Beyond Moscow and St. Petersburg Investment Opportunities Abound

By Jason Corcoran

Western investors are increasingly turning their attention from Russia's twin gateways of Moscow and St. Petersburg to what Russians call *millionniki* – cities with a population of more than a million. International property agency Jones Lang LaSalle used the expression recently to describe 11 Russian cities that are fast becoming the next hot spots for commercial real estate investment. Opportunities are not just in property, but also in retail, banking, telecom, transport and mining, and are leading fund managers on a scenic shopping route from Volgograd and Rostov-on-Don in the southeast of the country to Omsk and Novosibirsk in Siberia.

While markets are reaching saturation in Moscow and St. Petersburg, disposable income is rising in regional cities, where rents and competition are lower. "It's clear that there are a lot of attractive targets in the regions," says Stephen Cohen, chief executive of the hedge fund business at Troika Dialog, one of Russia's biggest investment groups. "GDP growth per capita in the regions is much stronger than in Moscow and St. Petersburg. Actually, the rate of growth for many economic indicators is actually faster in the regions."

Penetration levels for goods and services are significantly lower than in Moscow, with GDP per capita only one-third that in the capital. Retail loans per capita of $600 and housing loans of $120 per capita are less than half the levels seen in Moscow, while in such sectors as broadband Internet and media, penetration is around one-tenth of the capital's levels.

Cohen's $150 million Cayman-registered fund has exposure to a number of fast-growing companies, such as Ursa Bank, a leading regional bank headquartered in Siberia's Novosibirsk, and Center Telecom, the fixed-line operator in the Central Federal District, where more than 20 percent of Russia's population lives.

One of the key challenges for equity investors is finding profitable investments in the regions beyond obvious commodity plays in oil, gas and metals. Peter Halloran, founder and chief executive of Pharos Financial Group, which runs about $300 million in three Russian

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funds, identifies modern retailing as a significant driver of growth. "Moscow and St. Petersburg have built up retail outlets over the past seven years, but the rest of Russia has only started making this transition recently," he says.

"Real disposable income is growing at a 23 percent annual rate, thus fuelling demand for consumer goods of all types, but especially for electronics and other high-value goods that are not purchased in outdoor markets," notes Halloran. "As these modern retail outlets expand across the country, so does demand for modern warehousing facilities, which are in extremely short supply."

Growth of Retail Chains

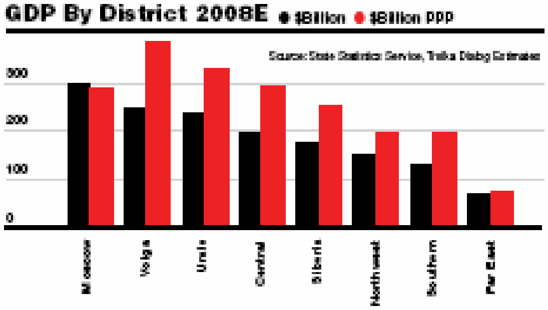
Swedish furniture chain IKEA and its vast Mega Mall shopping complexes have become a retailing phenomenon in Russia, transforming Russians into home improvement fanatics and stimulating consumer economies and commercial real estate in far-flung regional cities. IKEA already has three outlets in Moscow and two in St. Petersburg. Now it is building outlets in 12 regional Russian cities, including Volgograd, Nizhny Novgorod, Rostov-on-Don, Voronezh, Novosibirsk, Samara and Ufa.

IKEA's Mega Malls house well-known foreign chains as well, such as Russian retailers M.Video and cosmetics chain Arbat Prestige.

M.Video, the country's second-biggest electronics retailer, sold $365 million of its shares last year in an initial public offering to fund openings of new stores as sales growth has outstripped capacity. The company came to the market in November, at the peak of the global liquidity crisis, a time when several Russian companies opted to cancel their own listings. Despite market conditions, the listing was deemed a success, as it was priced at $6.95, the middle of its expected range, and rose as high as $7.24 in its debut on the Russian Trading System stock exchange. The company is using the proceeds to continue its regional expansion and has recently opened hypermarkets in Barnaul, Lipetsk, Kostroma, Kemerovo, Tyumen, Stavropol, Astrakhan, Novosibirsk and Rostov-on-Don.

