Making money in Moscow

With developed markets stagnant, emerging nations hold the globe's growth prospects. But can expansion in investment banking revenue in Russia keep up with Brazil or China?

By: Dominic O'Neill

On a crisp winter's night, the Kremlin walls and the Moscow river can paint a romantic picture for the visitor. Bankers more accustomed to the balmy climes of the French Riviera, however, might need more persuasion to set up camp here permanently.

So, should banks in London or New York bloat teams with overpaid expatriates in Moscow – one of the world's most expensive cities – in anticipation of an investment banking boom in Russia?

Even now, indeed especially now, the Bric (Brazil, Russia, India, China) nations are a byword for the rosier prospects awaiting capitalism, outside the traditional centres. Yet some would like to take away the 'r' from Bric, arguing that Russia is a country more in decline than ascent.

However, if Russia's institutions continue to crumble, investment banks can still make money in Russia in some business areas, if global demand for its vast natural resources keeps up thanks to growth elsewhere. Also, although Russia has a shrinking population, if more wealth from mineral exports is spent at home, the population will have more money to spend on consumer goods, which brings opportunities in areas such as M&A.

Russia's export competitiveness continues to decline, as the oil price stays high. Moreover, the protests against last month's disputed elections were a reminder that the oil price is not the country's only big risk. The protests caused the stock market to tumble and bond yields to spike, helping topple bond sales, including one by state development bank VEB.

Yet with oil prices holding up, the IMF predicts a relatively high 3.5% rate of GDP growth for Russia this year. This should be good news for western investment banks faced with higher human-development indices but lower GDP growth from home markets. Eurozone banks in particular are hoping, perhaps wishfully, to gain more fee income in Russia, now that their ability to provide dollar financing has declined.

"Banking in the region is no longer about loan growth for the sake of loan growth," says Gianni Papa, UniCredit's head of Central and Eastern Europe, and for whom Russia is by far the biggest market. "[Loan growth] will remain an important part of the activity. But we need to offer more products and services aside from mere financing."

Russia is also the biggest concern for Slawomir Krupa, Société Générale's regional CEO. "From now on, our growth in the region will be more focused on flow and structured financing, and some investment banking," says Krupa.

Société Générale, UniCredit and Raiffeisen have the biggest franchises of the foreign-owned commercial banks in Russia.

In investment banking, firms such as these will focus more on the mid-market corporate sector – introducing simple hedging and derivatives products, for example, or arranging local-currency bonds, rather than getting involved in the more exciting big-name and high-level, event-driven equity and M&A transactions.

Will there be enough business from the bigger deals to spur such firms as Goldman Sachs, Deutsche Bank, Morgan Stanley, JPMorgan or Credit Suisse to build up much bigger investment banking teams in Moscow? Perhaps, in the hope of replacing business lost further west in Europe because of the eurozone crisis and its effects, but anecdotal evidence would suggest otherwise.

The investment banking crowd at the international firms in Moscow might even be thinning, thanks to a lacklustre second half of 2011. The city will likely continue to see bankers packing their bags this year, as deal flow remains lethargic, at least in the short term, as a result of the eurozone sovereign-debt crisis.

Partly because fees in public M&A and capital markets deals tend to be quite low in Russia, the bulk of even big investment banks' revenue might continue to come from the flow side of their businesses, at least in the immediate future. In terms of more quantifiable investment banking revenue from public deals, the market is not big enough to command legions of bankers from international firms in Moscow. This is particularly so as the investment banking subsidiaries of VTB and Sberbank grow (see feature on page 98), driving up salaries and using their existing client relationships to win deals at the expense of the international firms.

According to Dealogic, total investment banking revenue in Russia for the first 11 months of 2011 was just over $800 million, compared with just under $700 million in 2010. That includes all disclosed or modelled fees from M&A, DCM, ECM and syndicated loans.

MOST OF THE INTERNATIONAL firms that Euromoney spoke to in Moscow in December were hesitant to boast of any big expected increases in staff. The average size of their Moscow teams is about 100, with core advisory teams perhaps numbering only about 10 people (sector-specific teams fly in from London or elsewhere).

