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From Russia with value

You can have cheap stocks or good news, but you can't have both at once. The profitable application of that dictum—it's the coinage of the wise Joe Rosenberg, chief investment strategist at Loews Corp.—is the subject at hand. To anticipate, this publication is bullish on Russian equities.

Concerning Russia itself, in particular the intentions of the Russian government, we are neither bullish nor bearish but uninformed. Either Vladimir Putin is or is not an aspirational Ivan the Great, 15th-century gatherer of the Russian lands. Either he does, or does not, intend to lead the world in a revival of conservative virtue, simultaneously waging a struggle against the lovely doctrine of live and let live. Either the not exceptionally wealthy Russian state is prepared to shoulder the financial and political burdens of absorbing portions of the failed Ukraine state, or it isn't. From the vantage point of the sixth floor of 2 Wall Street in lower Manhattan, it's all rather murky.

Clearer are the financial consequences of Russia's conduct. Toward similar kinds of statecraft practiced by other countries, Mr. Market seems altogether nonjudgmental. Unusually, for its domestic repression and international saber rattling, Russia is paying a price denominated in the currency of domestic equity valuations.

In Baron Rothschild's time, insurrection was dependably bearish (you can surmise as much by the baron's famous advice to "buy when there's blood in the street"). No more.

Thailand is engulfed in rioting over the court-ordered ouster of the sitting prime minister; the Thai equity index, valued at 16.1 times earnings, is up by 6.2% in dollar terms in the year to date.

China is provoking Vietnam over one contested group of islands, Japan over a second and Malaysia (and the Philippines, Taiwan and Vietnam, too) over a third. The Shanghai Composite index, quoted at 10 times earnings, has given up 5.8% in dollar terms in 2014.

An Egyptian court has pronounced the death sentence on 683 supporters of the deposed, democratically elected president Mohamed Morsi. Egypt's Hermes Financial index, capitalized at 58.6 times earnings, has generated a dollar-denominated, year-to-date return of 20.6%.

In none of the above cases has insurrection or international aggression or the miscarriage of justice cost the offending nations anything like the financial penalties that the accession of the Crimea has exacted on Russia.

Morality deals with right and wrong, stock selection with good and better, or with terrible and bad. The moralist weighs absolute standards, the analyst, relative ones. The MSCI Emerging Markets Index, which trades at 12.1 times trailing net income, is up 1.3% this year. Russia's market, which had long shadowed that index, is on the bargain counter.

Let it remain there, many say. Some reach their conclusion by moral reasoning. Putin, they say, is the 21st century's own Hitler. The eminent British author Paul Johnson argued this very case in the May 5 issue of *Forbes*. Other critics, abjuring moral judgment, simply explain that they would rather not be the victim of a state crime. Rosenberg himself tells *Grant's* that valuation is irrelevant in Russia (and in Argentina, too). A one-time owner of expropriated assets derives precious little consolation in the knowledge of how little he paid for them before the state swooped in, he observes. On the eve of the Bolshevik Revolution not quite 100 years ago, Frank Vanderlip, president of what is today Citigroup, set about scattering Citibank branches around Tsarist Russia. It was the country of the future, Vanderlip declared.

Russia vs. the global field

name	mkt. cap. (in mil.)	P/E	P/B	div. yld.	price per bar. of res.
Gazprom OAO	$93,877	2.8x	0.4x	4.5%	$1.54
Rosneft OAO	69,661	6.2	0.8	3.7	2.25
Lukoil OAO	47,047	5.3	0.5	2.8	2.40
Petroleo Brasileiro SA	102,640	11.0	0.7	—	8.05
Exxon Mobil Corp.	439,572	13.9	2.5	2.7	17.60
Chevron Corp.	239,576	12.2	1.6	3.4	21.50
BP PLC	155,195	15.6	1.2	5.1	8.72

source: The Bloomberg

Russia lags Ukraine

name	P/E	div. yld.	ytd. perf. in local fx	ytd. perf. in USD
MICEX Index	6.3x	4.0%	(7.9)%	(13.2%)
MSCI Emerging Markets Index	12.1	2.7	1.3	1.3
Stock Exch. of Thailand SET Index	16.1	3.3	5.9	6.2
Egyptian Fin. Group Hermes Stock Mkt. Index	58.6	2.7	22.4	20.6
Borsa Istanbul 100 Index	12.6	2.2	11.8	16.0
Ukraine PFTS Index	23.2	4.0	30.2	(9.4)
Shanghai Stock Exch. Composite	10.0	3.0	(3.1)	(5.8)

source: The Bloomberg

The Bolsheviks proceeded to carve out a future that set the banker back on his ear.

