralysis of new residential real estate development in much of Russia (ex-Moscow), and in St. Petersburg in particular, which has created a supply bottleneck – a situation which we do not expect to be reverted in the coming years. Additionally, housing stock obsolescence and a lack of investment in infrastructure represent serious constraints on a massive increase in per capita housing stock.

A strong management team. Arsagera's portfolio management team has extensive experience in the St. Petersburg residential real estate market and has perfected its investment process and risk management systems while building its current 200-apartment portfolio. The portfolio management anticipates that it will take around two months to purchase the targeted 250 apartments in order to be fully invested.

A defensive investment with significant upside. We estimate that on a NAV basis, Arsagera Residential Construction Fund will return 30-40% per year through the end of 2008, when the fund is due to be terminated. We believe that Arsagera Residential Construction Fund is a compelling investment vehicle for accessing the St. Petersburg residential real estate market and is particularly attractive for investors looking for diversification, safety and steady returns.

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Investment Case

Rising property prices have helped push Russian real estate onto the radar screens of global emerging market portfolio investors. Bolstered by a solid macroeconomic picture and an attractive supply and demand dynamic, selected real estate portfolio investments in Russia represent defensive value plays with attractive upside.

In this report, we focus on Arsagera Residential Construction Fund as an opportunity for portfolio investors to access what we believe is one of the most attractive subsectors of the Russian real estate universe via an RTS- and MICEX-listed, closed-end fund vehicle.

Macro environment for Russian real estate strong. The environment for real estate investment in Russia is positive, and broad-based economic growth is continuing to drive demand across all subsectors. Positive demographic trends – despite the overall gloomy population picture for Russia – underscore the attractiveness of residential real estate in particular. Extremely low levels of mortgage penetration (at 0.8% of GDP in 2006 (compared with, for example, 31% in Estonia) underline the potential for a dramatic increase in demand for residential real estate. The timetable for restructuring Russia's banking sector to a point where it could provide increased leverage is likely to be prolonged. But over the long term, growth in mortgages will be a powerful force for residential real estate development, providing support to residential real estate prices.

St. Petersburg residential real estate extremely well-positioned. Residential real estate in St. Petersburg is at an inflection point. Federal Law 214 (described below), a well-intentioned but misguided piece of legislation, has had the inadvertent effect of paralyzing residential real estate development in Russia (ex-Moscow), thus creating a massive supply bottleneck. Amendments to the law that were approved in July 2006 are unlikely to change the situation in the upcoming 2-2½ years as demand will continue to outstrip supply, which, according to the most optimistic forecasts, will increase by a modest 5% through 2008. On another front, price growth in the St. Petersburg residential real estate market has been lagging that of Moscow (up 37% from January 2005 to July 2006 vs. 83% in Moscow), with the gap only starting to narrow in 2H06. We think the current 55% difference in residential real estate prices between Moscow and St. Petersburg is unjustified, particularly in light of St. Petersburg's above-average rates of economic growth, the special status of the city in the eyes of the Kremlin (many of the occupants of which hail from Russia's second city and are unafraid of displaying their favoritism), and the anecdotal but nevertheless significant evidence of increasing corporate activity in St. Petersburg.

A unique vehicle. The proposed offering of Arsagera Residential Construction Fund represents a unique way of tapping the potential of St. Petersburg's residential real estate market. The fund will purchase apartments at varying stages of construction and generally sell them upon completion. Investment decisions are guided by a rigorous investment process, and a disciplined risk management system serves to limit downside. Arsagera controls 41 properties through Arsagera Residential Construction Fund, and during 2006 and 1Q07, the per-share net asset value of the fund increased by 98%. We forecast NAV returns of 30-40% per annum going forward.

Ready to go. The fund's asset managers have already identified 250 residential properties they anticipate purchasing upon closure of the offering, and they estimate the funds will be fully invested within two months. The increased real estate transaction volume for Arsagera will not require any additional headcount, which means that operational leverage is high and fund expenses will remain towards the low end of the comparables universe. Unlike the vast majority of other domestic real estate funds, Arsagera Residential Construction Fund is already listed on the RTS and MICEX, and, uniquely, will have a market maker, which should boost liquidity in the shares.

Fund and Market Review

Arsagera Residential Construction Fund represents a defensive, low-volatility investment. The dynamics of the St. Petersburg residential real estate market, i.e. above-average income and GDP growth rates, rapid development of the mortgage market, and legislative obstacles artificially limiting the supply of housing stock against a background of rapidly increasing demand point to sharp upside potential, underscoring that defensive does not imply dull. Arsagera's experienced and highly competent management has developed a structured investment process and a sensible risk management system to uncover the best real estate values on the market and reduce investment risk. Arsagera Residential Construction Fund, in our view, is a good fit for investors seeking diversification and tolerant to low liquidity.

Arsagera Residential Construction Fund

In our view Arsagera Residential Construction Fund is a compelling investment vehicle for accessing the St. Petersburg residential real estate market:

- **Sharp upside potential.** The dynamics of the market reflect local factors that we believe point to sharp upside potential (well above that offered by many Russian and other emerging market shares, in fact). Additionally, the regular calculation of net asset value of the fund's properties means that valuing the portfolio is straightforward and painless, allowing investors to easily track performance
- **Regulated, liquid and inexpensive.** There are roughly 100 domestic real estate investment funds. However, only a handful are MICEX- and/or RTS-listed, which ensures a significantly higher level of investor protection and regulatory oversight. None of the listed funds, to our knowledge, has an active market maker, which means share liquidity is minimal at best. Arsagera Residential Construction Fund is already listed on both the RTS and MICEX (although liquidity has been very low, given the small size of the fund), and will have a dedicated market maker. On another front, none of the small number of internationally listed real estate funds that invest in Russia is focused on the residential sector, or on St. Petersburg – both of which we think offer higher growth potential than the more mature office, retail and industrial sectors. Significantly, the expenses levied by the fund are lower than those of many competitors. The fund does not take a performance fee (unlike most other funds), believing that management is better incentivized through the long-term target of growing NAV (and thus increasing total fee take), rather than clearing short-term hurdles to earn a one-off payday.

Arsagera Residential Construction Fund – offering terms

Fund	Arsagera Residential Construction Fund
Legal structure	Closed-end mutual investment fund
Establishment date	27 December 2005
Closing date	31 December 2008
Size of offering	RUB820.6 mn/USD31.6 mn
Placement price	RUB1,963/ USD75.5
Fees and expenses* (p.a. of the average NAV)	3.7%
Extra charge (premium) for share acquisition through Arsagera Asset Management	1.5%
Performance fee	N/A
Early redemption penalty	N/A
RTS/MICEX ticker	ARSAHBG/RU000A0JC5V1
Geography of operations	St. Petersburg, Russia
Management company	Arsagera Asset Management

** includes VAT*

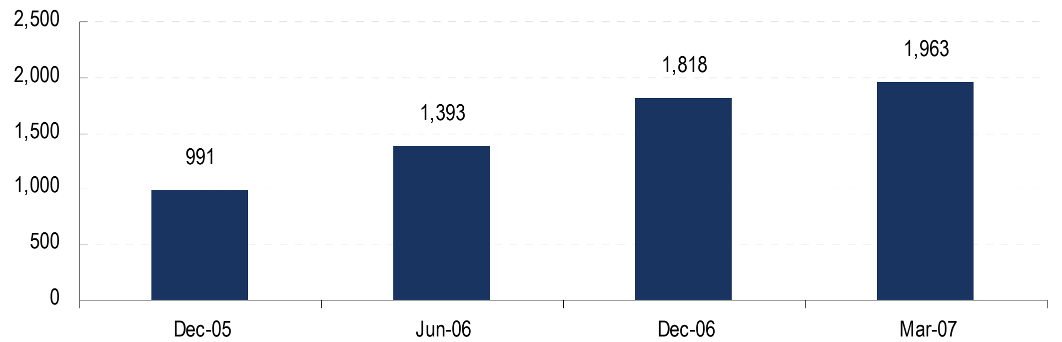
Source: Arsagera Asset Management

- **Defensive.** Given the prevailing volatility in global equity markets, St. Petersburg residential real estate represents a defensive, low-volatility investment that is virtually disconnected from concerns about U.S. interest rates and emerging market money flows.

- **Attraction of structured investment process and sensible risk management.** Using its knowledge of the local real estate market, Arsagera Residential Construction Fund invests during the early stages of development in properties built by the best and most reliable developers, and generally sells them upon completion of construction. Through this strategy the fund focuses on capital appreciation rather than on renting properties and upkeep. Arsagera has developed a multi-tiered investment process that searches out the most attractive properties based on a range of parameters, including macroeconomic and market analysis, supply and demand modeling, and constant ear-to-the-ground monitoring of residential real estate prices and market activity. Risk management is central to Arsagera's investment decision-making process; key elements of the fund's risk management system include selection and monitoring of developers, asset diversification and investment limits.

- **Experienced and highly competent management.** The St. Petersburg-based Arsagera team currently runs a stable of small but well-performing equity funds, and previously put together a very strong record at another asset management firm before striking out on its own. Arsagera has been building a solid track record in the St. Petersburg residential real estate market. It holds a portfolio of about 200 apartments assembled using the proceeds of the December 2005 primary offering of Arsagera Residential Construction Fund (which raised RUB10 mn) and subsequent three secondary offerings (which raised an additional RUB118.6 mn), and the February 2006 offering of Favorite Fund (RUB300 mn). The asset management team has developed a proprietary investment process that it has already implemented with considerable success: The per-share net asset value of Arsagera Residential Construction Fund increased 98% from its closure in late December 2005 through March 2007.

Per-share NAV of Arsagera Residential Construction Fund, RUB/share



Source: Arsagera Asset Management

- **Residential real estate offers easy diversification.** The nature of residential real estate investment through a fund structure makes it more broadly diversifiable than a fund focused on investment in other real estate subsectors, which tend to limit the number of projects per fund. Funds focused on industrial or office subsectors, for example, frequently hold only a handful of assets (each of which carries a large price tag), while each residential property in a fund is worth less on a per unit basis, meaning the total number of holdings in the vehicle will be significantly greater.

St. Petersburg residential real estate

Investment in residential real estate in St. Petersburg is promising:

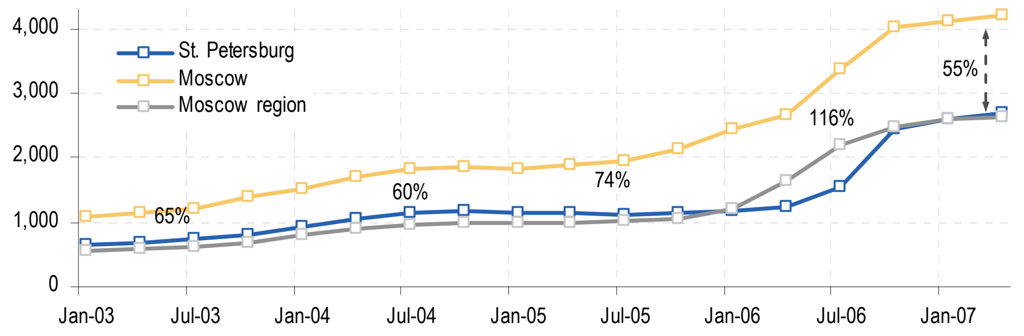
- **Misguided legislation has restricted residential real estate supply.** Federal Law 214 was implemented in April 2005 to protect prospective homeowners from inefficient or unscrupulous real estate developers. Indirectly, it achieved its intended effect, although at the cost of nearly halting residential real estate construction in much of Russia. As detailed in Appendix 2 of this report, the legislation had a disproportionate impact on developers that rely on banks for funding, while developers less reliant on bank credits, such as the largest Moscow firms, have been less affected. Construction outside Moscow has come to a virtual standstill, as developers are unable to fund their projects. Changes to Law 214 (which were passed by the State Duma in early July 2006 and approved by the Federation Council) should help alleviate the coming supply bottleneck. However, the extended nature of real estate development means that demand will far outstrip supply over the next few years. Positive side-effects of the law's amendment should include a more level playing field and a more welcoming investment environment, particularly for foreign investment.

- **St. Petersburg outperformance.** The city is expected to continue to outperform the Russian average in terms of economic growth, income and GDP per capita. We expect St. Petersburg's economy, measured by GRP, to exceed the GDP growth rate for Russia, with GRP climbing 7% in 2006-10, compared to Russian average GDP growth of 6.7% for the same period. As a result, by 2010, we estimate Russia's per capita GDP will amount to USD13,100, while GRP per capita in St. Petersburg will amount to USD13,870. Equally, by 2010, average nominal income should reach USD10,400 for St. Petersburg, compared with USD9,400 for Russia as a whole. Above-average growth will be positive for real estate demand in St. Petersburg.

- **A favored city.** St. Petersburg has been the destination of a disproportionate volume of investment and attention since President Vladimir Putin – who hails from the city – assumed power in 2000. This has partly been thanks to the direct intervention of the president, as well as many other influential politicians with a local background. While this emphasis on developing St. Petersburg is difficult to quantify, the city has clearly benefited from, for example, its emergence as the car-producing center of Russia, and the decision of a number of corporates (for example, Gazpromneft) to move their headquarters there or otherwise expand their presence. A number of large-scale infrastructure projects are to be implemented in St. Petersburg: Toyota Motor will construct a USD250 mn plant, while Pepsi Bottling Group will build a production and warehouse complex. Importantly, this trend appears likely to continue, as Putin's most likely successors as president also hail from St. Petersburg.

- **A national project.** President Putin in March 2006 delineated four so-called national projects to be the focus of government activity and funding: education, agriculture, healthcare, and housing – with the latter labeled the most "troublesome" issue to be tackled. While the practical implications of being on the national project list are unclear, any heightened focus will likely boost investment and lift the overall position of housing in the pecking order of national priorities, possibly to the benefit of residential real estate prices. St. Petersburg appears to disproportionately benefit from any Kremlin largess towards the sector.

Scope for St. Petersburg to play catch-up in residential real estate prices, USD/sq m



Source: Arsagera Asset Management

- **Further price convergence likely.** Prices for Moscow residential real estate have been historically 60-70% higher than in St. Petersburg (in absolute terms the price differential has ranged between USD400 and USD1,000/sq m). In 1H06 the price gap widened significantly to 116% (USD1,810/sq m in absolute terms), reflecting a medium-term market inefficiency and a more rapid increase of disposable income in Moscow. In 2H06 and 1Q07 the price gap narrowed to 55% as residential real estate prices in St. Petersburg rose 73% to USD 2,703/sq m from August 2006 to April 2007 vs. 25% in Moscow to USD4,201/sq m. In absolute terms the price differential is still high at USD1,498/sq m, though. We believe this gap will narrow, implying further price appreciation, as there is no sign of an absolute decline in prices in either city.

Real estate in Russia

We have identified a number of factors that make investment in Russian real estate, and residential real estate in particular, attractive:

- **Positive macroeconomic environment.** Eight years of an average 6.7% macroeconomic growth has resulted in surging demand throughout the Russian economy, leading to an average 10.6% growth in disposable income since 2000. The real estate sector has been a key beneficiary of significantly increased levels of liquidity throughout the economy. We anticipate the macroeconomic environment will remain supportive, with GDP growth averaging 6.7% in 2007-10E, broadly stimulating positive price dynamics, which will allow for continued support of the real estate sector.
- **Upbeat demand dynamics for real estate.** Macro-level strength has filtered into demand for real estate in Russia in recent years. Price levels for virtually every class and type of real estate – in the country's economic centers in particular – have increased sharply, driven by:
  - *Employment growth.* In many markets, employment growth is a better indicator than interest rates of demand for real estate. After the August 1998 crisis, employment began to fall and reached a nadir in May 2001, when Russia had 70.1 mn employed. Five years of strong economic growth later, employment stands at 73.8 mn. At the same time, the unemployment rate has fallen from over 10% at the beginning of 2001 to 7.3% as of February 2007.
  - *Declining interest rates.* In light of the underdeveloped nature of Russia's mortgage market, declining interest rates have a limited impact on demand for real estate. However, with the eventual evolution of a more robust mortgage market, the long-term trend of declining interest rates in Russia should have a significant positive impact on real estate demand.
- **Demographic trends support residential real estate demand.** Russia faces a challenging demographic outlook, as the country has been losing a net 500,000 citizens annually to the ravages of poor health care,

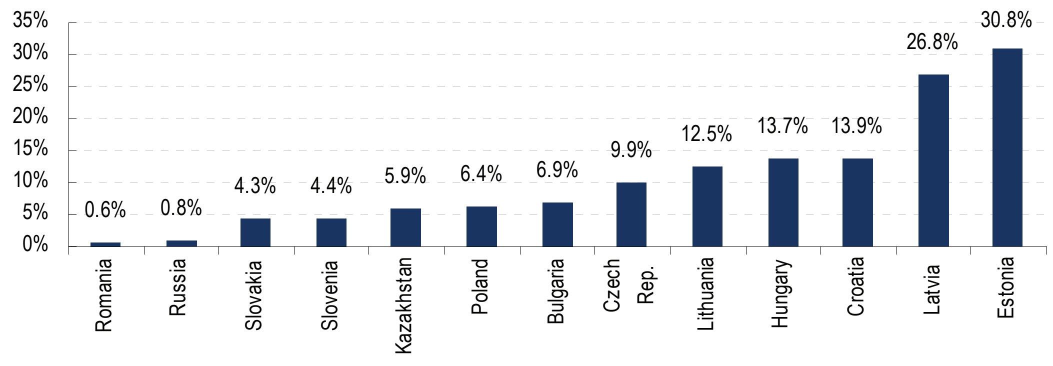
alcoholism, bad driving habits, disease, etc. However, this trend is largely a result of dislocation stemming from the breakup of the Soviet Union that, with sustained economic growth, will to some degree be self-correcting, and in any case is less perceptible in the country's major population centers. Indeed, a number of demographic trends are working strongly in favor of increased real estate demand:

- *Growing apartment-buying population.* The share of the Russian population aged 20 to 50 – those most likely to be home buyers – increased from 62.4 mn in 1989 to about 66.5 mn by 2006. The same age group living in urban areas increased from 47.9 mn to 50.3 mn. The rapidly growing middle class should also serve as a key engine of residential real estate demand.
- *Low average housing space per capita.* At 19 sq m, the Russian average is very low, and growth potential is substantial. In Europe, by comparison, there is an average 40 sq m of housing space per capita.
- *Immigration, internal migration and growing housing demand.* Broadly speaking, the Russian government has only recently begun to reverse its opposition to immigration, which is predominantly from former Soviet states. Modest numbers of immigrants have been boosted by Russians leaving the countryside for major population centers. Few new denizens of St. Petersburg or Moscow have the funds to purchase real estate immediately, but they contribute to demand for rental property, and in the long term will form an important support for growth in real estate demand.

■ **Investment environment favors increased focus on real estate.** A range of factors, including falling yields on fixed income instruments, recent heightened volatility in the commodity and equity markets, the growing sophistication of domestic investors, and continued high liquidity, suggest that real estate will continue to grow in popularity among both domestic and international investors. In particular, we think that large pools of domestic liquidity – stemming from commodity price strength, which has supported the Russian financial markets in recent years – will increasingly diversify into real estate.

■ **The potential for mortgages.** The potential for mortgage market growth is huge. In 2006, mortgages made up a mere 0.8% of GDP in Russia. But banks are refining their product lines and personal income growth is bolstering demand for housing. (President Putin, in his state of the nation address in early 2006, emphasized the need to provide lower interest rates on mortgages within two years, and set a goal of almost tripling the number of mortgage loans made in that period.) Our analysis suggests that by 2010, mortgages could amount to 6% of GDP (which is still below transition countries with a similar GDP per capita), feeding demand for real estate.

Russian mortgages – a fraction of comparables (2006)



Source: Central Bank, EBRD, IMF, MDM estimates

Risks

Investment in the Russian real estate sector, and in Arsagera Residential Construction Fund, is not without risks:

- **Challenging operating environment.** Contributing to the risk premium required by real estate investors is the difficult business environment in Russia. Stifling bureaucracy, corruption, confounding regulations, a weak work ethic, lack of qualified personnel, an underdeveloped banking system, poor construction standards, and a plethora of other factors can make doing business in Russia extremely difficult. The key is to find a strong local partner that has experience and contacts in the local environment, who can operate in a legal and above-board fashion.

- **Susceptible to a macroeconomic slowdown.** As with any consumer-related sector, real estate would suffer in the event of an economy-wide slowdown. Consumer demand would falter and prices would likely slip. We think the most likely trigger of such a slowdown would be a sharp decline in commodities prices, which is possible in the medium term. To have any real impact on Russian growth (and the real estate sector), however, a correction would need to be particularly sharp and prolonged, a combination that we consider highly unlikely in the current environment.

- **Legislative infrastructure weak.** The regulatory and legislative infrastructure governing the real estate sector is incomplete. Establishing title and ownership over real estate is a process fraught with time-consuming difficulties and uncertainties. Legislation intended to protect market participants, such as Federal Law 214, has instead slowed the market's natural development. The July 2006 amendments to the law may provide some relief, with mixed implications for property investors. The looming supply bottleneck will likely be eased somewhat – while demand is likely to surge, as the environment for investment in residential real estate will be sharply improved.

- **Administrative measures.** St. Petersburg city authorities have the scope to impact residential real estate prices through, for example, increasing the volume of land made available for residential real estate construction. Continued sharp appreciation in the price of residential real estate in the city may prompt officials to expand the space they make available to residential real estate developers, in an effort to boost supply and thereby moderate price growth. It is important to note, though, that land supply is only one element in the wide array of dynamics that drive real estate prices, and in a vacuum has little direct impact on prices.

- **Limited development financing available.** A key structural impediment to the development of the real estate sector is the lack of project financing and other long-term credits for investors. This is only rarely an issue for the largest and most liquid real estate developers, which are focused almost exclusively on the Moscow market. But it has a significant impact on other market participants, who are frequently unable to raise funds for construction and can only build after future tenants have prepaid. The lack of financing options represents a risk to future growth mostly outside of Moscow.