"Increasing the number of M.Video electronics stores in Russian cities is the foundation of our strategy," says Michael Kuchment, the chain's commercial director. "In particular, the company is interested in strengthening its positions in the most dynamic Russian regions, such as the Southern Federal District and Siberia."

GDP By District 2008E ● $Billion ● $Billion PPP



X5 Retail Group, Russia's largest grocery chain, is also driving retail expansion in the regions. It has more than 1,000 stores and plans to open an additional 900 stores this year, with hopes of hitting $6 billion in annual sales. The group has stores in 22 regions of the Russian Federation and has lately been buying out local franchises in strategically important regions, such as the Urals and the Central region.

The London-listed company postponed a $1 billion secondary offering in September last year. Instead, it borrowed $1.1 billion in three-year loans in January to refinance debt, but it stated that a secondary equity offering remains an option in the future. Group chief executive Lev Khasis says he intends to pursue a "diversified financing strategy."

The Regions' Differences

The 85 regions and seven federal districts of Russia are in very different stages of development. "In broad terms," says Kingsmill Bond, chief strategist at Troika Dialog, "the Urals and Northwest districts are around four years behind Moscow, followed by the Siberian and Volga districts, while the Far East, Central and Southern districts have lower levels of development."

The Urals Federal District, which is nearly as large as Sweden, is the heart of Russia's raw material sector, with 68 percent of its oil and 91 percent of its gas extraction. Meanwhile, agriculture makes up 15 percent of the Southern Federal District's economy, more than twice the national average, and manufacturing is most significant in the Northwest, Siberian and Volga districts.

Bond says investors can best gain exposure to the regional story by playing such sectors as broadband, media, retail, banking, consumer goods, automotive and real estate. "Companies we favor include VTB, ComstarUTS, WimmBillDann, PIK Group, X5 Retail Group, and pharmacy chain 36.6. All are making a major push into the regions," he says.

Originally a small wholesale company, 36.6 was the first Russian retailer to conduct an IPO in 2003, raising $14.4 million. It has since evolved, through acquisitions and by opening new stores, into a national chain of pharmacies in 29 regions throughout Russia. "We were focusing on the *millioniki* cities, but we are now targeting regional cities of 500,000-plus," says Masha Zhog, who heads the company's investor relations. "There is still a lot of room to develop when you realize there is only one pharmacy for every 2,500 people, compared with one for every 300 to 500 people in the UK."

Zhog says the chain, which raised a further $150 million in a secondary offering in November, is currently looking at refinancing its $270 million credit portfolio.

"We are still looking at increasing our market share. We have recently expanded into Sochi on the Black Sea and into Siberia," he says. "But this year, we are more concerned about consolidating our market-leading position."

Government Stimulus

In the run-up to Russia's presidential elections on March 2, prominent government ministers have made a number of proposals to stimulate investment in the regions. Regional Development Minister Dmitry Kozak, a longtime ally of outgoing President Vladimir Putin, announced plans to devolve more authority to the regions and to arrange additional funding from the federal investment fund.

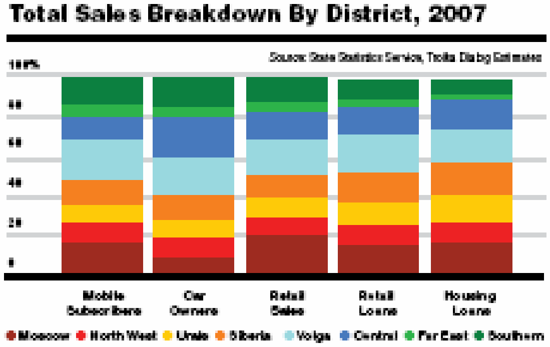
Russia's 85 regions would be allocated R1 billion ($42 million), on average, and be grouped into seven to 10 economic "macroregions." These regions would be similar to the seven existing federal districts but would be organized according to economic issues. "What we have in mind," said Kozak, "is seven to 10 macroregions that have common economic features, and in which, above all, policies specific to them can be carried out to develop their infrastructures with long-term development forecasts in view."