For a population of 140 million people and a GDP of $1.5 trillion, not to mention a landmass of 17 million square kilometres, this is not a very high GDP per investment banker – as one investment banker puts it. But the shortage reflects Russia's macroeconomic and socio-political instability.

"Investment banks have traditionally been ambivalent as to the sustainability of revenues in Russia," says Daniel Jacobowitz, co-head of Russia investment banking at Deutsche Bank, adding that his own firm has been something of an exception, given its acquisition of local firm UFG in 2004. As Jacobowitz says, Russia's size and growth numbers give it the markings of a potentially attractive market – but then the country has also suffered setbacks such as the sovereign default of 1998.

Such worries still prevent investment banks from scaling up their teams today. Moreover, political concerns weigh heavily on investment decisions too. Take the Yukos affair of the early 2000s, or the political protests that flashed across the country at the end of 2011. The latter was a reminder of how in Russia, as in the Middle East, governments sometimes only gain short-term stability by cutting off the institutional outlets for popular discontent.

Meanwhile, reliance on high oil prices, as well as on foreign and domestic borrowing, seems likely to increase as the Russian government, like its Arab counterparts, tries to spend its way out of trouble. Late last month, the government looked likely to post a surplus of around 0.6% of GDP for 2011, according to Barclays Capital. But Barclays was already expecting a 1% deficit in 2012.

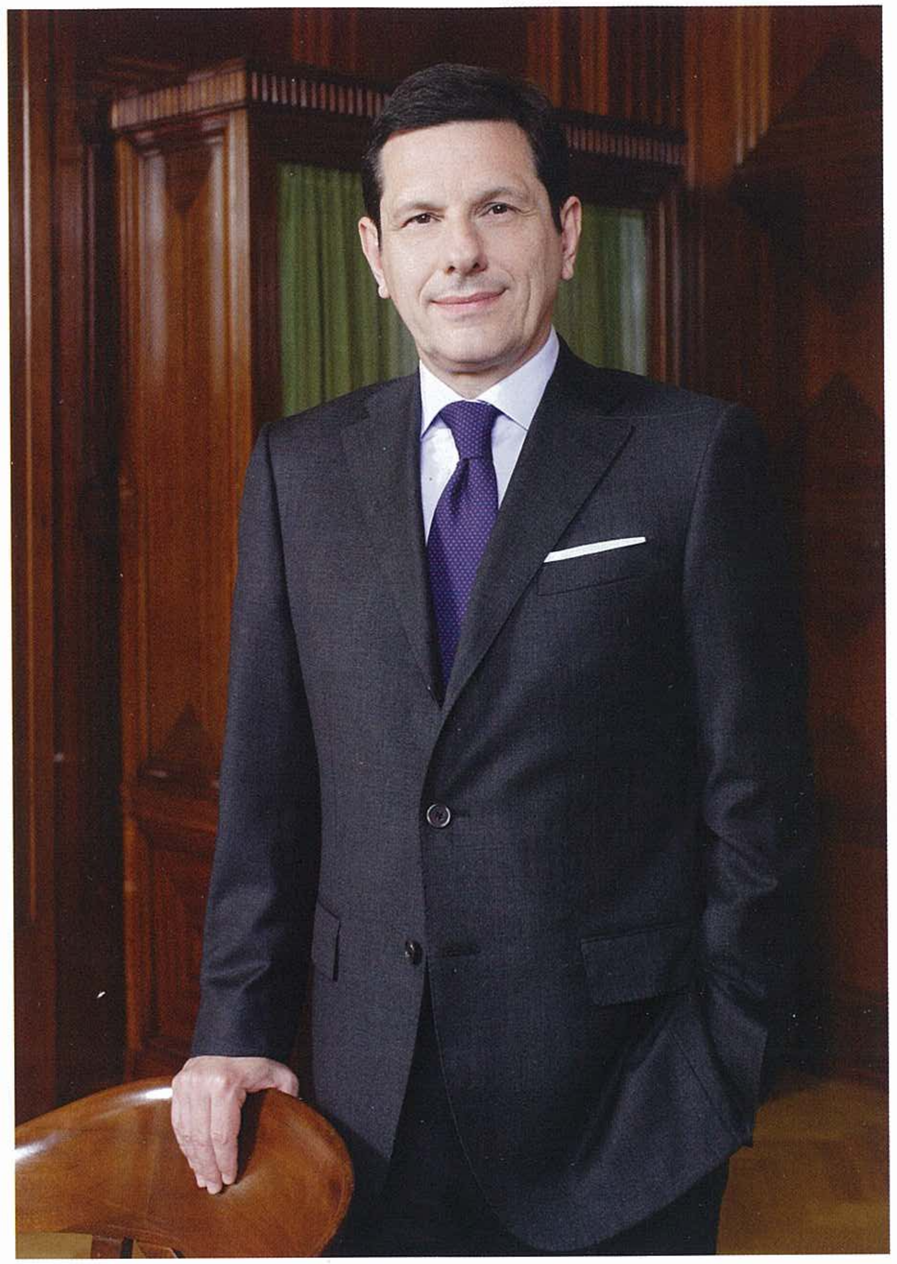
The sovereign says it will increase annual foreign borrowing to $7 billion in the next two years. This will bring investment banks more revenue. Last month, banks were pitching for a sovereign Eurobond expected early this year. That will be its first Eurobond since 1998's $5.5 billion two-tranche issue in 2010.

