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Russian homebuilding: A top-performing sector over the next decade

This long-term growth story can be accessed first via developers, then construction materials producers

The construction of new housing – especially of the affordable variety – has become the focus of policy initiatives by the Russian government designed to stimulate both demand and supply. These efforts are targeting a 2010-20 CAGR for the sector of 9.4 per cent. An outcome anywhere near this target would signify a boom, to which investors focused on the Russian market should seek optimal and sustained exposure. And the impact of any such housing boom on economic growth (not to mention social welfare and political stability) would strengthen the case for increased overall exposure to Russia.

Key judgments

- In no sector does the phenomenon of post-Soviet catch-up retain greater potential than in housing (with the possible exception of financial services, which, in any case, is closely related to homebuilding via mortgage lending).
- This long-term potential combines with a favourable conjuncture as demand for real estate pulls out of its crisis nosedive and resurgent inflation provides additional fuel.
- But the real engine of strong sustainable growth is to be found in two key government policy initiatives: on the demand side, the mobilization of individual pension savings for mortgage financing; and, on the supply side, providing government land plots for viable affordable housing developments. There is already strong momentum in both of these areas.
- In combination, these drivers presage neither a routine bounce-back nor another flash-in-the-pan surge but a multi-year expansion of new housing construction.
- This growth story can be played through property developers and producers of construction materials including steel, glass and cement. We see a case for sequenced exposure, starting with recovering developers like **PIK (PIKK RM)** and concentrating in the longer run on materials. The dynamic **LSR Group (LSRG RM)** falls into both categories.

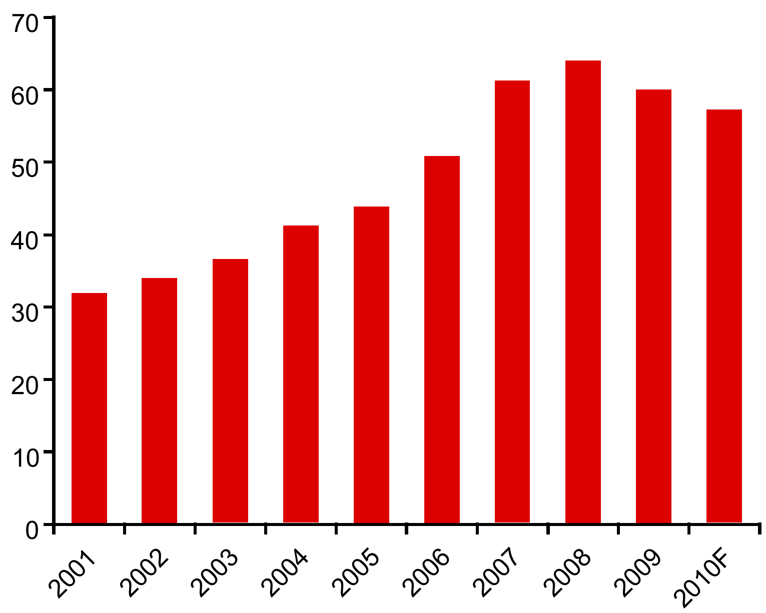
Context

This report examines the powerful combination of drivers that we believe will make homebuilding not only a top performing sector throughout this decade but also an important contributor to the overall growth of the Russian economy.

Recent housing sector history: More than meets the eye

The sector's recent record may be summed up as "boom followed by stagnation", which, though an improvement on the boom-bust pattern of the wider economy, would not appear at first glance to point to a sustained success story in the decade ahead. In the four years leading up to the recent financial and economic crisis, the sector grew 60 per cent – twice the pace of GDP during the same period. In absolute figures, the 40 million sq m of new residential floor space completed in 2004 rose to 64 million sq m in 2008. This surge was fuelled by funding from the government's affordable housing initiative, which, like other so-called national priority projects, was supervised by Dmitry Medvedev in his previous capacity as a senior government minister. While running for the presidency in early 2008, Medvedev proclaimed the goal of more than doubling the annual housing construction growth rate to 140 million sq m (that is, about 1 sq m per capita) by the end of 2010. This forecast would not have been borne out even under continued boom conditions – if only because of the supply constraints, which we review in detail below.

Chart 1: Completed housing construction, 2001-10 (million sq m)



Source: Rosstat.

Homebuilding proved relatively defensive through the depth of the post-2008 recession (completed new projects were down 6.7 per cent year on year in 2009 compared with a 15 per cent decline for the construction industry as a whole) but continued to contract in 2010 even as the wider economy turned the corner back into growth. Completed new housing fell 10 per cent in 2009-10 relative to 2008, while overall industrial output was down 1.2 per cent.

While this underperformance may look mild compared with the preceding growth surge, the figures themselves are problematic. Regional officials have a habit of booking around half the annual total of completed housing construction projects in the last several weeks of the year. This, in itself, would not matter if it were not for suspicions of double counting: based on anecdotal reports, projects frequently receive preliminary registration in December (a time of year when developers know that officials will be receptive so that they can boost their regions' performance in this politically high-priority sector) before being re-booked the following year as new projects.

