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Infrastructure: Build Russia a boom before it breaks down

by [Guy Norton](#)

Russia's infrastructure will cost trillions of dollars to fix. How are bankers and investors looking to profit from the rebuilding?

The economy is in good shape, which is more than can be said for the country's infrastructure. Links for land, sea and air transport are rapidly falling apart and are expected to cost trillions of dollars to fix.

IN ECONOMIC TERMS Russia has charged ahead since the turn of the century, registering annual economic growth of more than 7% on the back of growing demand for commodities from abroad and rising consumption at home.

But as anyone who has used the country's roads, railways, ports or airports can testify, the dilapidated Soviet-era infrastructure is clearly failing to keep pace with the increasing demands being placed upon it. The bill for fixing Russia's infrastructure problems is forecast to run into trillions of dollars over the next couple of decades alone.

And while the government's coffers are full to overflowing thanks to rising tax revenues, the authorities in the Kremlin recognize that only by harnessing private-sector capital and expertise can they ensure that their infrastructure development plans are turned into reality.

The good news for the government is that bankers and investors are increasingly excited about the prospect of a Russian infrastructure boom and are positioning themselves to take advantage.

"The numbers being talked about are enough to interest anyone," admits Trevor Sturmy, London-based director of project and export finance at HSBC. He adds: "If things develop to plan, Russia will be a very important infrastructure play."

Australia's Macquarie Group, with close to \$60 billion of infrastructure assets under management worldwide, has also hastened to answer the Russian government's call. It has teamed up with leading Russian investment bank Renaissance Capital to form a 50/50 joint venture, Macquarie Renaissance, to develop infrastructure advisory and fund management services in Russia. "We see significant opportunities in this market that we believe are well suited to our long-term infrastructure approach," says Jim Craig, head of the Macquarie Group in Europe. Macquarie Renaissance is reported to be establishing a \$1 billion investment fund so as to participate in the public-private partnership (PPP) projects that are set to be mandated in the course of the next few years.

Renaissance Capital is by no means the only Russian investment bank eyeing the infrastructure sector. Arch-rival Troika Dialog is said to be looking to raise a similarly sized fund, and the investment banking arms of leading Russian commercial banks VTB and Gazprombank have both been building infrastructure teams so as to be able to participate in the potential PPP bonanza.

Although there's excitement about the prospective infrastructure boom in Russia, there is also scepticism about how it will play out in reality. "There's been lots of talk about PPPs, but nothing really major has happened up until now," says Thies Ziemke, a director at Moscow-based hedge fund Parus Kreml Capital Management. He adds that sticky-fingered officials could easily help to upset the government's carefully laid plans. "The potential for corruption is a major concern – there are so many opportunities for bureaucrats to solicit bribes."

Florian Fenner, managing partner at UFG Asset Management in Moscow, says that heavy-handed regulation and politically motivated interference by the Kremlin is another worry. "Our policy when playing the infrastructure theme in Russia is to keep as far away from the government as possible," he says.

Others take a more charitable view. "The government and government-owned companies will play a key role in infrastructure development in Russia," says Eduard Faritov, transport analyst at Renaissance Capital.

Right direction

Although the Russian government's integration into the country's economy might not find favour with free market purists, Faritov argues that it is not a unique situation. "It's a similar model to the one that worked well in South Korea," he says. He adds that one of the key challenges for the government is to create an investor-friendly backdrop, which will help to attract foreign capital. "Russia's moving in the right direction but it's still behind India and China in terms of the legislative and regulatory environment related to infrastructure development."

Sturmy at HSBC says that although there are concerns about political risk in Russia the fact that international financial institutions such as the World Bank and the European Bank for Reconstruction and Development will play a big role as advisers and financial sponsors on many of the infrastructure projects in Russia should be a source of comfort to investors. "The IFIs are helping to drive the development of both public-private partnerships and pure private sector involvement in infrastructure and carry a lot of political clout with the Russian government," he says.

He adds that the Russian authorities need the financial, management and technical expertise of international contractors and financiers to ensure that their plans are translated into reality. "The underlying logic behind private sector involvement in infrastructure development is certainty of execution – the fact that there are lots of half-completed roads in Russia is one of the reasons that the government wants to get the private sector involved in the first place."

Upgrading and expanding Russia's road network is arguably the key element of the country's infrastructure plans, as it will ultimately connect the aviation, port and rail projects. The lack of roads and their poor quality is already a big drain on the Russian economy. For example, the ministry of economic development estimates that economic losses from the poor quality of roads are running at 3% of GDP – a substantial sum given that the Russian economy has now passed the \$1.5 trillion mark. As well as the financial cost to the country, there is also a human price: the number of road accidents has increased by a compound annual growth rate of 6.4% since 2000. The number of accidents on Russian roads is 1,000 times higher than from other forms of transport in the country, and some 34,000 people a year die on the roads in Russia, 10 times more than in the UK. According to Russian road agency Rosavtodor and ministry of transport statistics, less than 40% of even the country's main roads meet Russian regulatory standards. The poor quality of existing roads is one concern, but another worry is the total absence of roads in some parts of Russia. At present 85% of the country's road network is concentrated in the western half of the country, with large parts of Siberia and the Russian Far East totally inaccessible by road. About 50,000 localities in Russia do not have year-round road access, and an estimated 15 million people – more than 10% of the population – have no access to the road network at all.

