ACRA

SEPTEMBER 18, 2024

ANALYTICAL COMMENTARY

TIMUR ISKANDAROV

Senior Director, Head of Project and Structured Finance Ratings Group

+7 (495) 139 04 94

timur.iskandarov@acra-ratings.ru

Media contact:

SVETLANA PANICHEVA

Head of External Communications

+7 (495) 139 04 80, ext. 169

svetlana.panicheva@acra-ratings.ru

STRUCTURED AND PROJECT FINANCE | RUSSIA

PROJECT FINANCE, MORTGAGES AND ESCROW ACCOUNTS. WHERE ARE THE THREE WHALES OF RUSSIAN HOUSING CONSTRUCTION SWIMMING?

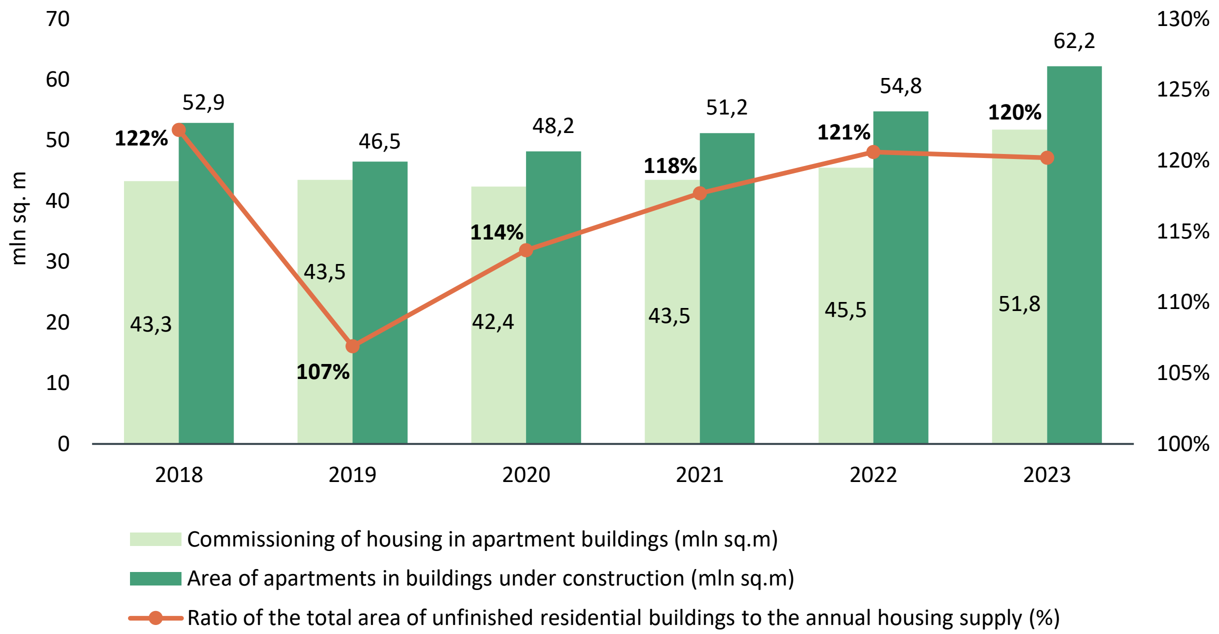
The development of the construction industry and residential real estate market is an important factor in economic growth. In Russia, purchasing real estate is seen as a reliable investment option and an effective way to retain savings, which is especially evident during periods of economic turmoil. On the back of growth of the population's welfare and development of mortgage products, this factor has historically promoted stable growth of demand for housing, often exceeding increases in the volume of supply, which in turn has fueled a constant increase in real estate prices. Since the construction industry transitioned to escrow accounts (on July 1, 2019), the bulk of financing for developers' activities has been provided by banks through project lending (usually with interest rates and other conditions tied to the rate of sales and commissioning of housing). This financing method currently operates to an extent sufficient to maintain a stable rate of housing construction.

