From Russia with interest

Investors in Russia are reaping the rewards of a strong economy and improving corporate governance policies, discovers Marc Smith

As the credit crunch claims investment bank victims and hits western stock markets, one country is bucking the global trend and providing the savvy investor with a lucrative alternative. The Russian economy has performed exceptionally well in recent times, which has led to seven Russians making it into the top 25 wealthiest people in the world.

"As the credit crunch has continued to weigh upon the global economy, Russia has consolidated its position as one of the few markets capable of acting as a genuine alternative for capital 'fleeing' the West," said Alexander Branis, founder and CIO of Prosperity Capital Management, one of the largest portfolio investors in Russia.

The reasons for his confidence are rooted in Russia's minimal exposure to toxic sub prime products and the heavy weighting of commodity-focused stocks on Russia's stock exchange (the RTS). Since last August, the RTS index has risen 18%, compared to just 3.5% for the S&P500 and the country also has a strong corporate earnings outlook.

The Russian economy is not just about oil and gas. Reports from the country's state statistical service Rosstat show that fourth quarter growth in 2007 was 9.5% year on year – the second quickest growth achieved in the post-Soviet era – and this growth was centered on the non-energy sectors – particularly construction (up by 13.1%), services (12.2%) and manufacturing (7.3%).

Family businesses have benefited from the growing economy. "Both economic growth and the change of the Russia's financial rating have given us a prominent advantage, namely the opportunity to develop joint business schemes together with international market participants," said Victor A Semenov, founder of family-owned diversified holding group Belaya Dacha. "The main benefit is in the large volume of credit resources now available in the country."

Semenov is also keen to highlight the benefits of investing in his country and in businesses such as his. "People should invest. And the earlier investments are made, the more benefit they will provide," he said. "Family corporations are underestimated in Russia, even though their capitalisation is increasing year on year."

So far, it has been more common for investors, including family offices, to invest indirectly. "We are investing in Russia via equity funds," the head of a Geneva-based single family office told *Families in Business*. "It is purely for diversification reasons," he continued, adding that the lack of a local contact prevented them from investing directly.

But as with any emerging economy there are still risks investors need to be wary of. Corporate governance is perhaps the biggest stumbling block for potential investors. While change is inevitable, old habits established during previous political regimes can be hard to shift.

"The Yeltsin-era of opacity is finished and today there is a much greater willingness and requirement for full and open transparency," said John Sandwick, managing director of asset management company Encore Management. "While some predatory business practices persist, we find a greater adherence than ever to the rule of contract law and the willingness to pay one's fair share of taxation. This is not yet a universally accepted business practice, but more widespread than ever before."

Semenov agreed: "We are learning the art of corporate governance from western companies. On the whole, many corporations in Russia have made significant progress in this sphere recently, but it's still too early to talk of worldwide standards in the corporate culture."

Traditionally, many Russian businesses, including family businesses, are highly fractured with no single entity owning or controlling anything of substance. However, the move to greater transparency has started to change this. "We've witnessed a willingness to consolidate, often resulting from the requirements of simple bank lending or more sophisticated international capital," explained Sandwick. "Business owners understand that despite risks associated with transparency, including in some few cases appropriation risk, there is still a very strong demand from domestic lenders and international investors to have clean, clear and modern capital structures, with lines of responsibility and ownership clearly demarcated."

Outside investors remain cautious yet optimistic. "We are aware that Russia has a higher risk profile," said the Geneva SFO head, "but we accept this because the returns are large enough."