



## Russia

Poised to re-rate

Agne Zitkute, V Seminario Mercados Globales LarrainVial  
Hotel The Ritz Carlton, Santiago de Chile, March 2008

# Why Invest in Russia?

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- **Macro Overview:** can Russia withstand the global slowdown
- **Politics:** change or continuation
- **Key Investment themes for 2008**
- **Key Risks**
- **Valuation:** poised to re-rate?



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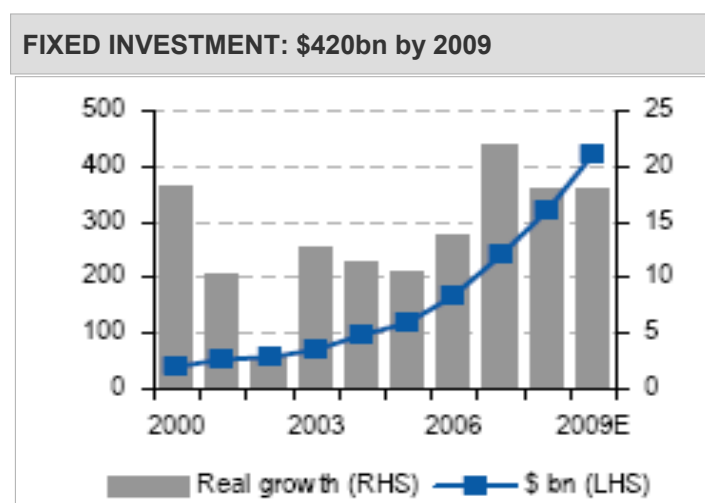
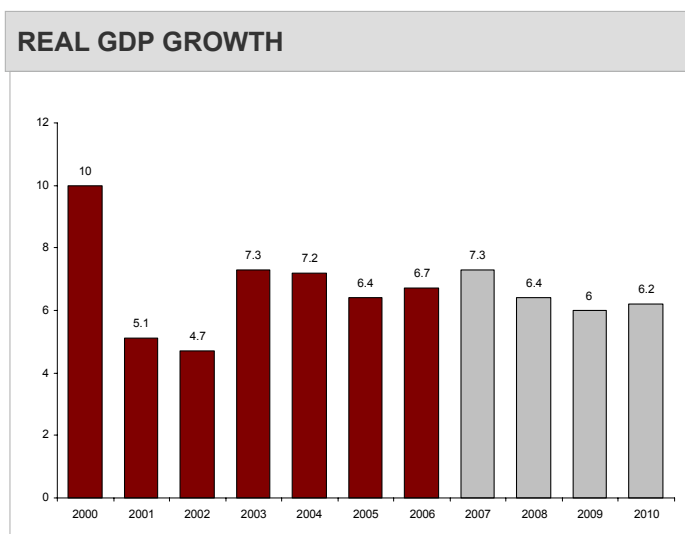
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# Russia: Political Risk Diminishing, Growth Continuing



- **Strong Economic Momentum:** Strong Russian domestic growth in 2008 will contrast with continuing concerns about weakening global growth
- **Increased State Spending** should act as the main growth driver, providing a significant degree of insulation against slower growth globally
- **Positive Earnings Revisions:** Higher oil and metals prices have yet to be factored into analyst forecasts
- **Increased Political Clarity:** A Medvedev-Putin tandem should be the best outcome for the investor community



Source: Renaissance Capital

## Russia's fundamentals best in 15 years



- **Current account surplus stands at 6% of GDP**, one of the highest levels in emerging markets
- **CBR reserves are the third largest in the world** (\$476bn at the end of 2007), covering 25 months of imports
- **State debt is one of the lowest in the Emerging Markets** at \$52bn as of the end of 2007 while corporate debt stands at \$408bn or 32% of GDP
- **Federal budget surplus** equals 5.5% of GDP, **stabilisation fund** 12% of GDP
- Russian economy has stayed immune to the global liquidity crunch posting the **fastest rate of economic growth since 2000 of 7.8%**
- **GDP growth to stay strong.** While Russia's growth rate may be somewhat affected by the global slowdown, a significant drop in GDP growth or a decline in GDP is not likely in the next couple of years

