TKB INVESTMENT PARTNERS

Russia in the spotlight
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Demystifying Russia

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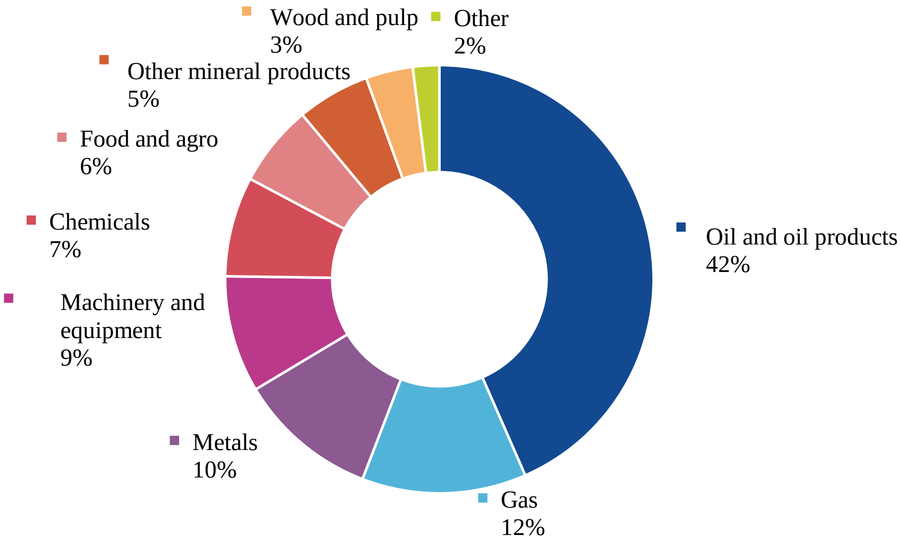
Often we face investors' preconceptions that Russian equities cannot grow unless oil prices rise, that Russia is unpopular with international investors, that sanctions have a material negative effect on Russia, etc. We think that these beliefs limit the ability of investors to benefit from exposure to Russian equities. In our view, such preconceptions paint a simplistic picture that does not stand up to scrutiny. We would argue that the real picture is far more diverse and sophisticated.

Myth №1: The Russian economy and equity market are driven only by oil prices

Indeed, the price of price is important to the Russian economy and Russia's stock market. Oil, oil products and gas account more than a half of Russian exports (Figure 1).

Figure 1: Russian exports: main components, 2016



Source: Customs, TKB Investment Partners, March 2018

Furthermore, direct taxes on the oil and gas sector accounts for about half of all government revenues (Figure 2)

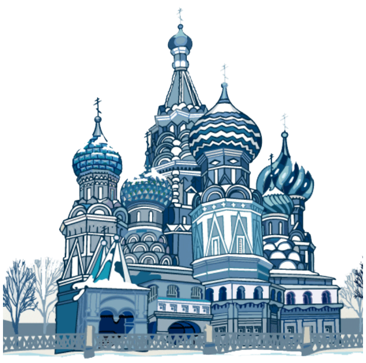
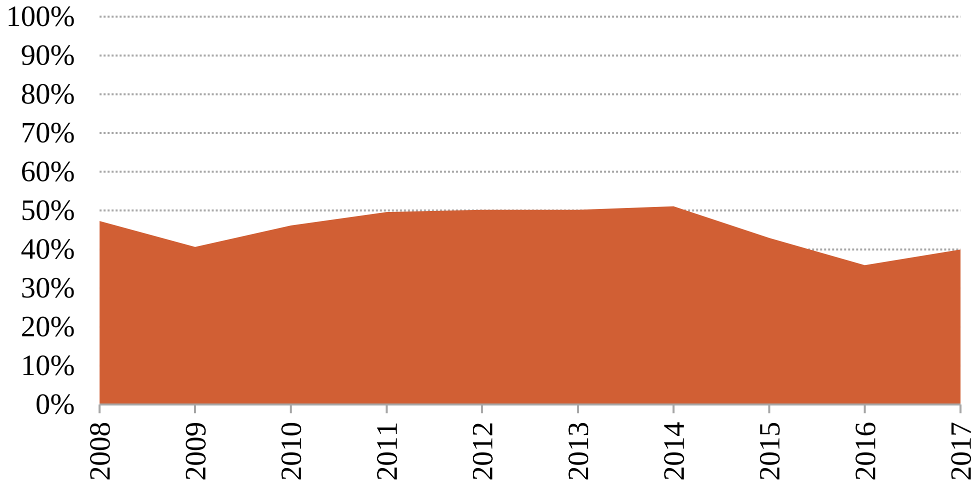