Nor does the bearish case against Russia end with the risk of expropriation. "There are few situations in the world that are attractive investment opportunities where there is a lot of open warfare going on," Ian Hague, a longtime successful investor in Russia—he's co-founder of Firebird Management LLC—reminds colleague Evan Lorenz. Businesses like Gazprom seem statistically cheap in the context of earning power and asset values undisturbed by war or embargo. They would seem instantly less value-laden in the face of a united Western push to isolate and impoverish the host country. Then, too, a recession or worse in China could sink commodity prices; energy exports produce two-thirds of Russia's external earnings. As matters stand, Russia's GDP has registered two consecutive quarters of contraction, according to the IMF; Russian consumer price inflation is running at 7.3%. The Russian ruble, in the year to date, has fallen by 5.5% against the dollar. To judge by average Russian life expectancy (short) and birth rate (low), the land of Pushkin and Putin is neither happy nor healthy.

In the face of domestic trouble, a man on horseback is wont to try to change the political subject. Putin has thus redirected the Russian public's attention away from poor economic performance to Western moral relativism. On May 5, the Russian leader announced a ban on swearing in Russian books, plays and movies. May 8 brought news that Russia intends to colonize the moon. So far so good for Putin, if not for the shareholding public: Since Crimea's citizens overwhelmingly voted to rejoin the Russian Federation—this was on March 16—Putin's approval ratings have gone straight up while the Micex index has gone straight down.

If there is an unhedged, unequivocal, fully invested bull on Russia, we have yet to meet him or her. It tells you something about the lopsidedness of speculative sentiment when the White House press secretary feels emboldened to proffer investment advice, as Jay Carney did on March 18. "I wouldn't, if I were you, invest in Russian equities," the president's spokesman told reporters in the wake of the Crimea affair—"unless you're going short."

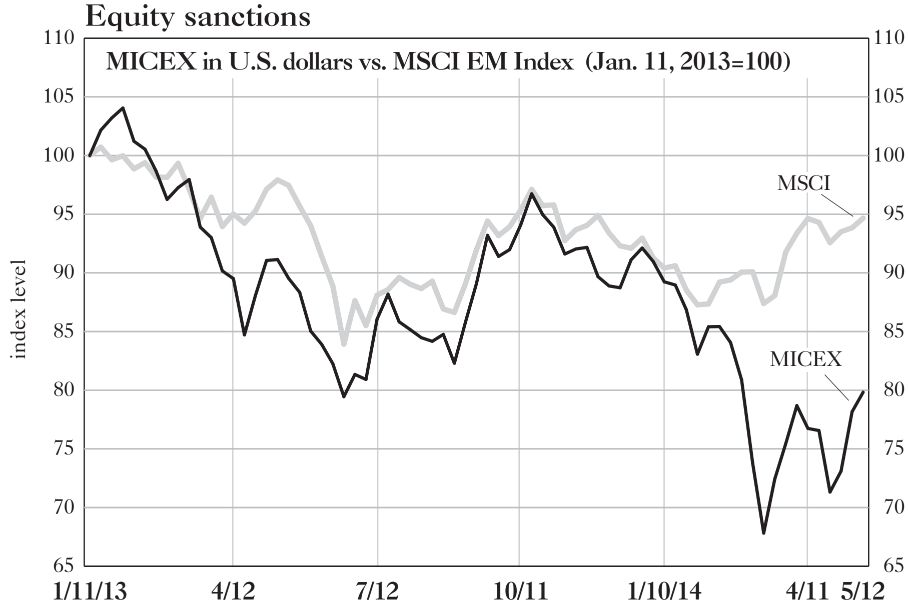
Many have. On May 6, Bloomberg reported a sign of the times: "The cost to protect against declines in the Market Vectors Russia ETF, the biggest U.S. exchange-traded fund that holds Russian shares, rose to an all-time high relative to emerging-market stocks, based on implied volatility data for options." Small wonder, then, that a measured softening of tone by the Kremlin on Ukraine elections the very next day sent the Micex index soaring by 3.4%, the ruble by 1.5%. Speculators would appear to be huddled on one side of the Russian vessel.