More generally, with eurozone banks less able to roll over loan financing, and with investors still shunning the equity markets, 2012 might be another year for disintermediation via the fixed-income market. However, more DCM issuance by the government and by the strongest names – which are also often state-owned – might shut off issuance to the needy.

The Russian government's intention to sell stakes in state-owned firms on the stock exchange could be the only near-term catalyst for any investment banking boom in Moscow. The government said this summer it would raise R1 trillion ($31 billion) by 2013 by selling down some key holdings. This privatization drive is one of the few reasons some international investment banks bother to have offices in Moscow at all.

Public-private partnerships in the infrastructure sector could also bring advisory and hedging mandates. Morgan Stanley estimates that capital expenditure on infrastructure to 2015 will amount to between $60 billion and $65 billion annually. Legislation needs to be changed, however, to allow more private investment; there is no easily replicable model in Russia for public-private partnerships.

Privatizations on the stock exchange



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> Gianni Papa, UniCredit

are not always an easy earner, either. Perhaps partly due to perceived or real obstacles to transparency in state institutions, banks can end up spending time talking to the wrong officials and losing the mandate as a result. Also, the government will not sell assets at any old price.

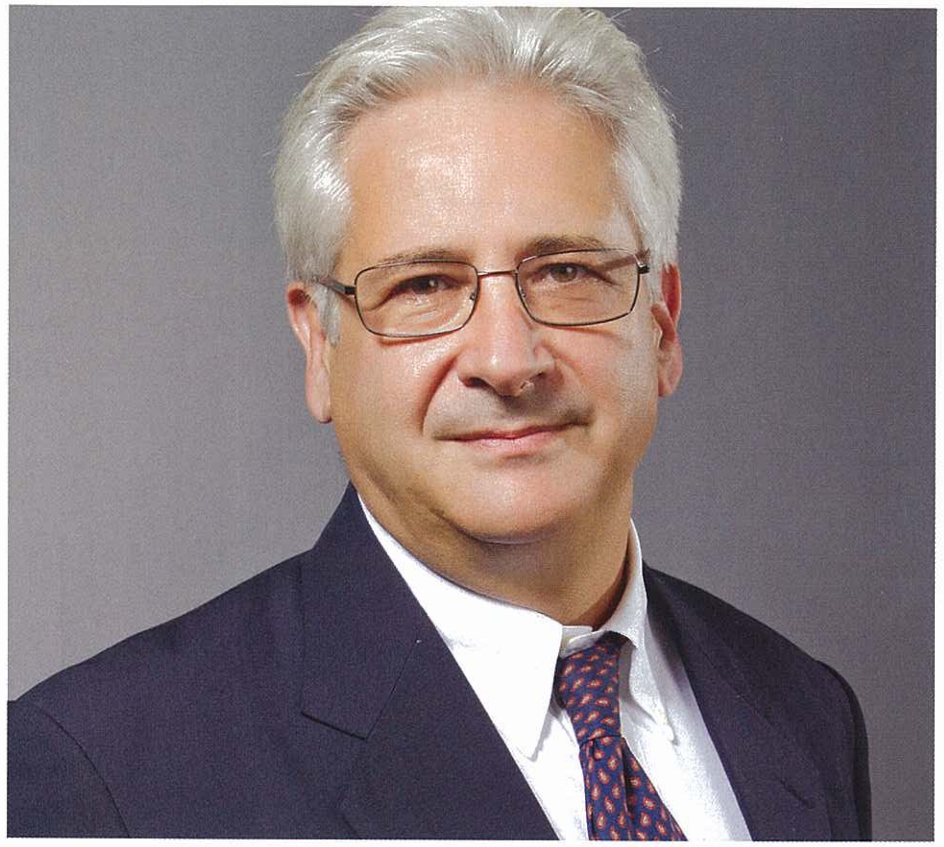
The state gained $3.3 billion in a sale of 10% of VTB's stock in February. But a slated sell-down of 7.6% of Sberbank's stock was postponed in September, as Russia's main equity indices lost around 15% over the summer. The drop in valuations in the second half of last year has further blocked a congested IPO pipeline.

Some bankers believe oligarchs will try to raise more money on the equity markets, either out of the desire to diversify or because their hold on their firms is stronger. But valuations are still the deciding factor for issuance volumes and numbers, even if bankers say there is the potential for much more primary market activity.

Russian equity issuance, both on local and international exchanges, totalled just over $10 billion in the first 11 months of 2011, compared with just under $8 billion in the same period in 2010, according to Dealogic.