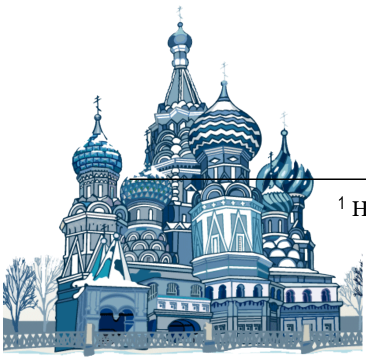
Figure 2: Share of federal budget revenue derived from direct taxes on oil & gas



Source: Customs, TKB Investment Partners, March 2018

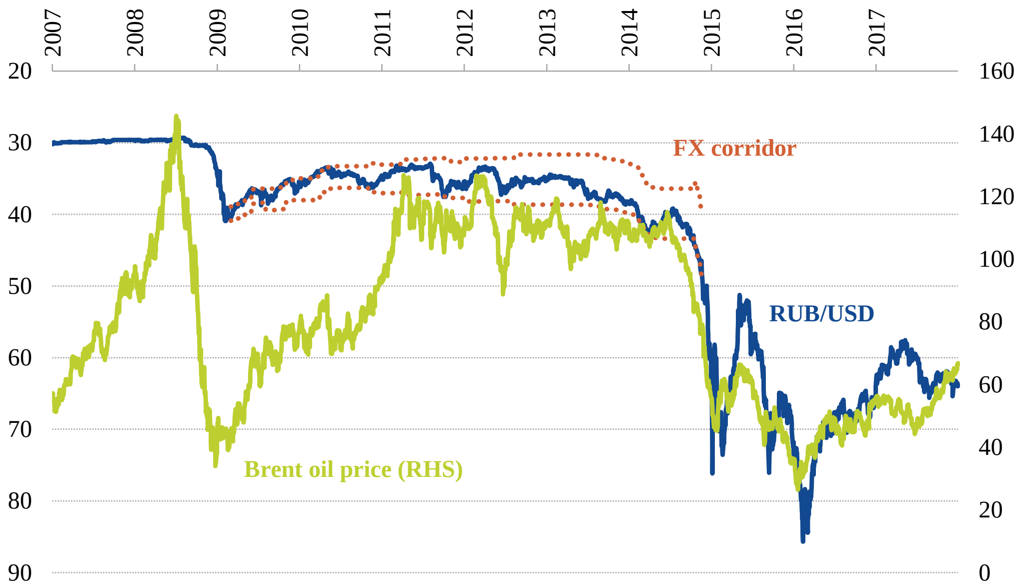
However, we believe it would be oversimplification to assume a direct relationship between oil price and Russian economy/Russian equity market, since there are two other important balancing factors: the free-floating exchange rate of the rouble and the progressive taxation of the oil and gas sector.

The free-floating exchange rate regime was introduced in 2014 to serve as a natural balancing tool for the economy when the oil price plummets (Figure 3). Without it, as was seen in 2008, a large drop in the oil price can be a real shock for the Russian economy. For example, in 2009, Russia's GDP contracted by 7.8%, while the average oil price fell by 36%[1]. The introduction of the free-float regime in 2014 helped to cushion the adverse impact on the economy of the oil price collapse in 2015. The average oil price fell by 47% over 2015, i.e. by much more than in 2009, resulting in a 2.8% contraction in GDP, i.e. much smaller than in 2009.



[1] Here and further in the paragraph the oil price data is for Urals crude

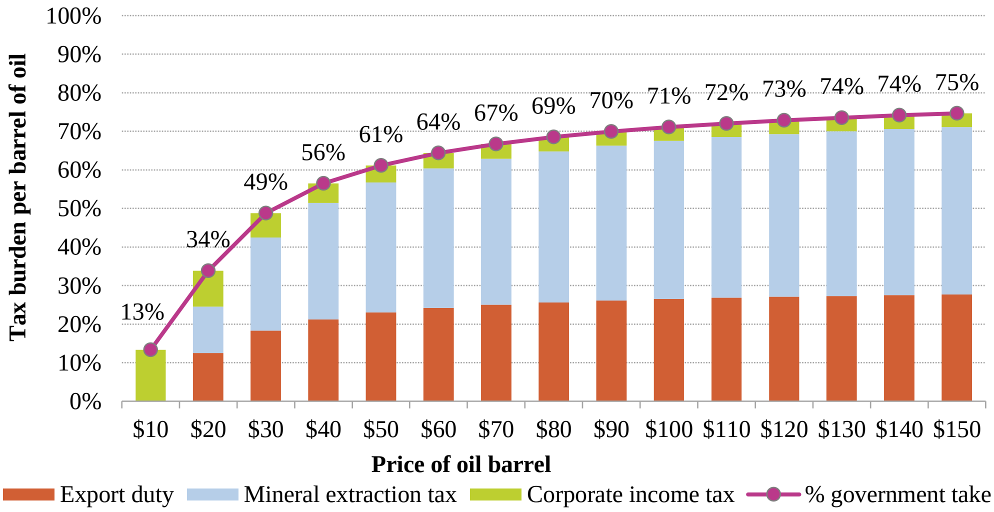
Figure 3: Rouble against bi-currency basket*