The system for using escrow accounts, in which the developer gains access to funds received from the sale of apartments only after the completion of construction and the commissioning of a housing construction project, implies that the profitability of construction activities (and, as a consequence, the creditworthiness of developers) depends on the presence of solvent demand and the speed of housing sales. A key role is played by the conditions for mortgage lending provided by banks and the quality of servicing these borrowings, and consequently, by the creditworthiness of borrowers. Can the challenges that the Russian economy has faced in recent years influence the established trends? How will a potential decline in the availability of financing due to lower solvent demand impact developers' operations and what other financing methods are available to them?

Dynamics and trends in the apartment building construction market

The housing construction market's development indicators were stable from 2018 to 2021, and the annual volume of housing commissioned in apartment buildings amounted to approximately 43 mln sq. m. Even the restrictions imposed due to the COVID-19 pandemic had a minor impact on these dynamics: from 2019 to 2020, the volume of housing commissioned declined by no more than 2.5% — from 43.5 mln to 42.4 mln sq. m. The indicators returned to pre-pandemic levels in 2021 and then went on to record considerable growth (*Fig. 1*).

Figure 1. Volumes of housing commissioning and unfinished construction of apartment buildings



Sources: Rosstat, ACRA

Contrary to the expectations of many market participants, the economic sanctions that Russia faced in 2022 failed to slow down the construction industry in the short term. Moreover, the acceleration of market dynamics observed in 2022 continued in 2023, which was a record year for housing commissioning (51.8 mln sq. m). This was accompanied by significant growth in the volumes of unfinished construction of apartment buildings (to 62.2 mln sq. m), which resulted in both metrics reaching maximum levels since 2018. The annual growth rates of housing commissioning and housing construction amounted to 13.9% and 13.5%, which also broke records. The indicator reflecting the ratio of the total area in apartment buildings under construction to the volume of annual housing commissioning is noteworthy: it has demonstrated positive dynamics since 2019 and has consistently exceeded 100%. Along with the growth of the mortgage portfolio, the increase in the project finance loan portfolio and the absence of a large number of projects with significant implementation delays, these indicators clearly indicated a growing market and low saturation of demand. At the same time, the average national value of the annual price index on the primary housing market also showed stable growth: by more than 20%[1] in 2021–2022 and by more than 13%[2] in 2023, which significantly exceeded the official level of consumer price inflation. Such trends are typical for a growing market with a constantly increasing supply volume amid incomplete saturation of demand.

