

**Russia's boom is spreading**  
prosperity to the provinces  
and driving a surge in  
lending by regional banks

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# Institutional Investor

NOVEMBER 2007 WWW.IIMAGAZINE.COM  
INTERNATIONAL EDITION · EUROPE

## Trading Up?

Kevin Parker is remaking Deutsche Asset Management with an aggressive push into alternative assets. Now can he make some money?

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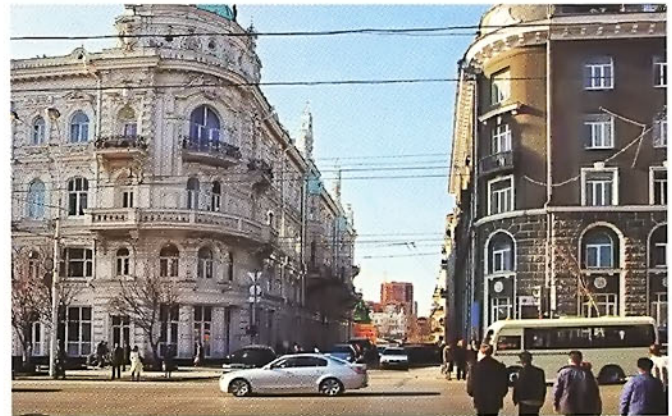
**RUSSIA**



# Banking on the New Frontier

Russia's economic boom is bringing prosperity to its far-flung provinces and driving a boom in regional lending.

**By Craig Mellow**



Chairman Vasily Vysokov (far left) and his wife Tatyana (top right) have built Center-Invest into one of Russia's leading regional banks with populist products such as high-interest savings accounts for war veterans. City scenes from Saratov (top and middle rows) and Rostov-on-Don (bottom) attest to growing provincial prosperity

VYSOKOV: STANISLAV BURDON; ROSTOV-ON-DON: VALERY MATYSIN/ITAR-TASS; SARATOV: OLEG NIKISHIN/GETTY IMAGES

**A** S THE CAPITAL OF AN AGRICULTURAL Russian province that has historically eked out a living from growing grain and sunflowers, Rostov-on-Don has always been something of an economic backwater. The city of 1 million, situated near the Ukraine border some 600 miles south of Moscow, lacks the natural resources of the Siberian oil capital Tyumen or mineral-rich Yekaterinburg in the Urals. But as Russia's oil-fueled economic boom, now in its eighth year, continues to spread wealth around the country, Rostov is rapidly sprouting signs of a rising prosperity. The city's

downtown district bustles with cars and trucks that rush among dozens of new outlets for national retail chains, such as cell phone store Evroset and upscale food emporium Perekrystok. Cranes loom over a half dozen high-rise apartment towers under construction.

The surging wealth has already caught the eye of Ian Hague, co-founder of New York-based Firebird Management, a \$3 billion-plus hedge fund firm with holdings throughout Eastern Europe. The firm acquired a 10 percent stake in Rostov-based Center-Invest Bank with two undisclosed private equity investments, in 2003 and 2004, betting that the country's then-nascent economic upturn would spread

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Express-Volga's Dmitri Dylnov (left) more than doubled consumer lending in Saratov last year and is looking to expand in neighboring provinces; Center-Invest deputy chairman Vladimir Glushko says problem loans remain modest despite the surge in lending; the Conservatory building graces central Saratov

to the provinces and spur demand for credit. So far Hague's bet has proved spectacularly right.

On a recent investment trip to Moscow and Tbilisi, Georgia, Hague made a stop in Rostov to visit with Center-Invest's deputy chairman, Vladimir Glushko. In a windowless conference room at the bank's headquarters, Glushko handed Hague a single sheet of paper with figures indicating that the bank's blistering 2006 growth — a 58 percent rise in interest income and 66 percent jump in profit, to 517 million rubles (\$21 million) — was continuing this year. Since Firebird first invested in the bank, deposits and loans have grown by a multiple of five and profits have jumped sixfold. Hague conservatively estimates that his investment has generated a 150 percent return so far. "This is what I really came to see," a delighted Hague told Glushko.

Hague, 46, is on the prowl for more winners among the 1,000 or so Russian banks based outside Moscow (the capital boasts 217), aiming to invest an additional \$100 million in the sector. "I'm going to need more investments like Center-Invest if I'm going to give my investors the returns to which they have become accustomed," he notes wryly. Firebird reports a compound return of 33.6 percent a year over the past ten years on its flagship Firebird Fund.

