

GRANT'S

INTEREST RATE OBSERVER®

Vol. 32, No. 16c

Two Wall Street, New York, New York 10005 • www.grantspub.com

AUGUST 8, 2014

For the outcasts

Concerning the conflict between Russia and Ukraine (and, as far as that goes, between Russia and nearly everybody else), *Grant's* takes the position, "This, too, will pass." As the seasons change, so will the geopolitical mood. And as tensions subside, so will Russian equities come in for what the comrades used to call "rehabilitation." We write in anticipation of that happy day.

Two stocks and an ETF feature in the analysis now unfolding. They are Sberbank (SBER on the Moscow and London exchanges), about which we had a bit to say in the issue of *Grant's* dated May 16, the Moscow Exchange (MOEX on, well, itself) and the Market Vectors Russia ETF (RSX on the NYSE Arca). Each is as cheap as a pariah stock ought to be.

It isn't just the West that shuns Russian financial assets. The Russians don't seem to have much use for them either. Thus, at year-end 2013, securities of one kind or another accounted for just 10% of the savings of Russian individuals; bank deposits captured 69%. And equities made up just 3% of the portfolio assets of Russian pension funds (a one-third allocation to equities is more typical of the BRIC world). While there may be no love lost between Putin's Russia and the outside world, foreigners are said to own at least 50% of the Russian stock market's free float.

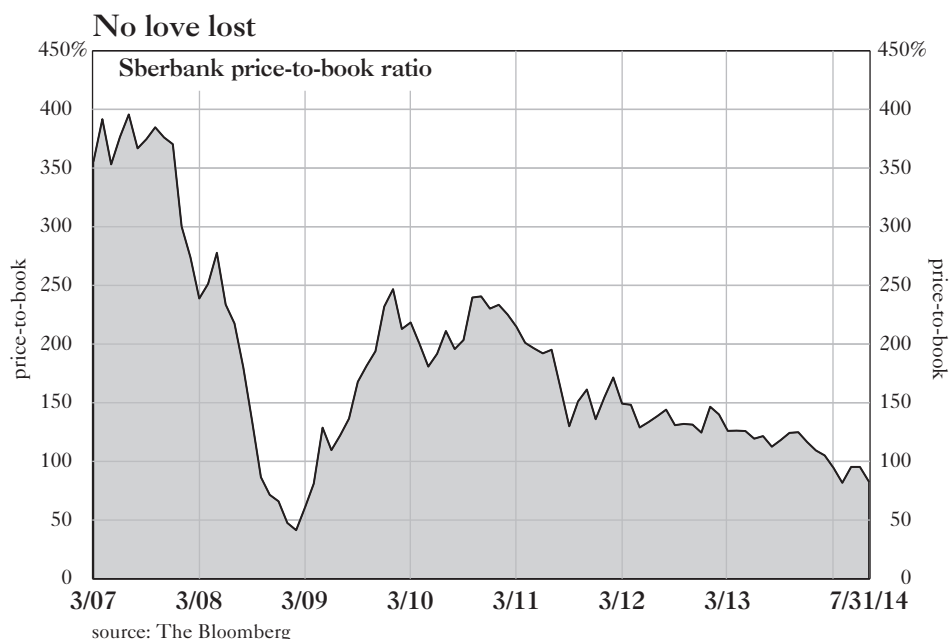
On, then, to Sberbank, successor to the old Soviet Gosbank and—by a mile—Russia's largest lender. With assets of 19.1 trillion rubles as of March 31 (representing 28% of 2013 Russian GDP and \$535.1 billion at

current exchange rates), Sberbank held 30% of commercial bank assets and 47% of retail deposits in calendar 2013. Its ubiquitous branch network makes for relatively low funding costs and relatively fat net interest margins. It would take America's five biggest banks to achieve that concentration of market share in the United States.

Sberbank has its critics—in Ukraine, it has sworn enemies—but nobody can hate it for being undercapitalized: Profitable during the financial crisis despite a 7.8% year-over-year decline in real Russian GDP (that was in 2009), the bank received state aid only to the extent of a 500 billion ruble loan at an 8% interest rate. The Duma, fretting now about Russia's wounded econo-

my, has ordered that such credits be converted into permanent capital. As it is, at the March 31 reporting date, Sberbank showed a ratio of equity-to-assets of 10%. The heavy weight of this capital notwithstanding, the company earned 19.4% on equity in the first quarter. Wells Fargo, which also deploys equity capital equivalent to 10% of assets, earned 14.1% in the same three months.

