

May 2008

Russian commodities: Giving investors food for thought

by [Guy Norton](#)

A plentiful supply of cheap, high-quality farmland means Russia may become key in the drive to solve global food shortages.

**Black Earth Farming – leader of the revolution?
Russia builds a future for wheat**

Given a plentiful supply of cheap, high-quality farmland, is Russia poised to become a key player in the drive to solve looming global food shortages? Guy Norton reports from Moscow.

THE SOCIO-ECONOMIC dislocation of the 1990s wrought widespread havoc in the Russian countryside and relegated agriculture to a bit part role in the country's unfolding financial drama. Before the break-up of the USSR in 1991, agriculture in Russia was a big industry, accounting for 15.3% of GDP. As of last year that figure had slumped to just 4.4%.



But given surging soft commodity prices across the globe and recent political upheaval in countries such as Haiti and Egypt as a result of soaring food prices, Russian agriculture could enjoy a dramatic reversal of fortune.

"Food security is now as big an issue as energy security," says Richard Ferguson, soft commodities analyst at Nomura in London. Given the growing supply-demand mismatch in the global food chain, he believes that agriculture is set for one of the periodic revolutions that as a rule of thumb occur every 50 years or so. The principal drivers are set to be a combination of demographics, urbanization and globalization. Put simply, with the world's population in excess of 6 billion, there are more mouths than ever to feed. Meanwhile, growing urbanization is boosting incomes, which have changed the affordability of food, as well as displacing valuable farmland. Finally, globalization has promoted greater international trade in agricultural goods.

The favourable changes in the macroeconomic environment have ushered in a fundamental change in investor attitudes towards agriculture in Russia. "When you hear the words 'agriculture' and 'Russia' in the same sentence, you tend to take notice now," says Michail Kart, managing partner at hedge fund group Marcuard Spectrum.

James Fenkner, managing partner at Red Star Asset Management, says that given Russia's massive land reserves there is certainly scope for the creation of a big agri-business company in Russia. "One of the agricultural companies out there could become the Archer Daniels Midland of Russia," he says, referring to the US agribusiness group, which is the global market leader and boasts a \$25 billion market capitalization.

Ferguson at Nomura in London agrees. "It's perfectly feasible that by 2015 you could see a Russian agricultural company with a market capitalization of \$10 billion or more given the ability to scale up operations in Russia."

Although the sheer size of Russia creates its own logistics problems, it's the availability of cheap, easily cultivable farmland that is exciting investor interest. At an average \$500 per hectare, Russian agricultural land is much cheaper than the \$2,000 to \$3,000 average for central and eastern Europe and a positive snip compared with the \$15,000 to \$30,000 common in western Europe. What's more, there is plenty of it. Estimates vary but a consensus figure would suggest there is at least 40 million hectares of arable land lying fallow in Russia. Bringing that up to full production could cost between \$40 billion and \$60 billion depending on the quality of the land. But with wheat prices at \$500 a tonne and rising, for example, agriculture in Russia could conceivably become a trillion rather than a billion dollar play. "We are talking about a massive, strategically important industry," says Ferguson.

As of now, none of the agricultural companies in Russia even remotely approaches the scale of Archer Daniels Midland but there is certainly no lack of ambition among those looking to position themselves as the agricultural play of choice in Russia.

Transforming perception

The company that has captured investors' imaginations in recent months is Black Earth Farming. Founded in 2005, it has developed from greenfield start-up to an internationally listed public company with a \$1 billion-plus market cap in what in farming terms is a twinkling of the eye. Formed by a former private equity banker, Michel Orlov, Black Earth Farming is trying to do what nobody has attempted before – to transform the popular perception of Russian agriculture as being a backward, twilight year industry into the high-tech, high-yield sector of the future.

At a time when other Russian initial public offerings were falling by the wayside, Black Earth Farming's flotation on the First North Stockholm section of the OMX exchange in Sweden in the run-up to Christmas 2007 romped home. At the equivalent of roughly \$300 million, it was the largest ever European IPO in the agricultural sector. Marketed at a range of SKr43 to SKr53, the offer priced towards the upper end of the range at SKr50, attracting a strong institutional and retail following. The deal defied the global bear market for equities at the start of the year, as the shares soared to SKr73 by the end of February, before succumbing to a softening in wheat futures to trade at SKr60.25 by mid-April – up 20% since listing versus a 5% fall for the benchmark Russian RTS exchange over the same period.

"We thought the IPO pricing was pretty ambitious, but the stock has performed well on the back of strong demand," concedes Thies Ziemke, a director at Parus Kreml Capital Management.

Investors expect that in the wake of the Black Earth Farming IPO there will be a series of copycat issues from companies looking to mimic its success. "We're hearing a lot of stories about people looking to put together Black Earth Farming-type businesses," says Kevin Dougherty, portfolio manager at Pharos Financial Group.

For his part, Black Earth Farming's Orlov relishes the prospect of increased competition. "We look forward to other people trying the same business model – we are more than happy to be the industry benchmark."

Although the business model pursued by Black Earth Farming is simple in theory, there are concerns about its viability in practice. "Agriculture in Russia is not simple," says Ivan Nikolaev, consumer analyst at investment bank Renaissance Capital. "Labour and labour productivity is a key problem." He adds that even experienced Russian farming groups such as Razgulay have struggled to match the yields produced by their international peers. "The average sugar beet yield in Russia is 28 tonnes per hectare, while Razgulay manages 34 tonnes per hectare. But in western Europe the figure is 56 tonnes per hectare." Nikolaev says that traditionally farm workers in Russia have been poorly paid and consequently poorly motivated. "There's a Russian saying 'I'll pretend to work, if you'll pretend to pay me' which sums up the situation." He says that by paying higher than average wages, Razgulay has built up a pool of skilled, motivated labour but this has come at a cost to bottom-line profits.