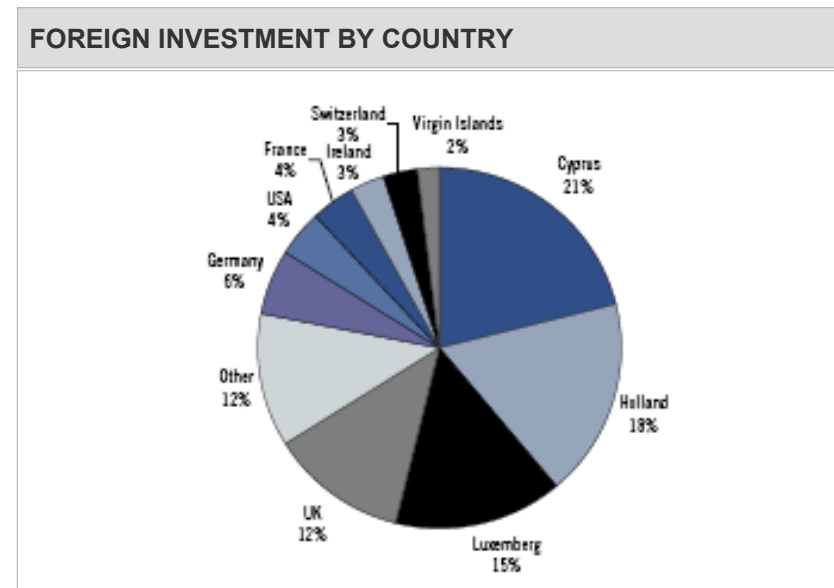
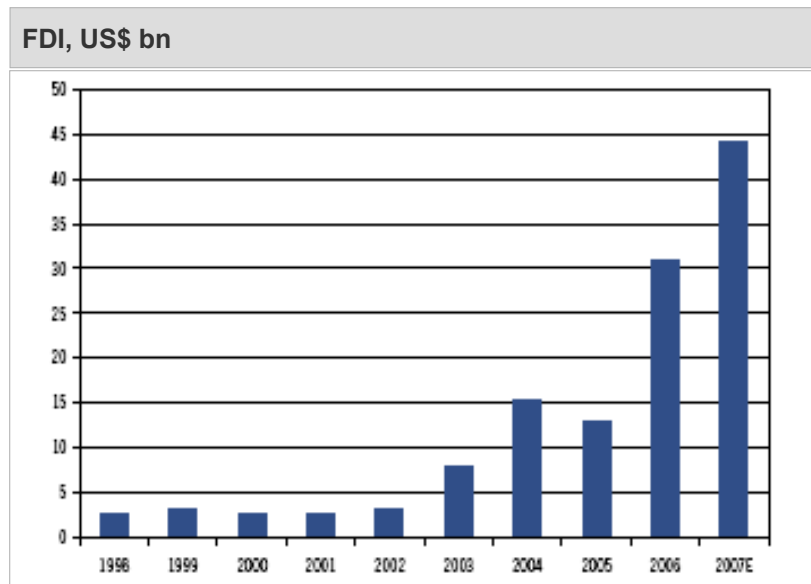
*To wipe out the budget or trade surplus, oil prices would have to drop*

*to \$41/bbl or \$27/bbl, respectively*

# FDI Growth: So far, Little Impact of the Liquidity Crunch



- **FDI boom continues.** FDI is estimated to have hit \$44bn in 2007 compared to \$31bn in 2006
- **The accumulated foreign investment** in Russia (excluding the banking sector) reached \$198bn as of the end of 3Q07. This is 52% increase year-on-year