The good ship Russia "suffers from the absence of a stable, long-term capital base," observes Boris Zhilin, co-founder and principal of Armor Capital, which, he says, is starting to build positions in Russian equities. "If you look at the free floats of a lot of Russian companies, they are probably 50%-80% made up of Western investors which contributes to this crazy volatility when people pile in or pile out."

Zhilin, a newcomer to Russian investments, though not to the country itself ("I obviously follow and have relatives in Russia, I'm very connected with what goes on there"), contends that reports of ruble flight are overdrawn. "When people see the going gets tough, they convert ruble deposits into U.S. dollar deposits," he tells Lorenz. "That gets captured as capital flight, as capital packing up and going offshore. Typically, once things normalize, a lot of that gets reversed."

Moscow's bourse is shallow and dry as opposed to deep and liquid. Companies with $100 million or more in equity capitalization number just 120. The two dozen companies with a market cap of between $100 million and $250 million trade on the average of $17,467 worth of stock a day. Listed in name, they are functionally private eq-

Equity sanctions



source: The Bloomberg

uity investments with a public ticker.

Like the Mumbai market, the Moscow Exchange features a full panoply of corporate investment opportunity: from the substantial to the dubious and the much worse than dubious. "Companies with perceived good management like the retailer Magnit OJSC, which trades at 21 times trailing earnings, and the Internet search engine Yandex NV, which trades at 24.4 times trailing earnings, still command premium valuations," Lorenz relates. "Companies with state ownership and/or less capable managements trade as low as 1½ to five times trailing net income. The auto and truck manufacturer GAZ Auto Plant ($340 million in market cap) and the chemical company Dorogobuzh OAO ($264 million) trade at trailing earnings multiples of 1.3 and two times, respectively. Would you like to own them? Would you like to own GAZ knowing that it has not yet filed 2013 financials? Or Dorogobuzh, knowing that it is 89% owned by Acron JSC, 'Russia's largest and one of the world's major [nitrogen, phosphorus and potassium] producers,' according to the parent's Web site? Be patient. Each stock trades less than $1,000 worth of value per day."

Constant readers are well acquainted with the big Russian energy names (*Grant's*, Sept. 8), Gazprom (OGZD), Lukoil and Rosneft (ROSN), each of which is listed in London, looked cheap nine months ago; they have subsequently become cheaper (prices are down by 5.9%, 7.6% and 17.2%, respectively, since we wrote). To declare an interest, your editor owns all three stocks, which, in the case of Gazprom and Rosneft, makes him a small partner of Putin's. The Kremlin owns 50.2% of Gazprom and 69.5% of Rosneft. The former changes hands at 2.8 times earnings and yields 4.5%, the latter at 6.2 times earnings and yields 3.7%.

Lukoil, in which the Russian state holds no acknowledged equity interest, is quoted at 5.3 times earnings and offers a 2.8% dividend yield. "Lukoil is our top holding in the Russian energy sector," Hague tells Lorenz. "It's attractive because it has a lot of assets outside of Russia and its governance has improved fairly dramatically since the mid-2000s. It's a good dividend-yielding stock, management walks the walk and we've been pretty darn

Who's the capitalist?

source: The Bloomberg

satisfied with their performance as a company."

Concerning Gazprom, the world's biggest gas producer, the largest stock by market capitalization on the Moscow bourse, and—*and*—a notorious instrument of Russia's not universally popular foreign policy, Hague is of a different mind. "As far as shareholder return is concerned, the most efficient price for Gazprom is probably zero," he says.

If Gazprom ever does reach Hague's price target, it likely won't be on account of the balance sheet. Net debt represents 0.7 times EBITDA, or earnings before interest, taxes, depreciation and amortization; operating income covers interest expense by a factor of 39. Lukoil and Rosneft, respectively, show net debt equivalent to 0.5 times and 1.9 times EBITDA; their operating income covers interest expense by factors of 26 times and 15 times (Exxon covers with still greater ease: 196 times over).