Rising capital flows to global emerging market equity funds might help, if it happens, once investors regain their risk appetite – perhaps in the second half of next year. But corporate governance and transparency concerns, when added to Russia's perceived vulnerability to oil-price shocks, consistently earn this market a discount. The average price-to-earnings ratio in Russia is 5.4, compared with an average emerging-market ratio of 8.7, according to research from Troika Dialog.

GREATER CONCERNS ABOUT political stability have also added to the problems in valuation. JPMorgan expects the psychological effect of the street protests last month to linger for several months in the equity markets. Private equity sales might be an alternative – perhaps involving state-linked



entities or family offices, and investment vehicles such as Suleiman Kerimov's Millennium Group or Vladimir Potanin's Interros Holding.

Yet Russia's billionaires often expect their firm's management to come up with their own M&A ideas. With corporate institutionalization and more diversified shareholding structures, firms might need to listen more to international investment banks' advice. But for the moment, global banks often have little to offer in negotiations between Russian owners. "Two oligarchs can decide on a merger without us," says one banker at a US firm.

For international banks, for now, there must usually be an international element to any M&A mandate involving Russia. In the case of in-country mergers, for example, the firms would probably have international shareholders, perhaps because of a listing outside Russia. UralKali's $7.8 billion acquisition last year of fellow potash miner Silvinit is such an example. Goldman Sachs and VTB Capital advised UralKali, which has a secondary listing

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in London; Bank of America Merrill Lynch advised Silvinit.

"Russian companies will seek to snap up assets on the cheap outside Russia after the eurozone crisis," says one banker. Firms such as Oleg Deripaska's Basic Element might do more to diversify away from Russia, says another banker. Sberbank's $600 million acquisition of the international operations of Austria's Volksbank is one possible example of Russian firms (in this case, state-owned) buying up distressed assets.