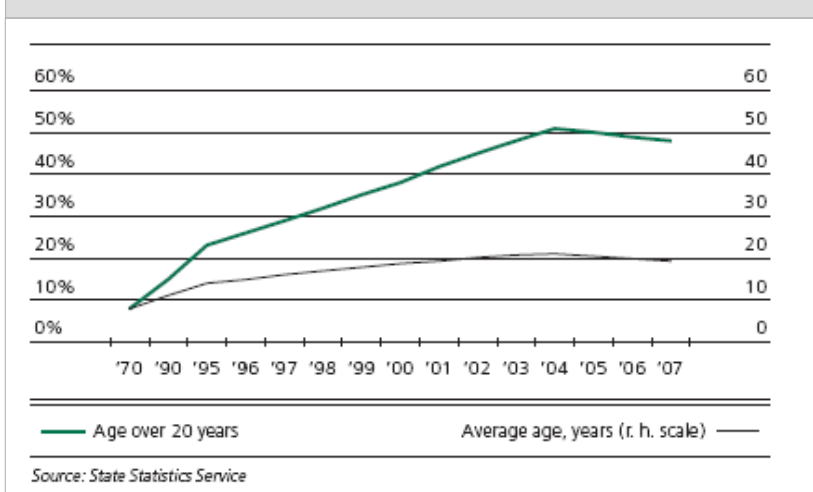
Source: Rosstat, Citi Investment Research

# Russian Infrastructure: The Beginning of the Boom

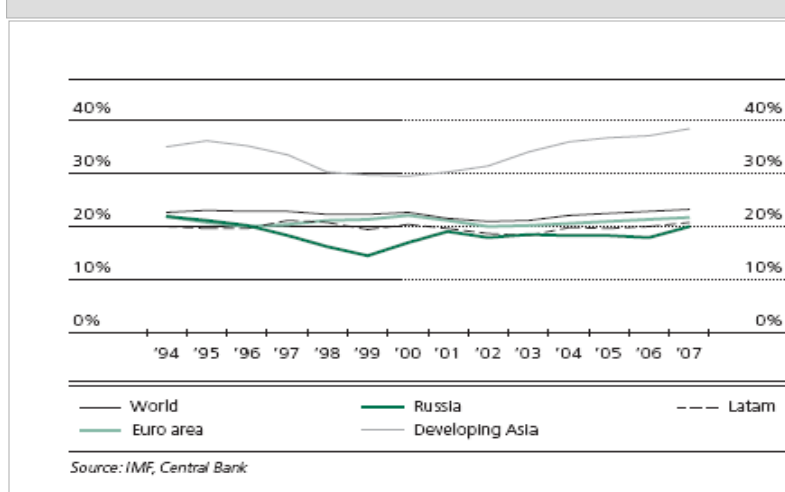


- **There are three key drivers to the need of infrastructure investment in Russia:**
  - Lack of investment in the 1990s (In 1999, the total level of investment was \$28bn, one tenth of the level expected in 2008)
  - The enormous growth that the country has enjoyed for the last nine years
  - Industrialization of China
  
- **Investment will be a major theme:** The state plans to double investment spending over the next three years with Russian fixed investment increasing from \$240bn to \$420bn by 2009

AGE STRUCTURE OF RUSSIAN CAPITAL EQUIPMENT



INVESTMENT/GDP RATIOS



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# Clarity on the Political Front

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- **The future configuration of power in Russia has finally been clarified.** Dmitry Medvedev is probably the most investor- and business-friendly successor among the various candidates that have been discussed
- **Next phase of development.** Putin's presidency was one of preparation, while Medvedev's is expected to be one of spending and investment.
- **Medvedev cannot afford the luxury of hoping the oil price bails out his reforms.** Investors will hope that the goals of this new phase are pursued with much greater vigour than those of Putin's two presidential terms
- **Medvedev wants to reduce the state's role.** During Putin's term, the State has focused on rebuilding a strong role in the so-called "strategic industries" and many of the biggest state enterprises are now headed by members of "Siloviki"
- **Several priority issues** are likely to feature on new president's list:
  - Inflation
  - Corruption
  - Sovereign Fund
  - Spending priorities

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## Russia – Investment Themes for 2008



- **Sectors with exposure to the investment boom likely to outperform.** Steel/Coal sectors should continue to benefit. Coal is an important input cost in the steel sector and companies with significant coal exposure such as Evraz and Mechel should be well positioned. Pipe companies and cement should also benefit
- **“Investing along with the state”** should continue to work. The big state companies such as Gazprom and Sberbank in particular are well placed to benefit from increased state spending
- **Domestic consumption:** gain exposure to regional growth; focus on telecoms, retail chains, food and banks with regional coverage
- **Real Estate** spending continues to rise. Since the rouble is now viewed as an attractive yet under-valued currency, the sector is likely to see continued capital inflows
- **Agriculture and Engineering** are just starting to unlock value although neither sector is particularly easy to gain exposure