Florian Fenner, managing partner at UFG Asset Management, has similar concerns. "Without the right workforce, you can't make your capital work for you," he says, adding: "It is difficult to scale up farming projects because of the lack of skilled labour." Fenner says that Russia is already highly dependent on migrant labour and that the Moldovan and Tajik overseers and labourers who are generally regarded as the best workers are quickly realizing the value of their services. "They're asking for 30% pay rises because they know they can get it," he says. Fenner says that one of the more outlandish suggestions put to him by a potential investor in the agriculture sector was to ship in white farmers from Zimbabwe who have had their farms confiscated – he's still not sure if the investor was serious or not.

Skills shortage

Black Earth Farming's Orlov acknowledges that efficient human resources management will play a key role. "In any overheating emerging market – and believe me Russia is an overheating emerging market – finding skilled labour is a problem. Right now, it's difficult enough finding a good secretary, let alone a senior agronomist. But if you pay people well and incentivize them, you can get good people here in Russia." He adds that the use of the latest agricultural machinery will mean that despite increasing its land bank by several times over the next few years, the company will actually need fewer than the present 1,200 employees. "The need for people is significantly lower if you have the right equipment," he says.

As with the rest of the Russian economy there is also the thorny issue of infrastructure. "The grain-producing regions in Russia need a lot more elevators," says Nikolaev at Renaissance. Grain elevators enable long-term storage of grain so that farmers are able to sell their crops at the best possible market price. But at \$250 to \$280 per tonne of installed capacity, they don't come cheap. With the prices of steel and other construction materials set to rise given the massive infrastructural needs in the rest of the economy, those costs are likely to increase. Nikolaev says that rural areas also need better road and rail networks to ease transport bottlenecks, and that port capacity will need to be expanded if Russia is to boost agricultural exports.

Given that cereal and grain prices have been hitting record levels in recent weeks, it's not surprising that arable farming has stolen much of the limelight in the Russian agricultural sector. But with rising incomes facilitating higher meat consumption in Russia there is also growing interest in livestock plays as well. One company looking to test investor appetite in the coming months is Cherkizovo Group, one of Russia's leading meat producers, which in April secured permission from Russia's stock market regulator, the Federal Service for Financial Markets (FSFM), to offer an additional 4.76% of stock to investors. Analysts say the company has a strong story to sell, having boosted its sales by 33% to \$840.8 million and gross profits by 51% to \$222.8 million in 2007. "We are upbeat on Cherkizovo's results, which is indicative of the company's ability to reinforce its positions in various meat-processing segments due to high sales. Additionally, we highlight that the company's effectiveness in terms of raw materials provisioning allowed Cherkizovo to considerably boost its margins in spite of the difficulties in the sector caused by the rapid growth of crop prices", says Sergey Filchenko, consumer analyst at Russian brokerage Finam.

In May 2006 the company raised \$251 million through an IPO listing its ordinary shares on the RTS and Micex bourses in Russia and its global depository receipts on the main market of the London Stock Exchange. Cherkizovo used the proceeds of the IPO to buy chicken producer Kurinoe Tsarstvo at the end of August last year, making it the largest poultry producer in Russia. It also opened a new abattoir for pork production and acquired more than 28,000 hectares of land in the fertile Black Earth farming region.

"During 2007, we have continued to take major steps towards achieving our aim of becoming Russia's leading producer of meat and meat products," says Cherkizovo chief executive Sergey Mikhailov. "This was achieved through our dual track strategy of organic growth from existing and expanded operations and carefully selected acquisitions such as that of Kurinoe Tsarstvo that complement our existing business.

"Overall we have meaningfully expanded our business, through new state-of-the-art facilities, increased operational efficiency and, at the same time, delivered excellent financial performance and increasing margins despite an environment of increasing grain prices."

Dougherty at Pharos says that Cherkizovo's plan to raise further equity capital makes good sense given the strong investor interest in agricultural plays. "Cherkizovo's a smart company, they realize that agriculture is a hot investment topic right now."

Nikolaev at Renaissance Capital says that Cherkizovo's "field-to-fork" business model is an example of the type of vertically integrated play that, he argues, offers the best form of exposure to Russian agriculture. On the one hand the company's land acquisition will ultimately give it long-term access to lower-cost feedstock for its pig and poultry farms, while on the other its meat-processing division is developing more premium high-margin products to take advantage of fast-growing disposable incomes in Russia.

Debt investors are also showing greater interest in the livestock sector, with London-headquartered Russian debt specialist Denholm Hall recently concluding a 12-month financing deal with a leading poultry producer in the northwest of Russia. Founder George Nianias says that, given the current credit squeeze, even well-established, cashflow positive companies with strong business franchises are finding it difficult to raise debt. "Chicken consumption is growing fast in Russia – it's up 16% in the last two years alone – but companies are finding it difficult to source expansion capital through Russian banks and are coming to us instead," he says. He adds that the poultry firm is looking to increase production close to urban centres such as St Petersburg and is willing to pledge its existing land, plant machinery and bank guarantees as security for the debt it has received from Denholm Hall. Nianias says that agriculture is just the sort of consumption-meets-import substitution play that Denholm Hall favours in Russia. "Some two to three years ago we looked at investing in agriculture with a view to land being rezoned for commercial or residential use. Now, given high world market food prices it makes sense to look at pure agricultural plays."