- **A real estate bubble?** The strength of real estate prices has led to escalating fears of a sudden and sharp collapse, particularly in the context of rising financing costs. But while this may be a realistic concern in a number of real estate markets, we think that the situation in Russia – and in the Russian residential market in particular – is different, given buoyant demand and a bright macroeconomic picture.

- **Execution risk.** There is some danger that Arsagera Residential Construction Fund's management could face challenges in deploying the funds it anticipates raising in the upcoming offering. The RUB821 mn (USD31.6 mn) fund is slated to receive is considerably more than the assets currently under management. However, we would note that the fund's management team successfully invested the proceeds from its four capital-raisings, plus that of Favorite Fund, quickly and efficiently, and already has properties selected as investment targets for the new funds. We see little reason why the same team would be unable to replicate its success with the proceeds of the anticipated offering.

- **Delays in construction.** The bulk of apartments that Arsagera envisages buying are located in properties due to be commissioned in 4Q08. In order to save on VAT the company aims to sell the properties upon commissioning. A delay in construction completion would require Arsagera selling apartments and paying a 18% VAT charge, limiting the proceeds. On a related note, the process of selling properties in itself has not yet been tested since the company has not yet sold any apartments. Selling as much as 290 apartments by the end of 2008 (when the fund is to be terminated) could prove to be difficult, and the company may wind up selling them at discount to speed up the process. However we believe the fund will be extended post-2008 (via an issue described in the next paragraph), giving Arsagera the opportunity to buy more attractive assets and more time to sell them upon completion.
- **Potential problems with exit.** A crucial part of the investment process is the ability to exit. In the case of Arsagera Construction Fund the most obvious exit point is the fund termination date in December 2008. However, we think Arsagera is likely to extend the duration of the fund taking into account the issue described above (delays in construction and the time-consuming process of selling properties on the market), as well as the attractiveness of the real estate market. In this event, Russian law guarantees that shareholders opposed to the move can exercise redemption rights, which somewhat smoothes the issue. On another front, Arsagera is also concerned with improving liquidity and creating a true secondary market using the efforts of market makers, creating more opportunities for shareholders to exit.

Valuations

Below we describe scenarios for the potential appreciation of St. Petersburg's residential real estate market and Arsagera Residential Construction Fund. We employ three different approaches to project future real estate values:

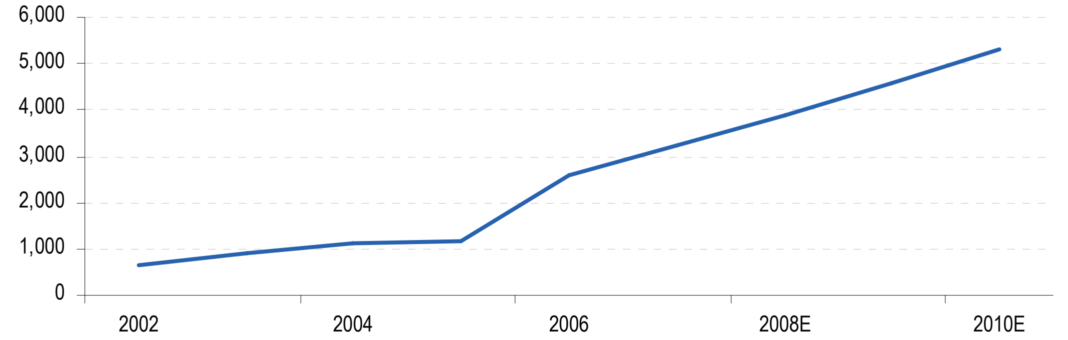
- Arsagera projections, based on a supply/demand model, economic forecasts, and a range of subjective market-specific factors
- Projections based on the historical relationship between economic growth and real estate values, extrapolated forward
- Forecasts using historical price growth for Moscow and St. Petersburg to ascertain future price levels.

Importantly, growth of real estate prices in St. Petersburg is only one driver of net asset value appreciation for Arsagera Residential Construction Fund. As described below, we believe the investment process and approach of the asset manager, involving investment in the early stages of real estate construction projects (as opposed to buying completed properties) will provide returns 5-10% above property price growth. All told, we think the fund will return 30-40% per year on a NAV basis.

Arsagera projections

Arsagera projects St. Petersburg real estate prices will climb 49% from USD2,703/sq m in April 2007 to USD3,870 at year-end 2008 (equivalent to a CAGR of 22%).

Projected St. Petersburg residential prices, USD/sq m

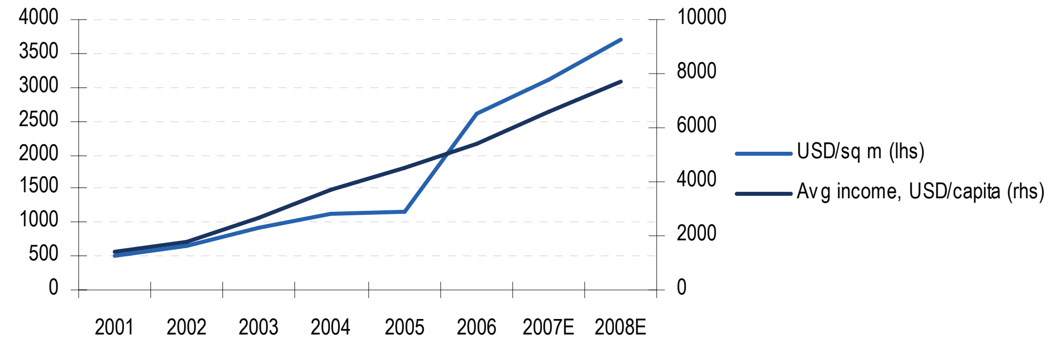


Source: Arsagera Asset Management

Economic growth and real estate values

Not surprisingly, over time there is a fairly close relationship between residential real estate prices and growth in disposable income. The graph below shows the relationship between disposable income in St. Petersburg and local real estate prices. In recent years, real estate prices in St. Petersburg (2002-06 CAGR of 39%) have sharply outpaced the rise in disposable income (2002-06 CAGR of 31%). We should note, however, that the assumption of a convergence between residential real estate prices and disposable income growth is quite conservative, taking into account the potential of the mortgage market, which represents a clear demand-boosting factor that is very likely to contribute to higher price growth rates.

St. Petersburg real estate and disposable income growth, USD



Source: MDM estimates

However, while real estate may appreciate more rapidly than disposable income for an extended period, in the long term there will be a convergence. We forecast this convergence to occur by 2010. Based on this, St. Petersburg real estate should cost about USD3,700/sq m by the end of 2008, implying a 2007-08 CAGR of 19%. Interestingly, this is close to Arsagera's projections for real estate price growth.

Historical price growth

Extrapolating future growth based on historic growth trends can be problematic, as past results are by no means a valid predictor of the future. But if carefully applied within a set time horizon, normalized growth rates can provide an instructive guideline for potential future returns. Below we evaluate the potential growth of St. Petersburg residential real estate under three scenarios based on historic growth.

St. Petersburg residential real estate price appreciation scenarios

Scenario	Description	CAGR '07-'08	Implied end-'08 prices (USD/sq m)	Chg from 2006
A	St. Petersburg growth through end-'08 at Moscow average growth rates of '02-'06	34%	4,650	79%
B	St. Petersburg growth through end-'08 at St. Petersburg average growth rates of '02-'06	39%	5,030	93%
C	Growth rate of Moscow slows to 15% per annum, and St. Petersburg gap with Moscow closes to 40% (from 55% currently)	22%	3,870	49%
	By comparison:			
	Arsagera Asset Management projections	22%	3,870	49%
	St. Petersburg economic growth and real estate price growth converge by 2010	19%	3,700	42%

Source: MDM estimates
Note: As of April 2007 St. Petersburg residential real estate averaged USD2,703/sq m

- **Scenario A.** We assume St. Petersburg residential real estate prices grow at an annual CAGR of 34%, which is the same rate at which prices for Moscow residential real estate appreciated in 2002-06. Such an acceleration in growth (St. Petersburg residential real estate actually appreciated at a CAGR of 39% over the same period) would see the city's real estate prices reaching USD4,650/sq m in late 2008, 13% above the current average price of real estate in Moscow.
- **Scenario B.** Under this scenario, the actual CAGR of real estate prices for the past several years (39%) is applied through the end of 2008. This implies a total return through 2008 of 93%.
- **Scenario C.** In this case, the recent heady annual growth rate in real estate prices in Moscow decelerates to 15%, and St. Petersburg's growth rate drops to 22%. As a result, the price gap between Moscow and St. Petersburg falls to roughly 40% by end-2008 from 55% currently, and St. Petersburg residential real estate is priced at an average USD3,870/sq m at the end of the period (in line with Arsagera's projections).

Conclusion and recommendation

We estimate that, in light of the multiple growth drivers detailed in this report, St. Petersburg residential real estate will appreciate at a CAGR of 20-35% through the end of 2008. The lower end of this range reflects conservative assumptions that we believe are unlikely to come to pass, and we believe the actual figure will be toward the top end of the range.

For Arsagera Residential Construction Fund, however, appreciation in St. Petersburg residential real estate is only part of the equation. Real estate properties purchased at an early stage of development can appreciate 5-10% per year, without factoring in appreciation in the underlying real estate, through:

- The shouldering of additional risk, as there is greater uncertainty in investing in a real estate project during its early stages, as opposed to a project that is complete
- Limiting this risk via the effective selection of development/construction companies. A key focus of Arsagera's investment process and its risk management system involves selection and monitoring of real estate developers to limit the risk associated with early-stage investment
- Negotiation of favorable contract terms with developers. As a large-scale buyer of early-stage real estate, Arsagera is in a position to understand the market and win better terms than other investors, boosting total returns.

Combining anticipated growth in underlying real estate prices with the element of value creation from the asset manager, we estimate that on a NAV basis, Arsagera Residential Construction Fund will return 30-40% per year. In our view the fund is a good fit for investors tolerant to low liquidity and seeking diversification, safety and steady returns.

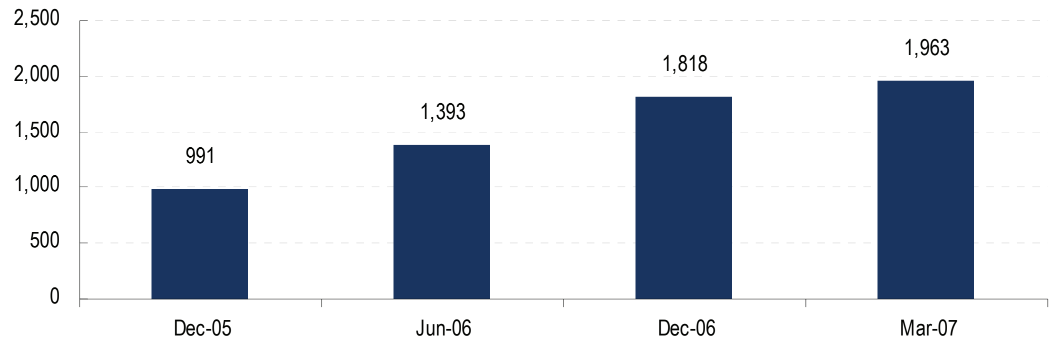
Arsagera Asset Management – Review

Arsagera Residential Construction Fund invests during the early stages of development in properties built by the best and most reliable developers, and generally sells them upon completion of construction. Through this strategy the fund focuses on capital appreciation rather than on renting properties and upkeep. Arsagera has developed a multi-tiered investment process that searches out the most attractive properties based on macroeconomic and market analysis, supply and demand modeling, and constant monitoring of residential real estate prices. Currently 41 apartments are in the portfolio and another 250 are targeted for purchase. Since its IPO in December 2005 the fund has posted a 98% return.

Arsagera Residential Construction Fund: A Real Opportunity

Arsagera Residential Construction Fund was launched in December 2005, with a net asset value (NAV) of RUB10 mn (USD347,200). In July, November and December 2006, three additional issues were performed, raising additional RUB118.6 mn (USD4.6 mn) for the fund. In February 2006, the RUB300 mn (USD10.6 mn) Favorite Fund, with a similar mandate to invest in St. Petersburg residential real estate (although the fund also invests in securities) was launched.

Per-share NAV of Arsagera Residential Construction Fund, RUB/share



Source: Arsagera Asset Management

Based on their previous experience in St. Petersburg real estate investment and their experience with building two portfolios focused on the sector at Arsagera, the portfolio managers have perfected their investment process, risk management systems, and due diligence procedures. The 98% return of the Residential Construction Fund in 2006-1Q07, albeit working from a low base, suggests that their process is robust. The terms of the proposed secondary offering of the Arsagera Residential Construction Fund are detailed below.

Arsagera Residential Construction Fund – offering terms

Fund	Arsagera Residential Construction Fund
Legal structure	Closed-end mutual investment fund
Establishment date	27 December 2005
Closing date	31 December 2008
Size of offering	RUB820.6 mn/USD31.6 mn
Placement price	RUB1,963/ USD75.5
Fees and expenses* (p.a. of the average NAV)	3.7%
Extra charge (premium) for share acquisition through Arsagera Asset Management**	1.5%
Performance fee	N/A
Early redemption penalty	N/A
RTS/MICEX ticker	ARSAHBG/RU000A0JC5V1
Geography of operations	St. Petersburg, Russia
Management company	Arsagera Asset Management

** includes VAT*
Source: Arsagera Asset Management

Key parameters of the fund include:

- **A buy and hold strategy.** Arsagera Residential Construction Fund invests in apartments at various stages of construction. To assess the investment potential of a property, the company starts by analyzing a range of macro-level factors that impact the economic environment for real estate (including inflation, disposable income trends, and other dynamics), and moves on to more specific analysis of local real estate trends, supply and demand movement, relative neighborhood and apartment block valuations, and other dimensions. Price developments are closely monitored, and properties are sold when they reach Arsagera's estimate of their full valuation, upon or prior to the completion of construction (generally the portfolio will hold a property until completion, to avoid triggering a VAT charge).
- **Transparent asset structure and regulation.** The fund's capital can be invested in real estate assets, either under a construction participation agreement or an investment agreement (for premises that already have a property holder). Arsagera Residential Construction Fund's assets are valued on a quarterly basis by a specially appointed independent appraiser, or else upon purchase or disposal. The valuation process involves assessing the market price for similar properties; determining the state and progress of construction; and interfacing with developers and builders as necessary.
- **Expenses limited to 3.7% of the fund's NAV.** Arsagera will receive a fund management fee of 2.0% of NAV, paid quarterly. Fund administration, auditing and appraising expenses are capped at 0.8% of NAV. Other expenses, including maintenance and insurance of real estate assets, service fees and general fund expenses will be limited to 0.9% of the fund's NAV. As discussed in Appendix 1, the maximum 3.7% annual fee charged to shareholders is low compared to similar funds. Significantly, the fund management company does not take a share of the performance of the fund (unlike most other funds), believing that management is better incentivized through the long-term target of growing NAV (and thus increasing total fee take), rather than achieving short-term hurdles to earn a one-off payday. However investors are also charged with a 1.5% extra fee for share acquisition through Arsagera Asset Management, which increases the cost of share acquisition.
- **Three-year duration.** The established duration of Arsagera Residential Construction Fund stands at three years, dating from the origination of the fund (the expiration date is December 31, 2008). Upon expiration, the fund's assets will be sold on the secondary market, or transferred to another fund at market value. According to Russian legislation, the fund should be fully terminated within 6 months of the date of closing, meaning that Arsagera should sell the properties by mid-2009. A decision by a general shareholders meeting, however, can extend the duration of the fund, although in this event, Russian legislation guarantees that opposing shareholders can exercise redemption rights.

Investment Process, Risk Management, and Assets

Investment process

To uncover the best real estate values on the St. Petersburg residential market, Arsagera uses a multi-tiered investment process that is comprised of

- **Macroeconomic assessment.** The company forecasts the implications of changes in the macroeconomic environment for real estate prices. Key parameters include inflation, savings rates, disposable income trends, and federal budget projections, all of which feed into a supply and demand model. Forecasting inflation is also critical to forecasting construction costs, and assessing potential liquidity issues for builders and developers.
- **Supply and demand modeling.** The input from the assessment of the macro environment, combined with analysis of a plethora of regional and local issues, create the foundation of the demand and supply model. Local variables the asset managers study include existing and anticipated residential stock; construction plans; recent pricing trends; transportation infrastructure; and proximity to shopping facilities. Arsagera has developed a system of quantifying qualitative factors in assessing real estate value, and uses this to more effectively model supply and demand dynamics.
- **Return assessment.** The objective of the analytical process is to uncover those properties that offer above-average return potential. The asset managers rank the universe of potential investment targets according to projected return, adjusted for risk. Naturally, the residential real estate market is organic and constantly evolving; Arsagera continuously and rigorously monitors macro dynamics, shifts in local and regional pressures, and prices in order to uncover pockets of opportunity and modify return expectations.
- **Optimal portfolio structure.** The Arsagera Residential Construction Fund's portfolio is composed of apartments at various stages of construction with different commissioning terms. Some assets are bought at the earliest stages of construction; others may be purchased within months of the completion of the construction process. Arsagera aims to ladder the duration of its assets so that it can pay dividends to shareholders by selling completed apartments. Selling an apartment before completion incurs a VAT charge, reducing the capital gain from the property, so Arsagera aims to sell an apartment prior to the completion of construction only when absolutely necessary (i.e., in the event of a deterioration in the financial status of a developer, or an unexpected development with the property). The fund otherwise does not pay taxes on its capital gains (for a more detailed discussion of tax issues please refer to Appendix 2).
- **Investment disposal.** Upon completion of construction Arsagera will have to sell the properties on the market. Generally three options are available. An apartment could be sold through a real estate agent, which would save Arsagera time and efforts, but require a commission of 3-4% of the value of the property sold. The second option is cooperation with developers, which may cost 1-2% of the apartment's value for Arsagera. Finally, the third possibility is creating an in-house selling department that would engage in disposing of commissioned apartments. We believe the later option is most likely. According to Arsagera, it takes on average 1-2 months to sell an apartment (from the time when an apartment is put for sale to the actual transfer of money from the buyer). To date Arsagera didn't dispose of investments, and the first sale of properties is scheduled for autumn 2007.

Risk management

Arsagera has developed a range of measures to reduce investment risk:

- **Real estate developer selection and monitoring.** One of the key dangers faced by investors in primary real estate is that the real estate developer building the property is unable to complete construction, and/or commits fraud with the funds raised from future tenants and investors. (This concern was the key driver behind the development of Federal Law 214, as discussed in Appendix 2.) The asset managers have significant experience with residential real estate developers active in the St. Petersburg market, and constantly monitor those with which the Arsagera funds are currently invested, and those with which they may invest going forward. Key parameters include relative market position of different developers; progress of projects underway; market share; construction values and practices; average delays; and registration specifics (i.e., whether land is registered in the name of the developer, rather than affiliated companies). Arsagera also monitors the financial standing and performance of partner developers, and oversees the construction process, regularly visiting worksites to ensure that deadlines are met and quality standards are observed.
- **Due diligence.** Arsagera's legal department is charged with undertaking substantial due diligence required before a transaction is closed. The legal underpinnings of all anticipated partners, of the construction site, and of all other involved parties are assessed. An individual agreement between the developer and the investment fund is created in each case.
- **Asset diversification.** Arsagera purchases apartments in a range of buildings owned by different developers. Exposure to specific areas, developers, buildings and types of properties is carefully monitored and limited, so as to ensure that risk is adequately diversified. Given that upon completion of additional share issue the fund's assets will increase considerably, the limits that are in effect now will be further tightened. Limits are shown in the table below.

Arsagera Residential Construction Fund investment limits, as % of NAV

	Limits in effect at present	Limits to be introduced
Deposits in one credit institution	maximum 25%	maximum 25%
Investments in one property	maximum 20%	maximum 1%
Investments in premises in one apartment building	maximum 30%	maximum 7%
Investments in real estate constructed by one builder	maximum 40%	maximum 20%
Stocks and bonds	0%	0%

Source: Arsagera Asset Management

- **Focused only on real estate.** The Arsagera Residential Construction Fund is permitted only to invest in real estate projects, and it does not and will not invest in securities.

Assets – current and anticipated

The Arsagera Residential Construction Fund currently holds the properties shown in the table below.