*Key danger – too much money, not too little: Inflation and resulting cost increases continue*

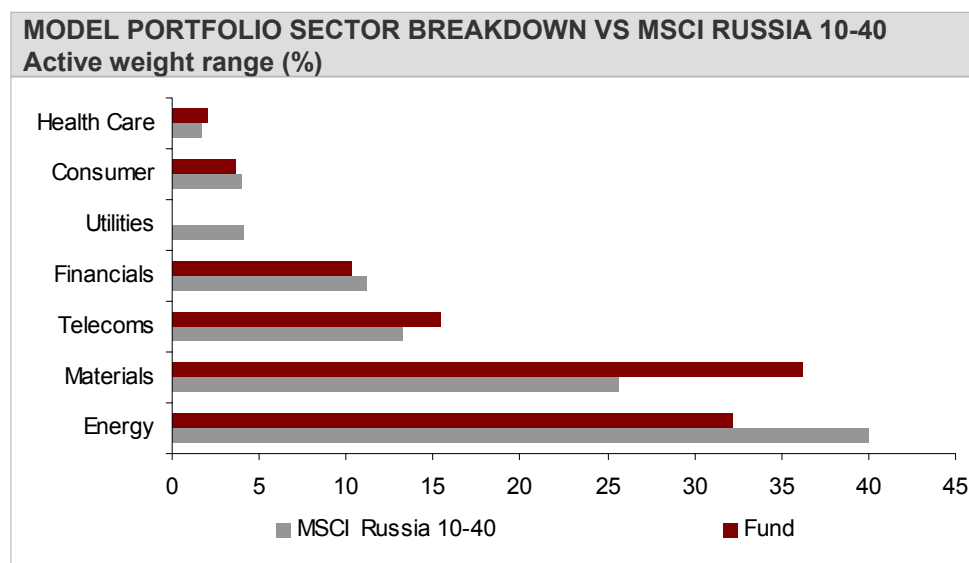
*to be major drag on earnings and cost pressure is expected to continue*

# High Conviction Portfolio



- Target to maintain no more than 25 – 30 stocks
- Aiming for a minimum 1-2% active weight across all holdings
- Top-10 holdings account for 60 - 70% of the NAV
- Ability to invest outside Russia adds flexibility. Kazakhstan, Georgia and Ukraine could account for c.10% of the total NAV

TOP-10 PROPOSED HOLDINGS VS MSCI RUSSIA 10-40				
	Stock Name	Fund	MSCI Russia 10-40	Active Weight
1	GAZPROM (USD)	9.1	8.4	0.7
2	SBERBANK RUSSIA COM(RUB)	9.1	8.1	1.0
3	NORILSK NICKEL MMC (USD)	8.6	8.0	0.6
4	NOVATEK GDR (USD)	5.9	4.6	1.3
5	VIMPELCOM (USD)	5.1	4.4	0.7
6	SEVERSTAL (RUB)	4.9	3.9	1.0
7	MOBILE TELESYS ADR (USD)	4.8	4.2	0.6
8	MECHEL ADR (USD)	4.8	3.0	1.8
9	SISTEMA (USD)	4.5	0.6	3.9
10	EVRAZ (USD)	4.0	0.0	4.0
		<b>60.8</b>		



