Got money? The Kremlin can help

REUTERS, *Moscow*

On an overcast day in May, a clutch of the world's most powerful investors gathered in a 19th-century mansion in Moscow to hear a proposition from Vladimir Putin: invest in Russia, and we will invest with you.

For forty minutes at the government's Vozdvizhenka guest house, the prime minister addressed private equity and sovereign wealth funds representing a combined $2 trillion of wealth. He was pitching a plan to launch a $10 billion state-backed fund that Russia hopes can win over those foreign investors who still regard the country as a no-go zone.

There was "a lot of back and forth and some tough questions", one participant said, as guests pressed Putin to convince them that the rewards of investing in Russia can outweigh the risks.

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Can the Kremlin turn that image around? For many potential investors Russia is synonymous with corruption, weak rule of law and political risk, its reputation hurt by events such as the jailing of oil tycoon Mikhail Khodorkovsky. In a straw poll at a major private equity conference in Boston last week, Russia was ranked as the least attractive investment destination of the BRICs -- Brazil, Russia, India and China. Russians themselves are moving money out of the country to hedge their bets ahead of a presidential vote next March, and even President Dmitry Medvedev has called the investment climate "very bad".

"I could not agree more with the folks that decided not to vote on Russia (in the straw poll)," said David Roux, co-founder of US private equity fund Silver Lake, who was not at the meeting in Moscow. "It is a high-potential place but ... it is easy to get your money in and almost impossible to get it out."

But Moscow says it has listened to the complaints and wants to use the new fund to change perceptions.

"Many investors have not done any business in Russia, who only read the newspapers and the different horror stories," said Kirill Dmitriev, the new fund's first head.

The May 18 gathering was a radical departure for Putin, who normally receives foreign executives when they seek his personal blessing to close multi-billion-dollar deals.

Speaking through an interpreter to guests including Blackstone's Stephen Schwarzman and Abu Dhabi's Hareb Al Darmaki, he spelled out how the fund would work alongside foreign investors to buy businesses in Russia.

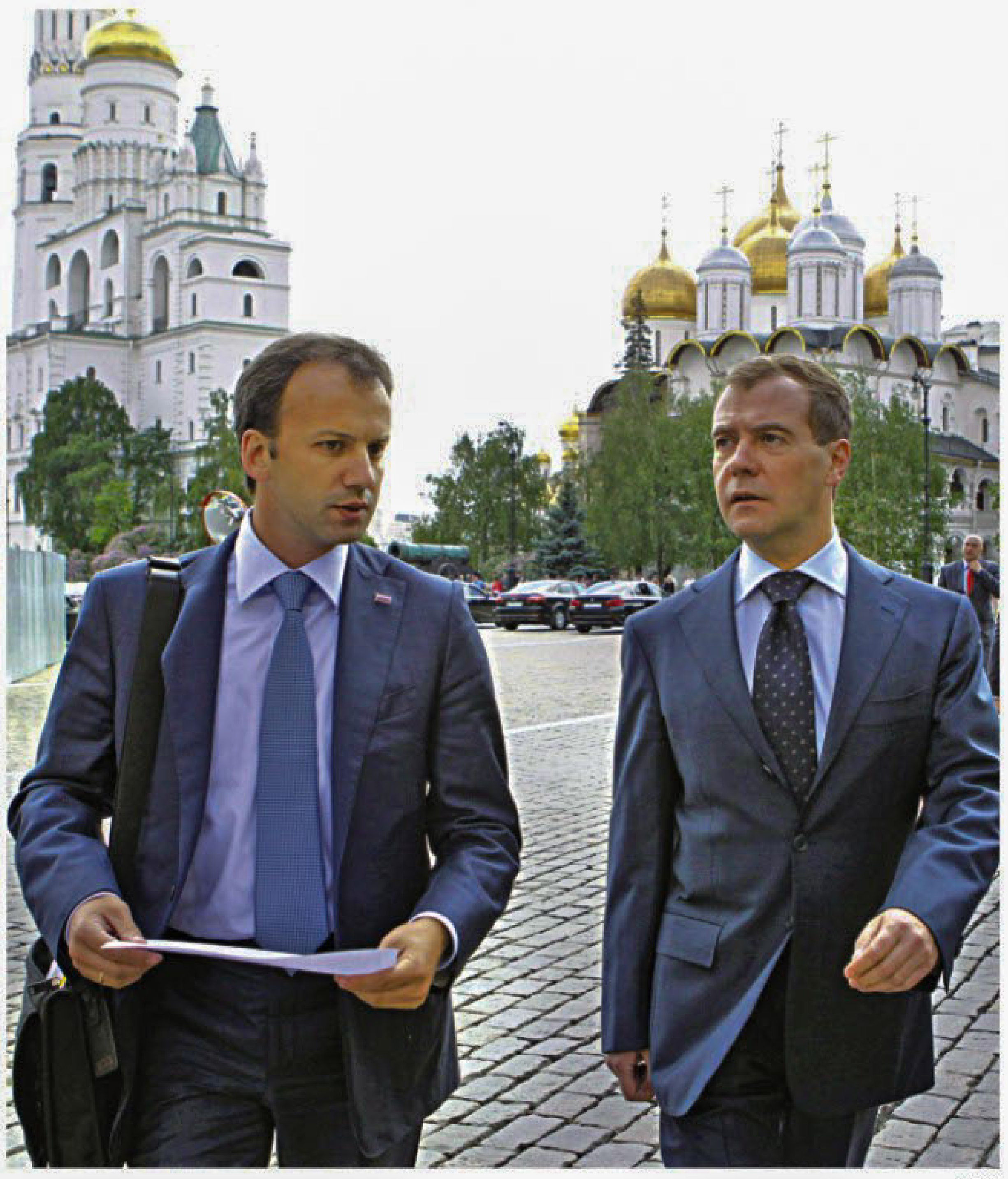
The response was encouraging. Lou Jiwei, head of sovereign wealth fund China Investment Corp., went on the record to say the fund "could be a flexible way to attract foreign investment" while Bader al-Saad, managing director of the Kuwait Investment Authority, said it would "give us the opportunity to increase our direct investment in Russia".

