

# GRANT'S

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## Popular pariahs

Never mind “global macro.” Global micro’s the ticket. Pick a good company in a bad country with a worse government. Now under way is a survey of a few of the ideas that you formerly couldn’t stand to mention in polite investment company.

Our old friend Sberbank (SBRCY is the ticker of the American Depository Receipt) is first on the agenda. It was not so obvious over the past two years that Russia’s top bank would survive, let alone prosper, under the dual oppressions of Vladimir Putin and Mr. Market. Yet prosper, lately, it has, with record first-quarter profits of 118 billion rubles (\$1.8 billion), a 286% year-over-year gain, compared with analysts’ expectations of 102 billion rubles. Nonperforming loans climbed to 5% of the portfolio as of March 31, from 2.9% at year-end 2013, but reserves cover those bad debts by 125%; equity capital amounts to 9.4% of assets.

The first of our four articles on Sberbank appeared in the issue dated May 16, 2014, which happened to coincide with a top in the oil market (and with a new leg down in the long bear market in Russian-American comity). A barrel of Russia’s No. 1 export has subsequently traded in a range of \$126.65 to \$27.88, while, over the same tumultuous span, the ruble-dollar exchange rate has varied between 82.4 and 33.7. Russian GDP, which contracted by 3.7% in 2015, is projected to weaken by another 1.8% in 2016. Yet, as we say, SBRCY has managed somehow not to dry up and blow away. Its share price is lower by

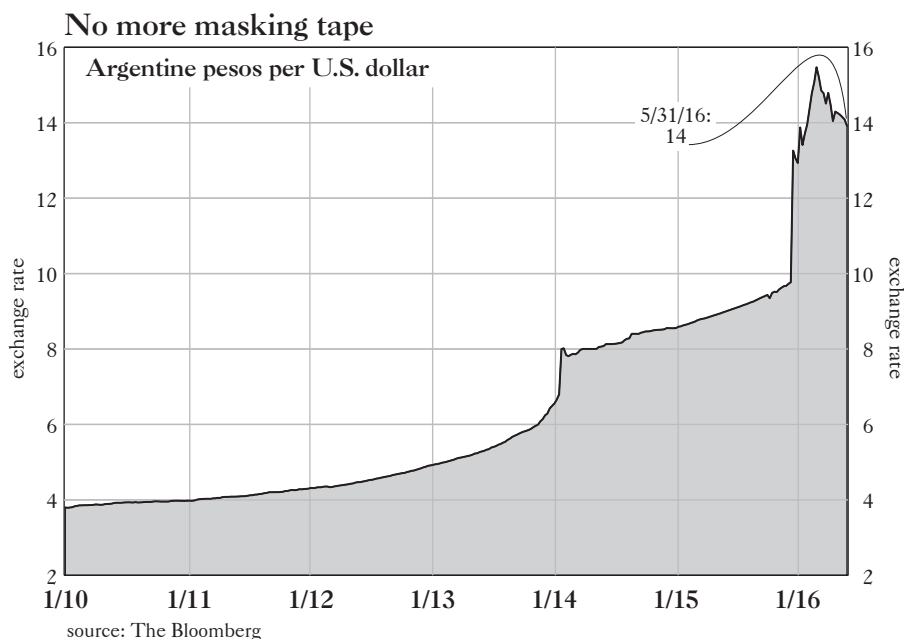
12% since our first story appeared two years ago but up by 71% from the date of our fourth installment, Aug. 7, 2015. Today, the shares change hands at eight times the 2016 estimate and at 115% of March 31 book.

Argentina is a different kind of pariah—or, we should say, former pariah, as “the country that ruined itself” (*Grant’s*, Sept. 5, 2014) has, with the 2015 presidential election of Mauricio Macri, and with the synchronous exit of Cristina Fernández de Kirchner, taken the political steps to rebuild itself. One must be careful about betting on instantaneous improvements, but the signs so far are propitious. In April an Argentine sovereign-debt issue (such

a thing would have been inconceivable before the Macri-led settlement of outstanding claims) raised \$16.5 billion and was four times oversubscribed.