# Current Best Ideas



## KEY BENCHMARK POSITIONS

### VALUATION UPSIDE OF 30%+

- GAZPROM
- NOVATEK
- SBERBANK
- MECHSEL
- MTS
- SISTEMA

## NON-BENCHMARK POSITIONS

### VALUATION UPSIDE OF 40%+

- EVRAZ
- OPEN INVESTMENTS
- URALKALI
- CTC MEDIA

## NON-RUSSIAN IDEAS

### VALUATION UPSIDE OF 50%+

- BANK OF GEORGIA
- KAZAKHMYS
- AICHEVSKY STEEL

## COMPANY PROFILE

Gazprom is the fourth largest listed company in the world with a market cap in excess of \$330bn. State controlled Gazprom is the worlds largest energy provider accounting for 19% of global natural gas production in 2006 It has proven and probable reserves in excess of 20.7 trillion cubic metres, or over 25% of the worlds known reserves. In addition the company owns an extensive 156,000km high pressure gas pipeline network, over 75 per cent of the major oil producer Gazprom Neft (formerly Sibneft), 19% of gas producer Novatek as well as numerous non-core assets including Gazprombank and Sibur chemicals.

## HISTORY OF PICTET VALUE RELATIVE TO THE MEDIAN



### Industry Dynamics

Beneficiary of high oil prices as export price is linked to fuel oil. Gazprom has a monopoly on gas exports and is well placed to benefit from dwindling North Sea production and growing consumer demand.

Domestically prices have been heavily capped resulting in operating losses for Gazprom on domestic sales. This is changing rapidly as the government has committed to moving towards netback parity pricing. Domestic gas prices are set to rise in 2008 by 25 percent in 2008, 20 percent in 2009 and 28 percent in 2010.

### Business Franchise

Onshore production growth is minimal with new fields replacing older declining fields. Growth is coming from LNG however, with capacity coming from the development of its arctic its arctic Shtokman field and Sakhalin-2 project to supply LNG to Asia and North America.

Strategy is to lever dominant position in European gas supply to become a diversified downstream energy giant with high-margin operations in Europe.

### Balance Sheet/ Management Strategy

Cost control on operations and capex remain a significant challenge with net debt heading towards \$40bn. On the back of domestic gas price reform earnings should grow c.30% yoy 2007 to 2008. With capex commitments increasing, one acid test will be whether the free cash flow yield can materially improve from the 2006 level of 4 per cent.

### ↑ VALUATION ↓

Still below Pictet value at 0.93 but significant re-rating has taken place

P/Book Value (2007E) 2.3x

P/E (2008E) 10.8X

EV/EBITDA (2008E) 7.2x

Dividend Yield 0.7%

**Conclusion: One of the cheapest energy plays globally on an asset basis with strong earnings growth.**

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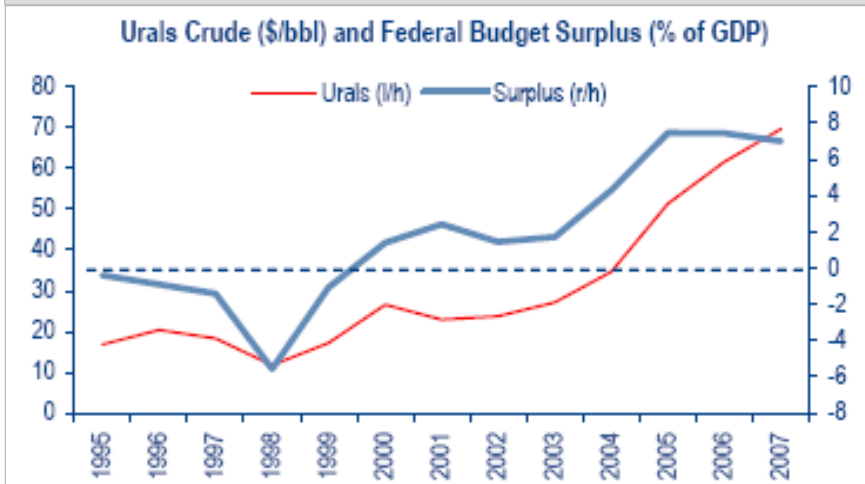


