The Case for Russia

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Where are we coming from?

2014 marked the beginning of a difficult period for Russia. Oil prices fell, eventually reaching as low as $34 per barrel in 2015, and Russia's annexation of Crimea and involvement in the Syrian Civil War led to draconian sanctions from the United States and the European Union. As a response to the initial economic shock, Russia let its currency float and the ruble weakened from roughly RUB 34 to RUB 86 per US dollar. This currency weakness translated into rising inflation, as the CPI rate moved up from 6% to 17% in less than a year. The Central Bank of Russia, in response, prudently and independently raised its key interest rate by 900 basis points to 17%, which not only curbed inflation, but also created a carry trade, which attracted foreign investment back into Russia while also supporting the ruble.

Where are we now?

On Sanctions

Russia has learned to operate in a sanctioned environment. By increasing the use of domestic products over imported products (a policy known as "import substitution industrialization"), and employing orthodox central bank policy, the country has been able to find a healthy balance of positive growth, low inflation, a fiscal surplus, a current account surplus, conservative debt profiles, and low unemployment rates. The US announced its most recent round of sanctions (related to the Skripal poisoning case in March 2018) in August 2019. These were required under the Sanctions for Chemical and Biological Weapons Control and Warfare Elimination Act and were ultimately more fair than initially feared. Most recently, US President Trump discussed inviting Russia to the next G7 meeting. Looking forward, we believe that the risk/reward scenario tilts dramatically to the upside and that Russian equities could see a dramatic re-rating if sanctions ease.

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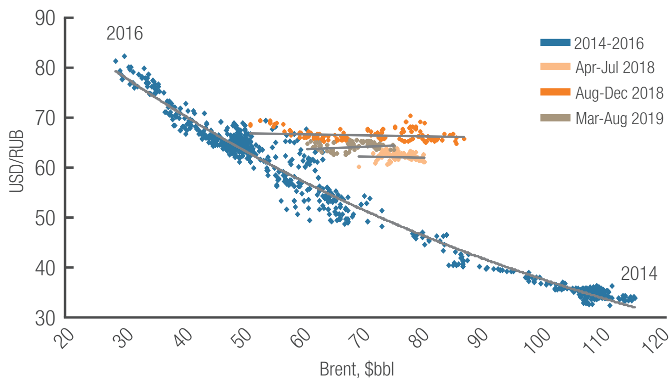
Currency and Fiscal Stability

Russia has turned into a stable counter-cyclical player in the developing world. This is a different platform from where Russia sat, even in 2017. The ruble, in simple terms, used to act as a proxy for oil prices. Now, with the "budget rule", the government has delinked the exchange rate from oil prices. As oil prices rise, the government buys US dollars and sells Russian rubles. When oil prices drop, we should expect the opposite. As a US dollar based investor, this dynamic removes an additional layer of commodity and currency risk. The rule also leads to a stable fiscal balance. Russia has moved from a 3.9% fiscal deficit in 2016 to an expected 2% surplus this year, leaving room for increased fiscal spending and upwards revisions for GDP growth expectations. Note that President Putin has declared infrastructure projects as a priority with key performance indicators tracking transportation, energy, and electric power infrastructure investment.

Relationship Between the Ruble and Oil Prices

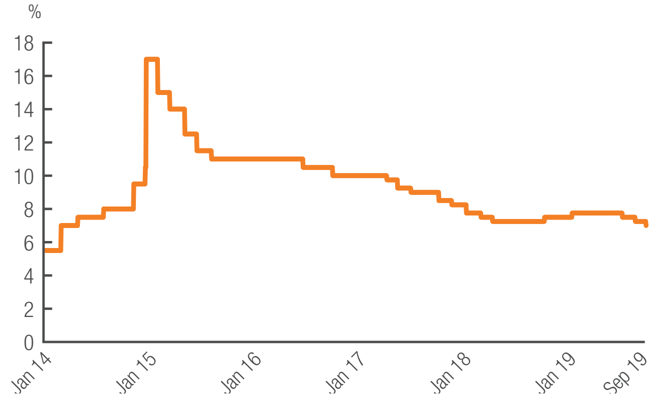


Source: Bloomberg, Sberbank CIB Investment Research.

Monetary Policy

Since 2014, GDP growth has been, understandably, slow. With that said, in 2014 the government also introduced inflation targeting. Inflation is now under control and the Central Bank of Russia has cut interest rates by 950 basis points since 2015. As many corporates now have to borrow in local capital markets, this rate reduction translates into lower net interest expenses and positive earnings revisions. In addition, this should lead to (1) investors shifting assets from bonds to stocks, (2) stronger consumer sentiment and (3) a slowdown or end of corporate deleveraging.

Russia's Rate Cutting Cycle

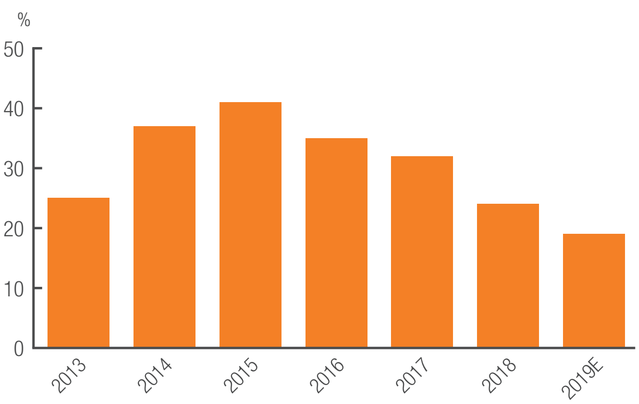


Source: Central Bank of Russia. As of 9/9/19.

Deleveraging and Capital Structure

Russian corporates have spent the last few years moving toward conservative balance sheet models. Net Debt/Equity levels now stand below 20%. As low leverage inflates the weighted average cost of capital (WACC), this seems inefficient and we believe that corporates could dramatically increase dividend payouts to shareholders. Not only will this be attractive for investors looking for cash flow in a global low interest rate environment, but it could also reduce WACC levels and increase valuation targets. With dividend yields already above 7%, it's unlikely the market will allow yields to rise much higher, leading us to believe that upward price movements could be forthcoming.

Russian Corporate Net Debt/Equity Levels



Source: IMF. E=Estimate. Estimates are projections and not guarantees.

Governance

Given improving perceptions of local economic policies, Russia has moved up from 120th place in 2012 to 31st place in 2019 in the World Bank's Ease of Doing Business rankings. This comes from reduced bureaucracy, improvements in access to electricity, lending, and contract enforcement. International Financial Reporting Standards are required for listed companies in Russia and the majority of the companies we meet also have international listings in New York and London. We are also seeing reforms to Russia's judicial system with the aim of improving independence and transparency.

Bottom line

Russia boasts a fiscal surplus, a current account surplus, low inflation, single digit unemployment, improving governance and a central bank in the midst of a rate cutting cycle, but still remains undervalued, trading at 0.8x price-to-book, 6x price-to-earnings, 7.5% dividend yield.[1] We believe that prices will not remain disconnected from fundamentals and that Russian equities should continue to outperform for the rest of the year.

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