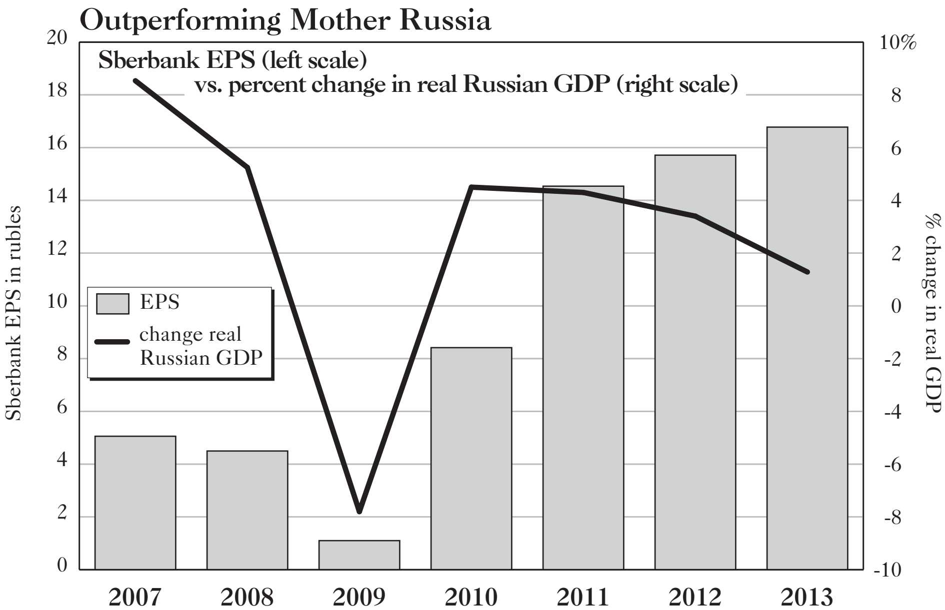
Contrary to Sen. John McCain (R., Ariz.), Russia is not merely "a gas station masquerading as a country." There are banks there, too. Sberbank, successor to the old Soviet Gosbank, is the biggest; its ubiquitous branch network holds 45% of the country's retail deposits. The Russian central bank, in turn, holds 50%, plus a share interest in Sberbank.

By the numbers, Sberbank is a picture of good health. Equity capital foots to 10.25% of assets; nonperforming loans amount to 2.9% of total loans; reserves for loan losses cover 155% of admitted non-performers.

Granted that no outsider is privy to the true condition of any bank, but it does speak well of Sberbank that it survived the 2008 crisis-induced collapse in the price of a barrel of crude oil (to $36 from $146 in six months). The aid that Russia vouchsafed to Sberbank took the form of a 500 billion ruble loan at an 8% interest rate; this was in December 2008. Sberbank repaid 200 billion rubles in May 2010, at which point the government cut the borrowing rate to 6.5%. Unlike certain too-big-to-fail American institutions one could name, Sberbank was profitable both in 2008 and 2009, if in the latter year by the skin of its teeth.

The afore-quoted Zhilin owns Sberbank, despite the government's control and the attendant suspicion "that there are some elements of light coercion when it comes to participating in large, state-sponsored projects as a lender, which you could say is an implicit tax," as he puts it. Zhilin goes on: "Another knock is that it has made some moves expanding outside of Russia. They bought a bank in Turkey, not at a crazy price but their Russian franchise is much cheaper and has much better returns."

As to valuation, Sberbank common (SBER on the Moscow Exchange) trades at 4.8 times trailing net income, 92% of book value and delivers a yield of 4%. Cheaper are the preference



sources: The Bloomberg, International Monetary Fund

shares, which, at a 13.8% discount to the common, are quoted at 3.9 times trailing net income, 80% of book and yield 4.6%. The preferred confers no voting right; then again, the Central Bank of the Russian Federation has the only vote that counts.

"There's another way to think about Sberbank," Lorenz observes. "It is formerly a communist bank. Industrial and Commercial Bank of China (1398 on the Hong Kong Exchange) is currently a communist bank. At a glance, the two institutions look like first cousins. Each is the biggest bank by assets in its home country. Each is commandingly cheap. ICBC trades at five times trailing earnings, at 97% of book value and delivers a 6.9% dividend yield. Like Sberbank, ICBC appears to be well capitalized and well reserved.

