



Russian commodities resurrected



Michael McCormack analyses the recent spurt in Russian commodities and considers whether this is a long term effect

Investors may look back on one market event in December 2006 as the signal that presaged a wholesale shift in how to think about Russian stocks: Sberbank's astonishing 42.4% rise. Three key decisions about Russia's future as a home to foreign capital are crystallised in that rise: that Russia has transcended its prior status as a mere supplier of commodities; that a fast-growing economy had reached the tipping point which translates domestic consumption growth into stock performance; and that, regardless of the name on the ballot, Putin's successor would guarantee continuity of the policies that have underpinned Russia's economic success.

It can be dangerous to read too much into the performance of one stock: although Sberbank has fumbled its communications somewhat, investors remain confident that the bank can put a forthcoming US\$12bn rights issue to profitable use and the extra capitalisation will boost the bank's weighting in emerging markets indices, attracting the interest of passive investors. However, a gain of that magnitude, particularly when achieved by a company whose fortunes are so closely tied to domestic economic growth, suggests strongly that investors' view of Russia has been reconsidered.

Russia's impact ignored

Until recently, investors had two excellent reasons to ignore companies attempting to capture a slice of Russian domestic growth: there were very few in which to invest (and far fewer if market capitalisation and liquidity were of concern), and those available offered a far poorer growth outlook than Russia's hard-charging oil and gas producers. The Russian government's decision to float its giant energy companies led them to the market in time to meet unprecedented demand for their output, with the result that the RTS Oil and Gas Index posted a 363.8% rise in the five years to January 2007. Of course, the rear-view mirror makes all investment decisions seem obvious: in fact, investors who placed all their Russian bets on energy endured a volatile ride. The sector was chilled through most of 2004 and early 2005 as the Yukos dispute raised questions about the extent to which the government might punish corner-cutting managers. By mid-2005, when it became obvious that Yukos would become a ring-fenced example to the rest, the upward progress of share prices resumed. Investors who sought to diversify away from Russian energy in this period found a satisfying alternative in the metals and mining sector, which enjoyed a 100.2% gain in 2004-2005. The global construction and development boom fuelled demand for steel and nickel, while Russia's undervalued gold producers quickly caught up with global peers.

Under these circumstances, investors could be forgiven for believing that there was little of interest in Russia outside the commodity space. For example, consumer-facing companies were thin on the ground and the largest, Baltika Brewery, boasted a market capitalisation of less than US\$5bn at the beginning of 2005 – less than one-fiftieth the market capitalisation of market leader Gazprom. Even the RTS Stock Exchange could not find enough consumer-facing companies to launch a sector index until December 2004. Electricity, property and construction stocks suf-

fered similar, if less severe, constraints. And many investors continued to subscribe to the belief that emerging markets – and Russia in particular – were only suitable destinations during commodity rallies, unable to sustain economic or market success in leaner times.

What happened to change this view? Oil and gas prices fell. The 30% drop in oil prices seen in late 2006, might, in prior years, have spelled disaster for stock prices in an emerging market oil producer. Commodity-production economies have had, until recently, a singularly poor record in stimulating growth, capital formation or sustainability in other industries. As a result, when commodity prices fell, so did their markets, not to recover until the next upswing in the commodity cycle.

Russia, like a handful of other commodity-producing emerging nations, now appears to have broken this cycle. Fiscal discipline has allowed Russia to pay off its foreign debts and amass a US\$90bn oil stabilisation fund. The effect of the Russian taxation regime is that oil prices must fall below US\$40bbl before the country's budget balance is imperilled (although oil stock prices would feel the chill at higher levels). With debts paid and a cushion against future price falls established, Russia's economy is flushed with cash – cash that is evident in rising incomes, rising spending, and fast growth in property, infrastruc-

ture and services. Equally important is the fact that neither growth nor confidence in its sustainability were significantly hampered by the falling oil price. From October to December 2006, when oil prices endured the bulk of their fall and the stock prices of many of the largest oil companies stuttered, the RTS Index rose by almost 20%. Where were the outperforming stocks that supported the index to be found? Among telecoms, industrial, property and construction firms, whose steady stream of earnings, growth announcements and cashflow gave the lie to the notion that Russia's market was a one-way commodity bet.

