

Institutional Investor

By Craig Mellow

Empire Builders

Developer Sergey Bachin's expansive vision for Russia's real estate market stems from a simple statistic: In the Moscow area -only 2 percent of the population lives in single--family homes, compared with some 20 percent in Western European metropolises. That big gap spells enormous opportunity for Bachin's company, Open - Investments.

"Russians want to move out of the city too, but there is nowhere for them to move to," the 44-year-old CEO tells Institutional Investor. -"That's why we can build suburbs for another 20 years before the market becomes -cyclical."

Open is putting its money where Bachin's mouth is. The company built one of Russia's first gated communities, at Pavlovo, just outside Moscow, where it sold 200 homes for an average price of \$1.5 million between 2003 and 2007. It is now developing a second such community in the same -area.

Bachin has even bigger plans for a place called Zavidovo, 100 kilometers from the capital, on the route of a projected Moscow--St. Petersburg expressway. He plans to spend as much as \$3 billion over 13 years to develop a community for 5,000 families at the site. Homes will start at \$500,000, which Bachin points out is no more than the price of a decent two--bedroom apartment in the -capital.

Such aggressive growth plans have made Open a leader of Russia's rapidly expanding property sector. Investors appreciate Bachin's boldness too. They name him the best chief executive in the Real Estate sector in II's fifth annual survey of Russia's Top Business -Leaders. Other winners include leaders in Russia's fast-growing consumer sector, such as Lev Khasis, CEO of supermarket chain X5 Retail Group; and industrial barons like Alexey Miller, the boss of state-owned oil and gas producer Gazprom, and Anatoly Chubais, the head of Unified Energy System of Russia, who is in the midst of a historical, long-term transfer of the country's power utilities from the state to the private sector.

These executives come from different backgrounds and are pursuing different strategies, but they have one common denominator: --Their companies are experiencing very strong growth. Earnings at the eight companies overseen by our top--ranked CEOs jumped by an average of 39 percent in 2007. And, far from being a by--product of sky-high energy -prices or monopoly positions, profit growth is strongest in consumer--oriented sectors where competition is -greatest. Excluding the three state--owned giants on the list -- Gazprom, Sberbank and UES -- earnings grew by an impressive 55 percent.

“Five years ago, Russia was entirely a -value play,” says Kevin Dougherty, a portfolio manager at Moscow--based Pharos Financial Group, which manages about \$165 million in Russian securities. “Now there are -very few companies that -don’t have rapid growth as part of their -strategy.”

The quick earnings gains go a long way toward explaining the resilient performance of the Rus-sian stock market. The country’s benchmark Russian Trading System index, which doubled -over the previous two years, fell 15 percent from January through late March in reaction to global credit worries, but it came roaring back to show a 7.4 percent year-to-date gain through May.

Business leaders in this rapidly developing market are perforce pioneers. Although -many international observers -focus on the country’s apparent political stasis and shortage of liberalizing reforms, Russia’s foremost executives are fostering a revolution in citizens’ everyday lives in their pursuit of -profit.

Alexander Izosimov, the 43-year-old CEO of VimpelCommunications, who wins in the Telecommunications sector, has brought cell phone service to hundreds of villages that -never -even had -fixed lines; now -he’s gearing up to deliver broadband Internet ser-vices around the country. In February, VimpelCom paid \$4.3 billion to acquire 63 percent of Golden Telecom, Russia’s leading broadband provider, which is in the midst of rolling out a fiber-optic network in 65 cities across the country.

X5’s Khasis, who ranks first in the Consumer sector, is opening hundreds of modern supermarkets in hinterlands like Vologda, a province northeast of Moscow. The company added 62 stores nationwide in the first quarter, raising its total to more than 1,600. -Former Economic minister German Gref, 44, took the reins at Sberbank in November, vowing to turn the Soviet legacy savings giant -into the preferred family bank for Russia’s burgeoning consumer class.

Our list of top CEOs -also illustrates the continued emergence of professional managers from the shadows of the oligarchs and “red directors,” a term used to refer to Soviet--era man-agers-turned-owners, who dominated the privatization of major enterprises in the 1990s. Mikhail Fridman’s Alfa Group controls X5 but in 2003 gave management control to Khasis, 41, a retailing veteran who pre-viously ran central Moscow department stores GUM and TsUM. Similarly, the founders of the Interros Co. mining empire, Vladimir Potanin and Mikhail Prokhorov, own 57.8 percent of -Open Investments, but Bachin has run the com-pany since 2005.