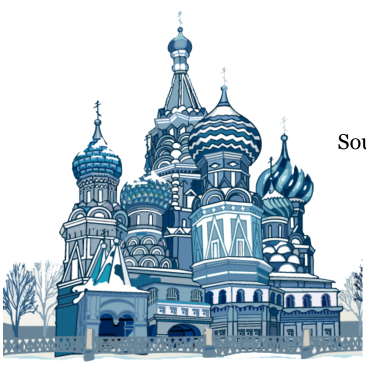
* Rouble against EUR/USD basket
Source: CBR, Bloomberg, TKB Investment Partners, January 2018

Progressive taxation of the oil and gas industry, which accounts for a significant share of the Russian equity market, makes this sector more resilient to falling oil prices compared to its global peers and at the same time helps to spread the positive effect of rising oil prices across many sectors. In addition to corporate tax of 20%, oil and gas companies pay mineral extraction tax and export duty, which is progressive and depends on the oil price. For example, when the oil price is USD 100/bbl, the state takes 71% of this selling price. According to our estimates, in 2015, when the average oil price was near USD 40/bbl, average oil production company EBITDA was USD 14/bbl, only slighter below than the USD 17/bbl level when oil prices were close to USD 100/bbl in 2013. (Figure 4).

Figure 4: Government take per barrel of oil, 2017 (upstream)



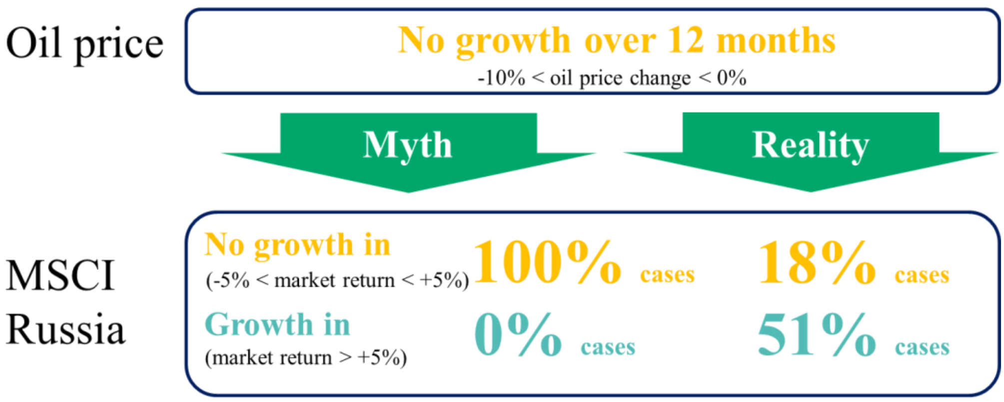
Source: TKB Investment Partners, May 2018



As exports comprise the biggest share of income for Russian oil and gas companies, a free-floating rouble provides balance for them if the oil price falls, as most of the companies' costs are in roubles. Thus, when we return to our example above about the EBITDA of oil companies, in rouble terms it actually doubled.

Another frequent assertion is that the Russian equity market cannot grow without growth in the oil price, which our empirical findings show not to be the case. The Russian equity market rose in more than 50% cases when oil prices were either flat or even declining by up to 10%. Only in 18% of cases was the market more or less flat with movements in the range between -5% and +5% (all figures in USD terms; Figure 5).

Figure 5: Test of the myth: no growth of oil price = no growth of Russian market



Time sample in the analysis: 2000-2018 (weekly step)
From 7/01/2000 to 20/04/2018 for MSCI Russia (including dividends) and Brent oil price
Sources: Bloomberg, TKB Investment Partners, May 2018

The bottom line is that the price of oil is an important factor for the Russian economy and equity market, but suggesting a linear dependency between them is in our view an oversimplification that could lead to crucial errors in asset allocation.