Other investors in Russia are following suit. Renaissance Capital, a homegrown star of Moscow investment banking, launched a \$200 million private equity fund, RenFin, last year to invest in regional banks and promptly bought a 15 percent stake in Vostochny Express Bank, situated in the Far Eastern city of Khabarovsk, for an undisclosed amount. RenFin also holds a 7.3 percent stake in Center-Invest.

Stockholm-based East Capital, which manages \$7 billion in Eastern Europe, last year earmarked €350 million (\$499 million) for investment in non-traded banks in the former Soviet Union. It paid €29.9 million for a 10.3 percent stake in Probusinessbank Group, a Moscow-based lender with wholly owned regional subsidiaries in Yekaterinburg, Saratov (a formerly closed military city on the banks of the Volga) and Ivanovo, the textile center of the former Soviet Union. The firm also spent €10.8 million for an 18.75 percent stake in Kedr Bank of Krasnoyarsk, Eastern Siberia's metals hub. East Capital's biggest investments are in neighboring Kazakhstan, where it invested €69.6 million for a

3.36 percent stake in Bank TuranAlem, and in Ukraine, where it paid €38 million for 6.62 percent of Nadra Bank.

The lure of the hinterlands is easy to see. About 80 percent of the country's banking capital is massed in Moscow, fighting for access to less than 10 percent of the population. Growth in some outlying provinces, though, is now outpacing the rate of expansion in the capital, according to the World Bank. "As Moscow and St. Petersburg have become more congested and expensive, the attractiveness of surrounding regions for investment has steadily increased," the Bank states in its latest economic report on Russia in June.

Meantime, an influx of foreign banks has driven up the acquisition of prices of major Russian lenders. Over the past 18 months, international players have acquired a half dozen Moscow-based banks, paying as much as four times book value. By contrast, stakes in regional rivals are selling for two to three times book, according to several investment funds. Sergey Nazarov, director of RenFin who previously oversaw Russian bank investments for the European Bank for Reconstruction and Development, says, "Regional banks are not spoiled on valuations." Not yet, at least.

The investors also attest to an aura of small-town virtue at the provincial banks, compared with their big-city cousins, many of which have balance sheets larded with loans to related parties and depend on fickle wholesale markets for funding. "Regional banks are surprisingly straightforward, with a funding base in their own deposits and real banking businesses," says East Capital senior analyst Margot Jacobs, who used to cover the sector for Deutsche Bank in Moscow. "They had no access to oligarch clients, so they had to do it the hard way."

Deploying money in regional banks isn't easy, though. Financial services are so underdeveloped and fragmented outside of the capital that there are few sizable targets for investors. Center-Invest is the ninth-biggest bank outside of Moscow and St. Petersburg, but it had only 23 billion rubles in assets as of January. "Regional banks have always done better in terms of retail and small-business lending, but there are only two or three really strong ones," says Richard Hainsworth, president of the Moscow bank-rating agency RusRating, which is 30 percent owned by Firebird. "The funds may find that the amount of money they can

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**Regional banks are surprisingly straightforward, with a funding base in their own deposits and real banking businesses.**

—Margot Jacobs  
 East Capital

usefully invest is less than what they have available.”

Regional lenders are also facing growing competition from the country’s biggest banks. Fifteen national banks opened new branches in Saratov oblast between January 2006 and June this year, according to executives at Express-Volga Bank, the Saratov-based lender owned by Probusinessbank. Saratov boasts 16 banks of its own, but only three — including Express — have more than €5 million in capital. And some bankers worry that today’s credit boom could quickly turn into a crunch if Russia’s economy slows or oil prices decline. “We have no culture of paying back debts,” says Dmitri Dylnov, management board chairman of Express-Volga.

For now, however, there are few signs of a downturn, and regional bankers are moving quickly to capitalize on the buoyant economy. In Rostov oblast the economy grew by 8.7 percent last year, ahead of the national average of 6.4 percent, boosting the per capita income to 61,142 rubles (\$2,472). Spanking-new branches of Russia’s biggest lenders, including Alfa-Bank, Impexbank and VTB 24, the retail banking division of Vneshtorgbank, line the main thoroughfares. A poster advertising Bank of Moscow mortgages adorns a passing bus.