Sovereign wealth funds managing hundreds of billions of dollars are looking to diversify their risks, particularly away from the bulging debt of developed nations that might be tempted to inflate, or even default, their way out of trouble.

Experts say the fund, with its inbuilt political insurance, is designed to meet their needs. "It's a very innovative and creative way to tap into long-term investors," said Ashby Monk, co-director of Oxford University's analytical Sovereign Wealth Fund Project. "If I were looking for a partner for private equity investments in Russia, the Kremlin would be top of my list."

The Russian Direct Investment Fund (RDIF) will be launched at the St Petersburg International Economic Forum -- Russia's answer to Davos -- this week. The product of over a year of soundings with foreign investors, the fund will receive $2 billion in state cash each year for five years.

Its structure mimics the private equity model: it would make direct investments of $50-$500 million in firms geared to the growth of Russia's middle class, in sectors like healthcare, IT or infrastructure. Foreign investors would take the lead, and the fund would restrict itself to a minority role.



AFP

Russian President Dmitry Medvedev (R) speaks to his aide Arkady Dvorkovich (L) as they walk past the Kremlin in Moscow on June 8.

"We came up with something that is very unique, and I think very positive," says Dmitriev, a 36-year-old Stanford and Harvard alumnus who made his name in Moscow with Delta Private Equity Partners, a Russia-focused fund that he co-ran.

The RDIF can only invest if foreign investors put up at least a matching sum. That will align its interests with its partners' and put a focus on returns which has been lacking in previous initiatives such as special economic zones and Rusnano, a state nanotechnology investment vehicle.

"If we can show to foreign investors that they can consistently make a reasonable return in Russia, they will put in a dollar now, and in three or four years they will put in $10," Dmitriev told Reuters.

He reckons the RDIF could attract as much as $50 billion in co-investment over the next 5-7 years. That capital is sorely needed in Russia, where investment is only around 20 percent of GDP -- less than half China's level.

Russia's dependence on oil and gas, which account for two-thirds of exports and over half of federal budget revenues, was not a problem during the past decade when rising oil prices drove annual growth rates of 7-8 percent.

But the crash of 2008 sparked an economic contraction of 8 percent the following year, and exposed weaknesses including Russia's over-reliance on foreign credit, a depleted capital stock and low productivity.

Russia has made progress in reducing its vulnerability to external shocks by strengthening the banking system. Hedge fund manager Viatcheslav Pivovarov said the fund marks a further step towards creating a broader base for growth.

Pivovarov, who returned from stints at New York hedge funds Third Point and Old Lane to advise the government on the fund, said it would help by meeting the common needs of the state and foreign investors. "The fund aligns the interests between foreign investors -- strategic or portfolio -- and the Russian participants because the government is putting its money where its mouth is," said Pivovarov, now managing partner at Altera Capital, a $350 million Russia-dedicated startup fund.

$2 TRILLION IN THE ROOM

Given Russia's record, the project was bound to meet scepticism. But the investors at Vozdvizhenka, renamed in the Soviet era as the House of Friendship with the Peoples of Foreign Countries, came away liking what they heard during two days of briefings by top officials.

People in the room said they had the impression that both Putin and Medvedev, who floated the fund idea at the Davos World Economic Forum in January, strongly backed the project. That might reduce the risk of it being torpedoed by any tensions that could emerge between the two in the run-up to next year's presidential election.