“Macri,” Cullen Thompson, co-founder and chief investment officer of Bienville Capital management, tells colleague Alex Hess, “represents an abrupt end to Kirchnerism. His administration has done a great job unveiling the policy changes promised. And we’ve been impressed with both the speed and skill of implementation.”

There can be no guarantees, of course. It’s said that Kirchnerism’s main contribution to anti-inflation policy-making was to fake the statistics. A second line of attack was to mask the



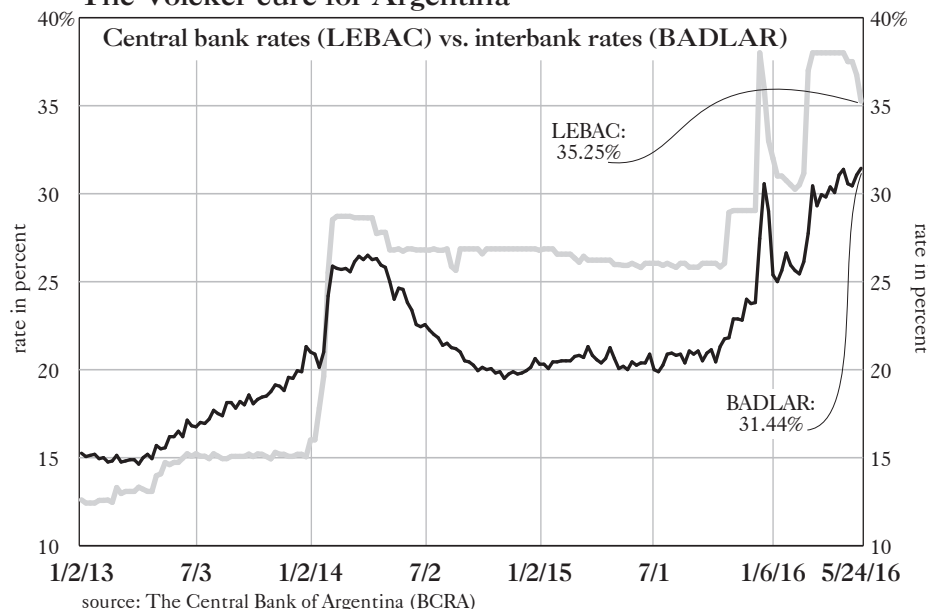
deterioration in the peso exchange rate. Macri has ripped off the masking tape; the liberated peso today trades at 14.0 to the dollar, versus the official level of 9.8 in the final days of Cristina.

Pending the reconstruction of the debauched national statistics office, inflation data come piecemeal from the regions. If the Buenos Aires CPI is a fair guide, prices are rising on the order of 40% per annum, up from the high-20s in December. What to do? The Argentine central bank is taking a page from the Volcker manual, pushing short-term interest rates to the sky, in this case to 35%. The fiscal situation is of a piece with the monetary one, with the government budget showing a deficit between 4% and 7%, depending on the accounting technique employed. Real GDP is on course for a 1% decline this year, according to the International Monetary Fund.

Kicking the slats out from under Kirchnerism will finally benefit all, Macri promises. Until that jubilee, there will be losers and winners. Not least among the latter is Argentina's top natural-gas producer, Transportadora de Gas del Sur S.A. (whose ADRs trade under TGS on the New York Stock Exchange). When we published our analysis of the company in September 2014, the stock commanded a forward multiple of 4.7 times EBITDA. Today, that multiple is 8.4 times—the share price has doubled—mainly thanks to the rollback of Kirchner-era price controls. In Buenos Aires, the no-longer-quite-so-suppressed price of natural gas has increased by 300%. Bulls, if not the consumers, hope for more. Macri & Co., yielding to local-government pressure, have recently dialed back plans to raise prices elsewhere.