Composition of Arsagera Residential Construction Fund assets

Developer	Project	Apartment area, sq m	No. rooms	Acquisition price, USD/sq m
Stroitelny Trust	Kondratyevsky 17	45	1	1,000
Stroitelny Trust	Kondratyevsky 18	45	1	1,000
Stroitelny Trust	Kondratyevsky 18	45	1	1,800
Stroitelny Trust	Kolomyazhsky 15, 2nd stage	82	2	1,820
Stroitelny Trust	Kolomyazhsky 15, 2nd stage	123	3	1,510
Stroitelny Trust	Kolomyazhsky 15, 2nd stage	127	3	1,510
Stroitelny Trust	Kolomyazhsky 15, 3d stage	81	2	2,150
Stroitelny Trust	Kolomyazhsky 15, 3d stage	81	2	2,150
Stroitelny Trust	Kolomyazhsky 15, 3d stage	81	2	2,150
Stroitelny Trust	Kolomyazhsky 15, 3d stage	81	2	2,150
GDSK	Pulkovsky Posad 2	59	2	950
GDSK	Pulkovsky Posad 4	34	1	980
GDSK	Pulkovsky Posad 5	59	2	1,989
GDSK	Pulkovsky Posad 5	58	2	1,989
GDSK	Pulkovsky Posad 5	59	2	1,989
GDSK	Pulkovsky Posad 5	38	1	2,223
GDSK	Pulkovsky Posad 5	38	1	2,223
GDSK	Pulkovsky Posad 5	38	1	2,223
GDSK	Pulkovsky Posad 5	38	1	2,223
LenSpetsSMU	Zolotaya Gavan 5/1	44	1	1,490
Peterburgskaya Nedvizhimost	Brusovskaya Mechnikova	62	2	880
Nevsky Syndicate	Rybatsky pr. 15	53	2	1,265
Nevsky Syndicate	Rybatsky pr. 15	75	3	1,540
Nevsky Syndicate	Rybatsky pr. 15	75	3	1,540
Nevsky Syndicate	Rybatsky pr. 15	75	3	1,540
Kondrat'evsky	Vasilievsky Island, 27th line	74	2	2,480
Kondrat'evsky	Vasilievsky Island, 27th line	74	2	2,480
Inkorstroy 58	Primorsky district, block 9D	64	2	1,887
Inkorstroy 58	Primorsky district, block 9D	64	2	1,887
Inkorstroy 58	Primorsky district, block 9D	64	2	1,887
Inkorstroy 58	Primorsky district, block 9D	64	2	1,887
Elis	Corner of Tipanova street and pr. Kosmonavtov	53	2	2,199
Elis	Corner of Tipanova street and pr. Kosmonavtov	53	2	2,199
Elis	Corner of Tipanova street and pr. Kosmonavtov	53	2	2,199
Elis	Corner of Tipanova street and pr. Kosmonavtov	53	2	2,199
Elis	Corner of Tipanova street and pr. Kosmonavtov	53	2	2,199
Elis	Corner of Tipanova street and pr. Kosmonavtov	53	2	2,199
Elis	Corner of Tipanova street and pr. Kosmonavtov	53	2	2,199
Elis	Corner of Tipanova street and pr. Kosmonavtov	53	2	2,199
Elis	Corner of Tipanova street and pr. Kosmonavtov	53	2	2,199
Elis	Corner of Tipanova street and pr. Kosmonavtov	53	2	2,199

Source: Arsagera Asset Management

In the table below, we present a list of real estate properties in which the Arsagera Residential Construction Fund may invest, upon the closing of the secondary offering. The properties on the list are a product of the fund's investment and risk management processes, and most have already been through due diligence procedures. (Importantly, the company has already signed contracts with half a dozen construction companies and developers, which will pave the way for the relatively quick closing on other properties purchased from these companies.) Given that it has already done a substantial amount of the legal and logistical groundwork required to purchase the properties that its research has indicated offer the best value, Arsagera estimates that it will be able to fully invest the anticipated RUB821 mn (USD31.6 mn) offering proceeds within two months of the closing of the transaction.

Arsagera Residential Construction Fund: Potential investment properties

Developer/Construction company	Project	Address/Area	Anticipated commissioning
Stroitelny Trust	Kolomyazhsky 15, 3^{d} stage	Kolomyazhsky 15	4Q08
	Severny/Yesenina, 1^{st} stage	Severny/Yesenina	4Q08
	Severny/Yesenina, 2^{nd} stage	Severny/Yesenina	2Q08
LenSpetsSMU	Oktyabrskaya Nab.	Oktyabrskaya Nab. 98	3Q07
	Novoye Sozvezdiye 2/3	Rustaveli/Prosveshcheniya	2Q08
	Novoye Sozvezdiye 4	Rustaveli/Prosveshcheniya	1Q09
	Zolotaya Gavan’	Savushkina/Yahtennaya	3Q09
	Petrogradsky Etalon	Lodeynopolskaya/Petrozavodskaya	3Q08
	Polezhayevskiye	Pr. Stachek/pr. Veteranov	1Q09
	Dom na Rudneva	Rudneva	2Q08
	Zhivoy Ruchei	Ushinskogo/Lunacharskogo	3Q09
	Grazhdanka Citi 2	Nauki/Grazhdansky	4Q08
Gatchinsky DSK	Komendantsky pr. 48A	Komendantsky pr. 48A	3Q08
	Dolgoozerny	Dolgoozernaya/Parashutnaya	2Q08
	Pulkovsky Posad 5	Dunaisky pr./Pulkovskoye highway	3Q08
	Pulkovsky Posad 6	Dunaisky pr./Pulkovskoye highway	4Q08
	Chudnovskogo	Chudnovskogo	4Q07
Peterburgskaya Nedvizhimost	Avangard	Bestuzhevskaya/Kondratyevsky	4Q08
	Stella Maris	Krestovsky Ostrov, Morskoy pr.	2Q07
	SKY	Novolitovskaya	1Q08
Rosstroy	Serebryanyie Kluchi	Dimitrova/M. Bucharestskaya	4Q07
	Serebryaniye Zvezdi	Optikov/Turistskaya	4Q08
	Metro Dybenko region		project
Severny Gorod	Primorets	Kamishovaya/Yahtennaya	3Q08
	Khasanskaya/Industrialny	Khasanskaya/Industrialny	3Q07
	Stachek/Lyony Golikova	Stachek/Lyony Golikova	4Q07
M-Industriya	Poema u tryokh ozyor	Engelsa/Lunacharskogo/Yesenina	4Q07
Nevsky Syndicate	Realist	B.Sampsonievsky	2Q07
	Rybatsky pr. 15	Rybatsky pr. 15	1Q08
	Piskarevsky 40	Piskarevsky 40	3Q08
LEK	Metro Frunzenskaya region	Moskovsky/Kievskaya	2-3Q08
	Ushinskogo	Ushinskogo/Prosvesheniya	2Q08
	Varshavskaya 23	Varshavskaya 23	4Q08
	Turku/Belgradskaya	Turku/Belgradskaya	4Q07
	pr. Slavy	Pr. Slavy/Bucharestskaya/Prazhskaya	3Q07
	Svetlanovsky	Svetlanovsky (closer to Uchitelskaya)	3Q07
	Lunacharskogo/Ushinskogo	Lunacharskogo/Ushinskogo	3Q07
	Oleko Dundicha	Oleko Dundicha/Bucharestskaya	3Q07
	Tovarishchesky pr.	Tovarishchesky pr./Podvoiskogo/Solidarnosti	3Q07
	Zolotaya Dolina	Zvyozdnaya/Pulkovskaya	4Q07
	Monplaisir	Leninsky/Stachek	4Q07
	Serebristy bul.	Serebristy bul.	3Q07
	Belveder 27	Leninsky/Dachny	2Q07
	Nastavnikov	Udarnikov/Nastavnikov	2Q07
	Yantarny Bereg	Novoizmailovsky/Basseinaya/Varshavskaya	2Q07
	Serebryanyie Zerkala	Divenskaya/M. Monetnaya	2Q07
Stroymontazh	Zvyozdny 10,13	Kosmonavtov 61	3Q07
	Yuzhnyie Parusa	Leninsky/Kuznetsova	4Q07
	Ogni Yugo-Zapada	Petergofskoye highway/Kuznetsova	4Q07
	Solnechny	Prosvesheniya/Bryantceva	2Q08
	Akademiya	Butlerova 42	4Q08
Okstroy	Kristall	Institutsky/Parkhomenko	4Q07
	Shcherbakova/Novoselkovskaya	Shcherbakova/Novoselkovskaya	3Q08
Lenstroytrest	Utkina Zavod	Oktyabrskaya 124/3	4Q07
	Leto	Dunaysky 7/2	4Q08
	Bolshevikov 38/3	Bolshevikov 38/3	4Q08
	Desyatinnaya/Novoutinaya	Desytinnaya/Novoutinaya	4Q08
Inkorstroy 58	Sinyaya Ptitsa	Parashutnaya/Baykonurskaya	4Q07
Sodruzhestvo	Orlovsky Kaskad	Bolshaya Desyatinnaya	3Q08
Elis	Yuzhny Front	Tipanova/Kosmonavtov	3Q08
	Dominanta, 3^{d} stage	Tipanova/Kosmonavtov	4Q08
	Dominanta, 4^{th} stage	Tipanova/Kosmonavtov	2Q10
Rant	Morskaya Rapsodiya	Nakhimova/Galerny	4Q07
	Bely Parus	Maly/Nakhimova	2Q09
Pioner	Shuvalovskiye Visoti 4, 5, 6	Viborgskoye highway	2-4Q08
	Shuvalovskiye Visoti 1, 2, 3	Viborgskoye highway	4Q09

Commissioning date refers to when property construction will be completed and ready for sale
Source: Arsagera Asset Management

Arsagera: Well Positioned in Russia's Second City

Arsagera is an independent, management-owned, St. Petersburg-based asset management company. Founded in 2004, it operates on the Russian stock and real estate market through five open- and closed-end funds, and provides individual portfolio management services. As of the March 30, 2007, Arsagera had RUB1 bn (USD40.5 mn) in funds under management, including private portfolios and company-owned funds.

Management team

Arsagera's funds are run by professional asset managers with a solid background. The company's management team, all of whom are based in St. Petersburg, previously worked for Industrial and Construction Bank Asset Management Company, where they established and managed a fund investing in a residential real estate; they also created the Stoik share fund, one of the top performing funds in Russia at the time. Below we present a brief resume of Arsagera's top management:

- **Andrey Belyavskiy.** Chairman of the board and chief executive since July 2004. From 1992, lead economist, investment management department, St. Petersburg Bank; worked in assets and liabilities department, Industry and Construction Bank, 1995-99; general director, Baltic Financial Agency, 1999; successfully led startup of Industrial and Construction Bank Asset Management Company, served as general director, 2002-04. Oversaw the launch of Stoik, Titan, and Finansist mutual funds, which became the most successful funds in Russia, 2004. He is 36 years old.
- **Alexey Astapov.** Deputy chairman of the board and chief of sales department since August 2004. From 1994-2000, securities department, Tavricheskiy Bank; head of investment analysis department, Russian Commercial and Industry Bank, 2000-01; sales and development director, Industry and Construction Bank Group, 2001-04; client and shareholder relations director for Arsagera, 2004. Currently manages marketing program development, new client attraction and cooperation programs. He is 33 years old.
- **Vasiliy Soloviev.** Deputy chairman of the board and chief investment officer from July 2004. From 1995 to 1999, lead specialist for securities department, head of currency, inter-bank and financial market transactions, Tavricheskiy Bank; head of currency and fund transaction department, Russian Commercial and Industry Bank, 1999-2001; head of financial consulting department, Industry and Construction Bank Group, 2001-04; investment director, Industrial and Construction Bank Asset Management Company, 2004. He is 33 years old.
- **Natalia Reuchenko.** Deputy chairman of the board and internal auditor from December 2004. From 1997, worked in securities market; back office head, Industry and Construction Bank Asset Management Company, 2002-04; head of internal control and risk management department, Arsagera, 2004. She is 35 years old.
- **Artem Abalov.** Head of research department since 2004. From 1998, published monographs and scientific articles on stock markets and precious stones market. Analyst, Baltic Finance Agency, 2001-03; head of research department, Industry and Construction Bank, 2003-04. He is 31 years old.

Funds under management

As of the end of March 2007, Arsagera had the equivalent of USD40.5 mn in assets under management, as shown in the table below.

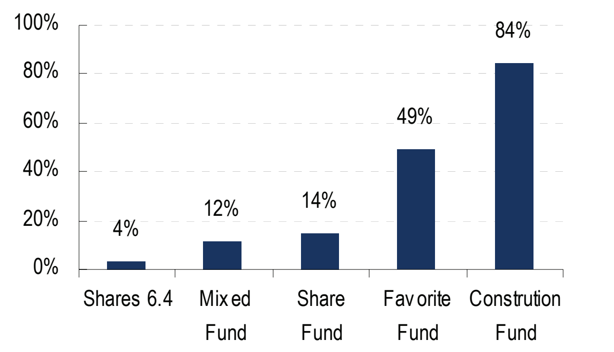
Current NAV of Arsagera funds, March 30, 2007

	USD '000	RUB '000
Arsagera Share Fund	305	7,933
Arsagera Shares 6.4	275	7,151
Arsagera Mixed Fund	215	5,594
Arsagera Favorite Fund	20,292	527,592
Arsagera Residential Construction Fund	6,195	161,086
Individual portfolios	9,246	240,388
Company funds	3,970	103,214
Total funds under management	**40,498**	**1,052,958**

Source: Arsagera Asset Management

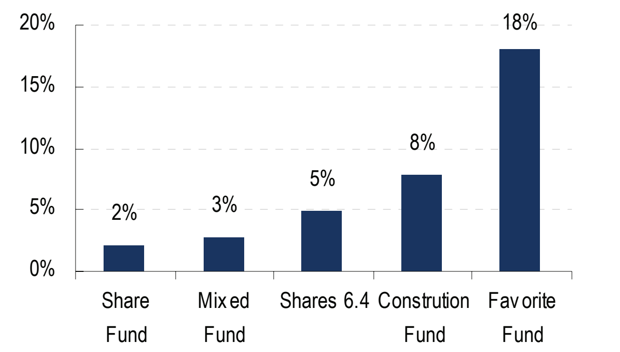
Arsagera currently manages two open-end unit investment funds, which invest in shares and other securities (Arsagera Share Fund and Arsagera Mixed Fund), one interval share fund (for an explanation of interval funds, see Appendix 2) investing in second-tier securities (Arsagera Shares 6.4) and two real estate funds (Favorite and Residential Construction Fund).

Arsagera funds performance in 2006



Source: Arsagera Asset Management
Return for the Arsagera Shares 6.4 fund is calculated from Feb 3, 2006
Return on Favorite Fund is calculated from Feb 8, 2006

Arsagera funds performance in 1Q07



Source: Arsagera Asset Management

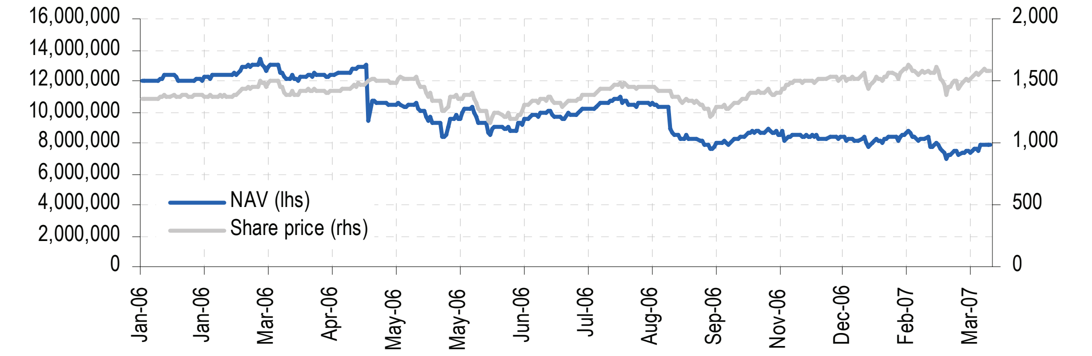
Arsagera Share Fund

The Arsagera Share Fund invests in the shares of Russian companies. At least 50% of its capital is invested in the Russian stock market.

Under Russian law, open-end unit investment funds are required to invest exclusively in shares of first-tier companies. Within this limitation, the company diversifies its investments by:

- Restricting maximum exposure in a single instrument to 15% of the total funds invested
- Limiting the maximum amount invested in non-liquid investment instruments to 10%
- Limiting investments in shares of private companies to 50%.

Arsagera Share Fund NAV and share price, RUB



Source: Arsagera Asset Management

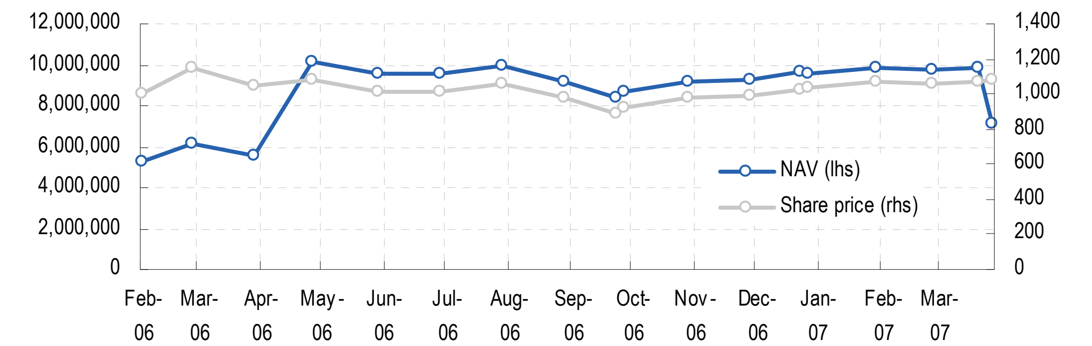
Arsagera Shares 6.4

The Arsagera Shares 6.4 interval investment fund is designed for investors seeking higher returns than available from open-end unit funds.

Arsagera Shares 6.4 invests primarily in second-tier securities that are less liquid and exhibit higher risk levels than blue chips.

The fund's name refers to Arsagera's asset ranking system, under which shares are numerically categorized according to capitalization and liquidity. Shares in mid- and low-capitalization companies, described as type 6.4 under the company's nomenclature, are the main target of the fund.

Arsagera Shares 6.4 Fund NAV and share price, RUB



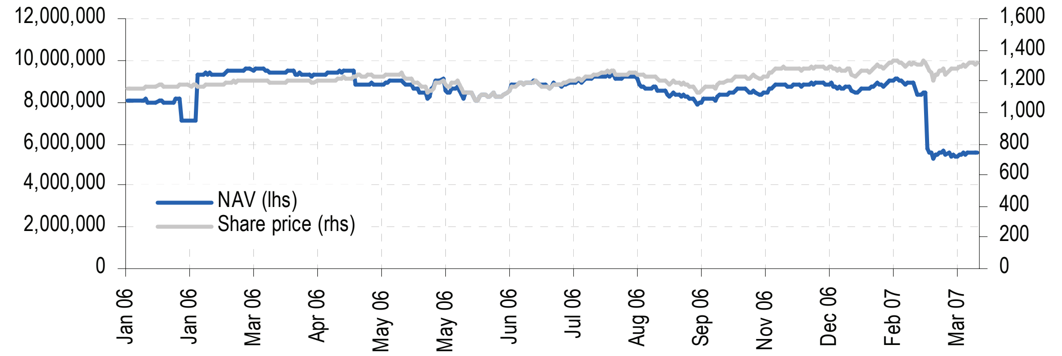
Source: Arsagera Asset Management

Arsagera Mixed Fund

Arsagera Mixed Fund invests in shares and bonds of Russian companies. At least 70% of the fund's capital is invested in the Russian market for at least two-thirds of every business day, and no more than 35% of the fund can be invested in government securities.

The remaining limits set for different asset groups (namely, deposits, investments in private companies and illiquid stocks) are similar to those applied to the Arsagera Share Fund.

Arsagera Mixed Fund NAV and share price, RUB

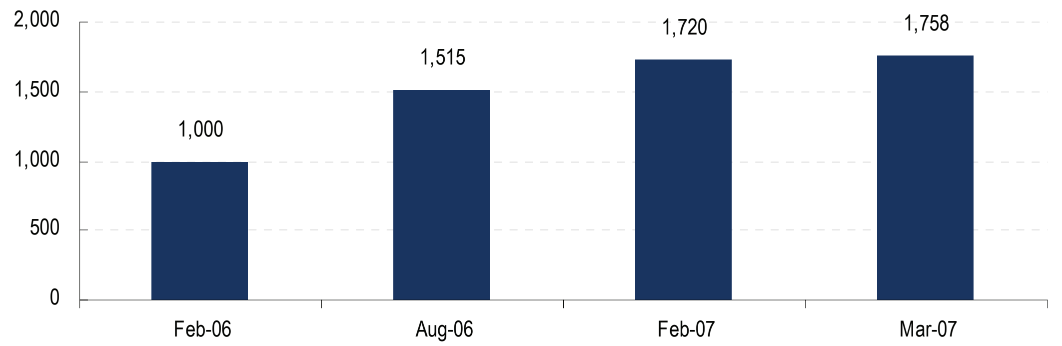


Source: Arsagera Asset Management

Arsagera Favorite Fund

The Arsagera Favorite Fund is invested in real estate, as well as in shares and bonds of Russian companies. At least 40% of the fund's capital is required to be invested in real estate in St. Petersburg. The key difference between the Favorite Fund and the Residential Construction Fund is that the former invests in government securities (to a maximum of 30% of NAV), Russian stocks and shares of other investment trusts (no more than 10%), and in the capital of limited liability companies (maximum 30%). At present, 70% of Favorite's capital is invested in residential real estate in St. Petersburg under the same principles as the Residential Construction Fund. The remaining 30% is equally split between shares and bonds.

Arsagera Favorite Fund per share NAV appreciation, RUB



Source: Arsagera Asset Management

Context: The Coming of Age of Russian Real Estate

With growing disposable incomes, mortgage market expansion, low per capita housing space and a deficit of quality real estate in Russia, the demand for real estate far outstrips supply, pushing up prices. Price growth in the St. Petersburg residential real estate market has been lagging behind Moscow, with the gap only starting to narrow in 2H06. We believe the current 55% difference will tend to shrink – while prices in both cities continue to rise in absolute terms.

Volatile world commodity and equity markets and falling yields on fixed income instruments suggest real estate may become a safe haven for investors. In this section, we assess four real estate subsectors: residential, office, retail and warehouse/industrial. Each sector is influenced by different dynamics, although a number of common trends are discernible.