Further distortion over the past two years has resulted from the "dacha amnesty". This popular and important reform is designed to put a stop to country retreats remaining designated indefinitely as "unfinished construction sites" in order to avoid paying property tax. Legalized dachas are counted as new homes even if, in reality, they are far from new. This means that the total homebuilding tally will have been inflated by the newly registered portion of the estimated national total of 90 million sq m of dacha plots.

So it may be that the sector has paid a higher price for the preceding boom than is suggested by the official preliminary figure of 58 million sq m completed in 2010 (down from the 2008 peak of 64 million sq m). Even taking that figure at face value, the contraction would have been far deeper – owing to the impact of the credit stop on over-leveraged private sector developers – if it had not been for sharply expanded financing of housing construction from the government's anti-crisis programme. Out of a total government funding package of Rb500 billion in 2009 (up 130 per cent year on year), around half was used to acquire unfinished projects from financially troubled developers. The remainder was directed towards financing mandated housing entitlements. The most important of these is for military personnel, especially World War II veterans, which accounted for Rb210 billion out of a total of Rb360 billion appropriated for homebuilding in the 2010 federal budget.

Though large, these numbers are declining in line with the post-crisis fiscal consolidation: the 2011 federal budget earmarks Rb250 billion for the sector. It follows that recovering private sector demand will have to match this contraction in the stimulus from the state budget merely to stabilize the level of new housing construction after two years of decline. We expect this test to be passed easily, and we see an alignment of four other factors that will brighten the lacklustre picture of the past two years.

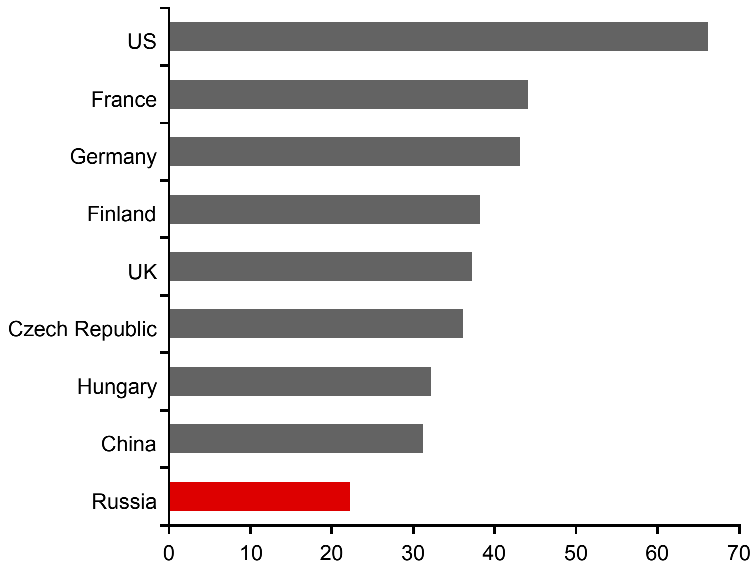
Four drivers of housing construction growth

We begin our analysis with the longer- and shorter-term factors: these are, respectively, the underlying catch-up potential in the size of housing stock relative to the population and the present conjuncture pointing to a brisk recovery in private spending on housing (on both the secondary and the primary market). We then turn to two medium-term factors that are set to become the "engine room" drivers of the expected sustained healthy growth in homebuilding: the mobilization of pension savings to finance the expansion of affordable mortgages, and a raft of supply-side reforms that cover a wide range of areas but will all help reduce costs for developers and final purchasers. These factors will both fuel and balance supply and demand.

Driver No. 1: Fundamental catch-up potential

Modern housing construction always lagged industrialization and urbanization in Russia. This was especially true under Soviet central planning, when resources were piled into factories required to meet five-year plan targets. The required labour was sourced from the villages (where the bulk of the population had hitherto lived in simple wooden dwellings); millions were assigned to temporary barracks, while the more fortunate were sent to live in the pre-revolutionary housing stock (the notorious communal apartments). A massive programme of housing construction that started from around 1960 under Khrushchev gave millions of urban families their first separate (albeit tiny) homes. However, the total housing stock remains not only well below that of developed nations but on a par with countries many times poorer than Russia.

Chart 2: Per capita living space, mid-2000s (sq m)



Sources: Rosstat, UNECE.

The fact that this catch-up potential existed was clear even before the sector's initial surge during the years before the 2008 crash. But a deeper historical context provides a useful reminder of how tightly the spring is coiled for further expansion. In contrast to other sectors that were left underdeveloped or ignored by the Soviet central plan and in which rapid growth since the 1990s has already approached a plateau (for example, beer and other consumer goods), the normalization of the size of the housing stock will take at least another one to two decades to complete. According to growth forecasts by the Regional Development Ministry, which oversees the sector, Russia's housing density will have increased from 22.4 sq m per capita (see Chart 2 above) to a mere 24.2 sq m per capita by the mid-2010s. The main reasons for housing being a longer-term affair than other components of the post-Soviet catch-up are the capital intensity of housing development, its dependence on material real increases in incomes and savings, and the link – through mortgage lending – to the equally long-term process of financial deepening and the maturing of the financial services sector.