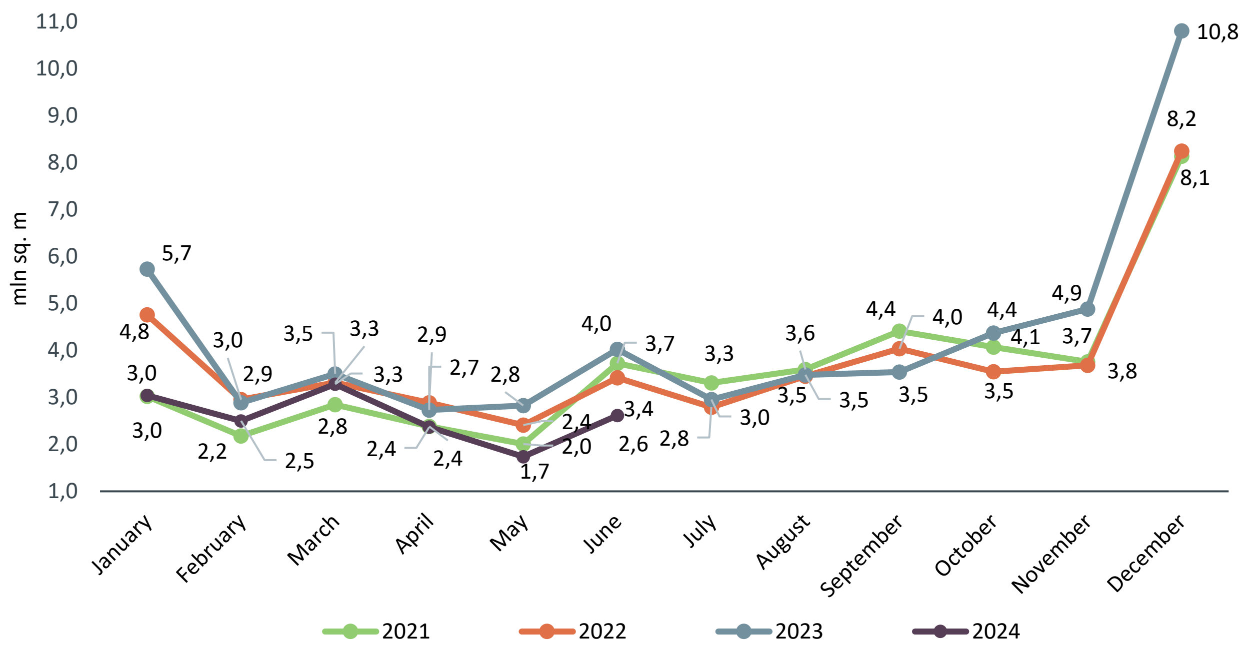
However, the figures for the first six months of 2024 give us reason to talk about the market cooling. Despite growth in the number of new projects in Q1 and Q2, the total area of which amounted to 10.8 mln and 12.8 mln sq. m, respectively, according to DOM.RF (13% and 16% more than in the same periods in 2023), the volume of commissioning of apartment buildings began to decline. The monthly dynamics of housing commissioning from January to June shows, on average, lower volumes than in 2022–2023, and the May figure was the lowest since 2020 (*Fig. 2*). Perhaps the decline in activity is a temporary phenomenon associated with the record levels of

[1] https://www.fedstat.ru/indicator/55402

[2] https://дом.рф/price-index/year_2023

2023, but the assumption of the formation of a new trend seems more reasonable, given the factors discussed below.