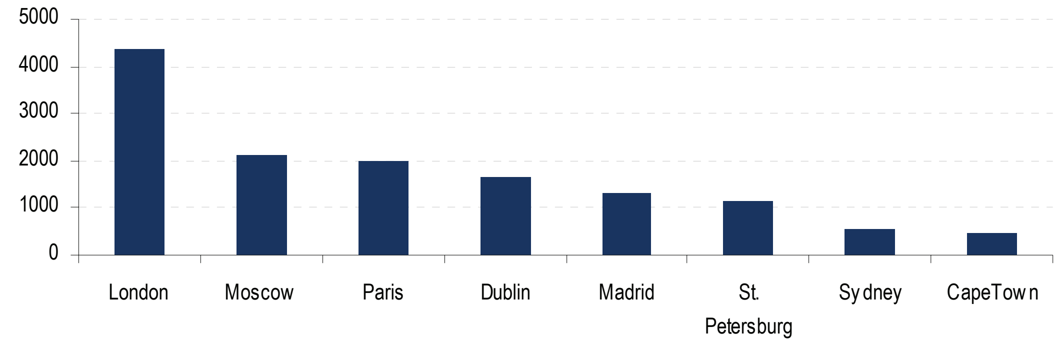
- **Primary focus on Moscow, and also St. Petersburg …** The vast majority of real estate investment takes place in Russia's two largest cities, with Moscow the clear leader. This is hardly surprising, as Moscow and St. Petersburg are Russia's economic, political, and population capitals. There is considerable real estate activity elsewhere in Russia, but the total volumes are relatively small, and the investment environment is more difficult to navigate outside the capital. Yields also tend to be higher, given the perception of greater risk outside Moscow and St. Petersburg.
- **… but increasing focus elsewhere.** That said, the focus of many investors seeking higher yields is increasingly shifting to new products and locations. Areas that have not yet been picked over by investors – including residential real estate in St. Petersburg, and assets in selected areas outside the two main cities – will likely be of increasing interest.
- **Investment demand still outstrips supply.** Broadly speaking, demand for high-quality assets – particularly Class A office space and quality retail space – is significantly greater than supply. Key factors constraining a greater flow of investment properties to the market include:
  - *Developers acting as investors*: Developers have been holding properties, rather than selling them, in anticipation of capital appreciation and yield contraction. Many of the largest developers, particularly in Moscow, have no need to raise cash, and thus are in no rush to sell, resulting in a reduced flow of real estate to the market. Estimates suggest that once market yields compress to the 7.5-8% level for Class A office space (from roughly 9.5% currently) there will be an increased flow of product.
  - *Sub-par quality:* Much of the existing real estate is not of investment grade; the quality of construction is sub-par; proposed leases are too short or otherwise unacceptable. Although investors are hungry for yield, they are unwilling to take risks on borderline properties.
  - *Long lead time:* The time to market for properties can be three times longer than is usual in many Western markets. This lag is partly attributable to the plethora of bureaucratic hurdles faced by developers, which act as another supply constraint.
- **Residential sector is a breed apart.** The residential market differs from the office, retail and industrial markets in a few important ways. The residential sector is far more fragmented, as the ultimate property buyers are individuals, rather than institutions – a distinction that filters through on a number of levels, from how funding is raised, to expected returns, and the relatively lower level of involvement of institutional investors (as opposed to developers). To an even greater degree than the other three real estate sectors, the primary focus of investment has been on Moscow and St. Petersburg, although this is changing with time.
- **Multiple signs of maturity.** The Russian real estate market has come a long way in a short period of time, as reflected by:

- *Lengthening leases:* Longer leases suggest that both tenants and investors anticipate relative stability in their business plans and operations, as well as in the economy overall. For example, the average pre-letting lease on two new development buildings in Moscow (Naberezhnaya and Gorky Park Towers) is 5-10 years.
- *Yield compression:* As mentioned, yields have come down sharply in recent years, from 22% in 2000 to 9.5% at present. Lower yields reflect the perception of decreased risk, and thus suggest a maturation of the market. Nevertheless, current yields are significantly higher than in other European capitals and 50% higher than in many other emerging markets.
- *Rent growth stabilization:* Average weighted rental rates for Class A and Class B stock grew 4.3% and 6.7%, respectively, in 2005. The dramatic price growth in recent years has decelerated somewhat, although demand continues to outpace supply for most assets.
- *Increased professionalism:* Although difficult to quantify, the clear increase of professionalism in the Russian real estate market – particularly among domestic developers and investors – is a key sign that the market is growing more mature.

Residential Real Estate: Supply Deficit to Continue Pushing Prices Up

Russians paying premium prices. Residential real estate in Moscow is among the world's highest priced. While London – as in other subsectors of the real estate market – is far and away the most expensive market, Moscow is not far behind. St. Petersburg, while also pricey, is substantially less expensive.

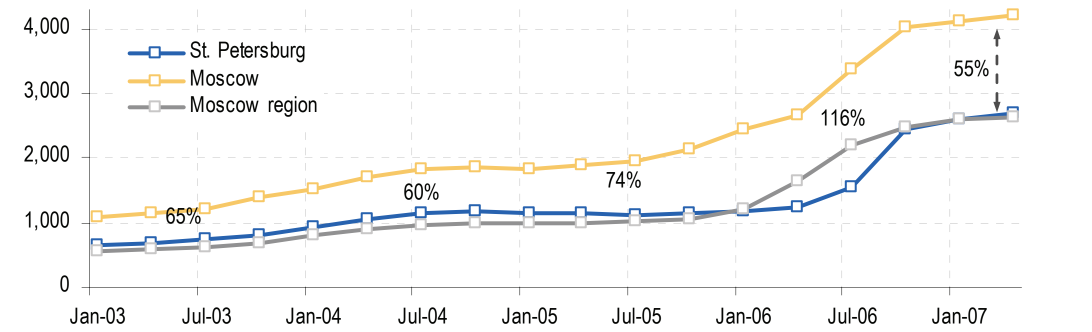
International residential prices, USD/sq m, 2005



Source: Knight Frank, MDM estimates

Prices rapidly trending upward. The residential property markets in Russia's two main cities have experienced steady and steep growth in recent years. This growth has recently accelerated, with Moscow prices moving up 67% in 2006 and St. Petersburg prices soaring by 123%. The price differential between Moscow and St. Petersburg remains high, though, which points to the potential for further price growth in St. Petersburg going forward.

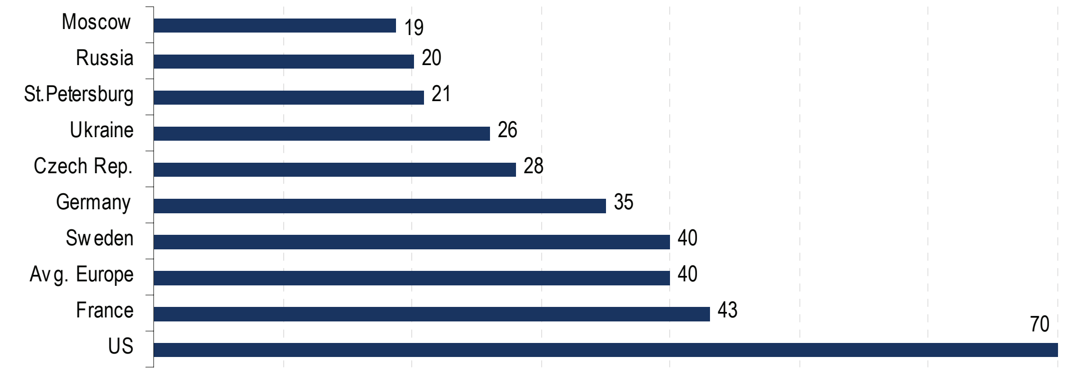
Scope for St. Petersburg to play catch-up in residential real estate prices, USD/sq meter



Source: Arsagera Asset Management

Demand continues to outstrip supply. Disposable income growth and favorable demographic trends have been among the key drivers of continued strong demand for residential real estate (see the Russia's Macroeconomic Landscape section of this report,). Lack of investment in infrastructure, in St. Petersburg in particular, represent a serious constraint on a massive increase in construction and, consequently, limit the supply of residential real estate. Also contributing to demand is the relatively small space available per capita: As of 2003 (the latest year for which data is available), Moscow had 18.8 sq m of residential space per capita compared with 20.9 sq m in St. Petersburg – vs. a European average of 40 sq m, and 70 sq m in the United States.

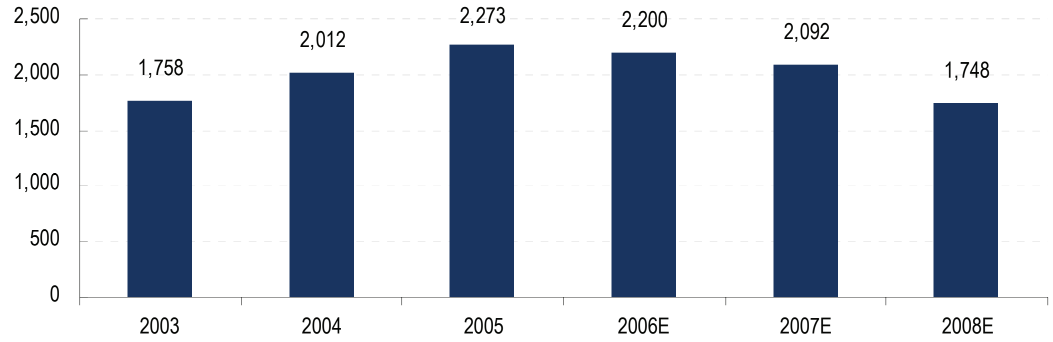
Housing stock, sq m/capita, 2003



Source: Rosstat, national statistics agencies

No signs of supply increase. Taking into account the housing stock obsolescence, estimates suggest that in order to increase per capita housing stock in St. Petersburg by 1 sq m a year, 5.6 mn sq m of residential space will need to be introduced. For example, in 2005, which was a successful year for developers, only 2.3 mn sq m were introduced. St. Petersburg Property research agency projects that in the coming years residential property completion will slow down to 1.7 mn sq m by 2008, further intensifying upward pressure on prices. According to the most optimistic forecasts, the supply of residential real estate will increase by a modest 5% through 2008, which still won't be enough to make up for the growing demand.

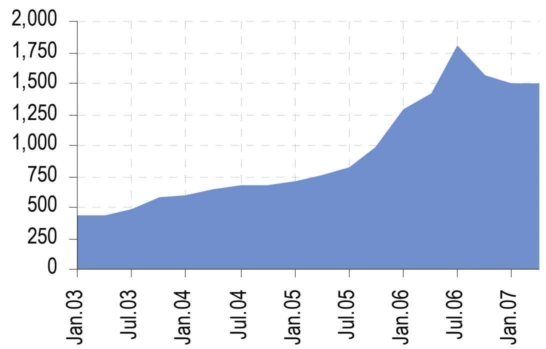
St. Petersburg residential property completion, '000 sq m



Source: St. Petersburg Property
Note: based on existing projects pipeline

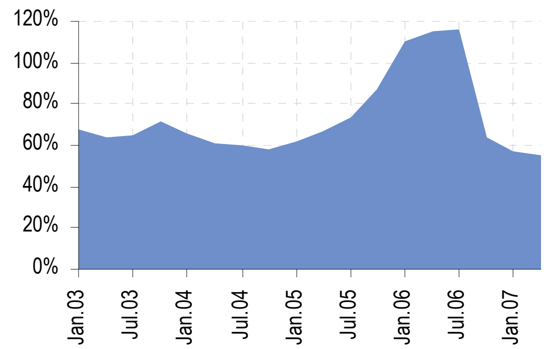
St. Petersburg lags Moscow – but not indefinitely. Moscow is Russia's financial and business capital and by far its biggest city. Not surprisingly, residential real estate prices there are nearly double those of St. Petersburg. While the price gap between the two cities narrowed sharply in relative terms during 2H06, it remains high in absolute terms. We believe this difference will tend to shrink – while prices in both cities continue to rise in absolute terms – in part thanks to St. Petersburg's increasingly strong economic performance and its status as a favored destination of investment and attention by the Kremlin.

Moscow vs. St. Petersburg price difference, USD/sq m



Source: Arsagera Asset Management

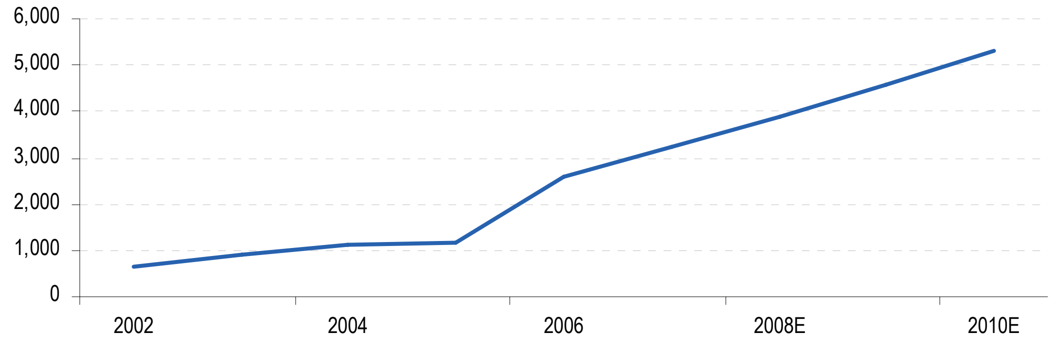
Moscow vs. St. Petersburg price gap, % of St. Petersburg price



Source: Arsagera Asset Management

Legal constraints driving up St. Petersburg prices. An important driver of residential price appreciation in St. Petersburg is Federal Law 214, which has restricted new residential real estate development (see Appendix 2 for details). The measure essentially blocked access to bank credits for residential real estate developers, dramatically reducing the number of housing projects. Although the law covers all of Russia, its impact in Moscow has been far less pronounced, as the main real estate developers in the capital are less reliant on bank credits. In St. Petersburg, developers are smaller and cannot rely on self-financing. While changes to the law may alter the situation, we project a sharp drop in supply in 2007 and 2008, with a concurrent rise in prices. (Projects underway when the law was enacted in April 2005 are not subject to the legislation.)

Projected St. Petersburg residential prices, USD/sq m



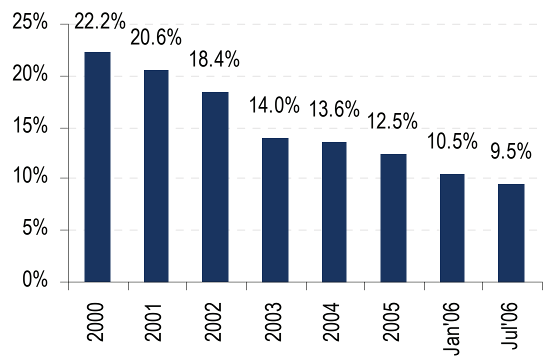
Source: Arsagera Asset Management

Mortgage penetration will further fuel market. Currently, mortgages total only 0.8% of GDP in Russia. About 90% of apartments are paid for in cash. As the banking sector evolves, legislation improves and disposable incomes continue to rise, we forecast that mortgages could amount to 6% of GDP by 2010 – still well below transition countries with similar GDP per capita. The evolution of a mortgage market will provide critical support for the residential real estate sector in the future.

Office Space: Yields Continue to Compress

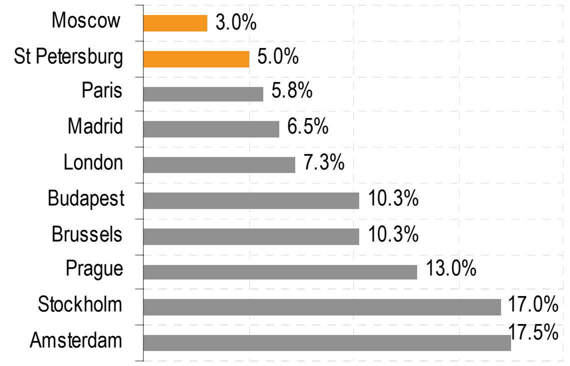
Has the easy money been made? The key metric of office space investment shows that office yields have fallen sharply since 2000, from 22.2% to 9.5% in 1H06, down roughly a full percentage point since the beginning of 2006. As global interest rates rise, returns – particularly when adjusted for Russia risk – are not as compelling as they were just a few years ago. However, yields are high on a global basis (see below), and vacancy rates are low, indicating solid support.

Moscow office yields down, but still high



Source: Cushman & Wakefield Stiles & Riabokobylko, Knight Frank

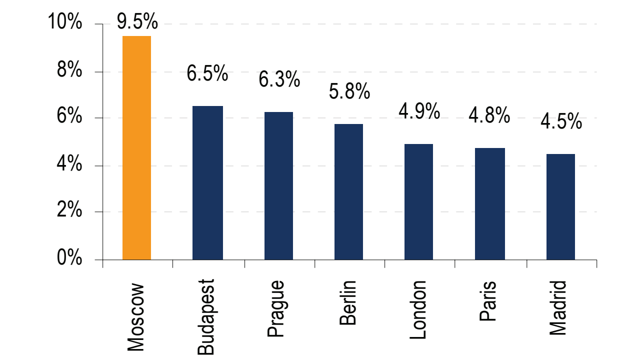
Russian vacancy rates well below Europe, 2005



Source: Jones Lang LaSalle

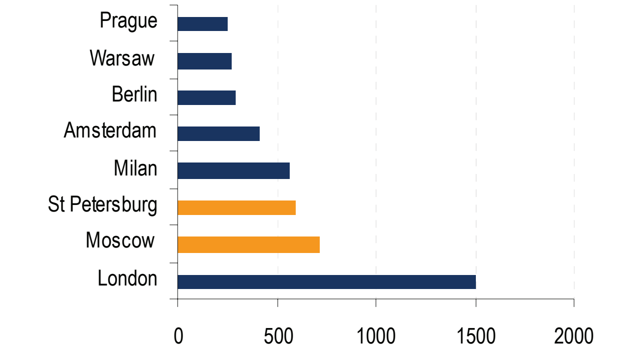
Still attractive in absolute terms. Office space rents and yields are high by international standards. As of 2005, yields for office space, at 9.5%, were significantly higher than in the rest of Europe (with the exception of Kiev). Rent levels are among the highest in the world. Additionally, when assessing total office space per 1,000 capita – admittedly a fairly raw statistic, as it does not factor in relative levels of economic output – Moscow appears dramatically under-serviced, resulting in a vacancy rate of just 3%, the lowest internationally.

Moscow office yields highest in Europe, 2005



Source: PMA, Jones Lang LaSalle

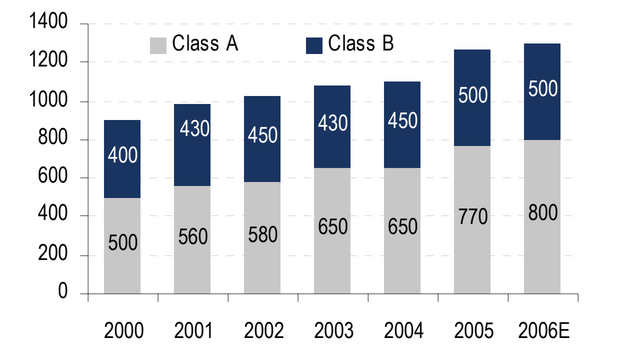
Russian rents second-highest in Europe, USD/sq m, 2005



Source: Jones Lang LaSalle

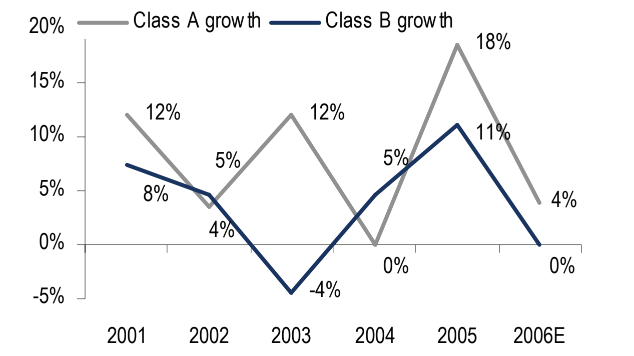
Moscow, St. Petersburg show robust rent growth. In Moscow, prices for Class A office space rose 18% to USD 770/sq m in 2005 and 11% to USD500/sq m for Class B. In St. Petersburg, prices rose 6% to USD584/sq m for Class A office space, and 8% to USD378/sq m for Class B (all figures are gross). Indications for 2006 suggest that rents continue to move upwards, though with growth easing from the extremely strong rates posted in 2005.

Moscow office rents moving up, USD/sq m



Source: Colliers

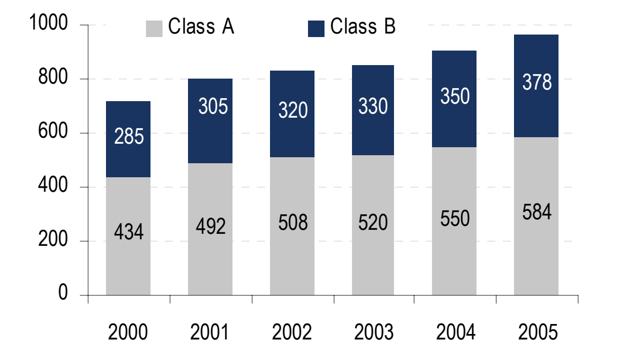
Moscow office rent growth, 2000-2006E



Source: Colliers

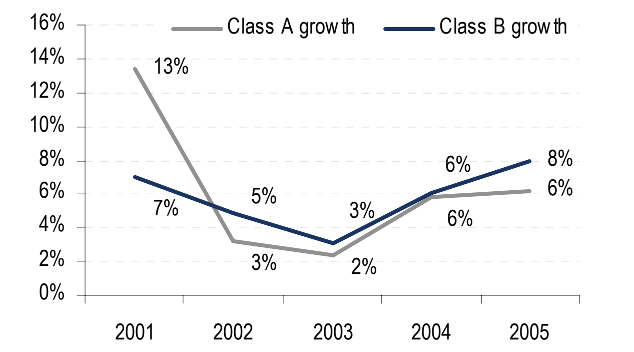
St. Petersburg's office stock small, but expanding fast. St. Petersburg's stock of modern office space is quite small: At year-end 2005 there was 285,500 sq m of Class A and B space available, compared to 4.7 mn sq m in Moscow. Office space per capita stood at only 0.06 sq m in St. Petersburg, compared to 0.45 sq m in the capital. Roughly 150,000 sq m of new office space is expected to hit the St. Petersburg market in 2006, as a slow but steady flow of corporates move their operations to the city, often at the expense of Moscow.