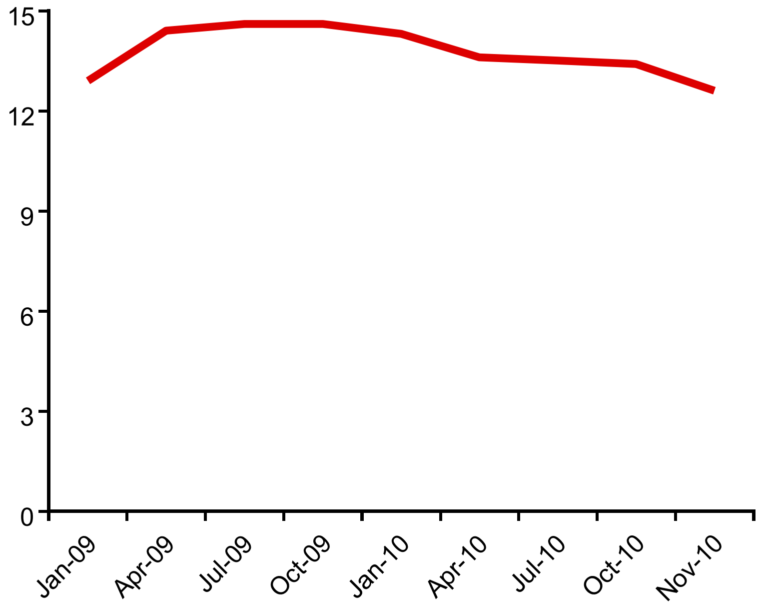
The sector's well-known potential is reinforced by another important feature of the present homebuilding scene – the programme to resettle hundreds of thousands of families living in officially recognized slums, which was launched by Vladimir Putin in 2007. Since then, Rb217 billion has been committed out of a total Rb240 billion endowment transferred from the oil-windfall Stabilization Fund to a special purpose agency called the Fund for Housing and Communal Services Reform. As a result, 113,000 people have already been re-housed. But while this very substantial investment will have improved the average quality of the housing stock, it will not have increased the headline quantity because existing (albeit dilapidated) accommodation has been replaced. In short, not even an initiative as important as this will have significantly dented the inherent potential.

Driver No. 2: Favourable conjuncture as private demand recovers

It was only during 2010 – some 18 months after the financial crash of 2008 – that the housing market began to show unmistakeable signs of recovery. This turnaround was visible in volumes well before it showed up in prices. The bellwether secondary market in Moscow saw the number of transactions increase by more than half in 2010 compared with 2009, but reviving demand met with abundant supply that had been pent up by the crisis. As a result, overall price gains were minimal (below the full-year consumer price inflation outturn of 8.8 per cent). At the same time, potential buyers' minds were concentrated by the prospect of prices heading upwards. The listed homebuilder PIK (see the "Relevant Companies'" section below) more than tripled its pre-sales of apartments in 2010.

To take a fundamental overall sector indicator, overall mortgage lending jumped 125 per cent year on year to at least Rb340 billion (pending publication of a definitive figure by the Central Bank, this estimate comes from the Agency for Home Mortgage Lending, a government entity described in detail below). This strong showing is flattered by the low base in 2009 and was assisted by important policy drivers, to which we will return. But the recovery was also pushed by falling average interest rates on mortgages, which ended the year close to their record pre-crisis lows of 12.4 per cent in Q1/08. Sberbank, which has a 55 per cent share of the mortgage market, dropped its lowest rate in Q3/10 to 9.5 per cent (however, this rate is available only to its best retail customers among the employees of companies whose payroll accounts are held in the bank).

Chart 3: Average mortgage rates, 2009-10 (per cent)



Source: CBR.

Against this background, it may seem surprising that completed housing construction fell year on year in 2010. But as suggested in the preceding discussion of output trends, housing completions are a lagging indicator. Last year's impressive production growth in basic construction materials like cement and reinforced concrete (both up 14 per cent year on year) points to strong underlying momentum in housing starts as a key segment of the overall construction sector.

One of these short-term stimuli – falling mortgage rates – has already run its course, since sharply rising inflation will lead to monetary tightening (although, at the time of writing, the Central Bank has fallen behind the curve). Even on the safe assumption that interest rates remain low in real terms, the sensitivity of Russian borrowers to nominal rates will result in some weakening of marginal demand. But overall demand growth will nevertheless be maintained not only on the back of the continued recovery of real incomes but also because of the very same inflationary factor. This will increase the attractiveness of real estate as a store of value relative to bank deposits and other financial assets and provide incentives for home buyers to pre-empt the sustained price increases now in prospect.

