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A slightly different view on Russia

Paul Severin



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Alexandre Dimitrov, Senior Fund Manager for the Russia equity fund of Erste Asset Management, sums up his personal impressions of the investor conference in Moscow at the end of October. The picture is surprisingly positive...



Alexandre Dimitrov, senior fund manager

Mr. Dimitrov, you are just back from an investor conference in Moscow. What are your impressions?

Dimitrov: I have had numerous one-on-one talks with Russian companies as well as with equity analysts and economists. Remarkably, the impressions I received are quite at odds with the international news flow about Russia. It almost feels like I visited a completely different country than the Russia portrayed in our media. I have been fund manager for Russian equities for more than 15 years, and let me tell you: I have never seen such a discrepancy before. And I am not alone with this opinion.

The country is getting bad press, but having gained 30% in the year to date, the Russian equity market is among the best stock exchanges in 2016 so far. The market risk, i.e. the level of volatility, is at a historical low, and the rating agency Fitch has recently upgraded the outlook for government bonds from negative to stable. So the justified questions are: what is happening, where does this discrepancy come from, and even more importantly, what can we as equity investors and capital market participants expect in the medium to long run?

Would it be a fair statement to make that investors are ignoring the obviously difficult economic environment?

Dimitrov: No, because the weaknesses of the Russian economy remain a known variable. Everybody knows that the administrative apparatus is weak and governmental control in the corporate sector is high. Corruption is still around and therefore remains a big issue. Investors are of course aware of the fact that the prices of commodities, which are highly relevant to the Russian economy, have fallen by more than 30% on average since the highs in March of 2011. Also, there is

little doubt that the sanctions imposed in the wake of the Ukraine crisis are very likely to remain in place for quite some time. The mix is certainly no cause for celebration, but investors can also see the positive developments that the public in our region is not fully aware of.

Can you give us examples?

Dimitrov: The central bank policy stands out in this context – on the monetary and the fiscal side as well as with regard to bank regulation. From a monetary perspective, Russia is actually a model student: the country has pursued a flexible foreign exchange policy since 2014 that mitigates external shocks. At the same time, the Russian currency is freely convertible, and there are no restrictions or capital control on the rouble. Nowadays, as investor you can trade Russian equities and bonds from anywhere in the world and you can have them transferred to a depositary bank of your choice.

But the central bank is also effective as regulator: the banking system is being restructured at record speed. Since 2014, more than 100 banks have lost their licences due to non-transparent transactions and insufficient capital ratios.

The independent monetary policy has started bearing fruit. Inflation has fallen to levels we saw prior to the Ukraine crisis, and they will presumably continue to fall in the coming years. Gross foreign debt has been cut by no less than USD 218bn since the end of 2013 (to an estimated USD 510bn as of 31 December 2015). Actually Russia remains a capital exporter, i.e. government debt is not an issue.

This probably explains why Ms Nabiullina, Governor of the Russian central bank, was bestowed the Best Central Bank Governor Award at the annual IMF conference by Euromoney in 2015. Are there any others reports of success in addition to the central bank policy?

Dimitrov: I would like to mention two important successes. First off, the framework of fiscal policies dating back to the noughties, which is still in effect. The introduction of a flat tax in the area of general income tax and the progressive taxation of the oil sector have enabled the state to amass currency reserves, while companies have remained highly profitable despite low commodity prices.

And most recently: in the annual “Ease of Doing Business” report by the World Bank, Russia ranks 51st in 2016 (2015: 54th), ahead of Israel and Turkey for example. A closer look at the rankings in detail will surprise you. With regard to the registration of property, Russia is ranked 8th, way ahead of Austria (26th) and Germany (62nd). In the category “Enforcing contracts”, Russia ranks 5th worldwide (with Austria following in 6th place and Germany coming in as 12th).

The only really problematic category is “Trading across borders”, where Russia is ranked 170th, behind DR Congo and Djibouti. The main reason here are of course the sanctions.

The status of Russia as commodity economy will not change much though?

Dimitrov: No, that will not change, and why should it. The actual question is how efficiently these resources are being used. Gazprom is a prominent example of an inefficient commodity company. But I think that you cannot lump all companies together. There is a sufficient number of positive examples. Almost all companies in the metal industry, in mining, in the fertiliser sector, and in gold production are privately held, well-managed, and profitable. Even in the oil sector, there are few regulations, and infrastructure has been expanded over the past ten years. Nowadays the companies export oil and oil products via seaports, and in the past few years, Asia has been developed as well (for example, the Eastern Siberia-Pacific Ocean oil pipeline; China).

The LNG (liquid natural gas) sector is catching up as we speak; admittedly late, but it is happening. The pipelines to China and to the Pacific region are under construction. For example, Novatek will put the first big private LNG terminal into operation about a year from now.

In order to increase economic efficiency in the state-owned enterprises (SOEs), the pressure on management to increase the pay-out ratio, i.e. the share of earnings that is distributed as dividend, has been gradually stepped up.

One of the sectors that should benefit from the sanctions, or actually from Russia’s counter-sanctions, is agriculture. Did you notice that?

Dimitrov: Yes, a lot has been going on in the agricultural sector. Russia has become food exporter for the first time in its history – not only for grain, but also for meat. It is not only the sanctions that are of course beneficial in this case; it is also the massive volume of investments in the sector – also by listed companies – that boost production.