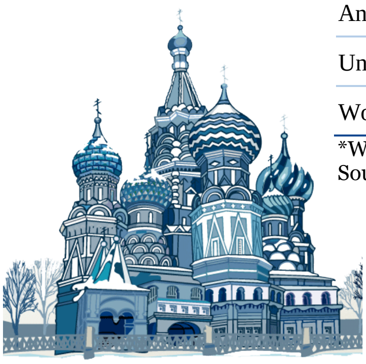
Myth №2: President Putin has done nothing good for Russia

Over 18 years under Putin's rule, Russia has gone through a remarkable transformation (Figure 6).

Figure 6: A remarkable transformation over the past 18 years

	1999	2017
GDP (USD billion)	196	1 570
GDP per capita (USD)	1 346	10 758
Average Urals price (USD per barrel)	17	53
Sovereign debt versus GDP (%)	162%	12%
Foreign reserves (USD bn)	11.5	432.1
Average monthly wage (USD)	64	570
Annual inflation	36.5%	2.5%
Unemployment	10.6%	5.1%
World Bank Doing Business Ranking*	79th	35th

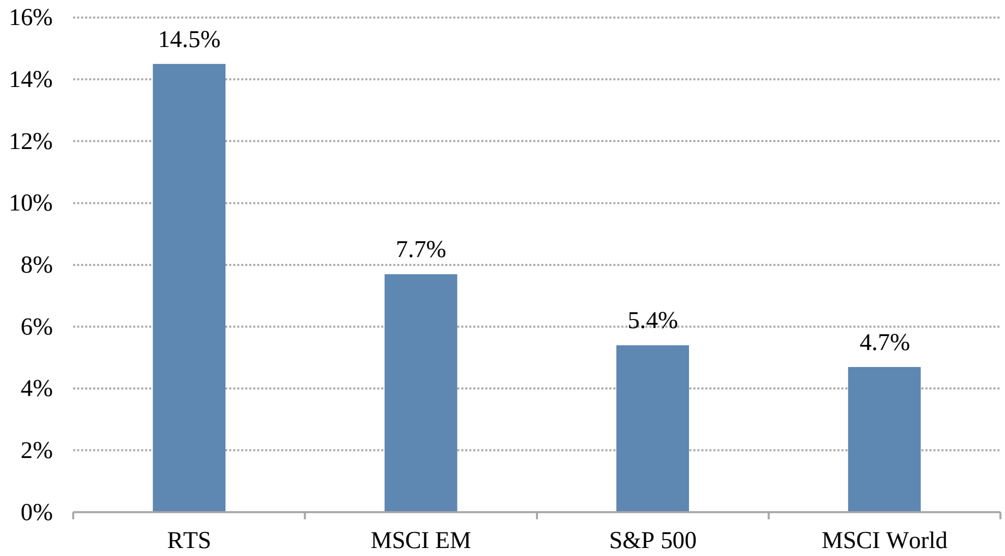
*World Bank 'Doing Business' rankings are for 2006 and 2018 respectively
Sources: IMF, Rosstat, WB, CBR, TKB Investment Partners, February 2018



Of course, this is partly a result of rising oil prices. At the same time, many other things have been achieved, which have transformed Russia enormously. For example, the tax reform of the early 2000s resulted in a much simplified tax system, significantly improving tax compliance and collectability. It was accompanied by the introduction of the fiscal framework, under which excess oil revenues are transferred to reserves. Other crucial economic transformations include the business deregulation of the early 2000s, new land and real estate codes, electricity reform, WTO accession, the transition to a free-floating rouble and inflation targeting, and a banking sector clean-up. As a result, both GDP and GDP per capita have increased eightfold, inflation has fallen to levels similar to those in developed countries, and Russia's sovereign debt has been enormously reduced. Meanwhile, oil prices have increased only threefold over the same period.

To add a further brief fact, throughout the 18 years of Putin's rule, the Russian equity market has seen significant volatility, but overall it would have paid to hold Russian equities over this period (Figure 7).

Figure 7: Average annual return over 18 years



Note: total return including dividends; from 31.12.1999 to 29.12.2017; in USD terms
Sources: Bloomberg, TKB Investment Partners, February 2018

The bottom line is that there is still much to do in the Russian economy, but there is no denying that a considerable amount has been already done over the last 18 years.

