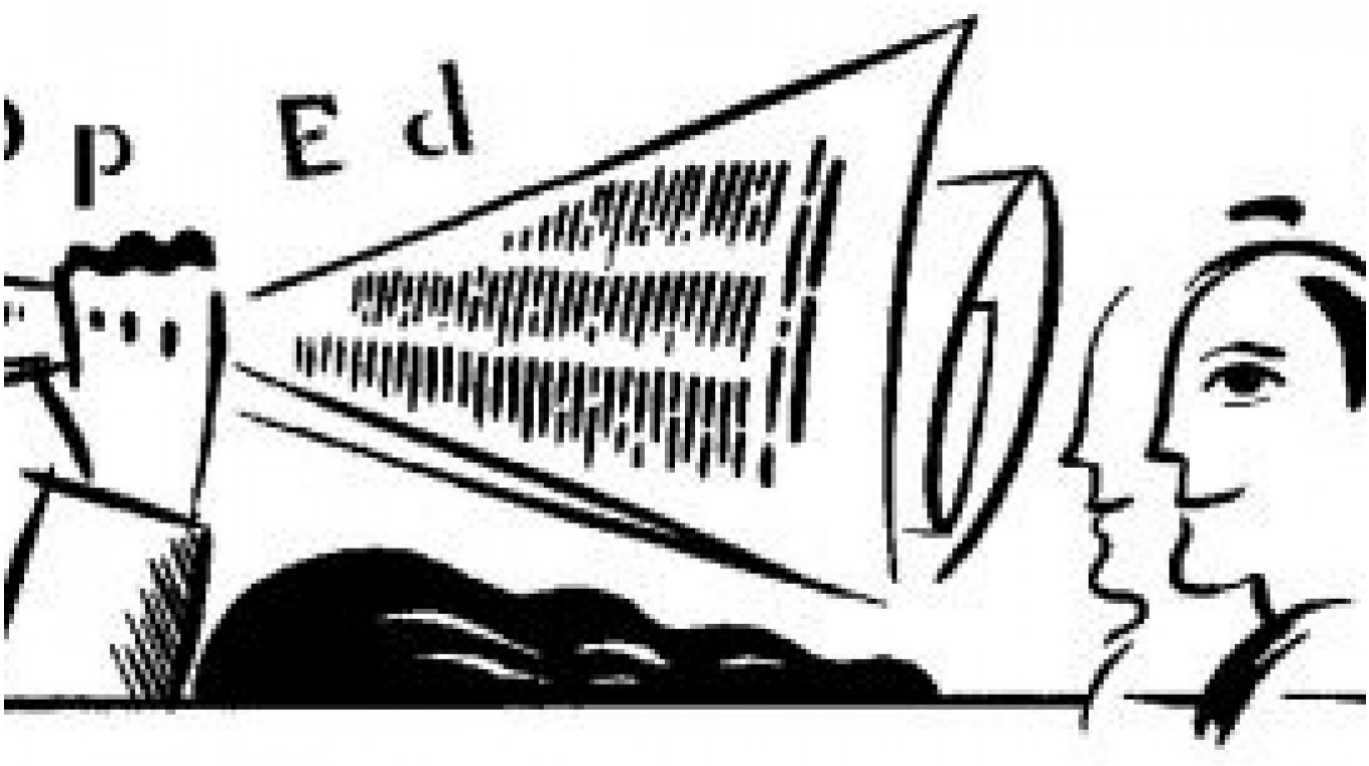
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Shaking Off That 'Cheap for a Reason' Label

By Chris Weafer

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One of the reasons cited by government officials to explain the recent scaling back of the privatization program is because Russian equities are far too cheaply priced to justify a sale at this time. This, of course, is by no means the most important reason for the program change because there is strong opposition within government to any loosening of state control of strategic industries at any price. But it does highlight once again one of the great frustrations for investors in Russia. They do get the opportunity to buy good assets, many with good growth prospects, at a cheap price. That is the most basic criteria for buying equities in any market. But the problem is that Russian equities are cheap for several reasons, and until those reasons start to change the relatively lower valuation base is unlikely to improve.