David Walker, an M&A-focused

Russian Railways: investing in the future

Russian Railways is one of the largest railway companies in the world. The company employs 1 million staff and carries nearly 1 billion passengers and 1.2 billion tons of cargo per annum. Its extensive network includes 85,200km of railway lines. The government of the Russian Federation is the sole shareholder in Russian Railways

The company's mission is to meet the market demand for transportation, increase the efficiency of its activities and the quality of its services, and secure integration into the Eurasian transport system.

Strategic goals of Russian Railways include:

- To grow the transportation business in Russia
- To boost the company's production and commercial efficiency
- To increase the quality of work and the safety of transportation
- To deepen the integration of the Russian railway network into the Eurasian transportation system
- To improve the company's financial sustainability and efficiency.

Investment policy

Since the company's inception its investment expenditure has been constantly growing. Over the past nine years Russian Railways capital investments have totalled over $91.9 billion, while the 2011 investment budget increased by 1.5 times as compared to 2004. The priorities of the company's investment policy include the development and the re-equipment of the national railway infrastructure, the modernization of the rolling stock, increasing speed for both passenger and freight trains, ensuring the safety of transportation, implementing new management techniques and optimizing the management structure.

The "state strategy for developing the railway transportation until 2030" sets large-scale goals for Russian Railways aimed at modernizing the country's infrastructure. The strategy stipulates that by 2030 over 20,000km of new railway lines will be put into operation and some 7,500km of lines will be electrified. This will make it possible to provide transportation services to 18 promising mineral deposits and industrial zones throughout Russia. The total value of investment projects exceeds $411.9 billion. Russian Railways accounts for about 40% of this amount, part of which the company plans to attract from the international capital markets.

Key projects implemented in 2003-11

High-speed trains

Russian Railways has invested $2.3 billion in Russian high-speed trains. The new trains, called Sapsan ('peregrine' in English) and Allegro, can reach a speed of 250km/h. Sapsan was launched in December 2009 on the Moscow–St Petersburg line and six months later started to serve the Moscow–Nizhny Novgorod line.

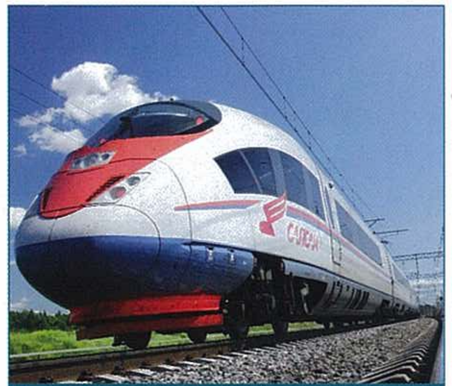
In December 2010 Russian Railways launched the Allegro train on the St Petersburg–Helsinki line, reducing the journey time by half to less than four hours. It is expected that the construction of a separate high-speed main line between Moscow and St Petersburg will allow speeds to increase to 400km/h, while the journey time will be reduced to 2.5 hours.

Renewal of rolling stock

When the company was established in 2003 it was obvious that the fleet of rolling stock inherited from the Ministry of Railways was becoming obsolete. This is why investment in re-equipment of rolling stock is one of the main targets of Russian Railways. Over the past eight years the company has invested $12.2 billion in new rolling stock, putting into service more than 2,100 locomotives, some 5,500 passenger cars, over 53,000 freight cars and 5,200 multiple-unit cars. The growth rates of investment in the company's transportation fleet have been continually increasing – within the next three years Russian Railways will spend nearly $6.3 billion on renewal of its rolling stock.

2014 Sochi Olympic Games

Russian Railways is playing a key role in preparation for the Olympic Winter Games, which will be held in Sochi in 2014. The company's investments in the Sochi project total $7 billion. All investments are channelled into two main areas: modernization of the current infrastructure and building of new routes. The main project of Russian Railways



Sapsan high-speed train

is a unified motor road and railway line from Adler to Krasnaya Poliana, the main venue of the games.