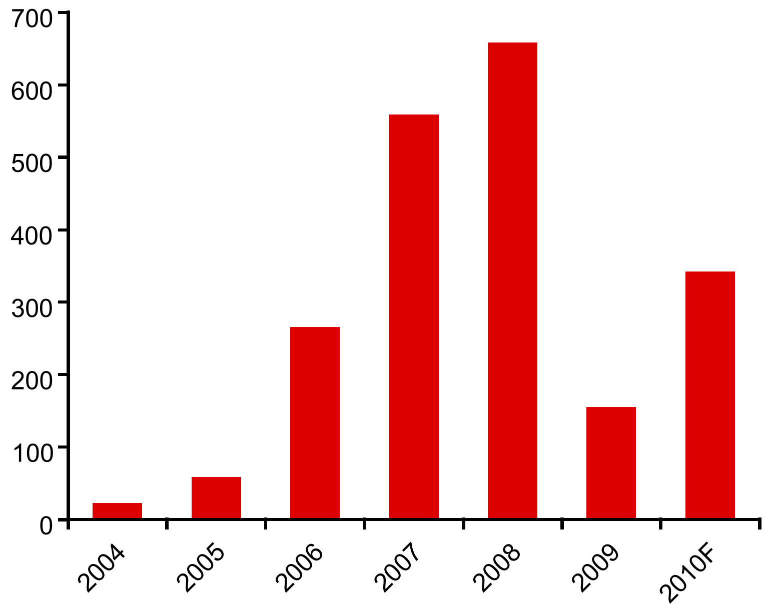
Driver No. 3: Mobilization of long-term mortgage financing

The most important reason for the bounce-back in mortgage lending in 2010 brings us to the first of two systemic changes capable of driving sustained strong growth in housing construction with reduced vulnerability to Russia's volatile business and credit cycles. One of the most serious threats to the prospect of sustained investment-led growth in Russia is the chronic scarcity of domestic long-term financing mobilized through classic savings products. This lack of long money has obvious and particular relevance to mortgage financing. But a breakthrough came in 2010 when, for the first time, savings in the state pension system were tapped to finance mortgages.

The total financing – including a contribution from the National Well-Being Fund (NWBF) – came to Rb250 billion, almost all of which was used to buy mortgage-backed securities (MBS). A central aim of this policy (including the supply-side aspects, which we discuss below) is to expand the primary market in affordable housing. Accordingly, the detailed rules for these mortgage refinancings state that the underlying loans must have been originally extended no earlier than H2/09 in amounts that do not exceed Rb3 million in the regions and Rb8 million in Moscow and St Petersburg.

A brief look at the background to this mobilization of pension savings for mortgage financing will help make clear the importance of this development. As is usual in the story of Russian reform, the path has been long and tortuous. A first mortgage law enacted in 1998 was ineffective. Its most serious flaw was to prevent lenders foreclosing on delinquent borrowers. It took until 2004 for this to be corrected. Only then did the mortgage market begin its strong growth.

Chart 4: New mortgages issued, 2002-10 (Rb billion)



Source: Rosstat.

But financing remained a constraint. The Agency for Home Mortgage Lending (AIZhK), established in its present form at around the same time (2004), was given the mandate of using its lower cost of capital resulting from state guarantees – worth up to Rb100 billion/year – to make mortgage borrowing more accessible. Meanwhile, the potential leverage created by the passage of enabling legislation for mortgage securitization in 2003 proved difficult to exploit. One impediment was not removed until as recently as March 2010, when an amendment to the 2004 MBS law reduced the minimum down payment on mortgages eligible for securitization from 30 per cent to 20 per cent. By far the most important change, however, came in late 2009, when MBS were made an eligible investment for pension savings.

The savings in question are the individual retirement accounts that accumulate under the so-called "third pillar" of the state savings system for employees born after 1967, which is mainly funded by a (small) portion of employers' payroll taxes supplemented by employees' voluntary top-up contributions (which can attract some matching government funding). Nearly 90 per cent of employees do not take up their right to choose from the approved list of private fund management firms to look after their accounts, and the individual pension savings of this silent majority are managed instead by the state financial agency VEB. Before the 2008 crisis, these funds were largely invested in ruble-denominated government bonds with a negative real yield. A law enacted in July 2009 stipulated that the savings of the "silent ones" would henceforth be invested in a riskier portfolio of municipal and corporate bonds as well as MBS not guaranteed by the state (for more details on this important reform, see our May 2009 report A bet on pensions).

The mortgage-related parts of this reform were implemented in decisions of the VEB supervisory board (chaired by Putin) in March and November 2010. The main elements are:

- VEB to lend to AIZhK its Rb40 billion profit from investing NWBF resources in domestic equities at the bottom of the market in Q4/08; AIZhK to pay a low rate of 9.5 per cent on this credit line;
- VEB to allocate Rb50 billion of its own resources to buy MBS from banks at a rock-bottom 3 per cent coupon;
- VEB to invest Rb100 billion from individuals' pension accounts into MBS with a 9 per cent coupon;
- VEB to invest a further Rb60 billion from pension accounts in refinancing state-guaranteed bonds issued by AIZhK.

