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RUSSIAN EQUITIES

LAND OF OPPORTUNITIES OPENS UP

The story of growth and reform in this risky market took a dramatic turn after events in 1998. Now, Russia's credit rating has risen and its oil and gas sectors look particularly appealing

The Russian equity market has shown a stunning performance following the defaults of the bonds market in 1998. The Russian RTS Price Index skyrocketed from the low of 38 to nearly 500 by end of July 2003. Even in euros the performance adds up to a staggering 800 per cent. What are the prospects for Russia now, what do we expect from the equity market and how do we deal with it?

'Very low income tax rates, improving tax revenues, rural reforms, liberalisation of the energy sector and better corporate governance demonstrate the strong political consensus in favour of change'
Steffen Gruschka, DWS Investments

HISTORY LESSON

The US-led coalition waging war against terrorism marks a milestone in the recent history between East and West. This co-operation forms part of a global realignment amongst the US and other key western industrial nations. The result is growing political stability.

In Russia, President Vladmir Putin has undertaken proactive reforms and, crucially, they have been implemented. Very low income tax rates, improving tax revenues, rural reforms, liberalisation of the energy sector and better corporate governance are just some examples which demonstrate the strong political consensus in favour of change. Privatisation and restructuring are attracting inward investments.

Meanwhile, the macroeconomic situation is also improving. In line with falling interest rates, Western investors are reducing the country risk assigned to Russia.

The development of the Russian stock market is far from over. At $145bn (€128bn), the value of listed Russian shares is only 37 per cent of gross domestic product (GDP), half the European ratio and less than a third of those of the US and UK. Russian equities provide investors with an opportunity to participate in a compelling growth story.

PROGRESS

The progress made in the real economy since the 1998 crisis is little short of remarkable. (See Table 1.) In 1999, after the dust settled, Russian GDP was only $190bn. This year, GDP should nearly reach $425bn, and it should exceed $500bn in 2004. Currency reserves,

FIVE YEARS ON 1

	1998	2003
Growth	–8.0%	+5.5%
Reforms	first stage	second stage
Rouble	weakening bias	strengthening bias
Oil revenues	$11bn	$31bn
Debt/GDP	63%	23%
FX reserves	$12bn	$63bn
Current account	$0.7bn	$27.6bn
Fiscal deficit	–$19.2bn	$3.1bn

which bottomed near $10bn, could end the year well above $70bn.

Economic growth is humming at about 5 per cent and personal incomes are rising at almost a 10 per cent real rate. The government budget, once deeply in the red, now regularly enjoys an annual surplus, while foreign debt has been halved.

Inflation is also now under control, even if, at 13 per cent, it still needs trimming. Capital investment is finally starting to rise on a sustained basis, and the regular bleeding of the economy by capital flight has stopped. Compared to $15–30bn annual outflows in the 1990s, this year could see a small net inflow.

Because of all these improvements, Russia's country risk has fallen sharply. One measure of this is the premium demanded by bond investors over the yields of US government bonds. This interest rate differential has fallen from over 1000 basis points (10 per cent) two years ago to about 300bp at present (3 per cent).

Russia's credit rating given by the major agencies, once a lowly B–, has risen to its current BB+/BB and is expected to rise to investment grade in the not too distant future (BBB–).

GAS REFORMS

One of the linchpins to Russian progress is reform of the gas market. At the moment the sector is not liberalised. The price level within Russia stands at 25 per cent of the global market price and the main domestic player Gazprom is unable to make profits within Russia. But reforms have been initiated.

Another key area is the bottleneck regarding oil export capacities. Transneft is the company in charge of delivering oil from Russia to the outside world via pipelines. There are a dozen projects aiming to double capacity within the next decade, which will enable Russia to increase its share of world oil supply from 5.6 per cent in 2002 to 9.1 per cent in 2010.

The pension industry is still embryonic, and legislation to establish its operating parameters is only now being prepared and implemented, with an eye to having some companies in operation in 2004. We expect it to become an important source of investment funds between 2004 and 2010, somewhat similar to the model seen in Poland. As individuals and companies move assets into privately