Myth №3: Foreign investors don't like Russia

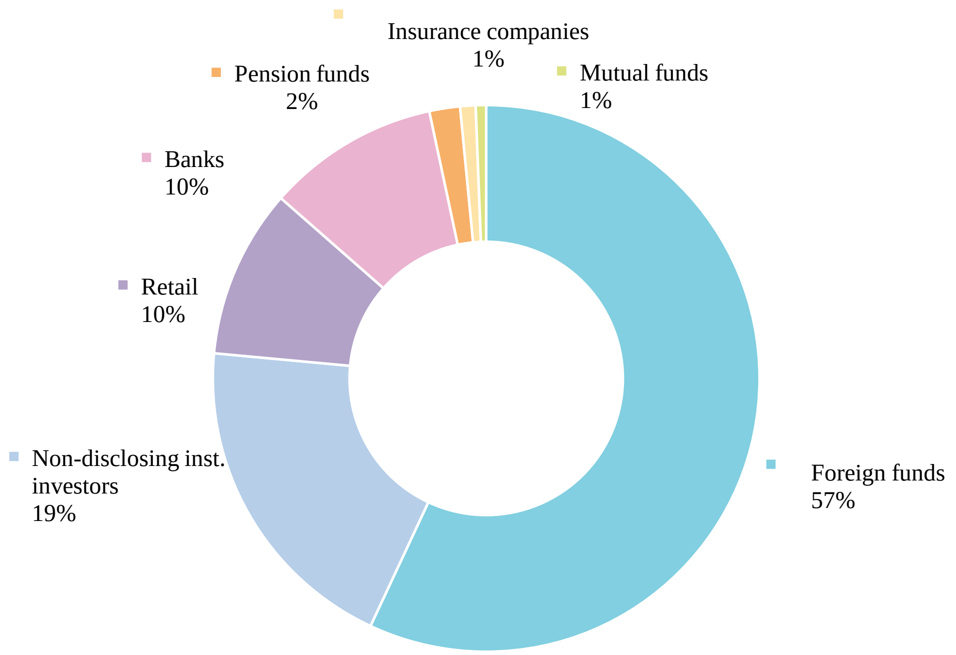
In our view, it is widely assumed that foreign investors used to find Russia attractive when its GDP growth rates and oil prices were high, and when relations with the West were warm. However, things changed in 2014 after a structural fall in oil prices put Russia's economy under pressure and international sanctions against some Russian companies changed the attitude towards Russia from some of the investors. The perception emerged of Russia being a bad place for international investors. However, we would assert that this notion is not backed by the facts.

Russian equities. Some 60%-70% of Russian free-floating equities are owned by foreign investors, including non-disclosing ones (Figure 8)[2]. Furthermore, in overseas general emerging markets funds, holdings of Russian equities account for about 40% of the total free-float. Russia is the second largest overweight market after India, according to

[2] Sberbank CIB estimates

Sberbank CIB estimates. The absolute overweight is between 2%-3% relative to the benchmark MSCI Emerging Markets index, in which Russia's weight is 3.5%.

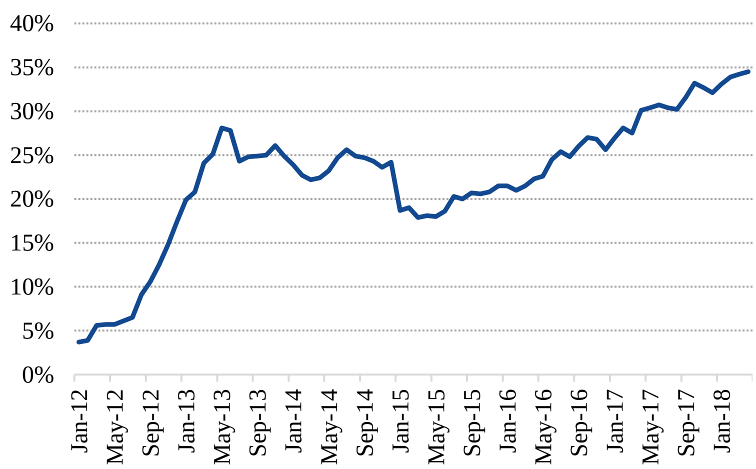
Figure 8: Free-float ownership structure



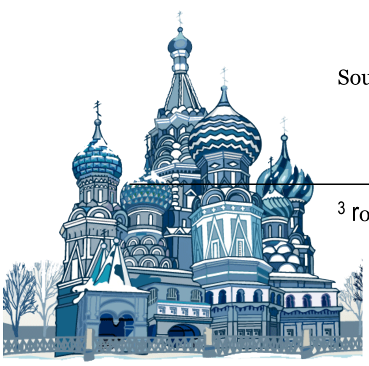
Source: Sberbank CIB, TKB Investment Partners, April 2018

Russian fixed income. The share of foreign ownership of local government bonds increased almost tenfold between 2012 and the end of January 2018, although it went through an interim period of decline in 2013-2015 (Figure 9). As for Russian sovereign Eurobonds, while foreign investors' holdings of these instruments have indeed fallen significantly in recent years, they still account for about one-third of the market, which in our view, is a significant share.