The total of Rb160 billion of pension savings mobilized for mortgages (that is, the last two items in the above list) is in keeping with the government decision that a maximum of 20 per cent of the total resources in VEB-managed individual pension savings accounts – now Rb800 billion – may be allocated to mortgage financing. VEB has announced that this Rb160 billion was fully taken up by the end of 2010. At first sight, this may suggest an imminent falling off in this policy-driven demand stimulus for the primary housing market. And the same conclusion could be drawn from the winding down of mortgage subsidies offered by various regional governments as part of their anti-crisis programmes launched in 2009. In Novosibirsk, for example, the regional authorities helped buyers of newly built housing with a contribution of Rb800,000 towards down payments and heavily subsidized interest payments.

In practice, however, there are several reasons for suggesting that this increased mortgage financing will have a sustained effect – especially on new housing construction:

1. The Rb160 billion of pension savings directed towards mortgage refinancing will have created slack on banks' balance sheets for fresh mortgage lending. This slack will be taken up during 2011. As suggested by guidance from the leading listed homebuilder PIK that the proportion of sales financed by mortgages will rise from an average of 8 per cent in 2010 to 30 per cent in 2011, an increasing share of fresh mortgage lending will be directed to primary market purchases in the expectation of further refinancing for mortgages granted to buyers of newly built housing.
2. This expectation is soundly based. Annual inflows into VEB-managed individual pension savings accounts are close to the equivalent of US$4 billion; assuming the 20 per cent rule sticks, this implies an

annual Rb24 billion of new money for mortgage financing. And in the plausible event that the NWBF – which was sitting on US$90 billion at the end of 2010 – was once again tapped for this purpose, the amount would be higher still. There will also be a multiplier effect from the use of pension money to refinance AIZhK paper, coming on top of the Rb40 billion recapitalization of the agency in 2009.

3. The very low cost of official mortgage financing in 2010 (especially the Rb50 billion from VEB at 3 per cent) was part of a sector-specific stimulus programme to revive construction projects stalled by the crisis: banks were given a good margin on lending first to financially troubled developers and then to final buyers of new apartments at 11 per cent.

4. This state subsidy to banks, allowing them to turn a profit in a challenging environment for mortgages, should blunt the deterrent effect on mortgage lenders stemming from the crisis-related surge in non-performing mortgage loans (according to the AIZhK, one in 10 mortgages are in arrears). In any case, this deterrent will be felt least in the primary low-cost market. Several mortgage lenders in Moscow and the surrounding region report that the most frequent problem mortgages have been business development loans taken out by entrepreneurs and secured on their own homes.

In summary, even if fully commercial mortgage lending is unlikely to grow as fast as in the pre-crisis period, these government initiatives to support mortgage lending to buyers of newly built homes lend credibility to official forecasts that, after doubling year on year in 2010, mortgage lending will double again over the next two years to regain the pre-crisis peak – namely, the Rb650 billion in mortgages issued in 2008. We would stress again that the policy-driven demand stimulus through mortgage financing is firmly directed at the market for affordable new homes. It supplements direct federal budget spending on housing for entitled groups (for example, the military) and offsets the decline in that spending from the annual levels of Rb500 billion and Rb363 billion seen in the 2009-10 anti-crisis programmes to the more modest annual average of Rb60 billion envisaged under the government's Housing Programme for 2011-15.

Driver No. 4: Unleashing the supply side

The government's efforts to promote affordable housing began in earnest with the 2005 launch of a national priority project of the same name. But the incremental demand stimulus in an already inflationary environment outstripped the supply response, which was hobbled by the usual bureaucratic inefficiency and corruption. Three problem areas stand out:

- Limited availability of land plots designated for residential construction under new town planning procedures which were introduced in 2005 to bring some order to previously arbitrary decision-making but which, in practice, are impossibly cumbersome;
- Permits for housing developments, which are notoriously expensive and time-consuming to obtain – especially in Moscow (taking an average of 18 months according to official data, but developers report many instances of three-year waits); and official approval of completed developments for occupancy on the basis of Soviet-era quality standards, which are for the most part contradictory and unrealistic;
- Infrastructure: developers face long waits for utilities, connection charges are unpredictable and arbitrary, and builders are confronted

with demands to defray the cost of building associated infrastructure.

All of these problems aggravated house price inflation, undermining the whole affordable housing agenda. One of Medvedev's first policy initiatives on becoming president in May 2008 addressed this problem by creating a new agency called the Fund for the Promotion of Housing Construction Development (henceforth the "Fund"). From the standpoint of this initiative, the financial and economic crisis, which followed soon afterwards and which triggered house price declines of 40 per cent in Moscow and other big cities, offered a breathing space. Before demand started to recover – as it is now doing – this allowed time to make progress in creating the conditions for an improved supply of affordable housing, hence for the sustainable growth of the whole residential segment of the construction industry.

The Fund outstrips structural reform

There are some encouraging signs that this opportunity has not been squandered. On 3 February 2011 Putin visited a housing development called "Sunny Bank" in the suburbs of Kirov (the capital of the region of the same name 1000 km northeast of Moscow). This is the first development under the auspices of the Fund that has produced apartments ready for occupancy. The Fund's mandate is to identify idle land plots that are directly or indirectly owned by the federal government and are suitable for housing developments; it then assumes the oversight of such plots from the nominally responsible agency or entity (which, in practice, usually means officials and managers who typically exploit such land for personal gain). To date, some 1,300 plots of land with a total area of 15,000 sq km (1.5 million hectares) have been transferred to the oversight of the Fund. (Initially, Ministry of Defence land was to be excluded, but the fund's current strategy provides for cooperation with the ministry "for the purpose of constructing housing both for servicemen and for sale on the open market".)