"It was very clear at the meeting that Putin is seriously committed to this venture," said a western investor, who declined to be named because of the sensitivity of the matter. "It is a very hopeful sign that they have appointed as a CEO an individual who is a highly competent professional ... There was certainly no evidence at the meeting that this was going to be a 'friends and family' thing. That is encouraging."

Factory floor, not software park, crucial to India growth

REUTERS, *Mumbai/Delhi*

If India is to become a manufacturing powerhouse it will need to make things easier for people like Nikhil Nanda, joint managing director of Escorts Ltd, a Delhi-based tractor maker.

The company self-generates up to 40 percent of its power, scrambles to find and retain staff to operate increasingly sophisticated machinery, and must ride herd over a stretched supply chain struggling to keep up with demand -- all typical of challenges faced by the country's manufacturers.

"It's very difficult to find skilled labour," Nanda said.

"In terms of forgings, in terms of castings, you have tyre shortages ... we are working very, very closely with the supply chain in requesting them to enhance their capacity and then you have so many players who are going after one supplier or four suppliers for the same issue," he said.

Heavily reliant on services, India must shift economic gears towards manufacturing if it is to maintain near-double digit growth and, more importantly, absorb the more than ten million people set to join the workforce annually in the coming years.

While New Delhi is aware of the challenge and aims to lift manufacturing's share of the economy to 25 percent over the next decade from about 16 percent now, getting there looks daunting.

Infrastructure is improving but remains poor, the country suffers from a costly talent shortage despite its 1.3 billion people, labour laws are restrictive, land acquisition is difficult and red tape and corruption are rampant.

Supply chains are underdeveloped, capital tends to be expensive, and conditions vary dramatically between states.

Those constraints mean most manufacturing operations in India are small and unable to exploit economies of scale.

"If you look at the growth of manufacturing in the NIEs (newly industrialised economies), if you look at it in China -- it all came from one very strong source, which was mass-manufacturing. You're still lacking that in India," said Sanjay Mathur, economist at Royal Bank of Scotland in Singapore.

In its favour, India boasts a vibrant corporate sector, a huge domestic market, and a favourable demographic outlook that, with better training, education and government policies, could turn it into a global force in manufacturing.

"There has to be a fast tracking on all these fronts -- on labour, on policymaking, on clearances," said Nomura economist Sonal Varma. "At this stage it does not look like we have done all that groundwork," she said.

WHY NOT SERVICES?

India's software sector is world class, leveraging lower costs to export services from high-tech hubs such as Bangalore and Hyderabad to the United States and Europe.

That success has fuelled the notion that India might make the jump straight from an agricultural economy to one based on services, bypassing the manufacturing stage.

That's a leap that no major economy has pulled off.

Manufacturing in India accounts for roughly the same share of its economy as peers Brazil and Russia, which unlike India are also big exporters of natural resources. By comparison, Thailand generates 40 percent of its output from manufacturing, while in China the figure is 34 percent.

Services can't be the sole locomotive for the Indian economy in large part because the sector does not create enough jobs. Services account for about 55 percent of GDP in Asia's third-largest economy but just 25 percent of employment.

Agriculture accounts for about 15 percent of the economy, a share that is shrinking, but employs 58 percent of workers.

"India is going to add something like 150 million odd workers over the next 10 years. The employment elasticity in the services sector is not that much, which means the manufacturing sector has to absorb that," said Nomura's Varma.

SCARCE SKILLS

A shortage of labour is often cited by manufacturers as the most troublesome bottleneck.

India, which spends just 3 percent of GDP on education, must ratchet up the skill levels of its workers if it is to take full advantage of the "demographic dividend" of a surge in its working age population.

Most Indians who work do so in the informal sector and have little or no training. Literacy has risen sharply but among the 74 percent who can read, just 2.2 percent have technical or vocational training, according to a Standard Chartered report.

Employers often spend months or more bringing new hires up to speed, which adds to costs.

"There is, for example, a huge scarcity in availability of civil constructors," said Armin Bruck, managing director of Siemens Ltd, the Indian unit of German conglomerate Siemens, which employs 19,000 people in India and can spend as long as two years training a single employee.

Less than 20 percent of working age women are in the workforce. By comparison, the factories of southern China are often staffed almost entirely by women.

Restrictive labour laws make it difficult to shed staff, which in turn discourages hiring. Any workplace with more than 100 people must notify the government if it wants to cut jobs.

Beyond bolstering its workforce, India needs to streamline land acquisition and speed building of infrastructure, meeting its target of $1 trillion in investment in the next five years and improving a poor track record of finishing projects on time.