A recent addition

Some of these companies have only come to market in the past three years. Between January 2004 and December 2006, Russian companies raised more than US\$14.4bn in IPOs, improving the range of companies and sectors to which investors could gain exposure. Another US\$15bn to US\$25bn of new issuance is expected in 2006-7. Others have only recently begun to reap the rewards of slow-burning trends such as the move from open-air markets to organised retail shopping, or the rise in incomes that is now allowing Russians to move out

from concrete-walled, Stalin-era flats. This gain in spending power has become a key driver of many companies' fortunes: annual household consumption growth has rarely dipped below 10% in the past five years and average incomes have reached the point where mass-market discretionary spending includes semi-luxury items such as cars, holidays and home entertainment equipment. The late-2006 success of companies focusing on domestic spending – consumer and corporate – and the evidence of growing demand for their products and services, demonstrated the extent to which domestic growth was now able to drive the values of investable companies. The tipping point had been reached.

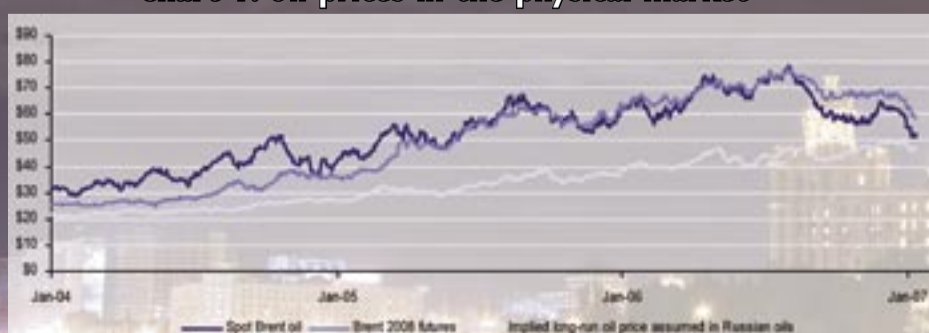
However, to capitalise on these trends, both companies and investors needed reassurance that the policies which had created wealth would be continued. In Russia, such questions centred on the successor to President Putin, who will take office for a minimum four-year term in March 2008. Unlike previous elections, no populist or demagogue is making a serious challenge for the post and the only party whose stated interest is dismantling Russia's market-friendly economy – the Communist party – are fading into memory. As a result, the next president is likely to be Putin's hand-picked man, with Putin himself remaining as an eminence grise to steer policy from the background. Putin's success at playing Kremlin factions against each other makes pricing the horses a difficult exercise, but it also guarantees that his replacement will owe him a considerable debt – one that Putin will have little trouble enforcing. This continuity of influence can give considerable comfort to investors, who are able to presume with confidence that the economic policies which drive market growth will survive the presidential transition.

Acknowledgement of the Russian market's new depth, combined with a willingness to believe in policy continuity, allowed investors to violate the long-held habit of abandoning an emerging market when commodity prices weakened. Newly convinced of the sustainability of Russian domestic demand, they were able to find constructive alternatives to oil and gas producers, such as telephony, industrial and consumer goods producers. And, of course, Sberbank: Russia's largest lending bank was perhaps the prime beneficiary of investors' new willingness to expose themselves in size to domestic economic growth.

Where should investors look to find companies best able to exploit Russia's domestic growth? Our search has led us to retailing pioneers, to telephony companies where deregulation and increasing demand are prompting a new focus on profits, to construction and property companies which are meeting the need for modern housing, offices and factories, and to the infrastructure companies which are re-wiring Russia and constructing the roads, rails and pipelines that will deliver its new goods. These companies, whose growth and prosperity is directly linked with advances in the domestic economy, are, in our view, also the ones most likely to inherit the investor approval so lavishly granted to Sberbank in December.

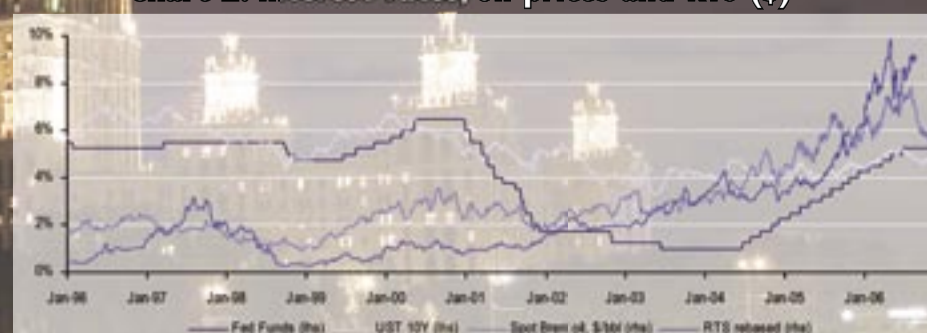
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Chart 1: Oil prices in the physical market



Source: Bloomberg, UBS estimates

Chart 2: Interest rates, oil prices and RTS (\$)



Source: Bloomberg, UBS