That Mr. Market has something else on his mind is obvious enough from the valuation of Sberbank's equity. The common changes hands at 4.4 times trailing earnings and 81% of book value; it yields 4.5%. The preferred, which has the same economic interest as the common but which confers no voting rights, trades at a



21% discount to the common (3.4 times price-to-earnings and 63% of book value; it yields 5.7%). “In no universe is it not cheap,” observes Ian Hague, longtime successful investor in Russia and co-founder of Firebird Management LLC.

“The 21% discount between the common and preferred stocks spells opportunity, of course,” relates colleague Evan Lorenz. “The Central Bank of the Russian Federation owns a 50% plus one share of the common. While you, prospective shareholder, may one day dutifully mail your proxy voting statement to Sberbank’s Moscow headquarters, don’t expect much in the way of corporate activism. This is not to say that the bank needs a Carl Icahnski to goad it into constructive action. ‘Management is very competent and technically skilled,’ Hague tells me. ‘CEO Herman Gref, when he was in government, was a voice for reform and he has run his bank in a very prudent but still ambitious way.’”

For further perspective on valuation, consider Barclays Bank of Zimbabwe (the largest bank by market capitalization in Zimbabwe), which trades at 32.8 times earnings and 218% of book value. Also, MCB Bank Ltd. (Pakistan) at 15.6 times earnings and 284% of book, Banco Macro SA (Argentina) at 7.9 times earnings and 269% of book and Halyk Savings Bank of Kazakhstan JSC at 7.9 times earnings and 144% of book. Each valuation seems opulent compared to Sberbank’s.

No Western sanction yet imposed prohibits anyone from buying Sberbank shares already issued and outstanding. There are, of course, plenty of other reasons not to buy the stock, yet—at least for Russia’s giant bank—the sanctions are not entirely undesirable. A strong balance sheet is a deposit magnet in bad times. Then, too, Russian companies shut out of the international capital markets are turning inward to borrow.

“A crisis situation is usually beneficial for Sberbank,” investor relations’ officer Kristina Bystrykh tells Lorenz. “We have the experience of 2008 through 2009 when we were perceived as a safe haven by retail customers and corporate customers as well. Smaller banks either went bankrupt or there was consolidation

in the banking sector. We gained business actually. It’s still too early to talk about it in numbers. We already see some intensifying with business clients, not only in terms of credit products but other services we provide like payroll, project conversion operations, and on the fee and commission side products.” In the March quarter, Sberbank’s assets jumped by 26% year-over-year.

A fast-growing balance sheet necessarily raises questions about the credit quality of the institution that’s doing the growing. Sberbank is in a better position with regard to underwriting than most such expansive institutions. At least, if it’s making bad loans, it’s not for a lack of authoritative credit information. “Almost all of the companies in Russia are, to some extent, our clients, and as of two years ago, we started collecting financial models from our corporate clients,” says Bystrykh. “We have a huge database of these models. We check this data with a federal tax database because of our significance in the economy and we have a very big lobbying power.” (So they have crony capitalism in Russia, too.)

“We tend to provision in advance, preemptively,” Bystrykh continues. “We take early steps to help the client at the same time. We are very conservative. As an example, when we saw deterioration in the [credit] quality in the third quarter (operationally we saw it earlier), we cut application approval rates. We took steps because our primary goal is to have a high quality asset portfolio.” While non-performers grew by 31.3 billion rubles year-over-year to 397.1 billion rubles in the first quarter, Sberbank’s provisions for non-performers grew by 94.5 billion rubles to 677.1 billion rubles. And while non-performers declined to 2.75% from 3.26% as a percent of total loans between the first quarters of 2014 and 2013, reserve coverage of non-performers increased to 170.5% from 159.3% over the same period. Sberbank’s Ukraine operations encompass less than 1% of the parent’s overall assets.