St. Petersburg office rents, USD/sq m



Source: Colliers

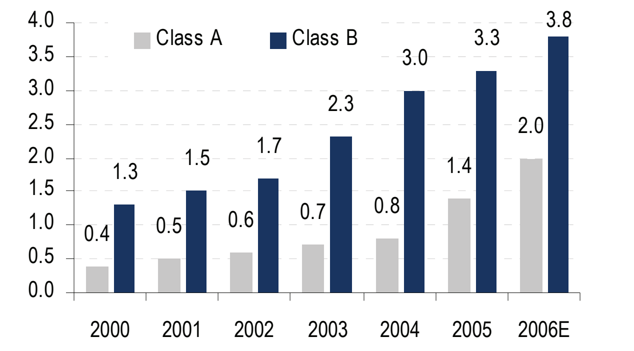
St. Petersburg office rent growth, 2000-2005



Source: Colliers, MDM estimates

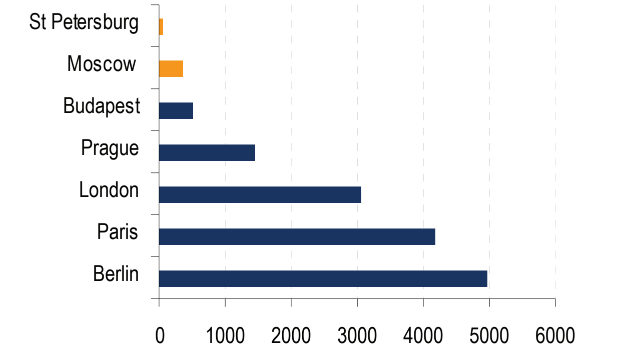
More office space means lower yields and slower rental growth. As with any market, sharply rising supply can undercut a strong price appreciation trend. Moscow's total stock of Class A office space grew at a CAGR of 28% over 2000-05, while Class B grew by 20%. Estimates for 2006 suggest that total stock grew by 43% and 15% for A and B classes, respectively, in Moscow. Whether growth in office space stock in 2006-07 will reduce the attractiveness of the Moscow market is unclear, but in any case the trend of convergence with Western European levels in both Moscow and St. Petersburg is already underway.

Moscow total office space shooting up, mn sq m



Source: Jones Lang LaSalle

Office stock, sq m/'000 inhabitants, 2005

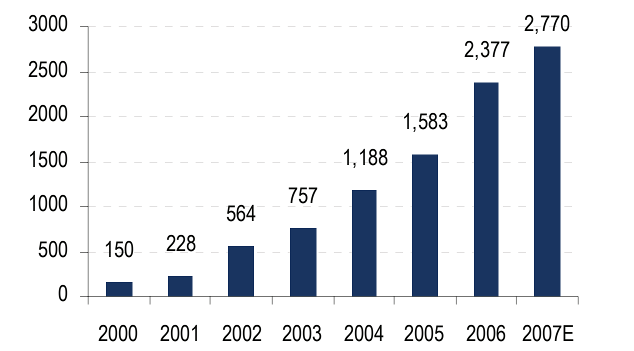


Source: Jones Lang LaSalle

Retail Real Estate: Room for More Growth

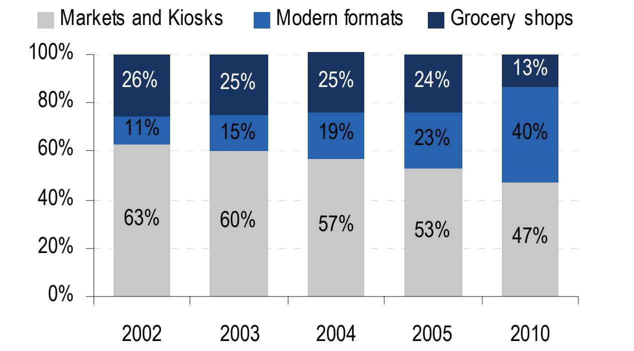
Retail has been growing dramatically. Just a few years ago, Moscow was a retail desert. As the post-crisis Russian economic boom has continued, though, the situation has completely changed, and now major retail parks and shopping centers are part of the landscape, at least in Moscow and St. Petersburg. Disposable incomes have risen dramatically, and the retail sector in particular has been a beneficiary of the low fixed costs of the average Russian consumer. The rise of modern format food retailing is a particularly telling sign of the evolution of retail real estate.

Moscow retail space skyrockets, '000 sq m , 2000-07E



Source: Cushman & Wakefield Stiles & Riabokobylko

Modern food retail formats coming to the fore



Source: X5 Retail Group

Market is maturing. Reflecting the coming of age of the Russian real estate market, there are numerous signs that the retail sector is maturing:

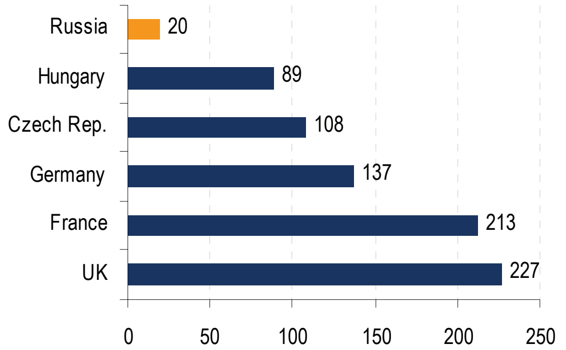
- **Fixed, not turnover-linked.** The growing dominance of fixed rental rates, rather than rates pegged to turnover, marks a shift towards standard practices in more developed markets.

- **New formats.** Retail centers are moving beyond basic formats to encompass retail parks, and soon, factory outlets. As consumers grow wealthier, they are demanding increasingly sophisticated retail options.
- **Major project development in smaller cities.** Emphasizing the near saturation of Moscow and St. Petersburg, smaller cities are increasingly the target of large-scale retail development.

Major city markets can expand further. While there has been sharp growth in the retail market since 2000, and Moscow and St. Petersburg may be reaching the end of the middle stages of retail expansion, retail stock is still well below international levels. The potential for continued strong growth in the retail sector stems from several factors:

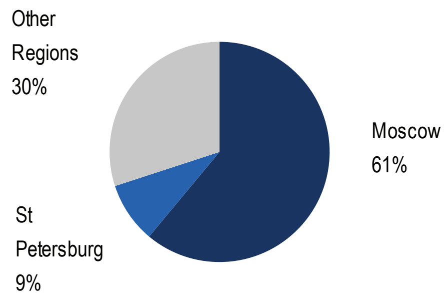
- **Format expansion.** The increasing market share of modern format stores within the food retailer universe has been and will likely continue to be an important driver of retail space expansion
- **Shopping center evolution.** The Western model of shopping mall development suggests that in time, Russian shopping centers will move beyond being venues to purchase goods and expand into entertainment centers that appeal to a broad demographic. This trend is already apparent in many Moscow shopping centers, as a number already have, for example, movie theaters.
- **Regional growth.** Roughly 70% of total retail space in Russia is in Moscow and St. Petersburg – with 61% alone in Moscow. While Moscow is admittedly the economic (and consumption) capital of Russia, the lopsided dominance of the city in the overall retail market will decline as the other regions of Russia catch up.

Retail stock per '000 inhabitants, sq m, 2005



Source: Cushman & Wakefield Stiles & Riabokobylko

Moscow, St. Petersburg retail share in Russia, 2005

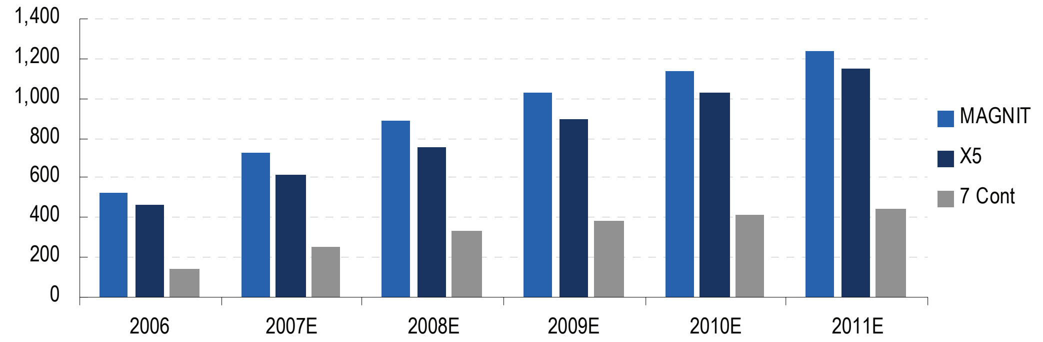


Source: Jones Lang LaSalle

Warehouse/Industrial Real Estate: Still in Short Supply

Retail chain expansion a key driver. The dramatic expansion of retail chains in Russia – food retailers in particular – is a key driver of demand growth for warehouse real estate. Retail chain expansion creates the need for distribution centers and storage facilities for retailers, and for the producers of goods. We estimate the total selling space of the largest food retailers will double by 2009; this figure likely underestimates the increase in Russia's regions, where growth is building from a much lower base.

Russian retail chains poised for major growth, '000 sq m, 2006-11E (year-end)

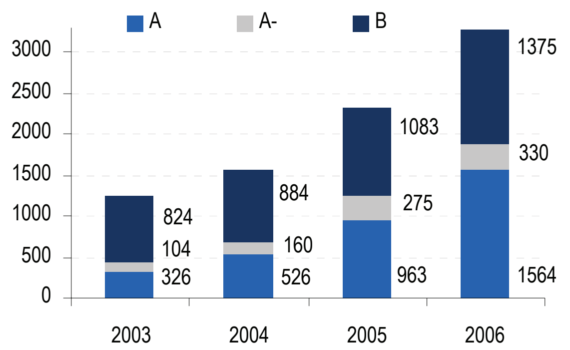


Source: MDM estimates

Supply/demand imbalance. Vacancy rates of industrial real estate are exceptionally low, reflecting the lack of supply, despite a six-fold increase in Class A facilities available since 2003 (in 2005, they accounted for 42% of total warehouse stock, compared with 25% in 2003). The sharp increase in higher-quality facilities compared with the relatively slower growth in the stock of Class B facilities reflects the demand profile. On a per capita basis, total warehouse stock is a fraction of what is available in other European cities.

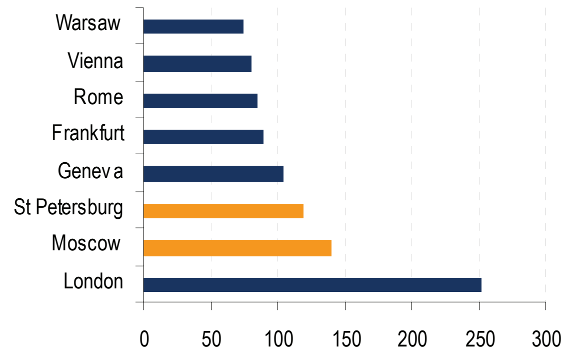
Price levels stable, but still high. Interestingly, price levels have remained relatively stable in recent years, despite the tight market. Prices are roughly USD110-140 per sq m, some 30-100% higher than in most other European cities, although only just over half the levels of London. Prices are unlikely to dip soon, in light of the difficulties associated with building infrastructure – including roads, power and basic facilities – for warehouse and industrial real estate.

Moscow warehouse stock by category, 2005



Source: Cushman & Wakefield Stiles & Riabokobylko

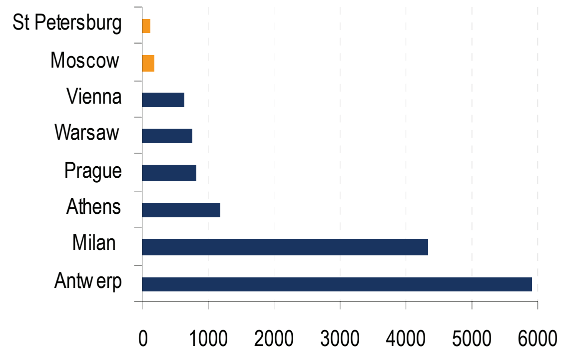
Warehouse rents, USD/sq m, 2005



Source: Knight Frank

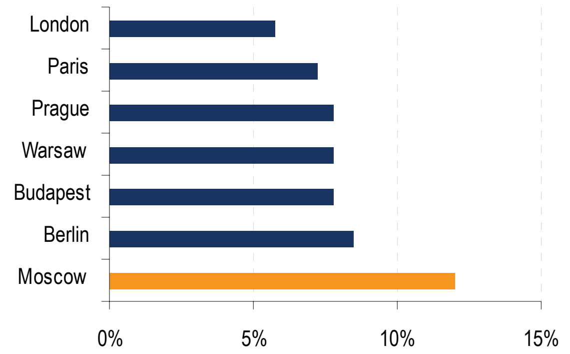
Warehouse market is still in its early stages. The low per capita volume of warehouse space – low even by Russian real estate standards – and the high yields of warehouse assets reflect the infancy of the market relative to other real estate subsectors. One large AIM-listed fund focused on investment in Russian industrial real estate has most of its assets in cash, awaiting investment opportunities. Until there is more product on the market, yields and rents for industrial real estate will remain high. On another front, the warehouse market currently almost exclusively caters to large businesses, and demand for space from small- and medium-sized businesses is virtually untapped.

Warehouse stock per thousand residents, sq m, 2005



Source: Cushman & Wakefield Stiles & Riabokobylko

European warehouse rental yields, 2005



Source: Jones Lang LaSalle

Russia's Macroeconomic Landscape

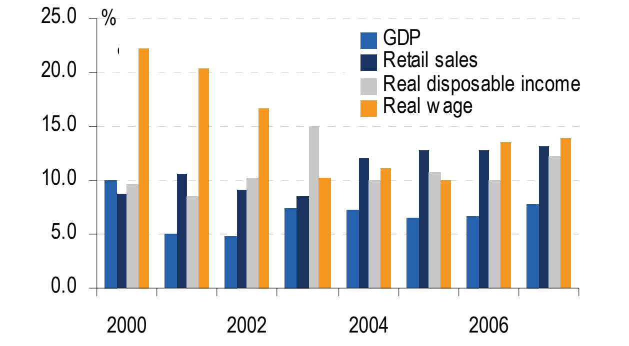
The macro environment for real estate investment in Russia is positive, and broad-based economic growth is continuing to drive demand across all subsectors. Positive demographic trends – despite the overall gloomy population picture for Russia – underscore the attractiveness of residential real estate in particular. The favored-city status of St. Petersburg and its above-average rates of economic growth suggest that demand for residential real estate will remain robust in Russia's second city. For St. Petersburg, and for Russia overall, the potential for increased demand for housing, stemming from growth of disposable incomes and the proliferation of the mortgage market, which is still in its infancy, represents a long-term value driver.

The Economy: Set to Enjoy Further Strong Growth

For more than seven years, Russia has been one of the world's fastest growing economies, and although growth has been underpinned by strong global oil prices, economic progress has been impressive. In 1999, Russia's nominal GDP was similar to that of Denmark, while today Russia's GDP is larger than the combined GDP of Denmark, Finland and Sweden. Rapid economic expansion has allowed for an exceptional consumption boom. As a result, Russia, with its population of 143 mn, stable economic situation and improved political stability, has managed to attract great interest from investors. More importantly, the potential for further growth is great.

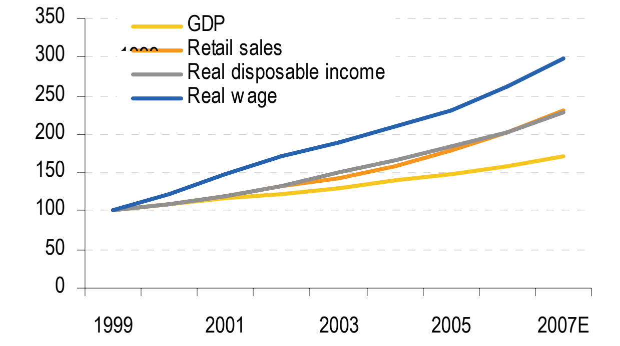
Since the 1998 crisis, economic growth, and especially growth of domestic demand-related variables, has been solid. Since 1999, GDP has been expanding an average 6.8% per year (including 6.7% in 2006, while it is expected to strengthen by a further 7.7% in 2007). In the same period, real disposable income and real retail sales growth both averaged 10.6%, while real wage growth averaged 14.9%. As a result, GDP rose almost 60% in seven years, while real disposable income and real retail sales almost doubled. Real wages grew 150% in the same period.

Economic growth has been strong



Source: Rosstat, MDM estimates

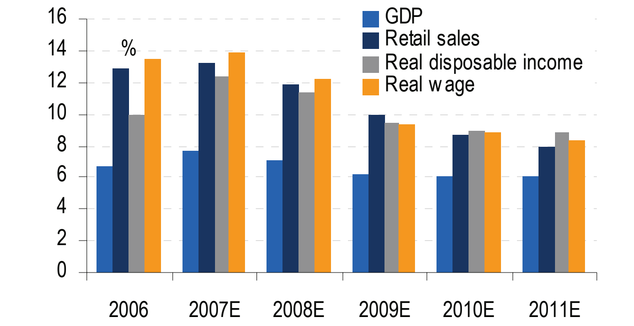
Demand related variables have doubled, 1999 = 100



Source: Rosstat, MDM estimates

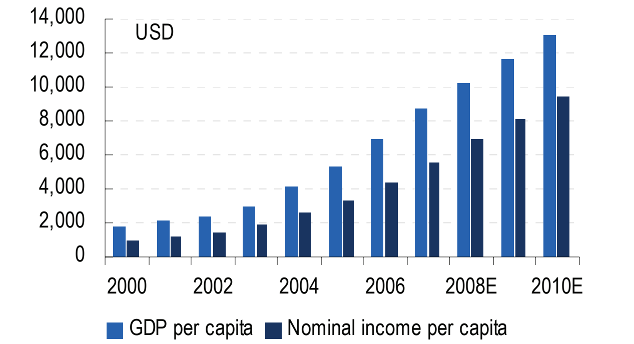
Strong economic growth has provided the source of the Russian population's increased purchasing power. In 2000-06, average annual nominal income increased from USD940 per capita to USD4,314 – a 360% increase. In the same period, GDP per capita increased 290% from USD1,790 to an estimated USD6,980. According to our forecast, nominal income per capita will reach USD9,300 by 2010, while Russia's GDP per capita will stand at USD13,100.

Growth to remain strong



Source: Rosstat, MDM estimates

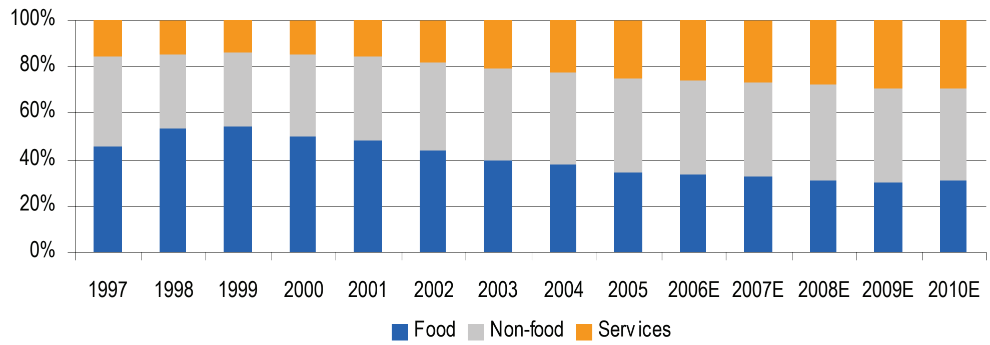
Per capita GDP and income set to expand



Source: Rosstat, MDM estimates

Rising income is associated with a change in consumption patterns away from food, with more being spent on manufactured goods and services. Food consumption is shifting away from low quality products to higher value added products and imports. Within manufacturing, the winners will be cars, furniture, building and renovation materials and home appliances, emphasizing rising demand for higher quality living. The latter is strongly associated with an increased demand for construction and real estate.

Consumption patterns shifting to goods and services



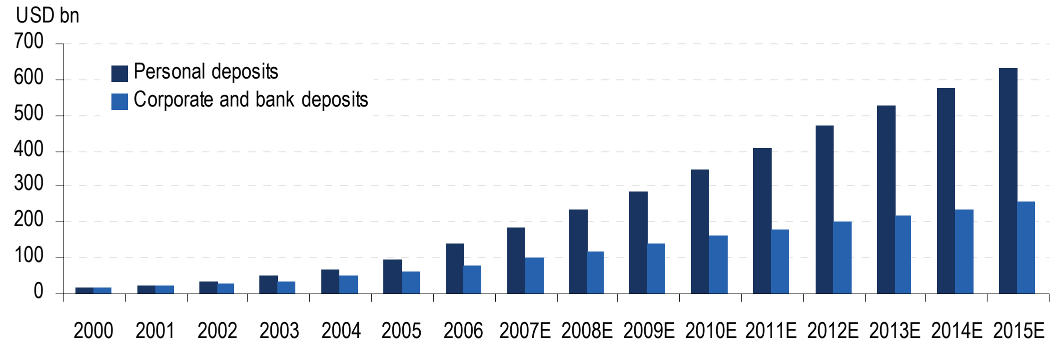
Source: Rosstat, MDM estimates

Banking: Household Credits and Mortgages on the Rise

The real estate sector's potential for growth is dependent on banking activities, such as loans and deposits, which are in turn dependent on economic growth, as well as the economy's re-monetization. Russia's money supply in 1999 amounted to a mere 12.3% of GDP – low by international standards. As the ruble's role as a means of transaction and storing value has strengthened, money supply has increased as well, and we expect it to reach 34% of GDP this year and 66% by 2015.

While nominal income has been growing more or less in line with nominal GDP, total deposits have been increasing by an average of 40% above the nominal income growth rate. This can be explained by shadow incomes and mattress dollars reaching the banking system. Going forward, we expect deposit growth will continue to exceed income and wage growth. The ruble is set to strengthen further, so shadow incomes and mattress dollars will continue to reach the banking system. In 2006 household deposits rose 44%, and we expect growth of 32% in 2007. As for corporate deposits, they rose 29% in 2007 and are expected to rise 27% in 2007.