Special economic zones (SEZs) of the type that China used to help kick-start its export-focused manufacturing sector are a partial solution but not a cure-all.

While some $45 billion has been invested in India's SEZs, which directly employ nearly 680,000, the zones have been dogged by allegations of land grabbing by real estate sharks taking advantage of relaxed regulations.

To reach its target, India needs more forceful policymaking than has been seen from a government that has often been mired in the sort of gridlock that took it six years to approve a $12 billion steel plant by South Korea's Posco.

The cost of failure will be slower growth.

"In the absence of the manufacturing sector in India taking off, it's hard to see India maintaining a growth rate of 9 or 10 percent for a sustained period," said Jahangir Aziz, chief India economist at JP Morgan.

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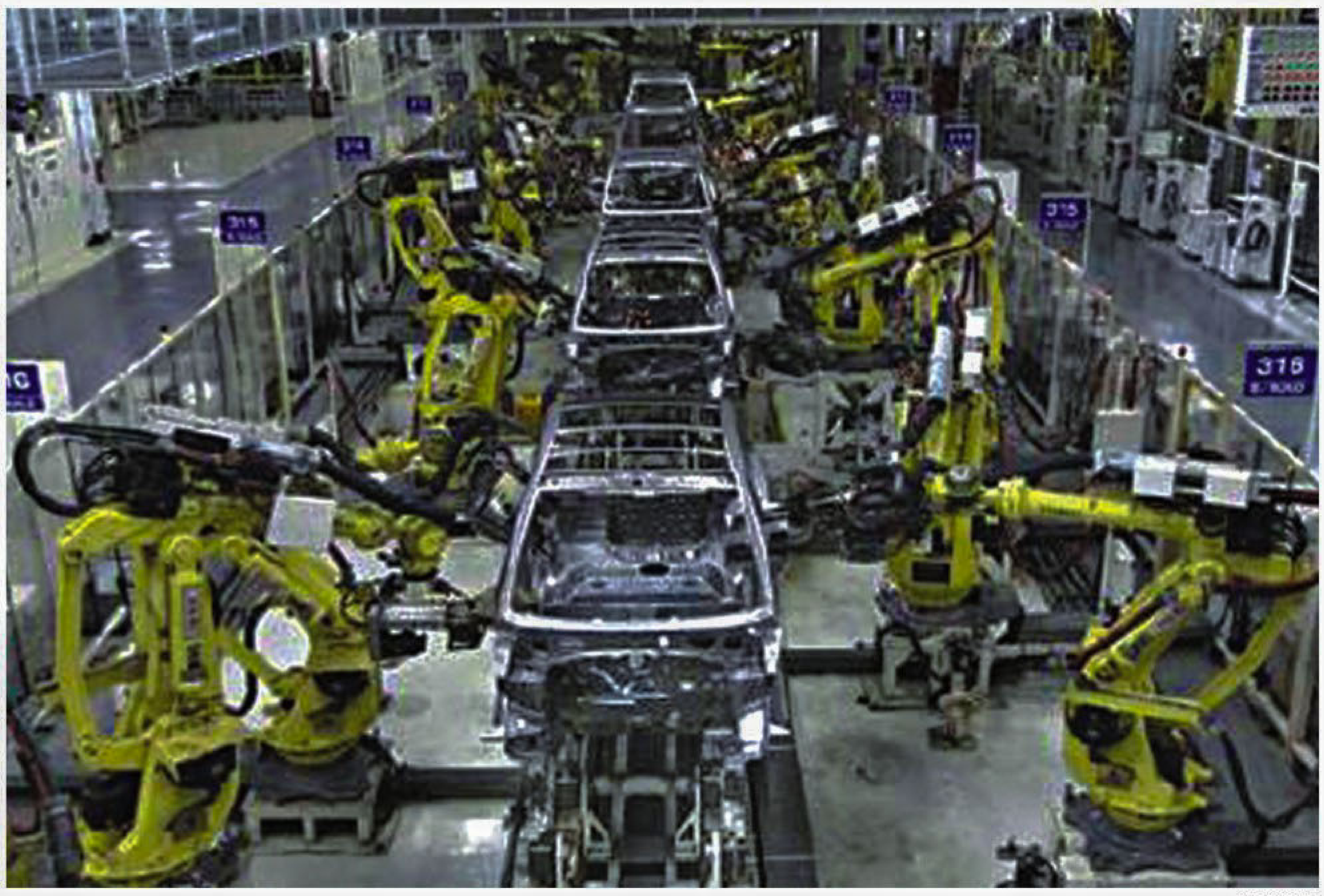

REUTERS

Hyundai cars are assembled at a plant of Hyundai Motor India Ltd in Sriperumbudur Taluk in Tamil Nadu.