That being said, we also expect other sectors to be able to benefit from an increase in domestic demand in the coming two to three years, because Russians have consumed less and saved more in the past two years. Also, the general framework is much better than last year: the currency is relatively stable, and further interest rate cuts are both possible and likely, which will support consumption and investments.

The impressions you received at the investor conference support your positive evaluation of the Russian equity market?

Dimitrov: In spite of the good performance to date, which should continue to ride a tailwind this year.

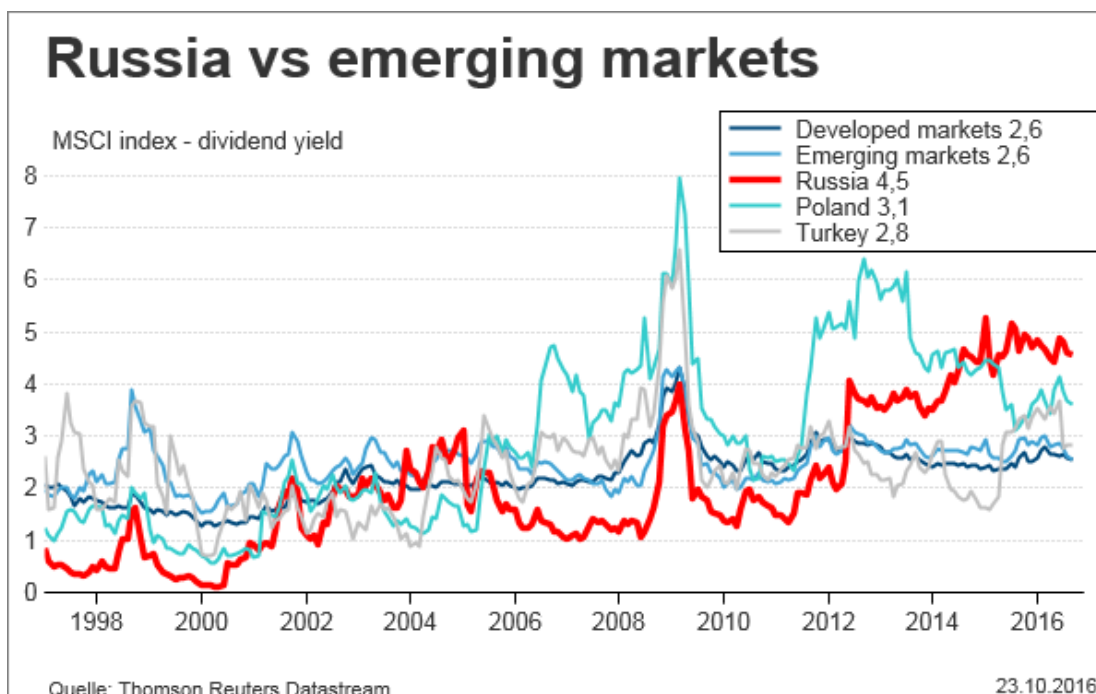
In view of the stabilisation of the macro data, I expect the economic downward trend to reverse. I am optimistic about the companies increasing earnings drastically yet again. This opinion is shared by analysts. According to Bloomberg, the consensus estimate for earnings growth on the Russian market overall is 13% (Bloomberg; as of 27.10.2016).

The dividend yield of about 5% for the overall market is one of the most attractive figures worldwide. The dividends are relatively safe and could increase still especially in companies owned by the state, given that the public budget also allows for higher income from these enterprises.

Lower volatility, a return to positive (albeit low) economic growth, and single-digit interest rates suggest a higher valuation for the Russian equity market. Currently the stock exchange is traded at a valuation discount of 55% on 2016 earnings estimates relative to the stock exchanges on global emerging markets. Historically speaking, this is very high.

Geopolitics: Sir Winston Churchill is frequently quoted in connection with Russia: "I cannot forecast to you the action of Russia. It is a riddle wrapped in a mystery inside an enigma." You have heard that. But I think one has to be precise when quoting, so we should not ignore the second part of the quote, because, as Churchill added: "... but perhaps there is a key. That key is Russian national interest." This means that Russia is a significantly more stable and predictable factor in the international concert of interest than it sometimes comes across.

Dividend yield Russian Equities compared to Global Emerging Markets, Global Developed Markets, Poland and Turkey (1997-2016):



Source: Thomson Reuters Datastream; as of 23.10.2016

Please note: Past performance is not a bad indicator for future developments.

Charts/Links:

<http://www.churchill-society-london.org.uk/RusnEnig.html>

<http://www.doingbusiness.org/data/exploreeconomies/russia>

<http://www.euromoney.com/Article/3488964/Nabiullina-named-Euromoney-Central-Bank-Governor-of-the-Year-2015.html>

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Paul Severin has worked at Erste Asset Management since April 2008. Until 2012 he was responsible for the company's product management; he has directed communications and PR activities since April 2012. From 1992 to 2008, he was director of equity fund management and deputy director for institutional funds at Pioneer Investments Austria in Vienna.

His career in the securities business began in 1992 at Constantia Privatbank as a portfolio manager and analyst. He worked as primary analyst at Creditanstalt Investmentbank in Vienna from 1994 to 1999.

He studied international business at Innsbruck University and Marquette University in Milwaukee, WI, USA. Before his university studies, he worked at Dornbirner Sparkasse in letters of credit and export financing.

Paul Severin is a member of the board at ÖVFA (Austrian Association for Financial Analysis and Asset Management) and a CEFA charter holder.