BEAR MARKET

While the West continues its steady recovery, political wrangling and sanctions have left Russia struggling for growth — despite immense economic potential

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The Russian market spent a decade regaining credibility following the currency default of 1998. By the time I wrote about this market in 2008, its engine was firing on all cylinders and the prospects for investors were bright. Then the global financial crisis came along and Russia, along with Eastern and Central Europe in general, was especially hard-hit by the credit crunch and the freezing of capital markets as Western European banks withdrew from the market or cut their credit lines.

Russia is looking at a flat zero this year in terms of economic growth and has been locked out of capital markets as a result of sanctions. But unlike the downward turn of an economic cycle from which a recovery tends to take longer, Russia's problems today could be resolved in a much shorter period because the reason for them is political rather than economic.

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'During the global economic crisis all the countries of Eastern Europe suffered badly,' says Michael Ganske, head of emerging markets at Rogge Global Partners, 'whereas now we have a separation phenomenon whereby one country, Russia, has some economic problems for political reasons, but other countries in the region are doing very well, relatively speaking.'

What makes Russia a tougher call from an investment perspective, Ganske believes, is the fact that its economy remains so sensitive to fluctuations in the oil price. 'Russian officials are always talking about rebalancing the economy, diversifying it to make it less energy-dependent. There may be some developments on the margin, but it's not really changing. Whenever energy prices go down there is some sense of disappointment and panic in Moscow.'

Nonetheless, Russia still has a strong credit profile. 'The best sectors from a fixed-income perspective are either buying the sovereign [debt] or buying energy or buying banking,' says Ganske. 'Then you have Russian Railways, infrastructure, but obviously with a recession looming it is not a very attractive investment scene. We also believe that probably the currency sell-off we've seen, which was very much driven by exporters in the local market, means that the rouble is cheap.'

Ganske is hoping that the ceasefire in Ukraine will hold and that President Petro Poroshenko, who is after all essentially a Russian businessman, will reach a compromise with Vladimir Putin. 'If there isn't a major escalation of violence by the middle of next year we'll begin to see sanctions being revoked. Then we will be back to a more normal growth pattern for Russia.'

ROUBLE AHEAD

Not everyone shares Ganske's view about the rouble. Matthias Siller, head of emerging markets for Baring Asset Management, believes Putin is prepared to see the rouble devalue against the dollar by around 9 per cent (currently the rate of carry interest) over the next two years, partly to encourage exports and partly to restrain the appetite for imports.

Marina Akopian, a partner at emerging markets investment management boutique Hexam Capital, believes that once the Ukrainian situation is sorted out the Russian market is likely to have a major resurgence. She points out that since 2010 the growth-rate differential between emerging and developed markets, which is the major driver for emerging markets, has shrunk. 'In 2008 there was a massive reduction in the earnings outlook of the Russian market,' she says. 'There was a de-rating of the market, with analysts slash-and-burning forecasts across the board.'

Since then, the market has gone back to the 2008 level while earnings per share have been consistently upgraded by 5 per cent over the past six months. This discrepancy, says Akopian, has opened up a unique buying opportunity.

Once the Russian market returns to normality, Akopian argues, all sectors look promising: oil, banking, mining and more. She still favours Russian blue-chips, or 'the usual suspects', such as Lukoil and Yandex, the internet portal: 'They are fantastically run companies and we haven't witnessed any corporate governance issues for years. However, there is always an unpredictable risk coming from a bigger picture — not necessarily the way the company is run or the accounts are prepared, which we believe is transparent and good in Russia — but a bigger, wider regulatory risk.'

Akopian cites the recent arrest of Vladimir Yevtushenkov, chairman of the major holding company AFK Sistema, on charges of money laundering. 'If

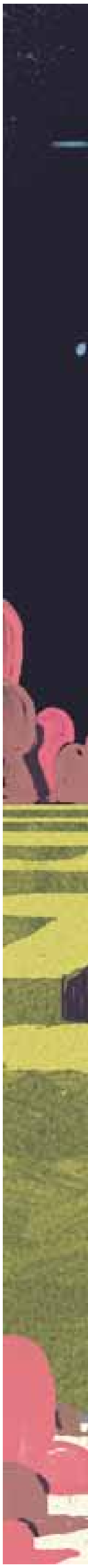

Illustration by Kyle Smart

you talk to CEOs and CFOs,' she says, 'Russian companies are run in accordance with best practices in the world, but obviously you cannot predict wider regulatory risk or corruption allegations.' Indeed, says Olga Boltenko, a Zurich-based partner at law firm Withers, 'Property rights and the rule of law are perhaps not as strong in Russia as we believed they were a year ago.'

NET GAINS

Matthias Siller, freshly returned from a trip to Moscow, likes the prospects for fertilisers, agriculture and metals and mining but is more intrigued by the internet sector, where he believes the Russian government understands the need to groom entrepreneurs. 'You and I will never buy a Russian car,' he says. 'Russian consumer durables are not going to be distributed all over the world. But Russia has a legacy in computer science and yet Russian internet companies don't have to pay Silicon Valley salaries. If you're a global investor interested in tech, the only other place you can invest is in US and Asian companies at horrific multiples.'

Russia has some entrepreneurial companies — a handful — with 'super-strong' balance sheets in internet-allied fields like social networking, payment systems, search and advertising and IT outsourcing — names such as Yandex, Kiwi, Luxoft, Siller says. 'Did you know that a German car has 55 million lines of code in its IT operating system and that this code was written in Eastern Europe? Every global emerging market investor should be interested in the Russian internet sector. These companies trade at low multiples compared to their historic multiples and there have been no disappointments in terms of operational performance.'

Of course, the investment adviser's mantra of 'not for the faint-hearted' still applies to Russia, which despite its enormous potential has been one of the worst-performing markets this year. 'If you look at the history it is either the best-performing global market or the worst,' notes Akopian. 'It is never in the middle range.' Even without a geopolitical crisis, the Russian economy is still very much geared towards the outlook on global commodities and the general emerging-markets cycle.

Maksim Khludeev, a Citi private-client manager, believes that major Russian stocks are 'unbelievably cheap'. He did a valuation model of Sberbank for a diploma four years ago and the share price was the same then as it is now, despite Sberbank having had 'a massive business expansion in the meantime'.

It may be too early to talk about a significant, long-term re-rating, but given how far Russia has de-rated as a result of the Ukrainian crisis and given that fundamental earnings are coming through, Marina Akopian believes it will certainly happen: 'Russia is the cheapest global equity market.' Time to don the fur coat and crack open the vodka: everything's coming up roubles.