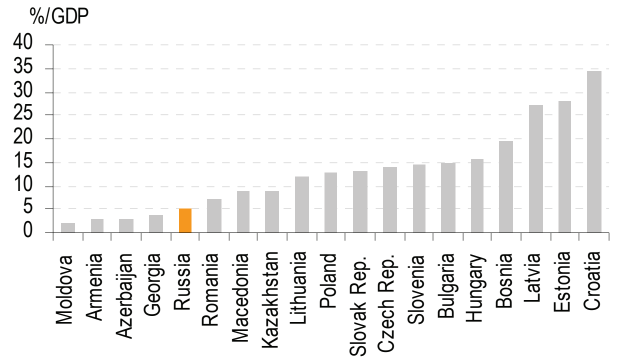
The outlook for deposit growth remains positive



Source: Central Bank, MDM estimates

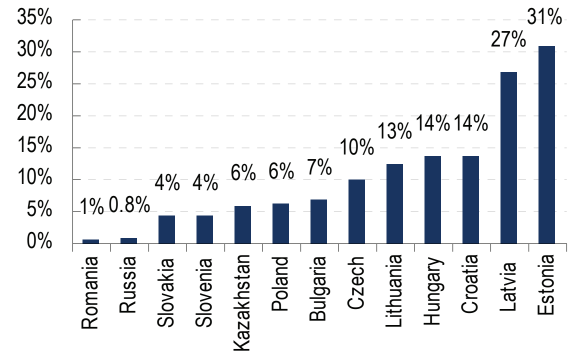
Access to credits, in particular mortgages, is a crucial component in the developing housing and real estate market. As with deposits, Russia's current level of credits is low by international standards. This is particularly true for credits to households. In 2006, overall credits amounted to USD301 bn, or 25.4% of GDP. Corporate loans amounted to USD222 bn (19.4% of GDP), while personal loans reached only USD79 bn, a mere 5% of GDP. Mortgages are still fairly new in Russia, and more than 90% of apartments in Moscow are paid for in cash. In 2006, mortgages equaled only 0.8% of GDP.

Household credits remain small



Source: Central Bank, EBRD, IMF, MDM estimates

Russian mortgages – a fraction of comparables (2006)

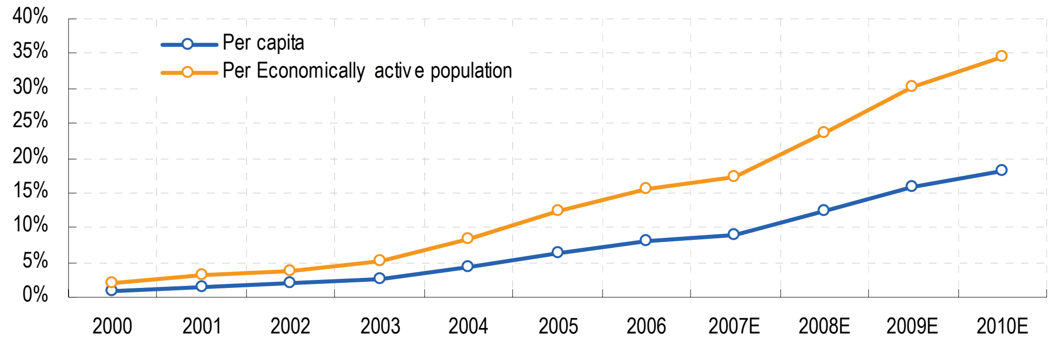


Source: Source: Central Bank, EBRD, IMF, MDM estimates

Since 2001, personal loans have grown faster than corporate loans – a trend we expect will continue. Over the last six years, corporate loans have increased 10-fold, while personal loans, which include consumer loans and mortgages, have increased more than 30-fold.

Personal loans as a percentage of income currently stand at 9% when calculated on a per capita basis and 17% when measured according to the number of economically active people (in developed economies these ratios range from 100% to 150%). The low level of credits highlights the lack of access to personal lending, but also the fact that Russians are still culturally uncomfortable with borrowing for consumption – partly a legacy of the Soviet period. Nevertheless, as Russia's economy continues to develop, we expect personal borrowing to take off, in particular mortgages.

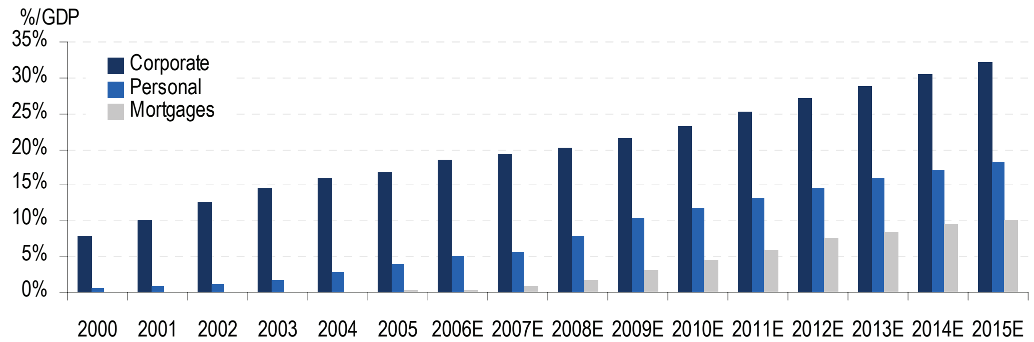
Personal borrowing over personal income low, but set to grow



Source: Central Bank, Rosstat, MDM estimates

With consumer lending, including mortgages, so underdeveloped, this segment can be expected to show the strongest growth in the future. Furthermore, we expect growth of personal loans to be driven by mortgage growth. We estimate corporate loan growth will average 23% per year for 2007-10, and we forecast 43% annual growth for personal loans, with mortgages doubling every year. This means that by 2010, personal loans should reach 13% of GDP, which is close to the current level of the Czech Republic, Hungary, Poland and Slovenia. By 2015, we see household loans reaching 18% of GDP. Mortgages should reach 6% of GDP by 2010, equal to the current level for Poland, but well below that of other more developed transition countries.

Credit growth – in particular mortgages – will remain strong



Source: Central Bank, Rosstat, MDM estimates

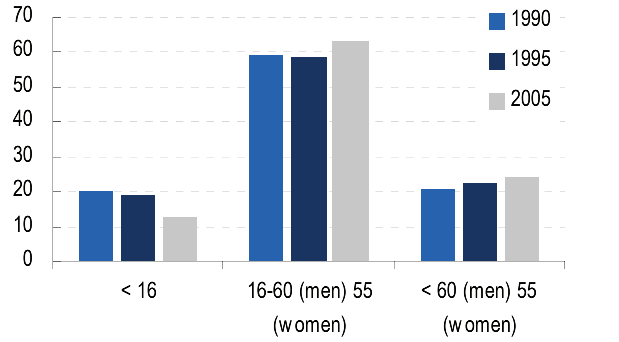
St. Petersburg Is for Real (Estate)

With 4.6 mn people, St. Petersburg is Russia's second largest city after Moscow (according to official data, the capital has a population of 10.4 mn, but unofficial estimates suggest a significantly larger number). It is the second most important retail market in Russia, benefiting from its geographical location in the northwest of Russia, only a stone's throw from Finland and Russia's European borders. Furthermore, St. Petersburg's average personal income and gross regional product (GRP) per capita lie above the Russian average.

Like most of Russia's regions, St. Petersburg is experiencing a population decline. However, over the last 15 years, St. Petersburg has seen an increase in people aged 16-60, i.e. the economically active portion of the population and the group that can be expected to purchase new homes.

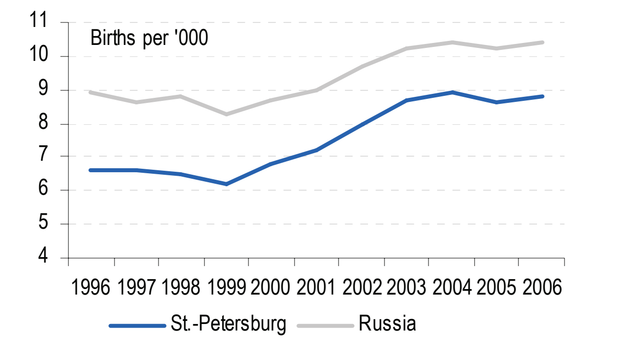
The demographic situation in St. Petersburg shows some worrying tendencies. There has been a decline in the numbers of people aged under 16 (which may spell trouble going forward), and although St. Petersburg has experienced a recovery in its birth rate since 1999, the birth rate is below the Russian average. That said, and as we will show below, St. Petersburg's economy is showing significant strength. Living standards are improving and we estimate they will continue to do so, suggesting birth rates will continue to improve as well.

Distribution of St. Petersburg's population by age group



Source: Rosstat, MDM estimates

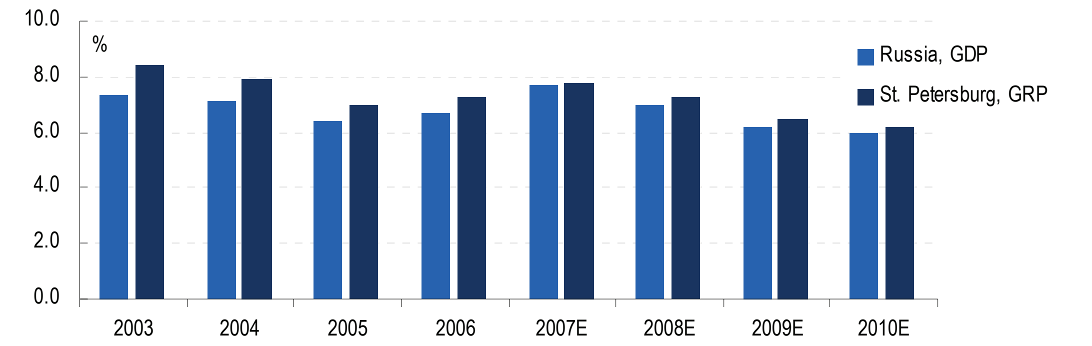
St. Petersburg's birthrate is recovering fast



Source: Rosstat, MDM estimates

The growth of St. Petersburg's economy, measured by GRP, has exceeded that of GDP for Russia, and we expect this to continue, with annual growth of GRP averaging 7% in 2007-10, compared to average Russian GDP growth of 6.7% for the same period.

St. Petersburg growing faster than Russian average

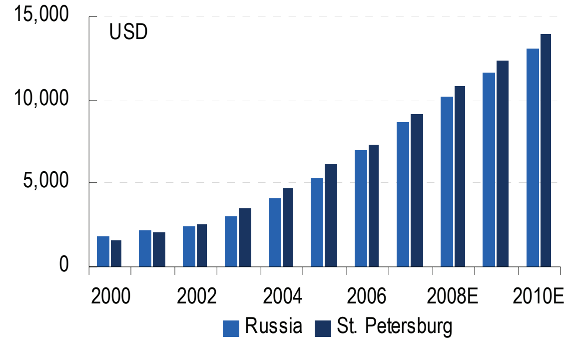


Source: Rosstat, MDM estimates

As a result, St. Petersburg's GRP per capita also exceeds that of the Russia's GDP per capita. For 2007, we expect USD9,170 for St. Petersburg compared to USD8,660 for Russia as a whole. By 2010, we estimate Russia's per capita GDP will amount to USD13,100, while GRP per capita in St. Petersburg will amount to USD13,870.

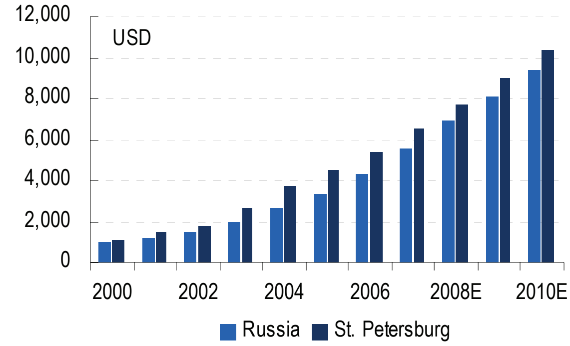
Equally, average per capita income per year in St. Petersburg, according to our estimate, exceeds the Russian average by 25% in 2006, and we expect nominal income to reach USD6,580 for St. Petersburg this year, compared to USD5,580 for Russia as a whole. By 2010, average nominal incomes should reach USD10,400 for St. Petersburg and USD9,400 for Russia. Higher personal incomes will be positive for real estate demand.

St. Petersburg's per capita GRP exceeds Russia's...



Source: Rosstat, MDM estimates

... and the same is true for personal income

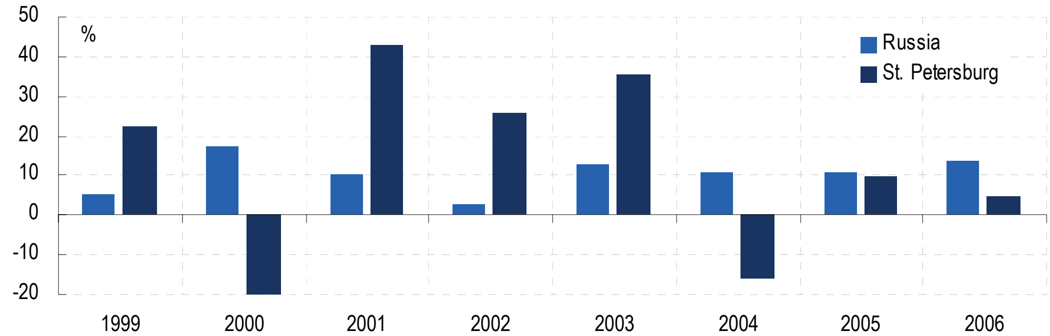


Source: Rosstat, MDM estimates

It is worth mentioning that the data presented above is based on official figures. Russia has a significant shadow economy and workers are often paid shadow wages as a mean of avoiding taxes. Shadow income and mattress dollars have been oiling Russia's economic machinery, as they help finance the purchase of big ticket items, such as cars and apartments.

The real estate market will also be affected by domestic fixed investment, which by definition consists of spending on construction and new equipment. We can see in the chart below that over the last three years, investment in St. Petersburg has grown at a slower pace than for Russian at large. It even declined in 2004 and saw significantly lower growth of a mere 6% in 2006. The low investment growth in 2006 can be partly explained by the implementation of Law 214, which has led to the total paralysis of new real estate construction in much of Russia and in St. Petersburg in particular. Overall, however, a slowdown in fixed investment and thus construction implies a bottleneck situation, which could be supportive for real estate prices in the short run, but also indicates scope for increased construction in the longer run.

Fixed investment growth in St. Petersburg to remain impressive – a catalyst for housing



Source: Rosstat, MDM estimates

St. Petersburg remains an attractive target for both domestic and foreign investors, from a geographic and market perspective. However, another catalyst is currently at work, as the city will be home to a Special Economic Zone (SEZ), which should be fully functioning by the end of 2007. The St. Petersburg SEZ will focus on research, development of IT products and equipment. The cost of creating the zone's infrastructure will total about RUB1.5 bn (USD55.6 mn).

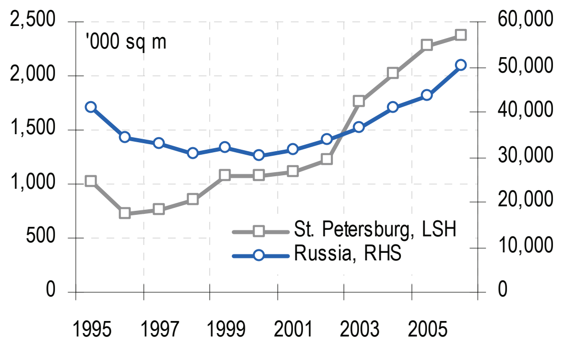
Furthermore, a number of large scale infrastructure projects are destined for St. Petersburg. The federal government and private investors will provide USD310 mn for the construction of a passenger seaport on Vasilievsky Island that will serve 1.2 mn passengers a year. Construction of the Orlovsky Tunnel under the Neva River is expected to be approved soon by the government and will receive cash from the Investment Fund, while construction of a Moscow-St. Petersburg toll highway has already been approved. A USD5 bn federal project to build a ring road that will facilitate residential development outside the center of the city is nearing completion.

Russia's second-largest city is also a hub for foreign investment, while a number of Russia's largest companies are also headquartered there. Since 2000, about USD7.0 bn worth of foreign investment has poured into the city and a number of large foreign-led projects are in the making. Over the past year, several large firms have begun quietly migrating to the city, which promises significant tax revenues and other economic benefits:

- Oil major Gazprom Neft (formerly Sibneft) has confirmed it will move its headquarters to St. Petersburg
- Finnish retailer Stockman will invest up to EUR110 mn to construct a major department store in the city center
- Japanese consumer electronics maker Matsushita is considering building a factory for its Panasonic brand
- German building materials maker Knauf will invest EUR60 mn to build a plasterboard factory in southern St. Petersburg
- Toyota Motor Co. will construct a USD250 mn plant covering 220 hectares that will produce 50,000 cars a year. The factory will be completed by the end of 2007
- Pepsi Bottling will invest USD25 mn to build a production and warehouse complex
- Bosch und Siemens Hausgerate will invest EUR50 mn to build a local plant to produce refrigerators. The factory will begin operations by 2007
- A Chinese investment group has said it will invest USD1.25 bn to construct a 180 hectare multifunctional complex on the Gulf of Finland comprising residential and office real estate, shopping centers and hotels that will provide living space for 35,000 people. The expected completion date is 2010
- Local authorities have declared an investment tender for a USD300 mn project to construct a multifunctional residential and business complex on New Holland Island.

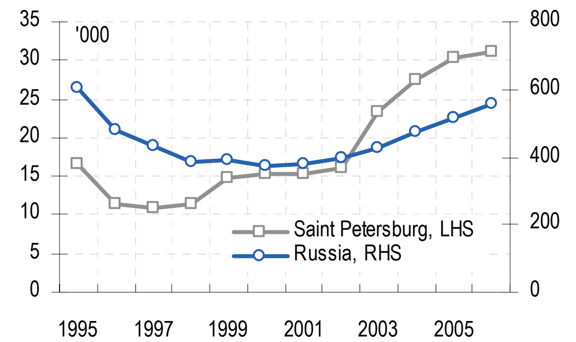
St. Petersburg's vibrant economy has brought strong growth in construction of new housing space. In the last five years, average yearly growth of new housing in the city has been twice the Russian average (16.3% for St. Petersburg vs. 7.9% for Russia as a whole). The same pattern can be seen in the number of new apartments constructed.

Total new housing space



Source: Rosstat, MDM estimates

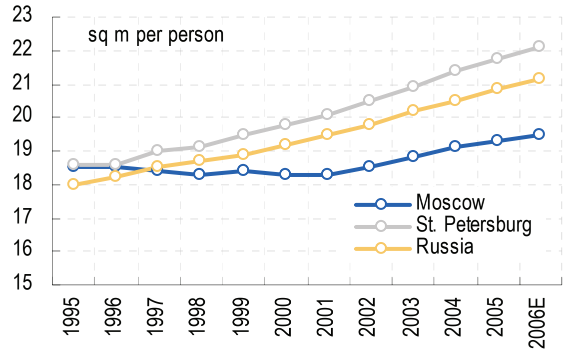
Number of new apartments



Source: Rosstat, MDM estimates

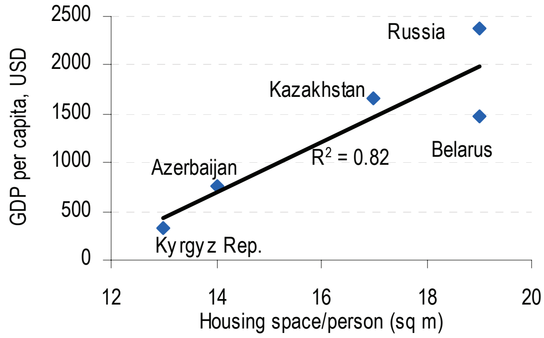
St. Petersburg has slightly more housing space per person than Russia as a whole, and more than Moscow, as well. Plotting data for 2002 shows a relationship between GDP per capita and average housing space per person for five other CIS countries. Although the small amount of data means the results are statistically insignificant, it is worth noting that as Russia's GDP per capita has increased (as has St. Petersburg's per capita GRP), so has average housing space per person.

Housing per person trend



Source: Rosstat, MDM estimates

Housing per person/GDP per capita



Source: Rosstat, MDM estimates

Appendix 1 – Competitive Universe

In this section, we assess the universe of investment companies that invest in Russian real estate. Broadly speaking, we separate them into two groups:

- **Foreign-listed funds.** These are listed on the AIM or other European exchanges, and have a predominantly international investor base. The universe is quite small, although it is growing rapidly. We discuss the key dimensions of the most important of these funds below.
- **Domestic funds.** There are upwards of 100 domestic funds that invest in real estate or real estate-related assets. However, only three of these have a net asset value greater than USD100 mn, and only six of the 30 largest funds have a stock market listing (five are listed on MICEX, and one on the RTS). For the sake of comparison, though, we provide a table listing the largest and most comparable of these funds, along with a brief comment on their focus and operations.

Overall, the Arsagera Residential Construction Fund is a unique vehicle in that it provides:

- Liquidity, via a MICEX and RTS listing, and market maker MDM Bank
- An exclusive focus on St. Petersburg residential real estate, one of the most dynamic real estate subsectors in Russia
- Proven and experienced management
- Broad diversification via investment in a large number of separate properties, each with different characteristics and investment dynamics
- Attractive upside potential of 30-40%.

Below we assess the competitive universe of the Arsagera Residential Construction Fund.

Foreign-Listed Funds

Eastern Property Holdings

EPH is a real estate investment and development company focusing on Russia and the CIS. The company listed on the Swiss stock exchange in November 2003, and at year-end 2005, the company had net assets of USD141.1 mn.

Management: EPH is managed by Eastern Property Management Limited (EPML), which consists of the core management of MCT Asset Management. The core investment team consists of both Russian and foreign nationals with considerable experience in real estate in Russia.

Structure: Following its IPO, the company raised additional capital through a convertible loan received from ENR Russia (one of EPH's shareholders). The company is incorporated in the British Virgin Islands and intends to pay out 90% of its taxable income as dividends.

Valuation: The fund is trading at a 46% premium to estimated 1H06 net asset value.

Investments:

- In mid-2004, EPH bought Berlin House, a Class A office and retail building in central Moscow with 7,775 sq m of total rentable space, for USD44.6 mn. In 2005, Berlin House was revalued at USD51 mn, a 10% increase over 2004.