Figure 2. Dynamics of commissioning of apartment buildings



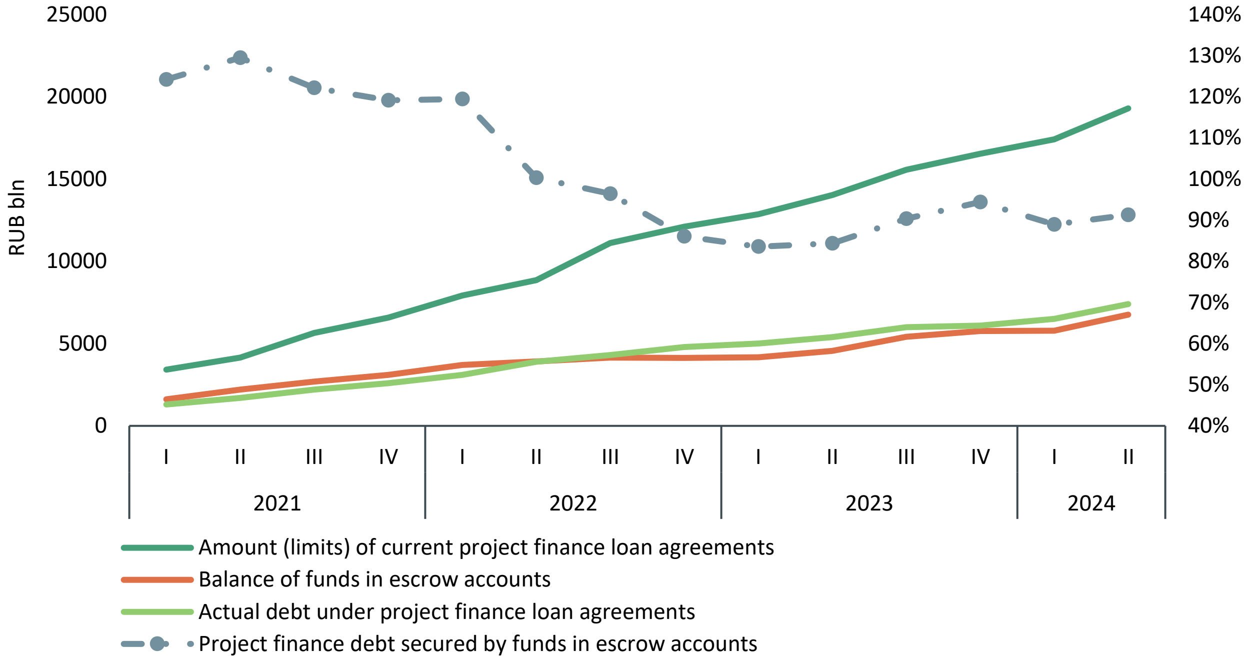
Sources: Rosstat, ACRA

The volume of current project finance debt is proportional to the amount of funds in escrow accounts (*Fig. 3*). Up to and including Q2 2022, the coverage of project finance debt (PFD)[3] exceeded 100%, but from Q3 this figure ranged from 84% to 94% (at the end of H1 2024 it was 91%). Market participants generally assess this level of coverage as sufficient.

It is worth noting the growth in the number of new project finance agreements, and, consequently, the volume of project finance credit limits. The total volume of current agreements as of July 1, 2024 amounted to about RUB 19.2 tln, with an actual debt volume of RUB 7.4 tln. Growth of lending to project companies and developers has been observed constantly since the beginning of the reform of the previously existing scheme for using shared construction participation agreements (SCPAs), which correlates with the increase in the volume of construction of apartment buildings. The degree of drawdown of credit lines remains quite stable at 38–40%, which is explained by the specifics