Figure 9: Foreign investor ownership of OFZ[3]



Source: Central Bank of Russia, April 2018



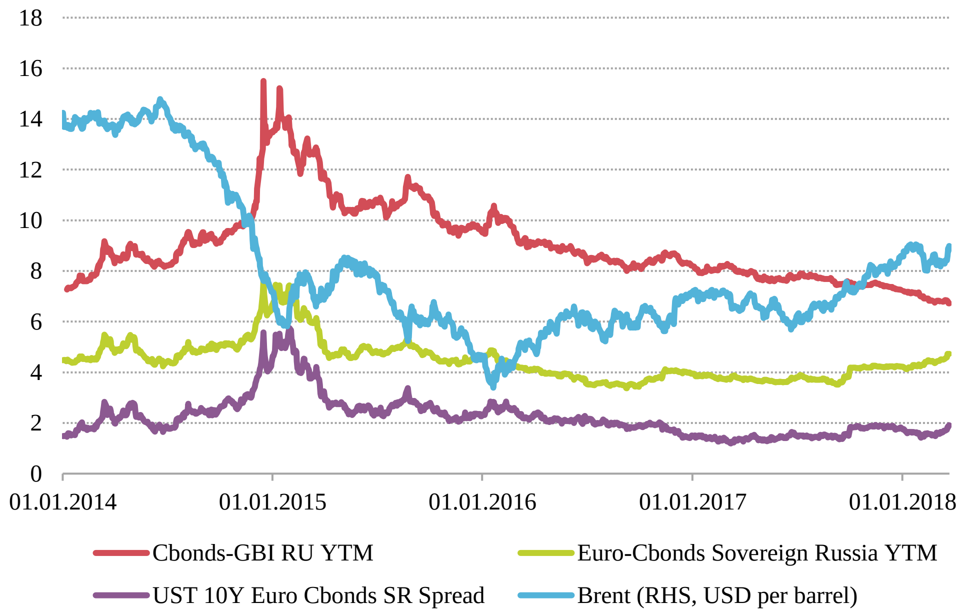
[3] rouble denominated bonds issued by the Russian government

As one can see from this data, foreign investors are still major players in Russian equity and fixed-income markets.

Myth №4: Sanctions hurt Russia

When financial sanctions were first introduced in 2014, the cost of debt indeed increased, as indicated by Russian government bond yields, which may serve as a proxy for the broader market cost of debt. However, this was more due to a fall in the oil price and the subsequent rouble devaluation rather than being caused by sanctions. In response to the rouble's devaluation, the Central Bank of Russia (CBR) increased its key rate, which in turn led yields to skyrocket. Yields then started to contract following monetary policy easing and reached pre-sanctions levels last year (Figure 10).

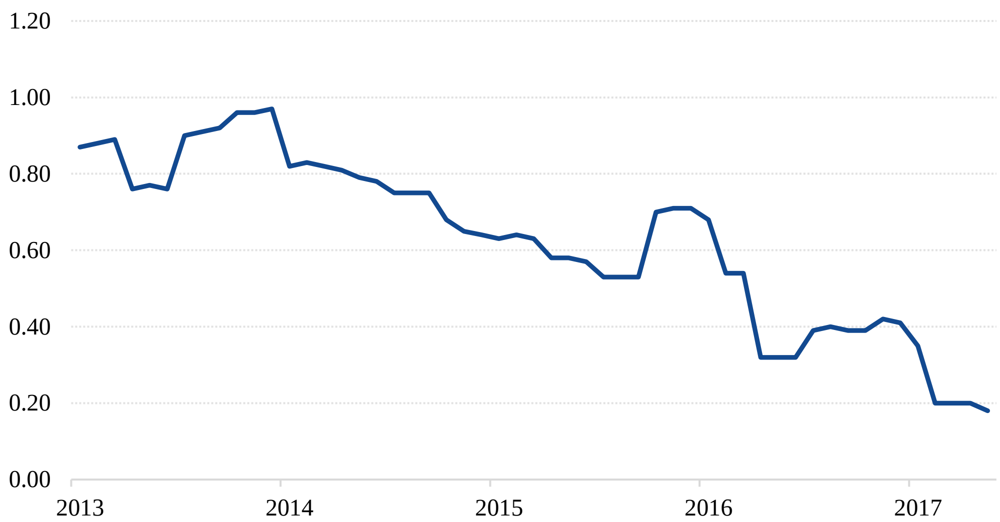
Figure 10: Russian government and corporate bond yields, in %, and the oil price