Izosimov, a repeat winner in telecoms, is also an outward--oriented manager who spent more than a decade working for U.S. candy maker Mars and consulting firm McKinsey & Co. before joining VimpelCom in 2003. He negotiates an -often fractious divide between strategic shareholders -Alfa and Norway’s -Telenor.

At Severstal--Auto, Industrials group winner Vadim Shvetsov, 40, bought 49.3 percent of the company last year from Alexei Mordashov, the billionaire who heads steel producer Severstal, raising his stake to 58 percent.

“We’re seeing a new generation of managers who want to be invested in their businesses by borrowing -either from the market or their controlling oligarch, and that is a fine thing,” says Mat-tias Westman, founding partner of Moscow--based Prosperity Capital Management, which oversees some \$5 billion in -assets. Last month saw another such deal when managers at Sibur, Russia’s largest petrochemical producer, announced a \$5.4 billion agreement to buy 50 percent plus one share of the com-pany from Gazprombank, the financial arm of the gas - company.

Among the state managers voted as best CEOs, Miller, 46, is a career technocrat who has overseen the restoration of Gazprom by reversing the -murky spin-off of subsidiaries during the 1990s. Gref was a liberal stalwart as minister of Economic Development and Trade under former president, now prime minister, Vladimir Putin. UES CEO Chubais, 52, who wins in the Utilities sector for a fifth straight year, has been laboring for years to put himself out of a job by breaking up his vast power monopoly and privatizing most of it.

One so-called red director remains in the winners’ circle: Victor Rashnikov of Magnitogorsk Iron and Steel Works. He was overshadowed in previous years by - younger rivals like Evraz Group oligarch Alexander Abramov, who last year bought South Africa’s Highveld Steel and Vanadium Corp. for \$678 million and Portland--based Oregon Steel Mills for \$2.3 billion. But the 57-year-old Rashnikov’s relative conservatism appeals to many investors now. “Magnitogorsk is not buying expensive things abroad just for show,” says -Westman.

Rapid domestic expansion is bringing new challenges for Rus-sian CEOs, investors say. One trend is the rising importance of deal making – not the notorious kind typical of the chaotic 1990s, when some businessmen would try to cut off a rival’s supplies or have him thrown in jail in order to seize assets, but mutually agreed mergers and acquisitions or cooperative ventures with foreign -partners.

Supermarket operator X5 is one of the most--prominent products of such deal making. Alfa created X5 last year by merging two fledgling store chains, Perekryostok and Pyaterochka. The company is making another big push through the recent acquisition of Karusel. The expanded X5 is now Russia’s top food retailer by far, with a presence in everything from corner discount shops, under the Pyaterochka brand, to Karusel’s -hypermarkets.

“X5 is the consumer play with the most upside because of its strong position across most regions,” says Alexei Kretov, director of asset management at Corporate Finance, a brokerage in the southern city of -Krasnodar.

Severstal-Auto’s Shvetsov wins admiration for his artistry in striking deals with foreign partners. His com-pany bought out two -nearly -idle -auto plants in Russia’s Volga region rust belt and put them to work producing Fiats, Isuzus and South Korean--designed SsangYong sport-utility vehicles under license agreements struck between 2005 and 2007. With the Russian market booming and sales now running at more than 2 million cars a year, Shvetsov’s timing was perfect. “Severstal--Auto

actually executed all its joint venture agreements, and sales are above expectations,” Pharos’s Dougherty says. “With other companies, years and years pass and nothing happens.”

Open Investments was a first-mover in Russia’s exploding property market. The company was founded in 2002 by Interros, the holding company for Norilsk Nickel and Rosbank. In 2004, Open became the first Russian property company to make an initial public offering. Its share price has risen nearly seven times since then, more than double the gain of the RTS index, and five subsequent secondary share offerings have boosted the company’s market capitalization to \$4.5 billion, or 51 times 2007 earnings.