of project finance agreements, which include conditions for maintaining preferential interest rates depending on compliance with construction schedules and the declared speed of housing sales. In practice, this means that the current degree of use of credit limits is tied to the amount of collateral in the form of funds in escrow accounts. The lower rates of filling of escrow accounts, as well as the decrease in the degree of PFD provision coupled with the simultaneous growth of limits, raise concerns about the availability of credit funds necessary for the completion of projects with planned commissioning periods of more than two years. This is especially important in a situation of a significant reduction in mortgage lending, i.e. a decrease in solvent demand.

[3] For the purposes of this analytical commentary, the indicator of the degree of PFD provision is calculated as a percentage ratio of the total current balance of escrow accounts to the volume of PFD.

Figure 3. PFD dynamics and escrow account balance



Sources: Bank of Russia, ACRA

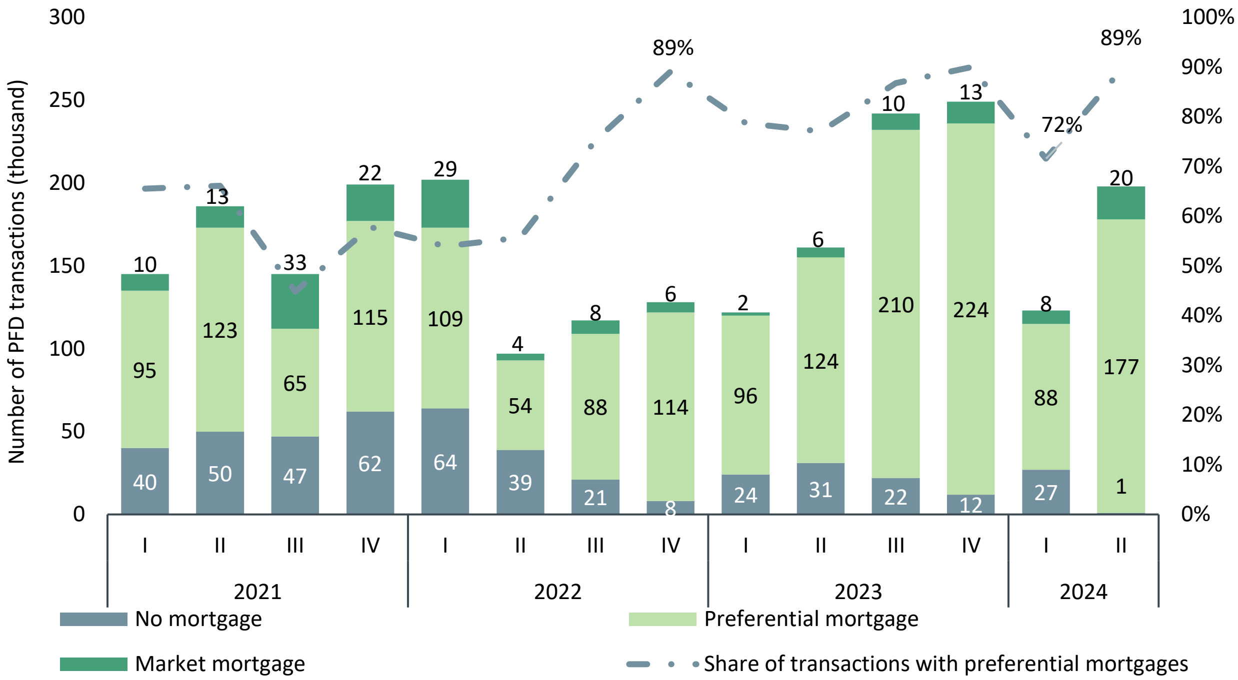
Mortgages are the main driver of residential real estate market growth