In 2009 work began on 96 of those plots; the projected volume of housing was 5.8 million sq m, including traditional apartment blocks, lower-rise buildings and even some detached single-family homes (which Medvedev has championed). The work in question is to prepare the plots for viable affordable housing projects. This means, in particular, securing the necessary town-planning designations and the commitment of regional authorities to maintain regulated utility tariffs at a long-term level sufficient to ensure a return for the utility companies that will provide the connections. The Fund's own resources and other federal government funding (including a VEB-backed PPP agency called the "Federal Project Financing Centre") are available to co-finance regional and local authority outlays on building roads, kindergartens and other infrastructure for new housing developments.

The Fund's strictly competitive auctions of land plots prepared to these standards have attracted interest from developers even though they are allowed to build only affordable housing (currently defined by the Regional Development Ministry as not exceeding Rb30,000 per sq m) on these plots. Developers can put unsold apartments back into the Fund (at a 15 per cent discount to the ministry's indicative price) – up to a limit of a quarter of the total volume of housing of the project. The Fund aims to transfer half of its plots to regional governments – but only to those that can demonstrate a track record of successful affordable housing developments.

In parallel with this important Fund initiative, there have been some systematic structural reforms targeting the supply side of the construction industry:

- A December 2009 law brought a breakthrough in the glacial process of modernizing Soviet-era quality and safety standards ("technical regulations") by allowing the government to apply EU standards where Russia had no equivalent post-Soviet regulation.

- Since 1 January 2010 construction companies no longer require licences to operate but must be approved by new self-regulatory organizations.
- In March 2010 the government approved an action plan on "Simplifying state regulation in the sphere of construction and land-property relations", which was spearheaded by Deputy Prime Minister Dmitry Kozak. The main innovations of that plan include setting a 60-day limit for bureaucratic processing of planning permit applications, involving outside experts in that process, prohibiting the assignment of land plots without auctions, defining the scope of on-site preparatory work that developers can undertake before permits are issued and banning retrospective hikes to contractual prices charged by utility companies providing gas, power, water and drainage.

At the time of writing, it is unclear how much (if any) of this admirable Kozak agenda has entered into force. But it is certain that the initial deadline of 1 January 2011 for the enactment of the entire plan has been missed. This highlights an interesting wider trend during Medvedev's presidency: increasing attention is given to project-based reform relative to the systematic overhaul of regulation. A prominent example is the planned Skolkovo innovation centre and technology park. In the field of homebuilding, the real prospect for a supply-side breakthrough hinges on the continued progress of the Fund.

It is still early days. Even the vanguard "Sunny Bank" development in Kirov has only 6,600 sq m of completed living space out of a projected 136,000 sq m. But other pioneering Fund projects are close to completion in Kursk, Tyumen and Cheboksary, and momentum is building. The Fund's goals are to achieve total annual construction volumes of 20 million sq m on its plots by 2012 and to account thereafter for between one quarter and one third of the overall volume of new housing completed every year. After visiting "Sunny Bank", Putin himself declared the goal of increasing the share of affordable housing in total homebuilding to 60 per cent by 2015.

Conclusion

This survey of drivers for homebuilding growth raises two questions:

- Is there a serious prospect that housing construction growth will meet the government's target of more than doubling annual housing construction volumes from the present level of around 60 million sq m to 140 million sq m a decade from now?
- If so, how can investors best approach this theme?

The growth prospect is real

As regards the first question, many investors might be sceptical. Politicians the world over are forever making overly optimistic forecasts, and the cultural legacy of central planning makes Russian officials particularly prone to setting unrealistic targets. But, in our view, the Russian government's ambitions for housing construction are far from being mere wishful thinking. We base this conclusion on the staying power of the medium-term demand and supply drivers.

The leadership's motivation for keeping these engines running will remain powerful. The interrelated dividends are economic, social and political. To demonstrate schematically the material impact of homebuilding growth on the overall performance of the economy, the anti-crisis programme implemented roughly over the 12-month period from mid-2009 injected an extra Rb500 billion into housing construction from a combination (as we have seen) of federal budget and pension saving resources. Assuming a GDP deflator of 12 per cent, this will have increased the sector's growth rate by 11.5 per cent and added up to 0.6 of a percentage point to overall real GDP growth.

Moreover, that is before second-round effects, which play out in demand for supplier inputs (materials and services) and through wages. At the height of the boom in 2008, the construction sector accounted for 8 per cent of total legal unemployment, a figure which would be considerably higher if the shadow economy were taken into account. The contribution to social welfare extends beyond rising incomes to the transformation of living standards for millions in a poorly housed nation. The positive implications for political stability and legitimacy are obvious.