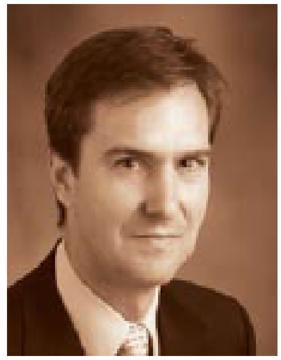
Prior to the election, the main presidential contender, Dmitry Medvedev, said the government will spend about R570 billion to develop transportation and energy infrastructure over the next seven years in Russia's Far East.

The government's priority is to promote clusters of growth rather than invest in depressed regions. One plan is to create a major Siberian hub by merging the regional capital Irkutsk with the towns of Angarsk and Shelekhov. Funding is expected for improving the Baikal-Amur Railway and a new airport in Irkutsk, along with developing the defense industry. The government says it will devote R30 billion to the remote, Far Eastern regions of Magadan, Chukotka and Kamchatka. Infrastructure is also a priority in Kamchatka, where construction of a new gas pipeline will start this year.

Now that deregulation of the electricity grid UES is almost complete, the government is keen to attract investment in its vast, shambling rail system. Vladimir Yakunin, boss of RZD, Russia's rail monopoly, has

Total Sales Breakdown By District, 2007





Peter Halloran
Pharos Financial Group

stated that RZD will need R13 trillion over the next two decades to modernize its steel railway network, to construct new railroads for high-speed passenger trains and to upgrade rolling stock.

Says Chris Weafer, chief strategist at Uralsib, a leading bank and insurance group: "[Yakunin] told us RZD has a value of about $75 billion, and they want to raise $15 billion, or 20 percent of the company's value, in the markets."

In January, the European Bank for Reconstruction and Development agreed to pay €134 million ($203 million) for an estimated 10 percent stake in RZD freight subsidiary TransContainer. RZD says it plans to follow up with the sale of a stake of 25 percent to 30 percent in TransContainer through an IPO this year. Further share issues in 2009 are planned in Moscow and London for such units as RZD's First Cargo Co., of which 50 percent has been earmarked for privatization.

Once all the subsidiaries have been disposed of, investment bankers say the parent RZD is eyeing an IPO worth a potential $12 billion before 2010.

RZD is Russia's largest employer with 1.3 million employees, but the revenues per employee that it generates are only about 7 percent that of its US peers. Uralsib's Weafer says RZD will have to compete with other privatizations, such as that of telecom monopoly Svyazinvest and other infrastructure sectors, to attract investment. "There won't be another event like the breakup of UES [Unified Energy System of Russia]," he says. "Russian railways have a huge opportunity for growth, and IPOs will be a feature, but there will have to be a lot of consolidating and restructuring first. I can see M&A playing just as big a part for RZD." RZD has already been buying up stakes in ports and a 50 percent stake in Aeroexpress, the company that will operate the rail link to Moscow's Sheremetyevo airport.

Two other high-profile, government-sponsored projects are the development of the Sochi area, to prepare for the 2014 Winter Olympic Games, and of the oil industry in Eastern Siberia, says Halloran of Pharos.

The Sochi effect has already kicked in: Many foreign and domestic firms are bidding for contracts to build the Olympic village, hotels, venues and communication networks. The Federal Target Program for the Development of Sochi (FTP) combines public (60 percent) and private (40 percent) investments amounting to more than $12 billion.

Eastern Siberia is a vast, unexplored and untapped region for the oil and gas industry. To open the area up for production, the full range of infrastructure – pipelines, railroads, employee facilities – needs to be built. "This is seen at the highest political levels as an essential national project," says Halloran, "and it will move forward regardless of any global developments." ■