Source: Bloomberg, CBonds, April 2018

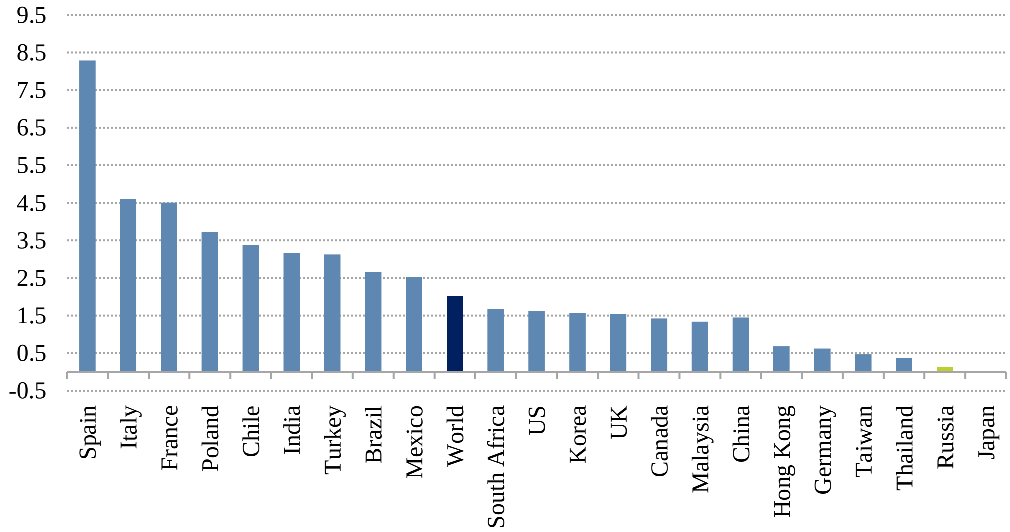
In addition, since the introduction of sanctions, many Russian companies have significantly reduced their debt levels. Those under financial sanctions indeed deferred from issuing international debt. For example, Sberbank ceased Eurobonds issuance after the sanctions were introduced. Companies that are not under sanctions have also reduced their debt loads significantly, although it is unclear to what extent this is attributable to financial restrictions, as many of them generated significant free cash flow and used this for debt repayment. As a result, Russian corporate debt is on average among the lowest in the world. The result of the reduced debt load is demonstrated in Figures 11 and 12.

Figure 11: Russian companies' average net debt/EBITDA ratio has fallen drastically



Sources: Bloomberg, May 2018

Figure 12: Average corporate net debt/EBITDA* ratios around the world



* based on MSCI indices
Sources: Bloomberg, May 2018

Sanctions against the Russian oil sector, which banned provision of oil and gas equipment and technologies to a limited number of oil companies in Russia, has not affected oil production volumes. These rose steadily after the imposition of restrictions, and only started to decline in 2017 when the OPEC+ supply restriction deal came into force (Figure 13).

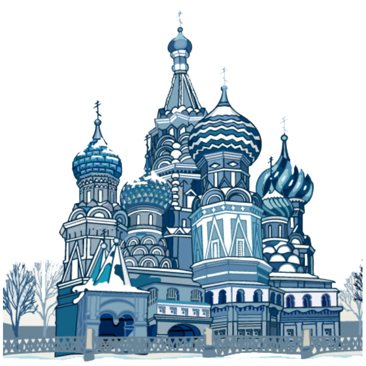
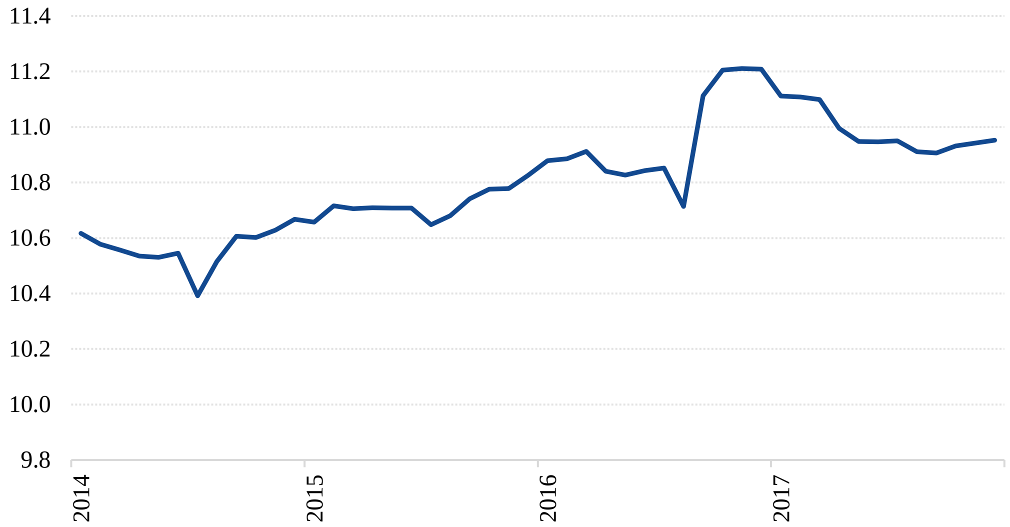