- The company has a 10% investment in Sarnatus (25% when combined with EPH affiliate ENR). Sarnatus fully owns ZAO Hypercenter, which operates three hypermarkets in Moscow under the Mossmart brand.
- EPH committed USD39 mn to Hypercenter Investment SA, a real estate developer created to build further hypermarkets and lease them to Mossmart. This venture is 26% owned by EPH.

Open Investments

In autumn 2002, Russian conglomerate Interros founded Open Investments to consolidate its assets and operations in the real estate sector and seek out new development projects in the Russian real estate market.

Management: Key managers have broad experience in industry and real estate development and management.

Structure: In November 2004, the company conducted an IPO that raised USD69 mn of new capital, and listed on the RTS. The group is controlled by Interros, which owns 61% of the structure.

Valuation: The fund is trading at a 111% premium to estimated 1H06 net asset value.

Investments:

- The Meyerhold Center in central Moscow is a Class A building employed as a mixed-use complex of offices, a theater and a hotel. It was bought in 2000 and transferred to the new company in 2002. The total rentable area is 7,874 sq m, with occupancy levels of 95%.
- The Novotel Moscow Central Hotel, owned by OAO Hotel Novoslobodskaya, caters to business visitors, 80% of whom are foreigners. As of the end of June 2006, Open Investments controlled 60.01% of OAO Hotel Novoslobodskaya, which was independently valued in 2004 at USD47 mn.
- Open Investments' Pavlovo project involves the construction of over 200 elite single-family houses on the outskirts of Moscow.

Raven Russia

Raven Russia, a subsidiary of Raven Mount PLC, an experienced British property developer, was established in 2005 to invest in warehouse property in Moscow and St. Petersburg and other development projects with local partners.

Management: Raven Russia is managed by a team with significant experience in international property development.

Structure: In July 2005, the company listed on AIM in London, raising GBP153 mn. In April 2006, it raised an additional GBP310 mn in a new share issuance.

Valuation: Raven Russia net asset value is currently trading at a 9% premium to estimated 2005 net asset value.

Investments:

- The company announced in November 2005 that it had entered into an agreement to purchase two companies from a group of international investors, each of which owns a logistics warehouse (Baltia and Southern) in the Moscow region. The warehouses are newly constructed and of Class A standard, comprising an aggregate of 41,600 sq m.
- The company committed to buy upon completion a complex of four freehold Class A logistics warehouses on the outskirts of Moscow from RosEuro Developments comprising a total of approximately 114,000 sq m.
- In March 2006, the company's board announced its first acquisition in St. Petersburg after signing an agreement to forward fund and develop a 128,000 square meter logistics and distribution complex, via a

50:50 joint venture with Avalon Group, a company with interests in commercial real estate, logistics and consumer goods.

Ruric

Swedish-based investment vehicle Russian Real Estate Investment Company AB (Ruric) acquires, develops, manages and divests real estate assets in the Russian property market – in St. Petersburg in particular – and aims to achieve an IRR of 20% annually.

Management: The company's key managers have broad experience in industry and real estate development and management.

Structure: The company was founded in 2004 and financed by equity capital of SEK250 mn (USD34.7 mn) by listing on the Swedish stock exchange. In May 2006, new share issues added SEK240 mn (USD16.7 mn).

Investments:

- Ruric has made several investments in offices and retail space in St. Petersburg, including a business center on Dostoyevsky Street and offices on Vasilyevsky Island. Total investment has reached USD37.9 mn covering approximately 40,000 sq m of building space.
- The company is also in the process of acquiring new buildings at the Galinki site in central St. Petersburg, which will comprise a mix of restaurants, offices and a 127,000 sq m hotel.

Domestic Funds

The universe of domestic real estate funds covers a broad spectrum. The figure below is not exhaustive but shows those funds that are closest to Arsagera Residential Construction Fund in terms of approach and listing.

Russian real estate funds

Fund	Management company	Date Incorp.	NAV, USD mn	Mgmt Fee	Fund Admin Fee	Other Expenses (max)	Performance Fee	Comment
Our City	Stary Gorod	Mar 05	394	0.1%	0.1%	30%		Construction of residential, commercial buildings, Moscow region
Interra	AG Asset Mgt.	Apr 05	154	2.0%	2.0%	30%	15% of gain up to 7.7% of NAV	Developing 58 ha in Moscow's elite suburb of Rublevka
Ugra Real Estate	Region Development	Mar 05	100	1.0%	1.0%	0.3%	13.5% of gain up to 8.5% of NAV	Developing residential real estate, Khanty-Mansiisk region
Commercial Real Estate	Troika Dialog	Dec 04	94	2.0%	2.0%	10%	15% of gain up to 3.5% of NAV	Real estate and rights to real estate
Federation Fund	Concordia Asset Mgt.	Dec 05	80	0.5%	0.5%	n/a		Real estate property of Mirax Group, incl. Moscow Federation Tower
Family First Fund	Nashe Budushchee	Mar 03	64	1.0%	1.0%	2%		
Building Investments	Accord Asset Mgt.	Oct 04	55	4.5%	4.5%	2%		Residential, commercial development, St. Petersburg, Moscow; Equity investments
Alliance Rosno	Alliance Rosno Mgt.	Apr 06	50	2.4%	2.4%	10%	15% of gain up to 7.7% of NAV	Office space for rental
MOPE-Plaza Investments	National Mgt. Co.	Apr 05	40	3.5%	3.5%	20%		Acquisition and development of real estate
Mirax Real Estate Fund	Concordia Asset Mgt.	Dec 05	39	0.7%	0.7%	n/a		Real estate property of Mirax Group, incl. Moscow Federation Tower
Nevo-Invest	Muzey	Dec 04	29	1.0%	1.0%	50%		Development projects for compact residential, commercial space
First Real Estate Inv. Fund	Concordia Asset Mgt.	Jun 03	20	1.0%	1.0%	2.4%		Equity investments in property developers
Prospect Invest	Vitus	Jan 05	20	1.5%	1.5%	2%	20% of gain up to 7% of NAV	Equity investments in developing companies
Residential Real Estate	Promstroybank	Aug 04	18	2.0%	2.0%	2.4%	15% of gain up to 7% of NAV	Investment in property construction, St. Petersburg
Russian Res. Real Estate	Kit Finance	Feb 04	18	3.0%	3.0%	5%		Construction of residential high rises, St. Petersburg
Baltika	Lider	Sep 05	12	1.8%	1.8%	5%		

Source: Company websites; data as of March 2007
Fund administration expenses include appraisal fees and auditing
Performance fee net gain calculation includes capital appreciation and gains from rent accretion

Fee Structure

Arsagera Residential Construction Fund will receive a fund management fee of 2.0% of NAV, paid quarterly. Fund administration, auditing and appraising expenses are capped at 0.8% of NAV. Other expenses, including maintenance and insurance of real estate assets, service fees and general fund expenses will be limited to 0.9% of the fund's NAV.

The asset management company will not directly share in the capital appreciation of the fund through a performance fee. This contrasts with the fee structures of many domestic real estate funds, as shown above, in which the asset manager takes a portion of performance. The extremely low level of transparency of the vast majority of these funds exposes shareholders to risks that the asset manager could collect far higher fees that significantly diminish returns. Many foreign-listed property funds that focus on Russia or Eastern Europe levy performance fees that reduce the potential appreciation available to shareholders.

Foreign-listed real estate funds focused on the region levy hefty fees					
Company/Listing	**Focus**	**IPO (EUR mn)**	**Asset Management Fee**	**Performance Related Fee**	**Other Fees**
The Ottoman Fund AIM	Eastern Europe	223	1.5%	Return on development 10-100%: 20%	Upfront structuring fee of 1.5% of gross proceeds
			2%	Return on development 100%+: 30%	
The Black Sea Property Fund AIM	Bulgaria – Residential	94	2%	IRR less than 10%: 0%	1% of gross proceeds
				IRR 10-100%: 20%	
				IRR 100%+: 30%	
Raven Russia Ltd AIM	Russia – Warehouse	211	2%	Total shareholder return less than 12%: 0%	
				Total shareholder return 12-25%: 20:	
				Total shareholder return 25%+: 35%	
Eastern Property Holdings SWX	Russia – Retail, Office	29	2% of net asset value payable quarterly	15% of property appreciation	
Eastern European Fund AIM	Eastern Europe	29	1.75%	20% of excess of adjusted net asset value	

Source: Company reports

Liquidity

The trading liquidity of shares focused on Russian real estate (and Ukraine, in the case of XXI Century Investments, included for the sake of comparison) varies widely, as shown below. Information on funds that are not listed on any exchange is not available.

Russian concentrated real estate funds – liquidity			
Fund	**Listing**	**NAV, USD mn**	**Avg. Daily Trade Volume (USD mn)**
Ugra Real Estate	MICEX	100	0.56
Commercial Real Estate	MICEX	94	0.64
First Real Estate Investment Fund	MICEX	20	-
Raven Russia Ltd	AIM	147	0.99
XXI Century Investments	AIM		0.74
Eastern Property Holdings	SWX	83	0.48
Open Investments	RTS	70	0.22

Source: Company reports; Bloomberg. Average daily trading volume is for January 1-March 30, 2007

Appendix 2 – Legal Dimensions

Federal Law Governing Investment Funds

In Russia, investment trusts and mutual funds are regulated by Federal Law #156-F3, *On Investment Funds*, introduced on November 29, 2001, and amended on June 29, 2004 and April 15, 2006.

Investment trusts are public joint stock companies whose business is limited to investing assets in securities and other value-carrying objects. The minimum equity capital required for investment trusts is RUB5 mn (about USD185,000). A trust's assets are divided into funds used for investment and those supporting operations. The trust may issue no securities other than its own shares, which can only be placed through a public offering.

Mutual investment funds are standalone asset pools, passed by the pool's founders to the supervision of an asset management company. A mutual fund is not a legal entity and each founder's stake is determined by his share in the initial investment, and later changes in asset value. The asset management contract's duration is limited to up to 15 years. Any stake in a mutual fund is a nominated security, kept under custody.

There are three types of mutual funds: open, closed and interval. The number of shares that can be issued by open and interval investment funds is not limited, while in closed funds, the number is set in the asset management articles of the fund. Stakeholders may demand redemption of their stake according to the following timetable:

- **Open-end funds:** any business day with no notice period
- **Interval funds:** only on certain days, but no less than once a year, with the notice period defined in the management articles
- **Closed-end funds:** early redemption only in cases described in current law, while entitled to any dividends or payouts on a pro-rated basis.

Liabilities and liquidation. Any stakeholder can be held liable to the extent of the securities owned, but no liability can be extended to the asset pool under management. During the issue and redemption of securities, the premium or discount (to cover transaction expenses) to the net asset value adjusted value of the stake cannot be more than 1.5% and 3%, respectively.

If a mutual fund is liquidated (which may occur if demanded by the stakeholders, or under the order of government supervisory authorities), the redemption priority proceeds as follows: debt redemption, liquidator fees, asset management company fees, and the remaining funds distributed to stakeholders on a pro-rated basis.

Share/stakeholders have pro-rated ownership of the assets included in investment and mutual funds.

Fund management. The assets of investment trusts and mutual funds are managed under a special structure that provides for the division of rights and obligations to minimize risk and maximize transactional transparency. Management rights are passed to an asset management company under a contract between the shareholders and the management company, while a special depositary controls the assets and securities in the fund/pool under a custody management contract signed between the management team and the depositary.

Auditing requirements. At least once a year, an external auditor evaluates the assets under management, as well as all financial reports. Gains or losses in assets are calculated based on the valuations of an appointed independent appraiser. Division of responsibility assures the interests of the asset management company are aligned with maximizing shareholder value, while the interests of depositary funds and auditors are directed toward protecting shareholder assets. The structure of asset ownership limits the ability of management companies to employ the assets under management and protects these assets from any liabilities to which the management company may be exposed.

Tax issues. Investors should take notice of the following taxes, related to the operation of closed-end mutual investment funds in Russia:

- **Income tax.** Closed-end mutual investment funds are not a legal entity in Russia and are not subject to income tax. However investors in closed-end mutual investment funds are subject to income tax on the net proceeds of the sale or redemption of shares. The following rates are applied:
  - Russian private individuals are subject to an income tax rate of 13%.
  - Non-resident private individuals are generally subject to a 30% withholding tax; however, non-residents may be able to avoid Russian withholding tax if their country of residence has a double-tax treaty with Russia.
  - Russian legal entities and foreign legal entities acting through a permanent establishment are subject to income tax of 24%.

  The fund's net income distributed to shareholders is treated under Russian legislation as income and not as a dividend. Therefore, such income received by shareholders is also subject to income tax.
- **VAT.** Operations involving residential real estate are not subject to VAT in Russia under the Tax Code, except if a property is sold before completion, whereupon the fund becomes subject to VAT at a rate of 18% charged to the net asset value of the fund.

Requirements and limitations.[1] The minimum required capital for asset management companies was set at RUB20 mn (USD740,000) as of April 1, 2003. A managing company is limited in its transactions with the investment funds' property to prevent any affiliated transactions and exclude any connection of the managing company's liabilities with the fund's assets. Any forward contracts issued to hedge risk or loans issued against the investment fund's assets to buy back its shares cannot exceed 10% of NAV. The total of management, auditor, appraiser and depositary fees cannot exceed the expense as a percentage of NAV specified in the fund's documented rules.

A special depositary is an appointed body that acts as registrar and custody manager of the shares and assets of a fund. The special depositary can also provide consultation and bookkeeping services for the fund's shareholders. A management company carries out transactions with the fund's property upon agreement with the special depository.

In its information disclosure, the management company is not permitted to forecast returns and is obligated to provide full incorporation papers, financial statements and terms of investment upon the request of any interested party.

The investment vehicles that can be used by funds include currencies, municipal, sovereign and corporate securities, real estate property and the rights to real estate properties.

Russian Real Estate Investment Funds

Russian real estate investment funds generally resemble U.S. REITs by virtue of the nature of their operations and beneficial tax regime. However, there are some crucial differences:

[1] There is no legal limit on operating costs, and each fund sets its own limits in its charter. Arsagera has established a limit of 0.9% of NAV.

- Russian funds must invest at least 40% of their assets in real estate for at least two-thirds of the working days of a year, and no more than 30% in bonds or foreign stocks; in the U.S., at least 75% of total investments must be in real estate
- No more than 35% of total assets can be invested in a single issuer
- U.S. REITs are bound by law to pay out at least 90% of taxable income as dividends, whereas there is no stipulated minimum in Russia: it is up to the fund itself to decide on how income is distributed.

For most Russian real estate funds, a substantial proportion of income is derived from the revaluation and sale of property, whereas in the U.S. rental payments provide the majority of income.

Real Estate Law – Starting From Zero

As the Soviet Union had essentially no formal regulation of private real estate ownership, this sphere has been developing slowly since Russia regained its independence in 1991, and the process is still incomplete.

Russian real estate legislation is currently primarily based on the federal Civil Code, Land Code, Town Planning Code and the federal laws on State Registration, Mortgages and Turnover of Agricultural Land. Although Russian law recognizes the right to own, use and dispose of real estate, it makes an important legal distinction between land and buildings, which are treated as separate legal interests.

- Both the Civil Code and the Land Code permit private land ownership and the transfer of land from one person to another, with certain restrictions on land ownership by foreigners
- Buildings may generally be owned by anyone, including foreign companies.

The owner of a building is generally allowed to sell or lease it without any requirement to obtain state consent, unless the sale or lease falls within the jurisdiction of the Federal Anti-Monopoly Service.

Law 214 on co-financed housing construction

A key regulatory document that has had a significant impact on Russia's residential real estate market is Federal Law No. 214-FZ, *On Participation in Shared Construction of Apartment Blocks and Other Properties and On Amendments to Certain Legislative Acts of the Russian Federation,* which came into force on April 1, 2005. It defines the rights and obligations of parties under shared construction agreements, i.e., among property developers and participants in co-financed construction projects.

On November 14, 2005, government decree No. 645 was introduced, which amended Law 214 by requiring developers of co-financed construction projects to file quarterly reports with the state's Consumer Rights Protection Oversight Service. Law 214 contained a quarterly reporting requirement, but did not specify the procedure. The new law addressed this defect and facilitated government control over the ways developers collect and utilize funds in housing construction projects.

Good intentions, but flawed execution

Law 214 was formulated to regulate relations between residential housing developers and private investors who buy apartments during the building stage as a way of financing construction. It sets out fines to be paid by developers for delays in commissioning projects or by other project participants for delays in payment. The law introduced government registration of co-financed construction agreements to eliminate the double-sale of apartments, procedures for agreeing and changing prices, terms of delivery, mandatory guarantee periods and investor rights against developers for construction defects. It set out the concept of a project declaration (an offering memorandum containing information on the developer and the project), created rules for advertising, and empowered specified state agencies to regulate developers and co-financing activity. Most importantly, the law established joint liability for banks involved in providing financing, in any way, to construction or development projects.

The law did succeed in making relations between property developers and consumers participating in co-financing projects more transparent. It provided state regulators with the authority to oversee the financial operations of developers, and subsequent amendments to the law spelled out the procedure for mandatory quarterly reporting by developers to oversight authorities.

Law 214 was initially welcomed as a positive consumer protection measure. In the previous, largely unregulated market, consumers who had prepaid for apartments often found they had little recourse when developers failed to complete the project, which often occurred due to a lack of funds. The law introduced more clearly defined liability and recourse process for investors, but some market participants criticized it for introducing potential lender liability for banks that loan funds to cash-strapped developers.

In fact, as a result of the law, the participation of banks in shared construction projects has been significantly limited and effectively no new shared construction projects have been commenced since Law 214 came into force. Developers have had difficulties attracting bank financing for construction projects involving the participation of private individuals because of the joint liability clauses in the law. Moscow developers are sufficiently large to not require bank financing, and thus have been less affected by the measure. But developers elsewhere in Russia, including in St. Petersburg, are too small to finance projects on their own. Most current construction in the city was launched before the new law was implemented. Given the continuous demand growth and expected supply deficit in St. Petersburg in late 2007-08, we expect a hike in real estate prices.

Changes on the way

An amendment to Federal Law 214 approved by the Duma and the Federation Council in July 2006 was bound to significantly improve the legislation. Broadly speaking, whereas the original law placed the entire burden of responsibility on developers, the changes force investors to assume greater responsibility, thus helping to level the playing field. For example, previously, only investors could terminate development or construction contracts, which exposed developers to substantial uncertainty and risk. The changes to the law allow developers to limit downside in projects and permit them to terminate or modify construction and development contracts. Also, the penalties stemming from breaking an agreement were reduced.

On another front, the paralysis in financing real estate development stemming from the potential liabilities that banks were forced to assume if they became involved in funding a project was partially addressed. The revisions to the law reduce the responsibility of banks, which should make them more amenable to financing real estate projects. This represents a major step towards increasing residential real estate supply.

The upshot of the amendments is that the real estate market will be more transparent, vibrant and healthy for all participants. There is now a roadmap for unblocking the supply bottleneck that has developed since April 2005, which will open the way for greater residential real estate supply. While the changes may dampen residential real estate price appreciation somewhat, we would point to two key favorable effects – from the real estate investor's perspective – of the amended legislation that should more than compensate for any mild slowdown:

- The timetable for alleviating the supply bottleneck is fairly extended. The lead time for large-scale residential construction projects is normally 1½-2 years. In any case, we estimate that prices will continue on a long-term uptrend, and any increased supply stemming from the revisions to Federal Law 214 will at most slightly soften the pace of residential real estate appreciation a few years down the road.

- A more solid legal foundation for investment in residential real estate will help open up the sector to a dramatically widened investor base. Uncertainty surrounding the measure has been a factor in the relative dearth of interest on the part of international and institutional investors. The improved legislative framework could boost demand, and thus prices, from investors who were previously reluctant to enter the market.

The Land Code: Equality With Exclusions

The Land Code, which came into effect in October 2001, permits private ownership of commercial land, and together with Chapter 17 of the Civil Code, which has now come into effect, regulates the sale and purchase of land in Russia.

In general, foreign individuals and companies are allowed to buy and sell commercial land except in sensitive border areas and other designated zones. Agricultural land has been excluded from the Land Code and is dealt with in a separate law. Perhaps the greatest practical significance of the Land Code is that it applies to the whole of Russia, and the existing patchwork of regional land legislation must be amended to bring it into line with the federal law. The Land Code has therefore removed many discrepancies and inconsistencies that have appeared between regional and federal land law in the last few years as certain regions forged ahead with their own land reform programs.

The Land Code divides land into several categories based on use. Each category has different conditions for usage, and the code requires that each plot of land be used only in accordance with the category to which it is assigned. For example, a factory cannot be built on agricultural land.

In principle, foreign individuals and legal entities have the same rights to land as local residents. Despite this, there are certain restrictions applicable to foreigners. A foreign national may not own land located in border regions or in other special territories. The list of such areas has not yet been approved by the president.

Concerning apartments, the actual apartment can be privately owned and therefore bought and sold. However, the land on which an apartment building is situated is owned by the state. The owner of an apartment house or private home can acquire a 49-year lease to the land (which can be in private or corporate ownership), and in terms of using the property as collateral (for example, for a mortgage), banks generally accept these arrangements.

Appendix 3 – Real Estate Investment Trusts

REITs in the Global Real Estate Market

The following section is adapted from Ralph Block, *Investing in REITs*, Bloomberg Press, third edition, 2006; data and information from www.REITNet.com; and *The Investor's Guide to Real Estate Investment Trusts*, published by NAREIT, the National Association of Real Estate Investment Trusts. Usage of the term REIT refers to the investment vehicle as it is understood and employed in the U.S. market, which differs from European, Russian and other markets. However, many of the same principles apply, regardless of the specifics of the market.

REITs Basics: What is a REIT?

Real Estate Investment Trusts

A REIT is a company that buys, develops, manages and sells real estate assets. REITs allow investors to participate in a professionally managed portfolio of real estate properties. REITs distribute most of their income to investors without corporate taxation. As entities whose main function is to pass profits to investors, REITs are generally restricted to generation of property rental income. REIT investments are generally more liquid than traditional private real estate ownership. This liquidity results because the related shares are primarily traded on major exchanges, making it easier to buy and sell REIT assets than to buy and sell properties in private markets.