Obvious factors influencing the real estate construction market include not only the activity of developers and their ability to commission new properties, but also the presence of solvent demand for apartments in new buildings.

The average share of apartments sold in buildings under construction has remained stable since 2022: according to DOM.RF, the current value of the indicator is approximately 32–34% and corresponds to the levels of 2022 and 2023. This suggests that the market has so far managed to adapt to the increase in construction and housing commissioning volumes, and the sales rate has grown proportionally. The largest volume of housing sales (about 65%) is typical for buildings that are scheduled to be commissioned by the end of 2024. For properties with later commissioning dates — for example, in 2025 and 2026 — the sell-out rate is lower and is around 39% and 19%, respectively. At the same time, 2024 accounts for 24% of the commissioning of real estate under construction, while 2025 and 2026 account for 37% and 16% of the area under construction.

Until the beginning of Q3, the most important source of financing for the sale of real estate under SCPAs and the main driver of demand in the primary market was mortgage lending. As DOM.RF’s data shows, since 2021, on average, more than 70% of real estate transactions in the primary market have been financed through mortgages.

Figure 4. Number of real estate transactions and mortgage lending

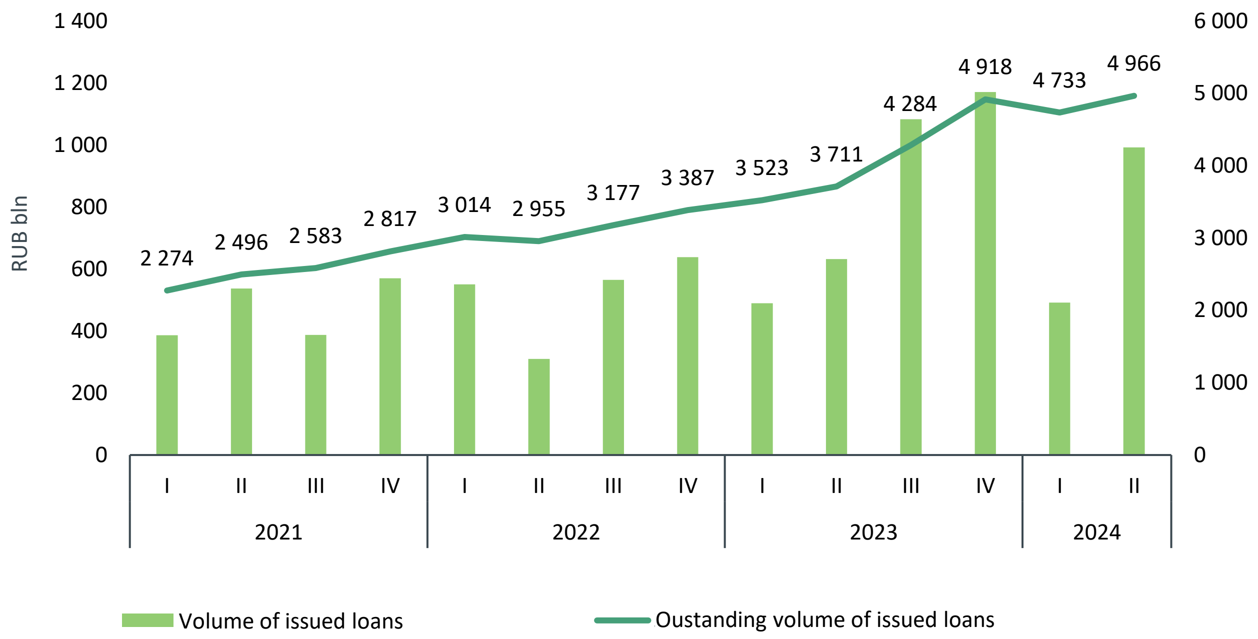


Sources: DOM.RF, ACRA

After the key rate hike in 2022, the Government of the Russian Federation expanded preferential mortgage programs, so that the average share of mortgages in the total volume of SCPAs grew to 76% and 87% in 2022 and 2023, respectively, reaching 91% in H1 2024. Since interest rates on market (non-preferential) mortgages have been de facto prohibitive over the past two years, the volume of these loans in general statistics is insignificant — about 1–5%. The main share of the mortgage portfolio was preferential programs, including government-supported preferential mortgages (on average about 45% of the total volume of preferential programs) and family mortgages (41–43%). As for the number of transactions on the market, their quarterly dynamics are almost entirely determined by the dynamics of mortgage loans (*Fig. 4*).

The dynamics of absolute indicators of SCPA mortgage lending in Q1 2024 show a market slowdown before a sharp increase in loan issuances in the second quarter. Over the period from 2020 to 2023, the total volume of the SCPA mortgage portfolio grew stably BY 5–9% annually. Despite the fact that the volume of loan issuances in Q1 2024 generally corresponded to the indicator for the same period last year, the total portfolio shrank by about RUB 185 bln or by 3.76%. Moreover, despite a significant increase in loan issuances in Q2 2024, total debt increased by a mere 1% compared to the previous maximum observed at the end of 2023. For comparison, during the analyzed period, a slight decrease in total primary mortgage debt was observed only once — in Q2 2022, which was a direct consequence of the surge in bank rates. However, at the time the portfolio decreased by 2% or by no more than RUB 60 bln. The main reason for the market contraction in Q1 2024 was the tightening of the terms of preferential programs at the beginning of the year, which did not allow record issuance volumes to be maintained in Q4 2023. At the same time, a sharp increase in new loan issuances and a return to historic maximums of the total debt in the second quarter were the result of excessive demand on the eve of the cancellation of the main preferential mortgage program. The share of mortgage transactions with government support in Q1 2024 fell from 90% to 73%, which is lower not only than in Q4 2023 (89.6%) but in Q1 2023 (78.7%) as well, after which it grew to 89%. Starting from July 1, 2024, the most popular government-supported preferential mortgage program, which, according to ACRA's estimates, accounted for about 30% of all mortgage loans in the primary market, was curtailed, which has already led to a significant drop in mortgage loans — according to market participants, in July loan issuances fell by 40–50% year-on-year. This is partly due to the record high figures of the previous month. The real decrease in monthly loan issuances can only be estimated based on the results of Q3 2024.

Figure 5. Mortgage portfolio of SCPAs



Sources: Bank of Russia, ACRA

It should be noted that the solvency of mortgage borrowers remains high since the current volume of delinquencies is only 0.13% of the total portfolio. This is backed by the low unemployment and the growth of real incomes. However, the effect of these positive factors will not be strong enough to support the issuance of market mortgages at current rates.