The Moscow Exchange—our second Russian investment candidate—traces its origins to the 1992 creation of the Moscow Interbank Currency Exchange (MICEX). In 1995 came

the Russian Trading System (RTS), a kind of regional stock exchange roll-up. In 2011, the MICEX and the RTS merged to form the Moscow Exchange (MOEX). In 2013, the Moscow Exchange went public selling 15 billion rubles in new shares. On MOEX today are traded equities, bonds, derivatives, foreign currencies and money-market products; the exchange offers clearing, settlement and deposit services through a modern central securities depository (CSD).

Until last year, all stock trades in Russia had to be pre-funded—in back-office lingo, settlement was T+0. In September 2013, the Moscow Exchange moved to T+2, that is, settlement is due two days after a trade is entered, bringing Russian practice more closely into line with that in the West. (The SEC requires settlement in the U.S. within three business days, or T+3.) The change seems to have sparked a trading boomlet; in the first quarter, equity volumes climbed by 35%.

“As a recent newcomer to the Russian market we can personally attest to the fact that the modernization drive has been reasonably successful,” Boris Zhilin, co-founder and principal of Armor Capital, recently advised his investors. “Getting set up to trade Russian equities took us one day vs. two weeks for Brazilian equities, three weeks for Turkish equities and 10 months for Indian equities.”

If the government gets its way, the MOEX will be seeing more of the famously securities-averse Russian saver. Thus, in December, the Duma amended the tax code to allow the creation of individual investments accounts (IIA). The first 400,000 rubles (\$11,170 at current exchange rates) contributed to an IIA are tax-deductible each calendar year. Capital gains of up to nine million rubles are tax-exempt for stocks held for three years.

Russian pension funds are equity-averse for a reason. Until recently, domestic pension funds were prohibited by law from showing a loss in any given year. The Duma has addressed this aspect of law—pension funds can now make losses and engage in the formerly proscribed activity of buying IPOs. While showing a loss may cost a Russian pension manager a promotion, it no longer puts him or her on the wrong side of the law.

Priced at 11.3 times trailing earnings to yield 4.0%, MOEX is not so cheap as Sberbank (then again, it isn't—so far—under the gun of sanctions). In the first quarter, volume across all of the markets that MOEX serves was up 43.7% year-over-year to 120.5 trillion rubles, helping to produce a 23.8% leap in earnings per share.

"The Moscow Exchange has a \$3.6 billion market cap," Zhilin tells Lorenz. "They probably have about \$800 million of excess cash above any kind of regulatory requirement you can think of. To date, on the capital allocation front you can't fault them. They've committed to a minimum 50% dividend payout and most likely it will be 60%, and they recently bought

back 4.2% of their shares for cancellation." The Central Bank of the Russian Federation is the holder—temporarily—of a 16.5% equity interest in the exchange. It pledges to sell its stake down to nothing by Jan. 1, 2016.

"The central bank favors MOEX in other ways," Lorenz points out. "Thus, the authorities require that currency trading be conducted on the exchange transparently, as opposed to the dealer-to-dealer method that notoriously prevailed in London and New York. Chalk up one, at least, in this regard for the Russian despots."

Last but not least is the aforementioned New York-listed Russia ETF. With a \$1.4 billion market capitalization, the RSX is a liquid and di-

versified way to invest in peace and prosperity in Mother Russia. Energy stocks comprise 43% of net assets, followed by telecoms (18%), basic materials (16%) and financials (11%). RSX's largest holdings are in Lukoil (8.1% of NAV), Gazprom (8.1%), the retailer Magnit (7.4%), Norilsk Nickel (6.6%) and Sberbank (6.1%). Year-to-date, the ETF has borne a 15.7% markdown in its share price. Despite trading at 4.9 times earnings and yielding 3.2%, the RSX is a honey pot for the bears, with some 15% of the float sold short. "In other words," Lorenz concludes, "there are multiple someones who expect the ETF to trade at four times earnings."



Grant's® and Grant's Interest Rate Observer® are registered trademarks of Grant's Financial Publishing, Inc. PLEASE do not post this on any website, forward it to anyone else, or make copies (print or electronic) for anyone else. Copyright ©2014 Grant's Financial Publishing Inc. All rights reserved.