The Moscow Times
30 YEARS
INDEPENDENT NEWS FROM RUSSIA

Trends for 2012 and 2013

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December 13, 2012





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In a world pictured as a big village, a country is probably pictured as house. Just like an old house, with its known and unknown problems, with parts undergoing renovation and new construction and parts where constant attention must be paid and funds need to be spent, Russia and its inhabitants have lived through most of 2012 and are preparing for 2013.

The global trends are mostly outside the house. They are like severe winds, snow or rain that may cause flooding, or like sunny and pleasant days that may later bring sweet summer evenings. And on the contrary, the things that occur inside the house are all internal domestic topics.

One such external trend, or wind in a big village, is globalization, a trend that allowed to use a village analogy in a first place. That term first used in 1897 by Christian minister Pastor Russell to describe expanding corporations. Pastor Russell became a founder of the student bible study movement from which Jehovah's Witnesses and numerous other independent bible student groups emerged after his death. However, Russia has been quite familiar with that part of globalization. Most of the global corporations spent the last 20 years to get into Russia, and are now fully established here. Russia is now a fully integrated world trade partner and a member of WTO. But there is another consequence of globalization that Russia is now dealing with, as globalization and especially the new information model limit state power. Some view the most recent protests in the Middle East and in Russia as a consequence of limited state power. Though the Russian protest movement has been far more inert than that in the Middle East, the rates of capital flight and volumes of real estate being bought by Russians in Europe and elsewhere in a drive to diversify away from some state influence demonstrate the trend and have direct economic consequences on Russia. Only the high oil prices are helping Russia's ruble not to succumb to the capital flight. The state's and policymakers' reaction to the problem of capital flight in Russia, for as long as it lies outside of the currency controls mechanism or closing off the borders for immigration, will most likely involve a more liberal approach to capital control, even a capital amnesty perhaps in a drive to repatriate capital. But capital flight also should stimulate a tougher stance on corruption, since, theoretically, the profits made by corruption are the first to flee from the country. Therefore, curbing them can be a very effective way of saving Russia's balance of payments account. The globalization therefore stimulates very healthy internal processes.

The second big trend in the village is convergence of capitalist and socialist economic styles or replacement of private capital with public. This is not only a trend in the eastern part of the village. There have been lots of developments on this front in the West, as the state serving as the lender steps in and takes over key companies or bankrupt banks. And as much as conservatives in the West would argue that there is no such thing as convergence, or its effects are anything but positive — for the U.S. government stepping in and rescuing AIG in the fall of 2008 allowed the U.S. government to make $27 billion on investment and save the stock markets from abyss. Yet in the West the policymakers see the opportunity for the state as really temporal, as they try to exit the private companies as soon as the opportunity

comes along. In the east, which is still quite nostalgic of the predictability of the socialist system, the trend is to institutionalize the state presence in some sectors of the economy. Despite Russia's declared goals to privatize and to minimize state presence in the economy, the temptation for the state to keep its presence in key Russian enterprises is high, while declared privatization plans still keep many commentators skeptical of the announced timeline. The efficiency of some of the key state enterprises versus their private western analogues further builds the case of the advocates of state capitalism, e.g. China Construction Bank's ROE of 22 percent or a similar result for Sberbank's ROE vs. just 6 percent return on capital for Citi, 10 percent for JPM and 4 percent for Morgan Stanley and 9.7 percent for GS. The main effect of the convergence trend is the increased M&A events as what has been private becomes public and vice versa. Another consequence of the process, especially when private succeeds to the state, is the increased role of business for politics. The state will be much more prone to tackle its political problems using all resources at its disposal, both domestic and international and this includes the companies it owns. Gazprom is one example, but the list can be expanded Politics is usually just an additional burden for anybody's cash flow.

The effects of the economic slowdown in the West and in China for Russia. This is just like watching a couple of your neighbors in the village making more money in their respective jobs in each consecutive year, coming to the country market and spending lavishly without paying too much attention to prices as their families grew and their visiting relatives multiplied and their friends became used to only very expensive wines. Then all of the sudden one of these neighbors reveals that he's been borrowing quite irresponsibly to maintain this lifestyle, while the second has been relying too much on very cheap labor and all of her servants in the house demand higher pay, so she needs to pretend that she's not making enough money to pay them and the game might take a while. These neighbors are unlikely be seen at the market next Sunday or even in a couple of months, and lots of stuff that they used to buy will be unsold. They will be trying to sell products that they produced at a cheaper price, causing havoc in their respective markets. The Chinese were big buyers of iron ore and coking cole as they are global leaders in steel production, producing 10 times more steel than either the U.S. or Russia. Tough times for the companies int the metals and mining sector unless there are repairs in the house as guests are coming for the APEC summit, for the Sochi Olympics or for the World Cup.