Above all, the means exist to act on these incentives. On the demand side, we have noted the annual inflows of third-pillar pension savings, which can now be channelled more or less automatically into mortgage financing, with strong potential top-ups from the NWBF. As for the supply side, the key point is that positive developments have already passed well beyond the stage of nice-sounding policy declarations. Fundamental regulatory improvements – affecting permitting, licensing and construction standards – have been enacted since 2009. We believe that, allowing for the usual lag, the desired effects will start to make themselves felt from around about now. Most important, the core project-based initiative for affordable housing under the auspices of the Fund for the Promotion of Housing Construction Development is now into its third full year of operation; and the conditions are firmly in place for healthy momentum.

Investment strategy: First developers, then construction materials

That said, even if this serious supply-side initiative creates the prospect of much more sustainable medium-term expansion compared with the pre-crisis boom, the mortgage-fuelled demand recovery will, on a 12-18 month view, outstrip supply growth – not least because the bounce-back in crisis-depressed real estate prices is still in its early stages and will be fuelled by the present resurgence in inflation. This creates a case for a sequenced investment strategy.

The clear winners in 2011 will be developers, whose volumes and margins will benefit directly from the growing share of mortgage financing in sales (including pre-sales of early-stage construction projects). Among listed companies, the developer most specialized in homebuilding (rather than other construction activity) is **PIK**, which until now has operated mainly in Moscow and the surrounding region but whose land bank extends farther afield into European Russia. The “Relevant Companies” section below provides our usual thumbnail sketch of other developers. For investors, the combination of high leverage and post-crisis debt restructurings that is typical of these developers (and, in the case of PIK, a change of controlling shareholder as well) increases the due diligence challenge – but also the re-rating potential.

Looking further ahead, the homebuilding business – especially in the low-cost segment, which will continue to expand on the back of official support – looks set on a course of higher volumes and lower margins. In the context of homebuilding leading a healthy overall construction sector, there is a strong case for maintaining steady exposure to producers of construction materials. The exposure that can be gained via the big domestic steel groups is of the more generic kind, although many of these companies are themselves visibly responding to this specific opportunity. For example, **NLMK** announced in January 2011 the completion of a new rolling mill for rebar and other construction-related products. Listed opportunities in other construction materials are more limited. In cement, they include **Sibirsky Cement**, which, though much smaller than the privately held sector leader Evrocement (controlling more than 40 per cent of capacity country-wide), benefits from the less competitive environment in Siberia.

One name spans both parts of this investment strategy – the St Petersburg-based **LSR Group**, which is both a construction materials manufacturer and a developer. At a Moscow investment conference hosted by the local broker Troika Dialog on 3 February 2011 – the very day on which this company announced a giant 325,000 sq m residential development near Domodedovo airport – Igor Levit, Chairman of LSR Group, declared that affordable housing construction would be the best game to be in for years to come.

Relevant Companies

Developers

Ticker	Name of company	Description
AFID LI	AFI Development	Focuses on office and retail construction mainly in Moscow; residential construction accounts for just over 20% of its operations. The company is 54% majority-owned by Israeli businessman Lev Leviev. It raised US$1.4 billion in an IPO in London in May 2007 and obtained a premium listing on the LSE in July 2010.
	Coalco Development	Owned by the metals magnate Vasily Anisimov. It builds both commercial and residential real estate in Moscow and the Moscow region. It is anchoring the Greater Domodedovo project, which is part of the federal government's affordable housing programme to build a new town in which some 600,000 people will live and work.
GMST RU	Glavmosstroy	A subsidiary of Glavstroy, which is 100% owned by Oleg Deripaska's holding company Basic Element. Founded in 1954, it is one of the largest construction companies in Moscow and the Moscow region, accounting for some 75% of all residential construction in the Russian capital. Despite a high level of debt and various court cases brought against the company by its debtors, it has been able to stave off bankruptcy. Market cap as of early February 2011: US$97 million.
	Inteko	The private company Inteko is 99% owned by Yelena Baturina, the businesswoman wife of the long-serving former mayor of Moscow, Yury Luzhkov. Inteko develops both commercial and residential real estate mainly in Moscow. Its residential housing projects are mainly high-end, but it is also involved in some affordable housing construction.
LSRG RM	LSR Group	A vertically integrated construction materials producer and homebuilder whose operations are focused mainly in the city of St Petersburg and the surrounding region, where it builds both elite and affordable housing. It is also one of the largest producers of ceramic bricks and aerated cement in Russia. The company is majority-owned by Andrei Molchanov (62% stake). It raised US$772 million in an IPO in November 2007 in London and Moscow and US$398 in an SPO in summer 2010. Market cap as of early February 2011: US$4 billion.
MLD LN	MirLand Development	70% owned by Israel's Fishman Group. Its operations are split almost equally between commercial and residential construction, largely in the regions. It raised US$282 million in an IPO in December 2006 in London. Market cap as of early February 2011: US$497 million.
OPIN RM	Open Investments	Founded by the holding company Interros of Vladimir Potanin, which has a 42% stake (soon to