A Brief History of REITs

Real Estate Investment Trusts (REIT, pronounced "reet") originated in the United States in the 1880s. At that time, investors used REITs to avoid double taxation because trusts were not taxed at the corporate level if income was distributed to beneficiaries. This tax advantage was reversed in the 1930s, but following World War II, the demand for real estate funds skyrocketed. In 1960, President Dwight Eisenhower signed the real estate investment trust tax provision, which re-established the special tax considerations that qualified REITs as pass-through entities, eliminating double taxation.

REIT investment increased throughout the 1980s with the elimination of certain real estate tax shelters. Investments in real estate provided investors with income and appreciation. The Tax Reform Act of 1986 allowed REITs to manage their properties directly, and in 1993, REIT investment barriers to pension funds were eliminated.

In 2001, REITs were included in the Standard & Poor's 500 Index, reflecting the real estate sector's growing importance to capital markets. REITs are now acknowledged as important players in the economy and in diversified investment portfolios, with more than 193 publicly traded REITs operating in the U.S., with assets totaling over USD500 billion.

REIT Classification

For a corporation to qualify as a REIT and gain corporate tax advantages, it must comply with the following U.S. Internal Revenue Code provisions:

- Structured as a corporation, business trust, or similar association
- Managed by a board of directors or trustees
- Shares need to be fully transferable

- Minimum of 100 shareholders
- Pay dividends of at least 90% of the REIT's taxable income
- No more than 50% of the shares can be held by five or fewer individuals during the last half of each taxable year
- At least 75% of total investment assets must be in real estate
- Derive at least 75% of gross income from rents or mortgage interest
- Have no more than 20% of its assets consisting of stocks in taxable REIT subsidiaries

Types of REITs

REITs fall into three broad categories:

- **Equity REITs:** These invest in and own properties and are thus responsible for the equity or value of their real estate assets. Their revenues come principally from rents.
- **Mortgage REITs:** This type deals in investment in and ownership of property mortgages. They loan money to real estate owners for mortgages, or invest in existing mortgages or mortgage-backed securities. Their revenues are generated primarily by the interest they earn on mortgage loans.
- **Hybrid REITs:** Hybrid REITs combine the investment strategies of equity REITs and mortgage REITs by investing in both properties and mortgages.

REITs often focus their investments geographically or on particular property types, such as office buildings, shopping centers, industrial parks, warehouses, apartment buildings or healthcare facilities. Some REITs invest in several types of property and mortgage assets, diversifying across a spectrum of locations.

Investing in REITs

REITs are owned by thousands of individuals, as well as large institutional investors. The investment goals of REIT share ownership are much the same as investment in other stocks: current income and long-term appreciation potential.

Most REIT shares can be purchased on major stock exchanges, with orders placed through stockbrokers. Financial planners and investment advisors can help match an investor's objectives with individual REIT investments.

REITs provide an annual report and other financial information directly to investors. In the U.S., they are required to make regular financial disclosures to the investment community, including quarterly and yearly audited financial results that are filed with the Securities and Exchange Commission.

Some of the key elements in evaluating a REIT include management, capital sources and earnings.

Management

As with any business, successful performance is linked to the expertise of management. Indicators used to assess REITs include management's experience, as well as the length of time the management team has worked together. If a REIT has recently booked a new source of funds, it can be inferred that the institution providing the capital positively assesses the strengths and strategies of management.

Capital sources

Because REITs by definition are obligated to distribute 90% of their taxable income to investors, they must rely on external funding as their main source of capital. Investors must consider whether a particular REIT has access to debt or equity capital sufficient to fund future growth plans. REITs that can properly leverage themselves usually deliver superior returns. However, it should be noted that most REITs in the United States are only moderately leveraged, with an average debt ratio generally below 50% over the last decade (funds that invest in real estate in Russia are not permitted to use leverage).

Earnings

Net income under GAAP assumes the value of assets diminishes predictably over time. However, real estate values tend to rise and fall with market conditions. The valuation metric of Funds From Operations (FFO) was adopted to address problems in valuation and performance by excluding historical depreciation costs from the net income figure.

FFO has become the industry standard for assessing REIT operational performance. Other factors to be considered include whether a REIT's portfolio includes older properties, as higher capex requirements make a FFO value misleading. Many REIT investors calculate cash flow after capital items (known as Cash Available for Distribution, or CAD) as another measure of performance. Investors must also be familiar with the REIT dividend payout ratio to measure the sustainability of dividends.

Benefits of REITs

REITs generally perform similarly to small-cap stocks and bond investments. However, REITs have several advantages in terms of dividends. All REITs pay dividends and dividend growth rates for REIT shares have outpaced inflation in recent years. REITs possess low relative historical volatility and provide some degree of inflation protection. In addition to avoiding double taxation, REITs provide investors with a stable current income at an often attractive rate of return.

REITs share many similarities with other mainstream businesses:

- **Liquidity.** Investors can purchase shares in REITs as easily as they purchase shares in any other publicly traded company.
- **Shareholder value.** Just like investors in other public companies, REIT shareholders benefit from dividend income and share value appreciation.
- **Active management/corporate governance.** Publicly traded REITs adhere to the same corporate governance principles that apply to all major companies. They have a senior management team headed by a chief executive officer who actively manages the overall strategic vision and equity of the enterprise. A board of directors appoints the CEO, and the board is elected by and accountable to the REIT's shareholders.
- **Disclosure obligation.** REITs, like other public companies in the U.S., are required to make regular financial disclosures to the investment community, including quarterly and yearly audited financial results with concomitant filings to the Securities and Exchange Commission.
- **Limited liability.** As is the case with investments in other publicly traded companies, shareholders have no personal liability for the debts of the REITs in which they invest.

- **Low leverage.** One reason so many REITs (65%, based on equity market capitalization) are rated investment grade is their moderate financial leverage. In fact, the average REIT debt ratio has generally been below 50%.
- **Predictable revenue streams.** Reliable income is derived from rents paid to the owners of commercial properties (whose tenants often sign long-term leases), or interest from financing those properties. In addition, the companies' ownership of tangible assets with established values tends to reduce risk.
- **Earnings transparency.** Most REITs operate under a straightforward business model: by increasing rents or occupancy rates, higher income levels can be generated. When reporting financial results, REITs, like other public companies, must report earnings per share on the basis of GAAP net income. Financial progress can also be gauged by comparing levels of FFO, which differs from net income mainly by excluding depreciation and amortization of real estate assets and gains and losses from most property sales.
- **Total return.** The combination of income returns from dividends and capital gains from share value appreciation can result in strong overall returns. REITs have demonstrated a long-term track record of providing high current incomes with long-term share value appreciation, inflation protection and diversification for investors.

How Are REITs Valued?

Investors interested in REIT stocks need to know how to determine their value. There are several commonly used methods and formulas that provide insight into a REIT's relative strengths and weaknesses.

Real estate asset values

Historically, investment analysts tended to focus on a company's book value, which is simply the net carrying value of a company's assets, after subtracting all its obligations and liabilities, as recorded on the balance sheet. Investors now place more emphasis on a company's "going concern" value and growth prospects, rather than tangible assets. Furthermore, intellectual capital and franchise value are also deemed more important than physical assets. Indeed, few stocks sell today at prices even close to book value.

Book value has always been a poor way to value real estate companies, because offices, apartments, and other structures do not necessarily depreciate at a fixed rate each year, while land is carried at cost but tends to increase in value over time.

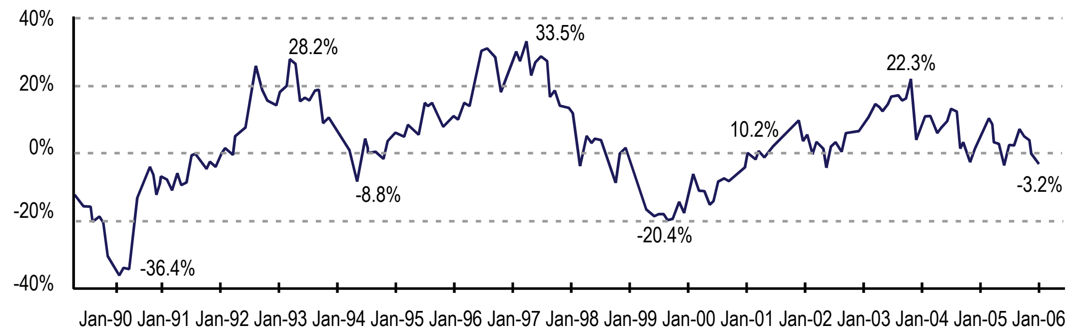
Some investors examine private-market or liquidation values rather than book values, and most focus on a company's earning power, rather than its breakup value. Nevertheless, while most REITs focus on increasing FFO and dividends, and are rarely liquidated, they own real estate with valuations that can be assessed through careful analysis. These assets are much easier to sell than, for example, the fixed assets of a manufacturing company, a distribution network, or a brand name, and thus the market values of their assets are much easier to determine.

REITs are easier to value than other companies on a net asset value (NAV) basis, and many investors consider NAV to be an important valuation tool, either alone or in conjunction with other valuation techniques.

Assessing NAV is done by reviewing various segments of the REIT's properties, determining an appropriate cap rate to groups of owned properties, and subtracting its obligations. Undeveloped land and developments in process are valued separately and then added in. The current value of debt is also taken into account. Recognizing that REITs vary widely in quality, structure and external growth prospects, the REIT's valuation is then adjusted to account for franchise value, sector and geographical focus, insider stock ownership, balance sheet strength, overhead expenses, share liquidity, possible conflicts of interest, and other factors.

The NAV premium

Average premium to net asset value of NAREIT universe



Note: NAREIT is an index of U.S.-listed REITs *Source: Investing in REITs*

Examining the chart above, we can see that when REIT shares have traded at a significant discount to NAV (at the end of 1990 and in early 2000), they were apparently very cheap, as suggested by their strong performance during the following 12 months. When they traded at a premium over NAV of more than 20% (such as in 1993 and 2H97), they were expensive, as indicated by their poor market performances in 1994 and 1998-99. However, a high premium over NAV doesn't always lead to an immediate decline in REIT share prices: REIT stocks traded at a 30% NAV premium in December 1996, but they performed well in the succeeding year (up 20.3% in 1997).

These examples could lead REIT investors to be cautious when the average NAV premium moves into double-digits. A handful of REITs, based upon their superior track records, could perhaps justify such large premium. However, during periods in which real estate markets are in relative equilibrium and do not provide an abundance of opportunities to create extraordinary value for shareholders, very few REITs could trade at 15-20% NAV premiums. REIT pricing history in recent years has been absorbed by investors, and it would be surprising to see stocks trading at a sizeable NAV premium, unless unusually strong real estate market conditions or major value-creation opportunities appeared.

Increases in company value are the long-term driving force behind stock price growth. The most common way of measuring company value involves valuing income streams and cash flow, which is the only metric currently sanctioned by modern accounting rules, as a company's assets must be carried on its books at historical cost, less depreciation, not at current fair market value.

As a result, rising earnings are a key driver for a company's share price. Steadily rising earnings normally indicate not only that a REIT is generating higher income from its properties, but may also suggest it is making favorable acquisitions or completing development projects. Higher income is also generally a precursor of dividend growth. In short, growing cash flow means, over time, higher share prices, increased dividends, and higher asset values. Value can be created in a REIT by investment activities that do not show up in current income or cash flow, but these metrics are most easily quantifiable.

Applying FFO and AFFO

The historical preference for FFO as a way to measure REIT valuations relates to the concept of depreciation. For REITs, net income is less meaningful as a measure of operating success than for other types of companies. In accounting, real estate depreciation is always treated as an expense, but in the real world, well-maintained properties can retain their value, or appreciate substantially, over many years. Increasing land values, rising rental and operating incomes, property upgrades, and higher costs of construction for competing properties are all contributing factors. Thus a REIT's net income under GAAP, reflecting a large depreciation expense, has been determined by most REIT investors to be less meaningful than FFO, which adds back real estate depreciation to net income. FFO thus allows a partial correction of the depreciation distortion, allowing investors to either look at net income before the depreciation deduction or add back the expense to reported net income.

Although most investors believe FFO is more useful way to measure profitability than net income, it does contain flaws. Most commercial property will slowly decline in value over time due to wear and tear, and structural improvements are generally necessary to retain value. When determining FFO, merely adding back depreciation to net income can provide an overly optimistic picture of operating results and cash flows.

In addition, commissions paid to leasing agents are usually capitalized, then amortized over the term of the lease. These commission amortizations, when added to net income to derive FFO, will similarly inflate that figure. The same can be said about tenant improvement allowances, such as those provided to office and mall tenants. Usually, these are so specific to the particular tenant's needs that they do not increase the long-term value of the property.

Short-term capital expenditures cannot be considered property-enhancing improvements and they should be subtracted from FFO to give an accurate picture of a REIT's operating performance.

Unfortunately, not all REITs capitalize and expense similar items in similar ways when announcing their FFOs each quarter. Also, some include investment write-offs and gains from property sales in the FFO, while others do not. With only FFO as a gauge, investors still lack consistency in the way adjustments to net income are reflected. There is no uniform standard to account for recurring capex that does not improve a property or extend its life, such as expenditures for furnishings (carpets, appliances, etc.) leasing commissions, and tenant improvements. The measure of adjusted funds from operations (AFFO) was developed to meet the need for this type of standard accounting.

AFFO – a better measure, but little used. Although FFO as a valuation tool is more useful to REIT investors than net income under GAAP, FFO was never intended to measure a REIT's cash generation or dividend capacity. AFFO is a much better measure of operating performance and is more effective at measuring free cash generation and the ability to pay dividends. Unfortunately, AFFO is not generally reported by REITs, and investors must calculate the figure themselves. Even when AFFO is disclosed, different REITs define it differently. The following is a generalized examination of this methodology.

Revenues, including capital gains, minus:

- Operating expenses and write-offs
- Depreciation and amortization
- Interest expenses
- General and administrative expense = NET INCOME

Net income minus:

- Capital gain from real estate sales

plus:

- Real estate depreciation = FFO

FFO minus:

- Recurring capital expenditures
- Amortization of tenant improvements
- Amortization of leasing commissions
- Adjustment for rent straight-lining = AFFO

Of course, when comparing the earnings and FFO figures reported by two different REIT companies, it is important to compare like with like: for example, care must be taken not to compare the P/FFO ratio of one REIT with the P/AFFO ratio of another.

In valuing a REIT, although net income should not be ignored, AFFO (when properly calculated) is the most accurate means for determining free cash flow.

REIT-related risks

Imbalance on the supply side, often referred to as a renters' market, allows tenants to gain favorable rental rates and lease terms from property owners. Excess supply results when construction exceeds immediate market needs or a major falloff occurs in demand for space. In either case, property owners can find themselves operating in difficult market conditions.

Rising interest rates can also drain property owners' profits. When interest rates climb, borrowing costs increase, which can eventually reduce growth in a REIT's FFO. In addition, rising interest rates can slow economic growth, which in turn may reduce demand for rental space. Growing interest rates can have implications for REIT share pricing: as investors seek higher yields in other markets, they may decide to sell their REIT shares, depressing prices, at least in the short term.

REIT Myths

Myth 1: REITS are no more than packages of properties

REITs are more than just portfolios of properties. Organizations that merely own and manage a basket of properties – limited partnerships, trusts, or even corporations – must contend with multiple specific investment concerns. Management may not be entrepreneurial and thus is often unresponsive to small problems that can, if left unattended, develop into major difficulties. Also, management does not usually have its compensation linked to the success of the properties and therefore has no particular incentive to be innovative in the face of strong competition. Often, there is no long-term vision or strategy for creating value for investors. Finally, inefficient management rarely has access to attractively priced capital, making it difficult for the entity to take advantage of a buyers' markets or attractive purchase or development opportunities. An investment in such a passive company, although it might provide a good dividend yield, offers little opportunity for growth or expansion beyond the value of the original portfolio.

REITs tend to be dynamic real estate market performers. However, REIT managers are motivated by their own ownership stake and other equity incentives. Expansion is usually directed into well-known areas or sectors where they can become dominant players, and they frequently have access to the capital necessary for growth. Successful REITs strive to strengthen relationships with tenants by offering innovative, cost-efficient services. To categorize successful real estate companies as mere collections of properties, or "mutual funds of real estate," is to underestimate the proactive nature of their operations.

Myth 2: Real estate is a high-risk investment

Real estate is perceived as risky – what about REITs? Many investors believe the real estate is a high-risk sector, where their equity can be wiped out by tenant defaults or declines in property values. This leads to the conclusion that if real estate is risky, investing in a REIT also must be risky. In fact, the three essential determinants of real estate risk are leverage, diversification, and quality of management (which covers the assets and property locations management chooses for ownership).

Leverage risks overstated. In terms of leverage, real estate is no different from any other investment: The more leverage you use, the greater the potential gain or loss. Any asset carried on high margin – an office building, blue-chip shares, or even a T-note – involves substantial risk, since a small decline in the asset's value will cause a much larger decline in one's investment. However, because real estate historically has been bought and financed with substantial debt, many investors have confused the risk of debt leverage with that of owning real estate. It should be noted that in Russia, leverage is not employed in real estate financing.

Although real estate investments have often been highly leveraged, it is the high leverage, rather than the real estate, that presents the greatest risk.

Diversification is the key. In any kind of investment, diversification lowers risk. Investors who would never consider holding a one-stock portfolio often purchase, individually or with partners, a single apartment building or shopping center. This leaves their investment vulnerable to myriad factors that can drive up costs and destroy value. Since the average REIT holds both residential and commercial properties in a range of geographical areas, investors are protected against negative developments affecting a single property.

Management quality. Real estate, like all types of investments, cannot simply be bought and neglected; it requires active, capable management. This factor often trips up individual real estate investors, who purchase a property, but then lack the time or expertise to manage it properly. The consequences of such questionable investments contribute to the perception of real estate as a risky investment. A capable professional management team can select real estate for acquisition and ownership and then run the properties correctly is an indispensable asset for successful investing in the sector.

Myth 3: Difficult market conditions are bad news for REIT investors

Are REITs fair weather friends? On increasing competitive global markets, real estate investors can find it difficult to generate excess returns. Nevertheless, if investors can obtain returns of 5-7% from property acquisitions and enjoy operating income growth in line with inflation, REITs should remain solid investments that are competitive with other asset classes. Furthermore, REITs may be able to take advantage of opportunities presented by challenging real estate environments, just as they take advantage of opportunities in favorable environments.

Skillful managers see difficult economic conditions as buying opportunities. Conversely, a strong real estate market can be bad for REITs. For example, many REITs saw their profit growth shrink in the mid-1980s, when real estate prices were skyrocketing. Not only were properties simply unavailable at prices providing acceptable returns, but owners were facing competition from new construction. The cycle then moved into the overbuilt phase and cash flow growth slowed markedly.

Profits available in poor markets. REITs can grow their profits internally through rising operating income and externally through property acquisitions and new developments. Poor real estate markets create external growth opportunities if there are a large number of distressed sellers. While it is difficult to estimate how a particular real estate or capital market cycle will play out, strong REIT organizations with access to ample capital can take advantage of the opportunities created in tough markets. While cash flow growth can slow temporarily in response to difficult market conditions, the ability of REITs to buy substantial numbers of quality properties cheaply enables them to create solid value for shareholders.

The extent to which a well-managed REIT can profit from opportunities presented in a down market depends on the skill of management, the amount and cost of available capital, the depth of market weakness, and the extent of competition from other buyers.

REIT stocks are all-weather investments for diversified portfolios. Investor concerns about real estate markets for a long time left these potentially lucrative investments largely undiscovered and undervalued. REITs have become more popular in recent years, but myths and misconceptions die hard. Investors who understand the real risks and rewards are likely to retain REIT shares in their portfolios over the long term.

MDM Bank

Investment Division
33/1 Kotelnicheskaya Nab.
Moscow, Russia 115172

Head of Equities

Vladimir Bril
Vladimir.Bril@mdmbank.com
+7(495) 228-3516

Institutional Sales

Vladimir Bril	Vladimir.Bril@mdmbank.com
Tanja Djurdjevic	Tanja.Djurdjevic@mdmbank.com
Alexey Kaminsky	Alexey.Kaminsky@mdmbank.com
Ivan Legenchuk	Ivan.Legenchuk@mdmbank.com
Kate Korolkevich	Kate.Korolkevich@mdmbank.com

enquiries@mdmfinancialgroup.com
+7(495) 795-2521
Bloomberg: MDMG <GO>
Reuters Dealing: MBWM, MDMB
http://www.mdmbank.com

Head of Research

Alex Kantarovich, CFA
Alex.Kantarovich@mdmbank.com

Oil & Gas

Nadia Kazakova, CFA	Nadia.Kazakova@mdmbank.com
Andrey Gromadin, CFA	Andrey.Gromadin@mdmbank.com

Metals & Mining

Andrey Litvin	Andrey.Litvin@mdmbank.com

Utilities

George Lilis	George.Lilis@mdmbank.com
Vladislav Nigmatullin	Vladislav.Nigmatullin@mdmbank.com

Consumer/Industries

Elena Afonina	Elena.Afonina@mdmbank.com
Alexey Gogolev	Alexey.Gogolev@mdmbank.com

Telecoms & Technology

Elena Bazhenova	Elena.Bazhenova@mdmbank.com
Ekaterina Generalova	Ekaterina.Generalova@mdmbank.com

Strategy, Economics, Banking

Alex Kantarovich, CFA	Alex.Kantarovich@mdmbank.com
Peter Westin	Peter.Westin@mdmbank.com
Irina Plevako	Irina.Plevako@mdmbank.com

Editors/Production

Thomas Lavrakas	Thomas.Lavrakas r@mdmbank.com
Nathan Gardener	Nathan.Gardener@mdmbank.com
Ekaterina Ogurtsova	Ekaterina.Ogurtsova@mdmbank.com
Andrey Goncharov	Andrey.Goncharov@mdmbank.com