Middle-class growth, another trend that occurring in many houses of the village especially in those where previously things were going quite bad and most inhabitants were poor. But that's the advantages of lower base — it leads to higher growth. If you looks at global stock performance, the sectors that have been outperforming in the last 15 years are the consumer, IT, financial and healthcare sectors, as the theme of growing consumption has surfaced mostly in developing countries. In Russia, for example, the middle class has increased vastly over this period, from 1 million in 1999 to 15-30 million now, according to various estimates. Consequently, stocks associated with the middle class — banks, real estate, IT, health care and retailers — have grown in line with this trend. The Russian middle class continued to expand in 2011-12, and it is expected to broaden further in 2013, as public spending in general has risen, most recently a particular focus is on military, police and other security service salaries surging as much as tenfold in some cases and these servants join the middle class ranks. Further consequences of the emergence of middle class can be associated with higher and self sufficient consumption growth in service sectors and higher import

substitution rates despite that Russia is in WTO now.

Food price inflation is another trend. As village families are growing and kids are becoming bigger and eat more, food is in good demand, and prices are growing for all kinds of stuff in the country market. The world's population has increased nearly fourfold in the past 100 years, according to the UN Population Division. In sub-Saharan Africa, for example, the population is expected to grow from about 770 million to nearly 1.7 billion by 2022 according to some estimates.

Increased fertilizer application and rising water usage from irrigation have driven over 70 percent of crop yield increases in the past 25 years. However, yields have nearly stabilized for grain, partly as a result of low and declining investment in agriculture. Furthermore, fishing yields have decreased in the past decade, due mainly to overfishing and unsustainable fishing methods.

Prices for beef, pork and soy clearly show inflationary trends. Fertilizer stocks are still far from their peaks of 2007 but have been rising steadily since the lows of 2009.

Ever since Barack Obama was elected U.S. president at the end of 2008 and U.S. Fed chairman Ben Bernanke was appointed, the bond rates dropped, money became practically free in the West, and one trend has been intact ever since: rising gold price. Everybody in the village rushed to buy some gold as they did not fancy that their paper money will buy them as much stuff next year as they did this year. As Barack Obama comes back to presidential office and as Ben Bernanke offers more and more U.S. dollars bailing out holders of illiquid assets, providing price support and trying to stimulate credit expansion. The same processes in Europe, Japan and even China drive gold prices higher. There are no big losers in this trend except the ladies in some parts of the village who got used to receiving gold presents. But they are not complaining either, since the gifts they got three to five years ago are now worth a fortune.

That cheap funding and printing press working non stop had another consequence for the village. It is now possible to take very cheap credit in US dollars and with that money to buy something really valuable. That is a driver of M&A activity. Wimm-Bill-Dann was sold, along with Kalina, and TNK-BP will be sold as well.

But it's not all that quiet in the village because there is one house, right in the middle of the village, where all of the family secretly at night very deeply underground are building and storing nuclear weapons. Actually, no one knows that for sure — but the rumor is that they are. There are a few houses in the village that already have these nuclear weapons underground, and some that even have them on the roof tops of their houses, but they are more friendly families. Whereas most of the villagers think that if the very mean neighbor gets his hands on these weapons, he will be quite prone to use them, as folks in that house are very short of temper. Some people in the village are watching that house in the middle of our village very intensively, and might even have plans one night to go into the house unexpectedly and destroy whatever is it being built deeply underground. And if they do attack that house, regardless of how successful they are, they will create a huge disturbance and fighting in the middle of the village. Hopes are that this kind of fighting will not be able to polarize the village but chances are that it might. The prices for oil will shoot through

the roof, and paper money will be far less valuable, stimulating more demand for gold. But there is an election in that house that is not expected to be easy for the current leaders. The wait for the outcome of the election might delay the military action, but it also might not, and will not divert them from attacking.

That's about it for the global themes and winds that blow in the village. There are a few domestic themes that effect Russia.