Unwinding Kirchner's most distortive policies may similarly benefit agricultural producers, including the \$1.3 billion market-cap Adecoagro S.A. (AGRO on the NYSE). AGRO, the owner of 203,520 hectares of farmland in Argentina, Brazil and Uruguay, operates three broad segments. The first, in Argentina, produces grains, oilseeds, rice and dairy. The second, in Brazil, cultivates sugarcane to make sugar, ethanol, and energy. The third, a land-transformation unit, buys crop ground with an eye to improving it and, finally, to selling it.

## The Volcker cure for Argentina



"Trading at 76.3 times last year's earnings and 14.9 times consensus 2016 earnings," Hess observes, "Adecoagro may not look cheap. However, the upside potential under the new regime is significant. Under Kirchner's thumb, the company's operating profit was \$130 million in 2015, barely changed from the level in 2011 (in the Argentine subsidiary, operating profit fell to \$41 million from \$54 million)."

Driven by gains in Brazil, Adecoagro's first-quarter operating profit more than doubled, year over year, to \$30 million from \$14 million. Argentine operations, too, started to pull their weight, thanks to the peso's devaluation and export-tax reforms. Fernando Suarez and Federico Rey Marino, analysts at Raymond James, note that, in tandem, the two reforms "more than offset lower yields and a delay in harvesting activities due to bad weather conditions." In the quarter, the Argentine segment's operating margin expanded to 52% from 36% the year before, while operating income rose to \$26 million from \$23 million, despite an 18% drop in sales driven largely by lower commodity prices.

Leverage is outsize, if measured by the razor-thin, 1.35:1 margin by which operating income covered net financing costs in the 12 trailing months. We rationalize the evident risk by noting that the cost of financing was swollen by the Kirchnerian foreign-exchange controls. If this cheerful view is correct, better (and more comfortable) times lie ahead.

One might suppose that a Kirchner-led country would be an encumbered one. "Argentina," says Bienville's Thompson, correcting that misperception, "is one of the most underleveraged countries in the world." With inflation running at well over 30%, lenders stay short, if they lend at all. According to the World Bank, Argentina's ratio of domestic private credit to GDP in 2014 was just 14.3%, the lowest of any country in Latin America and the Caribbean.

One likely beneficiary from the revitalization of credit is Grupo Financiero Galicia, whose American Depository Shares, equal to 10 shares of class-B stock, trade on the NASDAQ under the ticker GGAL. Valued in the stock market at Ps. 48.8 billion (around \$3.5 billion), the bank has assets of Ps. 180.4 billion and deposits of Ps. 107.9 billion. It's among the largest financial institutions in Argentina, as well as the top issuer of credit cards.

Like AGRO, Grupo Galicia hardly looks cheap. "However," Hess points out, "with inflation driving returns-on-equity that reached 35% in 2015, such metrics as price to book—quoted at 3.9:1—are distorted. Looking instead to Grupo Galicia's multiple of 11.2 times last year's earnings, the stock may in fact be counted cheap. In such a dramatically underbanked country as Argentina, credit growth can track well in excess of GDP growth for years without adding excessive risk to the financial system. If Argentina

can catch up to its regional peers in terms of credit creation, then Grupo Galicia should have significant growth potential.”

Inflation-pinched time horizons mean that no markets exist for such conventional banking products as mortgages and term loans. At a December tally, 55% of Grupo Galicia's loans fell due within a month. Further, the interest margins earned by Galicia are, in inflation-adjusted terms, negative—in the first quarter, earning assets yielded just 24.3%, compared to three-month-rolling gains on the Buenos Aires CPI of 32.5%. With respect to the possibilities for Galicia

of a return to real interest rates, we allow ourselves to imagine the position of the No. 1 brewery in a country that has just ended prohibition.

A Caa1 credit rating from Moody's—constrained by Argentina's low sovereign-credit rating—is no flatterer of Galicia's financial strength. As of March 31, just 3.3% of private-sector loans were nonperforming, and these were 108% covered by reserves. Balance-sheet equity for Grupo Galicia totaled 8.8% of assets—not good for an American bank, perhaps, but creditable for a survivor of Kirchnerism.

Good businesses are tyrant-proof.

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