By August 2012 the company will finish reconstruction of the stations at Dagomys, Sochi, Khosta and Matsesta. In the third quarter of 2012 a new passenger terminal at Adler railway station will be put into operation. This will become a transportation hub uniting rail, motor, air and marine transport. The terminal will consist of six levels and will be connected with Sochi airport. The floor area of the terminal will reach almost 30,000 square metres. Its capacity will be 15,000 passengers an hour. In a single day the terminal will service 56 pairs of long-haul and suburban trains as well as four express trains an hour.

In 2013 Russian Railways will launch 48km of electrified railway lines and 46km of motor roads. The implementation of the project will allow Olympic contenders and spectators to be carried by rail and road to the mountain stadiums of Krasnaya Poliana.

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> Daniel Jacobowitz, Deutsche Bank

banker at Troika Dialog, says more big-ticket inbound M&A deals will result, for example, from the need for international technological prowess, as Russia seeks to exploit mineral resources in less-accessible terrains. Similarly, Russia's fast-moving consumer-goods sector remains attractive for international firms, he says.

Some of the biggest, recent inbound takeovers have been in retail: for example, PepsiCo's $3.8 billion buyout of Moscow-based juice and dairy firm Wimm-Bill-Dann in late 2010; the $1.5 billion tie-up of SABMiller's Russian operations with those of Turkish brewer Anadolu Efes last year; or Unilever's $700 million acquisition of the Russian skincare firm Kalina, also in 2011.

The lure of the retail sector will probably increase if the government ramps up spending because of the protests. Indeed, retail-orientated stocks have held up well in the last month.

However, part of the problem for international banks is international bankers. Russian state-owned banks, such as Sberbank and VTB, often enjoy better relationships and connections because of their corporate banking business and ownership. They also have the economies of scale in Russia to afford more expensive bankers.

M&A and capital markets deals might still involve international advisers, alongside the likes of VTB and Sberbank, and state-owned banks have the capacity to offer financing to back up deals and make deals happen – bringing some benefits to international banks – but overall the need for international banks might be eradicated.

SBERBANK'S MOVE INTO investment banking, meanwhile, is partly motivated by the general desire to boost Moscow's status as a financial centre. If that is at least partly successful, it might bring a bigger investment banking revenue pot overall.

One aspect of the problem for the Russian capital markets is the lack of domestic pools of capital, partly due to the lack of a developed pensions and insurance sector. Sberbank's tie-up with Troika Dialog might help with this. Troika Dialog claims it has a 22% share in Russian mutual funds, even if this is still an undeveloped market – just 0.3% of GDP under management, according to Troika Dialog.

"What the asset-management industry always lacked was the big, dedicated player capable of deploying capital," says Anton Rakhmanov, head of asset management at Troika Dialog. "Troika Dialog's advertising was limited according to its size. Associating investment products with Sberbank's brand should accelerate sales."

Recent regulatory improvements, such as the merger of the two main stock exchanges and the move to a centralized securities depository could help develop Russia's capital markets.

Conversely, since the second half of 2011, there has been a trend among Russian corporates toward premium listings in London – notably Polymetal last year. It demonstrates the challenges still faced by Russia's capital market. The moves might be partly motivated by the desire to protect against political interference in Russia – fear of which is another barrier to the development of the private sector in the country.

Starting with government-linked issuance, there are efforts to make more roble-denominated bonds tradable via Euroclear, which removes foreign investors' need for a local trading account in Russia. Last year, for example, the government issued a two-tranche seven-year international bond totalling R90 billion ($2 billion).

"Making roble bonds Euroclearable will make the market more liquid, and it will be a step towards making the roble a major currency," says Alexis Rodzianko, CEO of local investment bank IFC Metropol.

The central bank's support via repo facilities, has helped keep volumes and tenors in the roble bond market have been on the up during the past two years. The total volume of roble-denominated bond issuance increased to $25 billion in the first 11 months of 2011 from $22 billion the year before – roughly equal to Russian firms' total Eurobond issuance in the period, according to Dealogic.

However, among the international firms those with Russian commercial banks – such as Raiffeisen and Société Générale – dominate rankings in the local bond market, partly because in the absence of any other large institutional investors, local roble bonds are, by necessity, taken up by the local banking sector. EM