The theme of Russian infrastructure spending has probably grown slightly tedious at this point. However, it remains an important play on Russia as long as Brent stays above $90/bbl. The APEC Summit budget was close to $20 billion, securing substantial revenues for Evraz, MMK, Severstal and NLMK. The Sochi Olympic Games budget is estimated at $18 billion, but the overall impact, including private development, residential construction in Sochi, hotels, and entertainment site construction, is probably twice that of the public spending budget. The 2018 FIFA World Cup is also coming, with total expected spending of close to $150 billion.

The average Russian dividend payout ratio is on the rise. Historically, key Russian stocks have always been undervalued on earnings. Meanwhile, earnings growth has been mediocre at best, and payout ratios have been miserable. Given mediocre growth, stocks could not be seen as growth stories. Given miserable payout ratios, they were not really proper value plays either. This will change once companies start showing normal payout ratios and can be properly classified as value stocks, which will reduce discounts to EM peers. Payouts from Gazprom, Rosneft, Sberbank and Transneft prefs will reach 25 percent, we expect, versus the average GEM payout ratio of 35 percent. However, this might spur a reduction in Russia's discount to GEM peers on P/E to 20-30 percent from the current 50 percent. The end result of developments around higher dividend payouts could be that Russia will become a lower-beta name and slightly more defensive.

The development of trade relations with China is another theme to watch. Transneft's new pipeline, to be commissioned at end 2013, will pump 20 million tons per year of oil in addition to the current 30 million tons per year shipped to Russia's Far East and China. China buys 15 million tons of the present volume directly from the pipeline, and it buys additional volume from Skovorodino. China imports up to 20 million tons per year, and this may rise to 30 million tons per year. In dollar terms, the oil trade with China could double from the current $1012 billion to $20-25 billion. The principal beneficiary here is Transneft. However, Rosneft, Surgutneftegaz and other companies that own assets in Eastern Siberia could benefit as well.

Much has been said about ongoing privatizations. The three main aims of the planned privatizations are increased efficiency, larger free float and improved corporate governance. All three should be viewed as positive drivers for valuations. Although it is difficult to imagine Rosneft, Sberbank or VTB completely owned by minority shareholders with 100 percent free float and CEOs appointed by a board completely elected by minority investors, this should be the eventual outcome of the proposed privatization plans. Key state-owned companies set to be privatized are our focus for this theme. Also, the electricity grids mentioned in the utilities section could re-rate if the government decides to privatize them.

Russia's entry to the WTO will have a limited short-term negative effect as imports become more accessible. Beneficiaries in the long run include transport and consumer stocks, as well

as those that depend on imports of expensive machinery and companies that currently have strong potential but need a small kick to become much more competitive.

Improving financial infrastructure via a launch of central depositary and T+n trading. Russia has embarked on financial infrastructure reform, aiming to deepen the pools of capital in Russia. Foreigners will soon be able to own local Russian shares in the same manner that they currently own GDRs or local shares in other geographies, perhaps even by next year. The key event awaited by investors is the launch of a central depositary that will enable international central depositories or local custodians to hold shares for international clients in nominee accounts. It was announced on Nov. 6 that the regulator had granted the National Settlement Depositary a central depositary license. Spreads of local shares to GDRs and the ruble should react positively to this.

The fight against corruption, while this might have been planned and discussed for a long time, was not really addressed until capital flight became a real problem while oil prices stabilized. Yet another stimuli among many obvious other ones to fight corruption was the recent APEC summit where 2 Hyatt hotels were supposed to be built and an opera theater — but hardly anything of that was finished — while the budget for that was enormous.

Pension reform that did not work showed that investing into bonds in the period of real negative interest rates as bond yields were below inflation for the most time since 2002 when the latest reform was started is not profitable and pension funds needs to be spend on stocks to provide adequate returns. Most of the houses in the village were already aware of that. Especially those that have been running negative interest rates, to monetize their debts or to jump start the economic growth. The switch to stocks could be quite interesting event to watch in Russia.

Since the world transformed, the habitat is becoming a more familiar place. The households' problems are becoming more predictable, the plumbing and sewage works better and there are more metrics in place to signal that flooding is coming. There are usual problems with authority in some houses, as it is not completely clear who is ruling the house — the servants or the people. There are also quite familiar problems of servants stealing and still being pardoned for it, since a good servant is hard to find. Some parts of the village are very good to spend the winter in, and some are very good in summer months. Some houses are quite modern but tasteless, some are from bricks other are wooden log houses and others are sturdy old villas.

Russia's house is one of several well-built brick houses that is quite far apart from others in the village. Its looks longer than the other bricks, but it's quieter and lots of its window are dark. It definitely needs some repairs, and some walls have already been constructed.

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