Despite a fall in demand in the primary real estate market amid current prices and higher mortgage costs, major market shocks are unlikely in the short term. Developers and banks have a range of tools to manage the situation. Developers have accumulated a substantial portfolio of new, already funded, projects. Accordingly, depending on the depth and duration of weak demand, developers will manage the timing of project commissioning and, jointly with banks, adjust loan drawdown periods, taking into account the dynamics of escrow account balances. The decrease in the volume of mortgage loans caused by the curtailment of preferential programs may be offset to some extent by the introduction of mortgage programs subsidized by developers. Of course, such programs cannot fully substitute preferential mortgages that have been cancelled, and their effectiveness will depend, among other things, on the position of the regulator, but they will help partially smooth out falling demand. The duration of the period of market cooling will depend on the pace of cuts of mortgage rates and changes in the terms of non-cancelled preferential programs. In the moderately conservative scenario, the fall in demand will not exceed 20% and last from a year to a year-and-a-half, which will lead to a temporary slowdown in project commissioning and sales, after which the market will recover relatively quickly and begin to grow. This scenario assumes the continued availability of project finance. Banks may have to increase lending costs due to a slowdown in market activity and moderate increase in associated risks, as well as consider scenarios for reducing the permissible volume of provisions for the current PFD in order to avoid significant changes in project commissioning timing.

In the worst-case scenario, which includes the invariability of current bank rates for a long time (more than two years) and even tighter terms of the remaining preferential programs, there is a risk of a more significant market slowdown, after which recovery will require more time and resources. Weak growth of funds in escrow accounts over a long period may negatively affect the cost and volume of project finance and, consequently, lead to a decrease in the rate of housing commissioning, a reduction in the number of new projects and even freezing of individual projects already under construction.

One of the main components viewed by market participants as a stabilizing factor is the price per square meter, therefore, it can be expected to correct only when all other opportunities available to banks and developers are exhausted.

Project and structured finance instruments are alternatives for refinancing and funding

After the escrow reform, almost all housing construction projects involve bank project financing. A number of scenarios of a slowdown of the primary real estate market and, consequently, the entire construction industry, may result in both higher borrowing costs and the need to refinance existing obligations. In this regard, it is advisable to consider the possibilities of diversifying funding sources for both developers and their lenders. For example, to finance projects or refinance PFD, project and structured finance instruments secured by project assets or future sales proceeds can be used. Developers will be able to reduce their bank debt or attract additional funding by issuing collateralized bonds through special-purpose vehicles. Banks, in turn, can use these instruments to release capital and refinance their own loan portfolios by way of assignment of a loan or loan portfolio to a special-purpose vehicle that will issue bonds secured by such loans. The advantage of these instruments is the possibility to adjust their repayment schedule depending on the commercial and risk characteristics and indicators of a particular project or pool of projects. Investors benefit from secure and transparent issue terms, since such transactions transfer non-public illiquid assets (loans) to the public domain with clear risk characteristics confirmed by credit ratings.

The project and structured finance instruments can also be integrated in government support measures, which can be carried out by both the government and authorized agents or development institutions in various forms. These may include targeted programs for the purchase of project and structured finance instruments on market or preferential terms, subsidizing the coupon rate for external investors, providing guarantees for the fulfillment of obligations, etc.

ACRA believes that the development of project and structured finance mechanisms will diversify the sources of long-term financing for the construction industry, redistribute risks between the banking, financial and public sectors, and help overcome the consequences of the potential stress scenarios in the real estate market.

The Analytical Credit Rating Agency (ACRA) was founded in 2015, with its 27 shareholders representing major Russian corporate and financial institutions and its authorized capital exceeding RUB 3 bln. ACRA's main objective is to provide the Russian financial market with high-quality rating products. Methodologies and internal documents of ACRA are developed in compliance with Russian legislation and with regard to global rating industry best practices.