		be transferred to Potanin's newly created real estate holding company ProfEstate). It focuses on residential construction, particularly high-end housing and single-family homes for the middle classes in the regions. It was the first Russian real estate company to hold an IPO – in November 2004 – which raised some US$50 million; since then it has held several SPOs, in which the capital raised totalled just under US$2 billion. Market cap as of early February 2011: US$685 million.
PIKK RM	PIK Group	The vertically integrated residential construction company is Russia's largest builder of affordable housing. More than 80% of its operations are in Moscow and the Moscow region. The majority-shareholder (with a 25% stake) is Suleiman Kerimov, who also has major holdings in the metals and fertilizer sectors. The company took a particularly bad hit from the 2008 crisis, having accumulated large debts to buy land at peak (pre-crisis) prices. In 2010 it planned to complete some 1 million sq m of housing. PIK held an IPO in London in May 2007, which raised US$1.85 billion – the largest of its kind in the Russian real estate sector. In late July 2010 it announced it may hold an SPO in London with a view to raising some US$300-500 million. Market cap as of early February 2011: US$2 billion.
	Renova Construction Group	Part of Viktor Vekselberg's holding company Renova Group. One of its most ambitious projects is Akademicheskoye – a new residential district in the southwest of Yekaterinburg for which the company is providing commercial real estate, affordable housing as well as shopping and leisure centres. A second such development is planned in Chelyabinsk.
RGI LN	RGI International	Focuses on the construction of commercial (mainly retail) properties in the Moscow region; housing accounts for around 10% of its operations. Earlier this year it announced that it was investing some US$1.3 billion in a housing complex in northwestern Moscow; originally, this was intended to be an elite housing project, but in the wake of the 2008 crisis the company decided to turn it into what it calls a "premium economy-class" housing development. RGI International is majority-owned by the Israeli businessman Emanuel Kuzinets (51% stake). It raised US$175 million in an IPO in December 2006 in London. Its shares are listed on AIM. Market cap as of early February 2011: US$453 million.
	SU-155	The private vertically integrated construction company is involved in a number of large-scale affordable housing and single-family home construction projects. Before the 2008 crisis it was reported to account for more than 20% of the residential construction market in Moscow, while the company itself claims to have a 30% share of the housing market federation-wide. It owns a large number of construction materials plants producing reinforced concrete products, cement, bricks and ceramic tiles, among other things.

Construction Materials

Cement (listed companies only)

Ticker	Name of company	Description
GZCE RU	Gornozavodsk Cement	Located in Perm (in the European part of Russia), the company owns a single (wet technology) plant with an annual capacity of 2.2 million tonnes. Its core markets are the Volga and Ural federal districts. It reached its peak annual production in 2007, when it manufactured 1.9 million tonnes of cement. Its products include oil well cement. Market cap as of early February 2011: US$194 million.
ISKC RU	Iskitim Cement	The second-largest cement producer in Siberia (after Sibirsky Cement – see below), with a 23% share of the regional market. Part of the regional holding RATM, it has a single (wet technology) plant, which produced 1.85 million tonnes in 2008. The same year it began building a second (dry technology) plant with an annual capacity of 1.3 million tonnes, but construction was suspended owing to the financial and economic crisis. The company plans to raise fresh equity capital in the public market at some (undisclosed) point in the future. Market cap as of early February 2011: US$67 million.
SCEM RU	Sibirsky Cement	The second-largest cement producer in Russia (after unlisted Evrocement). It has seven construction materials plants, mainly producing cement; all are located in Siberia, where it commands a dominant market position. The company has the capacity to produce 6.7 million tonnes of cement annually. A serious public market share placement may be in the offing: Sibirsky Cement announced such plans shortly before the 2008 crisis. Market cap as of mid-December 2010: US$637 million.

Steel

Ticker	Name of company	Description
EVR LI	Evraz	The steel and mining company has operations in Russia (including three large steel plants in the Urals region and Siberia), Ukraine, Europe, the US, Canada and South Africa. In 2009 its output of iron-ore products totalled just under 17 million tonnes and coking coal 10 million tonnes. It recently reported an increase in finished products of 15-35% (depending on product category) in 2010 compared with the previous year. Market cap as of early February 2011: US$17.6 billion.
MAGN RM	Magnitogorsk (MMK)	The iron and steel works has a 17% share of all steel products sold in Russia. In 2009 it produced 10 million tonnes of crude steel and 9 million tonnes of finished products. It recently reported that its total steel output in 2010 was 11.4 million tonnes. Market cap as of early February 2011: US$12.7 billion.
NLMK RM	Novolipetsk Steel (NLMK)	Produced some 11 million tonnes of steel in 2009. It recently reported that production was up 9% in 2010 compared with the previous year. Market cap as of

		mid-February 2011: US$26.5 billion.
CHMF RM	Severstal	Russia's largest steel producer – in 2009 it produced some 17 million tonnes – and one of its largest producers of iron ore and coking coal. Besides Russia, it operates in Ukraine, Europe, North America and Africa. Market cap as of mid-February 2011: US$17.5 billion.

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