"What's different is the macroeconomic context," Lorenz proceeds. "China is coming to the end—so we at *Grant's* believe—of a debt-financed investment bubble. In comparison, Russia is almost a credit abstainer. China's banking assets sum to 266% of China's GDP. Russia's banking assets sum to 88% of Russia's GDP. If anything, the comparison understates the true scale of China's debt derangement, as the risks associated with China's so-called shadow banking system are burgeoning. People who ought to know reckon that one-fifth of China's GDP is tied to real estate construction. It hardly inspires confidence that, according to China Real Estate Index System, property sales in 44 Chinese cities fell by 19% year-over-year in April, measured by volume.

"One might introduce another point of comparison, and that is corporate governance. As between Russia and China, which presents the more generous and enlightened face to the world?

"Buying a share in any of the three Russian energy stocks or Sberbank entitles you to an economic interest in the underlying business," Lorenz points out. "Buying a share in the upcoming IPO of Alibaba Group Holding Ltd., the celebrity Chinese Internet business, does not. It does not, in fact, buy you a direct exposure to Alibaba. Most of Alibaba's operating businesses are owned by Jack Ma himself—the founding genius—or by Simon Xie, his fellow founder. They control them through so-called variable interest entities."

To protect the tender eyes and ears and minds of their subjects is a shared mission of Putin and his autocratic counterpart in the People's Republic of China, Xi Jinping. Each dictator has obvious designs on the Web, though Putin—give the tyrant credit—does allow foreigners to buy direct economic interests in Yandex, the Russian Internet giant (YNDX on the Nasdaq). Then, too, ordinary Russians can—and have been—exercising their rights to convert ruble deposits into dollars and euros, as *The Wall Street Journal*'s "Emerging Europe Real Time" blog reported on Monday. No such choice is available to the average Chinese.

"One might also question the competence and honesty—certainly the oversight—of Chinese accountants," Lorenz closes. "Starting in 2012, China demanded that the Big Four auditors hand over control of their Chinese operations to Chinese citizens. It happens that Chinese law bars outside regulators from inspecting Chinese work. Here is the way that fact is presented to prospective Alibaba investors: 'The audit report included in this prospectus is prepared by auditors who are not inspected fully by [America's] Public Company Accounting Oversight Board and, as such, you are deprived of the benefits of such inspection." At least, Russia's accounting regulator can check the work on any Russian company it chooses."

Semi-final word goes to Ian Hague. "There's no doubt that it is a very attractive investment on a headline basis. But there are too many tape bombs right now. That problem a person coming to the market for the first time would face is that they could take a substantial hit before things get back to something resembling normal."

Thus, as we see the situation, investors are out of Russia, speculators are short Russia and the Western political class (including none other than the White House press secretary) is condemning of Russia. Cheer up, Vladimir Putin. *Grant's Interest Rate Observer* is bullish—on your stocks, anyway.

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Investing with Putin

The $1.3 billion Market Vectors Russia ETF (RSX on NYSE Arca) is the largest listed fund that invests solely in Russia. Its holdings feature energy (43% of AUM), basic materials (17%), communications (17%) and financials (12%). Top three names are Gazprom (8.8% of AUM), Lukoil (8%) and Sberbank (7.4%). While, in the year to date, the price of RSX shares has plunged by 15.7%, the number of shares outstanding has climbed to 59.5 million from 41.4 million. Who or what might be the source of the demand? To judge by the surge in short interest as a percent of shares outstanding—to 27.5% from 23.6% at year-end—it's the Russian bears.

For so-called qualified investors,

the UFG Russia Select Fund, with offices in Moscow and Ipswich, Mass., is a long-short fund with $102 million under management. It's open to new investors and charges a 2% management fee and a 20% performance fee. Firebird New Russia Fund invests half of its assets in Russian-listed stocks and the balance in former Soviet bloc countries. Open to new investors, Firebird has $144 million in assets and likewise charges 2% and 20%. Boris Zhilin's Armor Capital Management, which also has room for newcomers, is a diversified global equity fund that has begun to dip a toe in Russia. Zhilin's firm manages $400 million in assets and charges 1% and 20%.

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