Russia: The Wild East

04/01/2011

By any measure, Russia is among the cheapest of the major emerging markets. Martin Delaney asks, is this an opportunity, or a sensible 'wild east' discount?

In late 2003, a special team investigating tax fraud swooped on the offices of oil giant Yukos. Following the seizures of documents, the company was presented with a total tax bill of $27bn (€21bn) and its chief executive Mikhail Khordokovsky was eventually jailed for nine years (later reduced to eight). Yukos was declared bankrupt in 2006 and Khodorkovsky remains in jail, awaiting to hear whether further charges will be brought against him.

Yet while this seemed just another tale of Russian injustice and an attempt by former president Vladimir Putin to destroy a potential presidential rival, for many inside the country it was seen as a much-needed clamp down on some of the excesses of Russia's corporate culture.

While the truth of the Yukos affair may never be known, Russia has suffered for years from an image problem. Questions of corruption and issues around the protection of minority shareholders have swirled since the Soviet Union was formally dissolved in December 1991. Investors recognise there are opportunities, but feel the risks far outweigh the country's potential.

However, many would argue they are wrong. "There are important reforms going on in Russia at the moment," explains Vladimir Kirillov, chief executive of TKB BNP Paribas Investment Partners. "You are seeing a reform of the social security system, ongoing reform in the pension system and a significant decrease in the burdens on small and medium-sized enterprises."

Beyond the reform program the fundamentals remain sound – despite the ongoing fall-out from the global economic crisis. According to Franklin Templeton Investments' latest Market Perspectives note, while the Russian economy contracted by 7.9% in 2009, it is forecast to grow by 4% in 2010 – and 4.3% in 2011.

By the end of September 2010 Russian equities had more than doubled since they bottomed in January 2009. For October alone, the Russian equity market reported a rise of 5.7%. The Russian economy continues to stabilise, with unemployment falling substantially since the beginning of the year and retail sales and disposable income have increasing. The oil price remains relatively buoyant at just below $85 per barrel – well above the oft-cited $55-$60 range that Russia needs for its economy to break even.

"This means that the Russian government will be able to run lower budget deficits this year and next, which in turn should mitigate inflationary pressure and prove supportive for the ruble as it will limit the rate of money supply growth," notes Michael Kart, managing partner at Marshall Spectrum, the Moscow-based emerging markets equity manager specialising in Russia and CIS.

Concerns remain about the impact of the recent drought and wildfires, particularly on the agricultural sector, but the general trend of the markets and the economy is upwards. As the western markets falter, those in the emerging markets will continue to be the "the engine spurring the world's growth over the next years", explains Kart. "Russia as the world's main storehouse of raw materials will provide the necessary fuel for that. If we take a look at the country within the BRIC context, we would notice that the country has by far more natural resources, a more educated population, a higher proportion of the middle-class, a strong macroeconomic framework, a better track record - and it is cheaper."

And this is the key: on virtually any metric Russia offers potentially better opportunities than most other emerging markets. Kart remains convinced the country offers investors a multitude of opportunities. “Contrary to popular belief, Russia, according to various studies performed by institutions such as World Bank and the IMF, compares well with its peers on metrics like ease of doing business, market size, transparency, infrastructure, penetration, dividend yield, and return on equity,” he insists.

That is a bold statement to make, but one echoed by fund managers and investment analysts based in Moscow.

“The people who are able to identify and manage the risks should be able to benefit from the low multiples when the overall perception of Russia improves,” says Dimitri Kryukov, founder and CIO of Verno Investment Management, which runs the Verno Russia fund.

“Russia looks particularly interesting as it is one of the cheapest major markets in the world, supported by broad-based GDP and EPS growth, sound macro fundamentals and relatively high commodity prices,” agrees Marcus Svedberg, chief economist at East Capital. “Russian WTO membership, which seems more realistic than ever, would be a positive trigger that is not yet priced in by the market. A steady stream of IPOs absorbed liquidity and Russia has underperformed other emerging markets in 2010 and is still 40% below its pre-crisis peak. We believe this is a good entry point.”

Matthias Siller, co-manager of the Baring Russia fund, says that one can find opportunities to make money work harder than in other places as long as you are there on the ground. “The finance and consumer-related sectors offer much higher returns on capital than you would find in other markets in Europe – and that has never been more pronounced than now,” he says. “These sectors in Russia will only get bigger.”

The emergent middle class and an ancillary increase in consumer demand are fuelling an unparalleled period of expansion. And, in spite of rumbling concerns about its relations with its neighbours, Russia’s government remains relatively stable. Expected presidential elections in 2012 are likely to see a smooth handover of power – although doubts grow as to whether Putin will be able to reclaim the top job.

“Russia’s political risk is different [to that of other emerging markets],” explains Hugo Bain, senior investment manager of the Pictet Russian Equities fund. “For example, in Turkey the political risk is top-down, but in Russia it is more focused at the company and sector level. Clearly there is political involvement in certain sectors and companies, and sometimes that does make investing in Russia quite opaque. You learn to live with it.”About

Yet in spite of a general consensus that Russia offers one of the investment opportunities of the decade, there remain good reasons why valuations are so low. **Claude Tiramani**, manager of Lutetia Capital’s Emerging Opportunities fund, points out that infrastructure spending as a percentage of GDP has declined from 40% in the 1970s to just 20% today. The dependence of the economy on the oil and gas sectors is also a worry (see further article in this section) – although the government is making a concerted effort to diversify its tax revenues. Moves to establish a broader economy have led to investments into agriculture and the development of the banking sector.

Concerns around corporate governance and corruption are valid – exemplified by the Yukos affair. In its 2010 Corruption Perceptions Index, Transparency International, the anti-corruption group, ranked Russia at 2.1 on a scale of 1-10 where 10 represents “very clean”. The other BRIC nations, China, India and Brazil, all scored 3.5, 3.3 and 3.7 respectively. By way of comparison, the US and the UK scored 7.1 and 7.6 respectively. The owner of the UK’s Independent and Evening Standard newspapers, Alexander Lebedev, whose Moscow investment bank was recently raided by secret service agents, recently claimed Russians pay $300bn a year in bribes – almost a quarter of the country’s GDP. He has categorically denied any wrongdoing himself.

Ultimately, however, many of those based in Moscow say they read about a country in the press that they simply do not recognise.

“I don’t want to sound like an apologist, but Russia does receive a biased press,” argues David Thornton, fund manager of the Matrix New Europe fund. “They have a complete blind spot in their reporting of Russia.”

Even investors into Yukos could still have made money – despite the state’s tax levy. “From the first signs of trouble in July 2003,” explains Dimitri Kryukov at the Verno Russia fund, “Yukos still managed to post a high in April 2004 – nine months after the trouble first emerged. Investors who had done their homework would still have been able to protect their capital.”

In essence, his comments represent a good first lesson for investors seeking opportunities in Russia: with an understanding of the situation and insight into the risks posed by the BRIC nation, the country offers superlative investment returns. Russia may be viewed as the wild east of the BRIC nations, but now is the time that the great fortunes of the future are being made.