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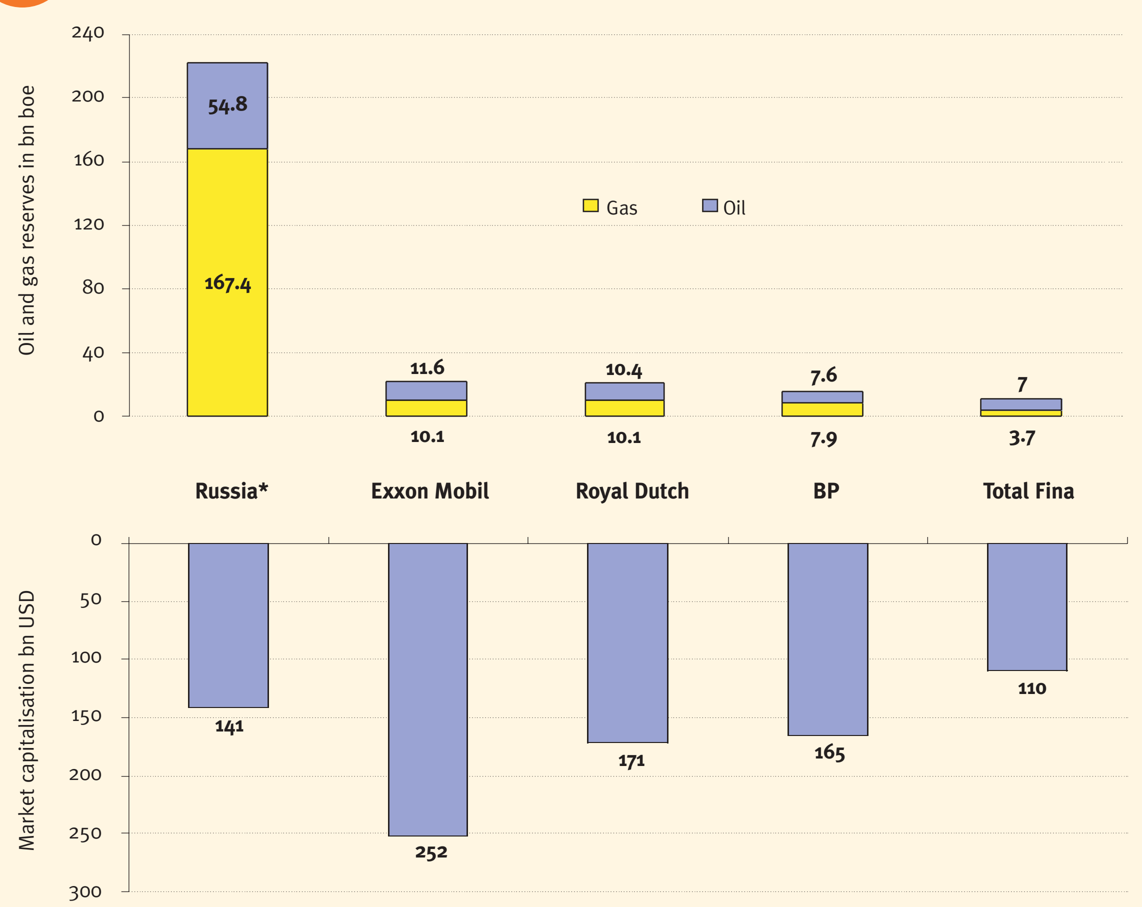
Russian energy: still very cheap by world standards



* Reserves of Lukoil, Surgutneftegaz, Yukos, Gazprom

Sources: Renaissance Capital, Deutsche Bank

managed funds, there will be a steady rise of portfolio cash and nearly all of this money will stay at home in the early years, due to restrictions on investing in foreign assets.

Another promising area is financial services, which was badly damaged during the 1998 financial crisis, but is now moving towards rehabilitation. The dominant (and only large-cap) listing in this sector is Sberbank, which accounts for over 70 per cent of retail deposits and 50 per cent of the loans in Russia.

We expect to see further listings as other banks expand and we may also see some insurance and finance companies listing in time.

ASSET VALUES

The Russian oil reserves of 54.8bn boe (barrels oil equivalent) account for 6 per cent of global reserves. The gas reserves of 167.4bn boe reflect almost a third of known global resources.

Market values put the combined market cap of the companies owning these reserves, including Lukoil, Yukos, Surgutneftegaz and Gazprom, at just $141bn. Exxon Mobil alone has a market cap of $252bn (it owns 10 per cent of the combined Russian resources). (See Chart 2.)

It is illuminating to compare price to earnings ratios of oil companies with the lifetime of their reserves. Lukoil's oil is set to run out in 27 years and it has a p/e of eight. Exxon's reserves will be emptied in 13 years, but it is valued with a multiple of 15.6.

PALLADIUM SHIFT

Palladium is another example of Russia's rich natural resources with a high embedded value. GM, for example, decided in early 2003 to increase the amount of palladium employed in the production of auto catalysts, as palladium prices are at historical lows. Norilsk Nickel has a worldwide market share of 48 per cent and is likely to gain extensively from this shift in demand.

The Russian RTS Index $ sells at a P/E of 9.5x based on the IBES consensus for 2003. Other Eastern European markets are valued a lot higher, for example the Prague Stock Exchange PX 50 trades on a 14.5 P/E and the Polish WSE WIG Index on a 15.7 P/E.

Putting all these arguments together, we think that the valuation of the Russian equity market relative to other markets around the globe is attractive. A final argument for investing in Russian equities is the low correlation of the MSCI Russia with the MSCI World – only 0.46 – and a mere 0.40 with the MSCI Germany.

Strategy for investing

When investing in such a unique market as that of Eastern Europe, a correspondingly unique strategy should be adopted:

- **the first step should be to identify the most attractive companies;**
- **one of the key factors to look at next is the quality of management;**
- **companies with a high-quality management are best, but companies which show a pattern of improvement are also worth considering;**
- **following this, an analysis based mainly on cash-flow figures will create the most objective picture of the company;**
- **sector selection can then be used to limit the strategic exposure to certain sectors;**
- **a liquidity analysis shows last but not least the risk/return patterns of small cap versus large-cap stocks.**

STOCK-PICKING

The best approach to Eastern European fund management requires a large team of professionals who have considerable experience, who are located close to the regions in which they are investing and who have a strong affinity with, or understanding of, those regions.

Local language skills are also of great use. Good connections with the management of the companies in which they are investing as well as with top local and international brokers are also important. The management of local companies should be visited at least twice a year, even if they are as distant as Siberia. Thus a steady flow of information is secured.

The main focus must be stock-picking. Research has shown that 40 per cent of share performance relates to the company, 35 per cent to macro-economic influences and 25 per cent comes from the sector.

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