That's frustrating to investors who carry out deep due diligence in Russia and who generally find that the country is actually in better shape fiscally and in terms of debt and budget execution than most other emerging economies. Also, despite the occasional small street protests, there is no sense of an imminent political threat that has shaken Turkey, Egypt or

even Brazil. Yet, according to consensus data published by Bloomberg, Russian equities trade at a discount of near 50 percent to their Turkish counterparts, a near 60 percent discount to Brazilian and South African peers, and a whopping 66 percent discount to the average valuation on Indonesia's stock market. Some of that discount is certainly technical in that Gazprom and the oil majors dominate the composition of the Russian equity indices, and these sectors always trade at a big discount to most other market sectors. But still, even if you exclude the oil and gas sector, the remaining Russian equities are still trading at a discount to emerging market peers.

So what is it about Russia in particular that dissuades most emerging market investors and pushes the investment risk premium higher than the other BRICS and other developing countries, including even coup-stricken Egypt? What are the issues the government and corporate executives must address if valuations are to improve even to emerging market average peer levels?

Corporate governance tops most investor concerns when it comes to investing in Russian equities. The perception is that governance risks are higher in Russia than elsewhere. But actually that is not a fair general assessment. It is a case of the exceptions grabbing the headlines, and unfortunately most of those headlines come from the big, state-controlled energy and industrial corporations. Companies in the fast-growing consumer, media, transport and financial sectors, for example, have either adopted good corporate governance standards or are at least on par with counterparts elsewhere.

Just take a look at this year's business headlines, which have been dominated by Rosneft's dismissal of TNK-BP minority claims, the lack of ownership clarity when Surgutneftegaz finally produced International Financial Reporting Standards accounts and by the continuing very high capital expenditures spending in Gazprom at the expense of dividend payments. Until these headline issues are eliminated, the negative contagion across the market will remain.

Continuing capital flight is also a major problem. Investors inevitably ask the question, "Why should we invest when Russians are leaving with their money?" and this is a tough one to answer. Over the past six months, capital flight has totaled almost $40 billion, and that brings the total outflow reported by the Central Bank to $325 billion since 2008. Economists correctly point out that this is not even mostly so-called suitcase cash; much of it is actually explainable due to normal trade flows. But that doesn't matter. Investors know that Russia's largest economic challenge is to boost domestic investment. The fact that capital is fleeing Russia rather than being used for investment at home generates screaming bad headlines and exacerbates the poor investment climate.

Economic trends are actually not bad when compared to other emerging economies if you exclude the global giants, China and India. There is a lot of discussion currently over such issues as stability versus stimulus, and between interest rates and exchange rate priorities. The bulls will rightly point to Russia's relatively better debt and budget situation. The counter-argument is the continuing high oil vulnerability, which is unique to Russia, and the projected budget shortfalls, something Russia hasn't seen since the 1990s. What looks like a favorable picture today may easily and quickly change faster than for other emerging economies, and that also justifies greater caution until policy is clarified and the

consequences assessed.

Russian officials regularly complain that corruption and bureaucratic red-tape are constantly highlighted as critical issues in Russia while, according to many surveys, the same problems exist in other emerging economies. But governments in Brazil, Indonesia and Turkey, for example, do not allow headline grabbing actions such as the recent Sergei Magnitsky case. Good public relations will only be effective when the actions generating the negative PR are stopped.

The final reason for the relatively lower valuation applied to Russian equities is technical. Among the large, emerging economies, Russia does not yet have a meaningful base of domestic investment capital. To be sure, there are plenty of short-term traders who are unwilling to take a medium to long-term equity view. That means the equity market is overly dependent on foreign investor activity and how those investors view Russia risk. To fix this problem, Russia will need to broaden out the pool of privately managed pension money. It also needs to create a regulated environment for insurance money to accept equity risk and to change the savings culture from mainly cash deposits to longer-term investment funds. The Central Bank's new mandate as a markets and investment super-regulator is an important step in creating that domestic capital base, and the hope is that other measures, such as pension reform, will be actively and effectively pursued in the coming years.

Investors can make excellent returns on the country's stock market by targeting individual stocks with sustainable growth and a strong record on good corporate governance. Companies such as Magnit, Megafon, Novatek and Yandex are prime examples. But for the broader equity market to shake off that "cheap for a reason" tag, Russia's systemic weaknesses need to be comprehensively addressed at both a state and corporate level. Complaining that Russian equities are too cheap because investors "don't understand Russia" is a waste of time. Unfortunately, most understand the country all too well.

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