Open has dabbled in commercial real estate, developing the Meyerhold center, an eight-story office-shopping-hotel complex in Moscow, but it has used most of its cash to acquire 20,000 hectares of land, mostly around Moscow. Bachin also spent C\$33.7 million (\$34.4 million) in February to acquire 61 percent of Viceroy Homes, a Canadian builder of prefabricated housing.

A physics graduate from Moscow State University in the waning days of Communism, Bachin turned to commerce in the 1990s. He obtained an MBA at University of Hartford in Connecticut, then picked up management experience in the Russian operations of aircraft engine maker Pratt & Whitney and confectioner Mars.

Bachin has combined his Soviet experience and Western knowledge to Open’s benefit, investors say. He excels at the grimy bureaucratic work of rezoning agricultural land for residential and commercial use, which represents half the battle for would-be developers of Russia’s suburban utopia. “Open has been much more successful than others at adding value to their purchases,” says Alexander Golovtsov, chief of research at UralSib Asset Management in Moscow, which controls \$4.5 billion in Russian investments. “They bought farmland fairly cheap and are now set to profit by developing it.”

Open’s success hasn’t gone unnoticed. Russia’s Real Estate sector, which we include in our rankings for the first time this year, is growing by leaps and bounds. Two competing residential developers, Moscow-based PIK Group and St. Petersburg’s LSR Group, raised a combined \$2.6 billion through IPOs last fall. Golovtsov expects more than \$5 billion worth of new equity offerings by builders this year, led by Coalco, a Zurich-based developer that focuses on the Russian office market.

Although CEOs like Bachin see almost boundless opportunity in the Russian market, there are still plenty of challenges. One of the biggest is the burden of the country’s heavy bureaucracy and persistent corruption. Notwithstanding the emergence of a dynamic consumer economy, Russia still ranks just No. 143 out of 179 countries in Transparency International’s corruption perceptions index, rubbing shoulders with the likes of Indonesia and Angola.

“If you compare Russian with, say, Asian corporate cultures, Russian managers -rely more on negotiating skills with -local authorities,” says Michael Kart, managing partner at Marcuard Spectrum in Moscow, which manages \$200 million in Russia. “Where the rule of law exists, it is not always applicable to -business.”

It remains unclear whether the recent change of government heralds any improvement. After ceding the presidency in April to his protégé, Dmitri Medvedev, Putin took up a new post as prime minister and named several prominent reformers to his cabinet, led by First Deputy Prime Minister Igor Shuvalov, a lawyer and deputy head of Putin’s presidential administration, and Alexei Kudrin, who was reappointed as minister of Finance. Their presence has raised investors’ hopes for a new round of privatizations, including those of fixed--line phone monopoly Svyazinvest and parts of the Russian Railways, as well as for a friendlier climate toward -business.

A new and potentially disruptive challenge for managers is inflation, which has accelerated to a 14 percent rate from 11 percent last year. Gas and electricity prices for companies are climbing at a rate of about 25 percent a year, as the government allows Gazprom and the generating companies spun off from UES to push tariffs -closer to world levels. The country’s efforts to keep the ruble pegged closely to the dollar have added a dose of imported inflation, owing to the depreciation of the U.S. currency in global -markets.

Companies are feeling the pinch. Average wage costs in Russia shot up by 16 percent in real terms last year, whereas produc-tivity grew by less than 7 percent, says Yaroslav Lissovlik, co-head of research at Deutsche Bank in Moscow. Compensation for skilled workers and executives is thought to be rising at an even -faster pace.

Squeezing costs will require something of a paradigm shift for Russian CEOs used to focusing on fast growth and simply passing along expenses in higher prices, but investors say they need to get --started. -“It’s too -early to tell who is going to be really good at continuing to grow while holding costs down,” Pharos’s Dougherty says.

From a broader perspective, though, many investors believe time is on Russia’s side. Each year brings more young, post--Communist talent -into the economy and -eases out more of the old Soviet generation. That trend should continue to improve the performance of Russia’s companies and its overall economy. “I see Russia as less stable than most people think in the medium term, because the people are bound to outgrow the form of government they have now,” says Ian Hague, co--founder of New York--based Firebird Management, which manages \$3 billion in Eastern Europe. “But in the long term, I travel around the country and meet all these smart 28-year-old managers, and that is very -encouraging.”