An IKEA store under construction on the city’s outskirts provides evidence of the improving fortunes and fast-rising aspirations of the local population. “Half the city is working for IKEA,” Glushko quips, quickly adding that Center-Invest is financing construction of a new auto dealership next door to the Swedish home furnishings store. On residential streets many of the two- and three-room cabins that have housed residents since pre-Soviet times have been knocked down and replaced by three-story brick homes with chalet-style slate roofs. “I know my job is to talk about how bad everything is, but the fact is, things are going pretty well,” says Elena Kulakova, editor-in-chief of the *Southern Reporter*, a Rostov-based weekly newspaper.

Center-Invest, the biggest local lender after state-owned giant Sberbank, boasts a proud, albeit recent, local heritage. The bank was founded in 1992 by chairman Vasily Vysokov, an economics professor at Rostov State Economic University, along with his wife, Tatyana, who heads the board’s audit committee, and Glushko, both lecturers at the university.

Although most Russian banks of the 1990s hid their owners behind layers of shell companies, Vysokov is an avowedly public figure who styles himself as a patriot seeking to revive Rostov’s 800-year history as a river delta trading center. His marketing has a populist touch: The bank has attracted clients through promotions such as offering higher-interest savings accounts to war veterans and state-subsidized mortgages for poorer families. “Vysokov has made social consciousness a big part of the Center-Invest brand,” says Yelena Tonna, an EBRD executive who oversees the institution’s investment in the bank.

Unlike the founders of many family enter-

prises in Russia, the Vysokovs have been content to yield management control of their creation. Hague invested in Center-Invest after meeting Vysokov at a forum sponsored by RusRating’s Hainsworth in Moscow in 2003. The following year the EBRD acquired a 27.45 percent stake and instigated a management reshuffle that promoted Anna Shtabnova, who had overseen the bank’s relationships with foreign institutions, to chief executive, removing the Vysokovs from operational control. One year later Deutsche Investitions- und Entwicklungsgesellschaft, an arm of the German state-owned development bank KfW Bankengruppe, acquired a 22.45 percent stake.

“The bank has gotten a lot bigger and needs new people,” says Hague. “The Vysokovs opened themselves to that transformation.”

The arrival of national banks offering credit at rates as low as 10 to 11 percent has cost Center-Invest some of its bigger customers, such as regional utility Rostovenergo. But the bank claims to have more than compensated for such losses by expanding its lending to small businesses. Center-Invest asserts that it has a 38 percent market share of small-business lending in Rostov oblast, charging rates of 17 to 18 percent. Other regional lenders have transformed their business in similar fashion. As RenFin’s Nazarov explains, most local businesses are too small to attract the interest of bigger banks, and they are content to deal with local bankers rather than wait for credit decisions to come down from Moscow. “The top 30 national banks just try to cherry-pick the biggest four or five enterprises in any region,” he says.

So far the trade-off appears to be working for Center-Invest. Busi-



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ness loans of more than a year's duration jumped 39 percent last year, to 3.2 billion rubles. One loyal customer is Stellar, a toy manufacturer just outside the center of Rostov that was started by local entrepreneurs Vladimir Efremenko and Vladimir Davydov in 1994. Fueled by credits from Center-Invest, the company has grown to 570 employees, but its factory might charitably be called dilapidated, with Soviet-era lathes and presses churning out plastic teddy bear heads amid materials stacked ceiling-high for lack of warehouse space. Production is split between five such overstuffed facilities spread across town. The partners dream of building one big factory on the outskirts of the city. If they manage another year or two of 10 percent growth in the face of stiff competition — Chinese firms are breathing down their necks — their dream may come true.

The growth of retail lending is even more dramatic. Center-Invest increased credit to individuals by a stunning 3.4 times during 2006, to 4.9 billion rubles. That represents 12 percent of the provincial market, or fully 35 percent if Sberbank is excluded. Roughly half of the bank's retail business is secured lending for housing or autos; the remainder is made up of unsecured credits averaging about 90,000 rubles each. Glushko estimates the rate of "problem credits" at less than 2 percent and jokes that "Tatyana [Vysokova] tells us we need to take more risks."

To keep up with demand, the bank opened 19 new offices last year, and it expects to establish 20 more by the end of this year, giving it a total of 117. At the flagship branch in downtown Rostov, customer service desks are arranged in a horseshoe and tidily groomed employees, most of them recent university graduates, patiently explain a raft of options, from personal credit lines to mortgages.

"I'm impressed with what I see," says Hague, as he observes activity from a cozy couch beside the receptionist's desk. "People are trained. They know how to sell the range of products they provide."