Figure 13: Russia's oil production



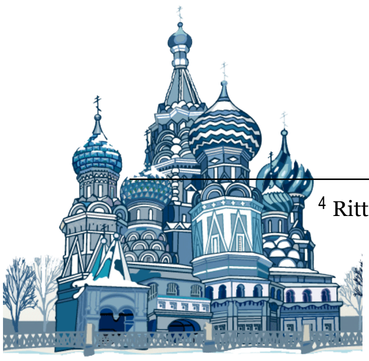
Sources: CDU Tek, December 2017

The latest US sanctions, in our view, should also not on the whole materially affect the Russian economy, as they target specific companies only. See our flash note for details.

Myth №5: Low economic growth implies low equity market returns

The misperception that the rate of GDP growth is crucial for equity markets applies not only Russia but other countries as well. According to academic studies, there is only a low (if any) correlation between economic growth rates and equity market returns (See, for example, Ritter (2005)[4]).

This belief fails to pass the back-test for Russia. Since 2009, Russian GDP growth has been consistently below the average level for emerging markets (EM). However, only in two years (i.e. 22% of cases) there was a material underperformance of Russia equity market vs. EM. Moreover, in three years (33% of cases) there was a material outperformance. Over the period from 2002 to 2008, Russian GDP growth rates were very close to the EM average each year. However, in three years there was a material underperformance (i.e. 43% of cases) (Figure 14).



[4] Ritter, J.R. (2005) Economic growth and equity market returns. Pacific-Basin Finance Journal 13, pp. 489-503

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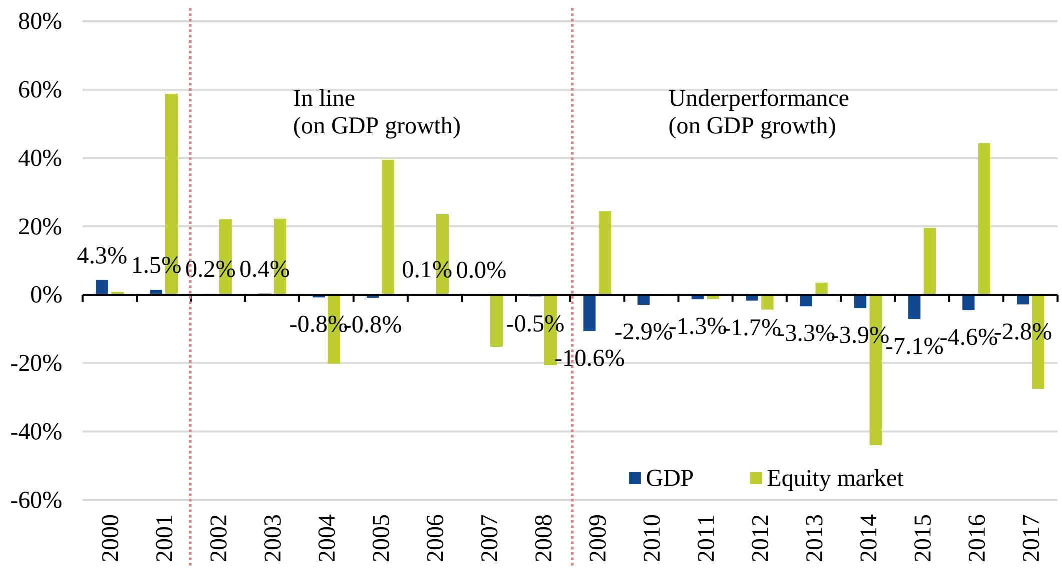
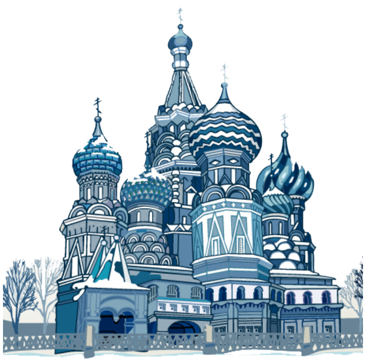
Figure 14: Difference (%) between Russian and EM average GDP and equity market returns

(GDP - in real terms; equity market in USD and gross of dividends*)



* based on MSCI indices

Sources: Bloomberg, IMF, TKB Investment Partners, May 2018



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