Faritov at Renaissance Capital says that improving and expanding the scope of the country's road network will be crucial if Russia is to develop the type of small and medium-sized enterprises that are a crucial component of developed economies. "For Russia to foster entrepreneurship it needs to have more and better roads," he says. He argues that although the country's rail network is well suited to servicing the needs of commodity producers that need to shift large volumes of cargo over great distances, SMEs that operate on a much more localized basis need to have enhanced road access for them to be able to deliver goods and services.

Until recently, road financing as a proportion of GDP has been minuscule. In 2006, the latest year for which figures are available, Russia spent just 1.04% of GDP on improving its roads. Russia lags well behind western European countries such as France, Italy and the UK, where the figure for 2006 averaged more than 4%, and was even lower than the 2.2% figure for Belarus and 1.6% for Mongolia. Renaissance Capital now expects that figure to increase to at least 2.5% of GDP and perhaps as much as 4%. Even so, Faritov says it will cost more than \$550 billion and take until 2020 for Russia to build the extra 451,000 kilometres of road needed to bring road density in Russia to 50% of that in Canada – which has one-third of Russia's population density. Although there is almost universal agreement on the urgent need to fix the country's creaking infrastructure, there's far less unanimity over how best to play the infrastructure theme. Part of the debate centres on whether to play it through international or Russian companies. James Fenkner, managing partner at Red Star Asset Management, argues that there is a case to be made for buying shares in international construction groups such as Austria's Strabag or Germany's Hochtief. Both are well placed to secure a greater share of business in Russia after the Kremlin's favourite oligarch, Oleg Deripaska, bought minority stakes in the two companies last year. "These are companies with experienced management teams and good corporate governance records," says Fenkner.

Aivaras Abromavicius, a partner at East Capital in Moscow, agrees that construction companies with strong track records in their home markets will be big beneficiaries of the infrastructure boom. "Russia will have opportunities for construction companies from all over the world – it's physically impossible for Russian companies to do all the work that is necessary." One of East Capital's favoured plays is Turkish construction conglomerate Enka Insaat ve Sanay. "It's already one of the largest building contractors on the Moscow market."

Others argue that while the share of Russian business won by such companies as Strabag and Hochtief will increase, it will still only form a modest proportion of overall revenues. "A foreign company really needs to have at least a 25% share of its business in Russia for it to represent a value play," says Kevin Dougherty, a portfolio manager at Pharos Financial Group in Moscow. Fenner at UFG Asset Management agrees. "Strabag is currently far more exposed to a downturn in western Europe than it is to an upturn in Russia," he says.

In terms of Russian plays, the steel sector is a strong favourite with many investors given that capital expenditure on new rail links and oil pipelines alone will likely total \$33 billion a year for the foreseeable future. Shares in steel companies such as Severstal, Evraz and Mechel also boast the high levels of liquidity increasingly preferred by domestic and international investors. "Five years ago, the steel sector was a boring value play, now it's an exciting growth play," says Michail Kart, managing partner at Marcuard Spectrum. "It's performed very well in the last 18 months and I believe it will continue to do well." He adds that although Russian steel companies are exposed to the threat of a recession in the US, rising demand at home should more than offset any downturn abroad. For those investors looking for other liquid plays on the infrastructure theme, Brady Martin, senior analyst at Alfa Bank, argues the case that real estate developers are a good proxy investment, with better road, rail and air connections helping to boost valuations. "A lot of value in the real estate market is created through infrastructure development," he says. Red Star's Fenkner feels that following the global sell-off in real estate stocks in 2007, there is now much better value in the sector. "Russian real estate developers are now trading at an average discount of 40% to net asset value versus a 40% premium, and so the sector looks like a good infrastructure proxy," he says.

Not everyone is convinced by that argument. "People wanted to believe that the real estate developers represented an infrastructure play," says Dougherty at Pharos. "But the reality is that they have been disappointing performers – a lot of companies have gotten ahead of themselves and failed to deliver on existing projects." He says that as a result of the global credit crunch, banks have cut back their credit lines to developers and real estate developers will need to demonstrate their ability to execute projects on time and on budget if they are to regain investor and lender confidence.

Although there are widespread concerns about limited financial transparency and liquidity as well as poor corporate governance standards, Dougherty at Pharos says that small-cap Russian construction and civil engineering companies are set to benefit from rising infrastructure spend. "From a risk/reward perspective they are looking more and more attractive, with the potential rewards increasingly outweighing the potential risks." He says that the key to successful investment is to have a diversified approach and to carry out extensive due diligence before committing any capital. "For every company that we invest in there are probably at least 15 companies that we look at, but which are not interesting for company-specific reasons." Ziemke at Parus Kreml says that while playing the infrastructure theme via Russian small-cap stocks is fraught with potential dangers, picking the right stock in the right sector at the right time can deliver stellar returns. "We had a very good run in [bridge builder] Mostotrest, which we bought at between \$250 and \$350. It soared to \$1,000 in the space of a month at the start of this year." In a lacklustre year for the Russian stock market – the headline RTS index was up just 18% in 2007 – Ziemke says Parus Kreml was able to generate a 40% return for its investors as a result of such selective stock-picking. So thinking small to make it big in Russia infrastructure may be the best way forward. It's certainly something to ponder next time you're stuck in one of Moscow's seemingly interminable traffic jams.