Competition has narrowed retail lending margins. "In 1999 we loaned money at 75 percent," Glushko recalls with a hint of nostalgia. Today rates range from a minimum of 12 percent on mortgages to a maximum of 20 percent for personal loans. But lower rates are fueling demand, and the bank is making healthy profits, with funding costs of just 7.5 percent on one-year deposits.

**S** LIGHTLY LARGER THAN ROSTOV, SARATOV and its sister city, Engels, across the Volga, are home to some 1.2 million people. The surrounding province enjoys a slightly higher per capita income of 64,634 rubles but shows fewer signs of growing wealth. Saratov looks like it is still in shock from the collapse of the Soviet Union 16 years ago and the accompanying plunge in military spending.

Commerce is budding, nonetheless. Nikolai Kara-Kush, a public relations manager at Express-Volga, takes a visitor to a small store crammed with pot-bellied stoves and other equipment for making home saunas. It was opened recently by Alexander Borodin with a 500,000 ruble credit from the bank.

Another Express-Volga client, Alexander Koshelev, runs a tailor shop in the ruined concrete shell of a onetime Soviet department store. Despite having been gutted by fire, the huge premises serve as an informal business incubator, with improvised offices throughout the building. "I guess we're getting into this market early," says East Capital's Jacobs. "It looks like there's nowhere to go but up."

Amid these inauspicious surroundings, the dapper Koshelev runs a surprisingly elegant atelier with long racks of tailor-made suits awaiting pickup by Saratov's emerging upper class, while half a dozen seamstresses work in the adjoining room. Like many small-business owners, Koshelev used to rely on cash before he became a customer of Express-Volga two years ago. "I got tired of going to Moscow with bags of money to buy cloth," he recalls. "A friend of mine said this bank was honest, so I tried them."

Express-Volga is a corporate descendant of the Saratov branch of Zheldorbank, an in-house financier for the Russian Railways. It was bought in 2006 and repositioned as a local lender by Probusinessbank, Russia's 51st-biggest financial institution. (East Capital is actually an investor in PBB, owning Express-Volga indirectly.) To jump-start growth, the owners recruited a new boss in Dylnov, a Saratov native who had been in the neighboring city of Samara running a branch of Bank Menatep, the financial arm of Yukos Oil Co. founder Mikhail Khodorkovsky's now-defunct empire. The 39-year-old banker brought Menatep's go-go culture with him. "The client who says, 'I need money here and now' — that's our segment," he says. "We are expanding very aggressively, especially in retail."

The bank's consumer lending grew by 119 percent last year, to 3.3 billion rubles, making it the dominant player in the province, with 17 percent of the market.

With growth beginning to slow in its home market, Express-Volga is looking to expand in smaller cities in central Russia, where financial developments are "a year or two behind Saratov," says Dylnov. "We stay away from the bigger markets, where the Moscow banks come in willing to lose money." He brags that the bank has become the second-biggest lender in Tambov oblast, an agricultural province in the fertile black-earth region south of Moscow.

At Center-Invest, Vysokov, who still has strong influence over strategy as chairman, is also looking to expand outside his home province, believing the bank can become a large regional covering much of southern Russia. His first priority is to add to the bank's existing five branches in neighboring Krasnodar province, which contains the big Black Sea port of Novorossiysk and a nascent tourism industry based around Sochi, which was recently awarded the Olympic Winter Games of 2014.

The question remains whether Center-Invest can establish the same kind of hometown appeal it has cultivated during the past 15 years in Rostov. Vysokov is putting his business diplomacy to work on a regional level, creating the Southern Education and Science Fund this year to distribute grants to promising students across the bank's hoped-for new footprint.

The outcome of the bank's development efforts will have a big bearing on the exit strategy of Center-Invest's foreign shareholders. Nazarov of Renaissance leans strongly toward a trade sale. "When we get to the point of serious regional expansion by either big Russian banks or foreigners, they will have no choice but to buy us," he says during an interview in his Moscow office. He expects such a sale to take place in about three years.

Firebird's Hague leans toward an eventual IPO, hoping for a repeat of the killings his fund made on previous stock offerings by Bank of Georgia and Kazkommertsbank in Kazakhstan. He dismisses a sale to a bigger bank as reflecting the "ideological bias" of the EBRD, which has fostered the sale of many Eastern European lenders to larger foreign institutions. "Vysokov may need me when the endgame comes here," he says.