# Evaluating the Risks



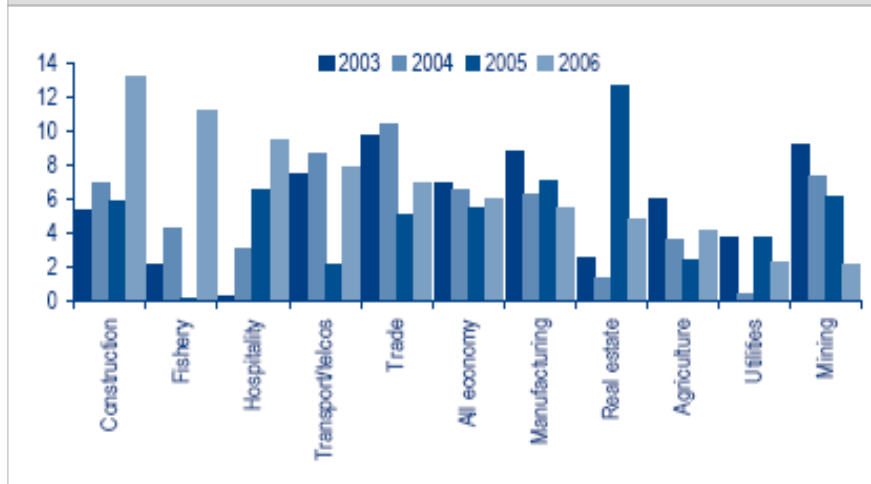
- **External: Commodity prices, interest rates.** Higher borrowing costs and/or lower oil prices would cut corporate and consumer credit volumes and reduce the ability of the state to support growth
- **Structural: Competitiveness, Productivity.** In all sectors of the economy, productivity gains are significantly lagging increases in real wages and output
- **Financial: Inflation, Ruble rate.** High inflation halts the expansion of credit activity in the economy, while a strong ruble – if used as a tool against inflation – could lower competitiveness of many sectors

## STILL AN OIL PLAY



Source: Bloomberg, Uralsib

## LABOUR PRODUCTIVITY GAINS BY SECTOR, % YoY



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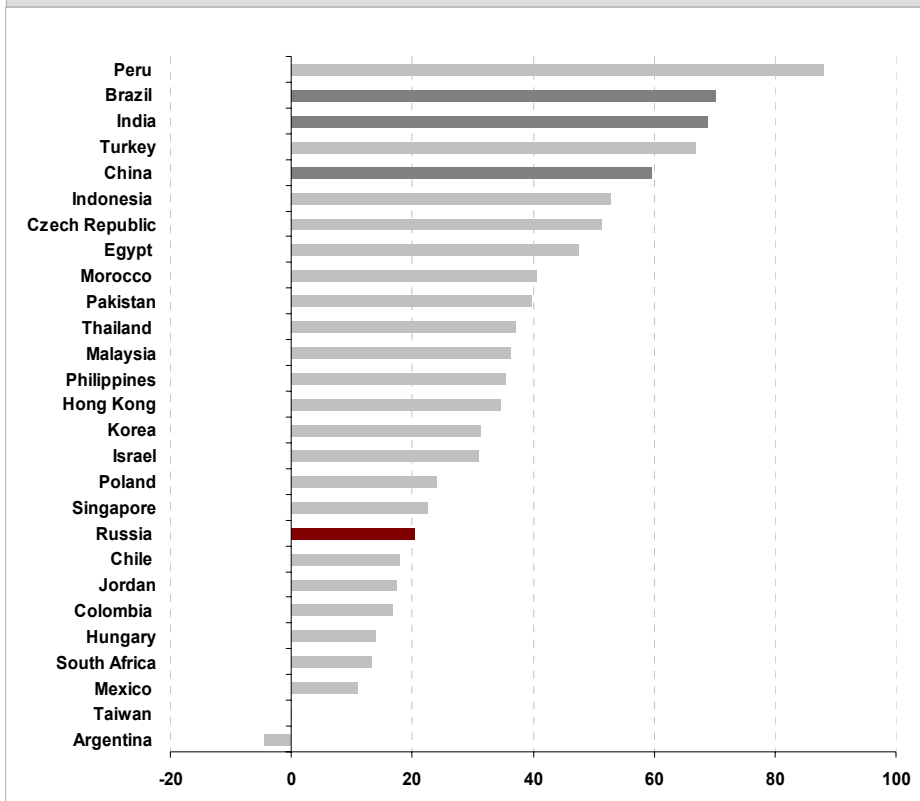


# Re-rating in 2008?



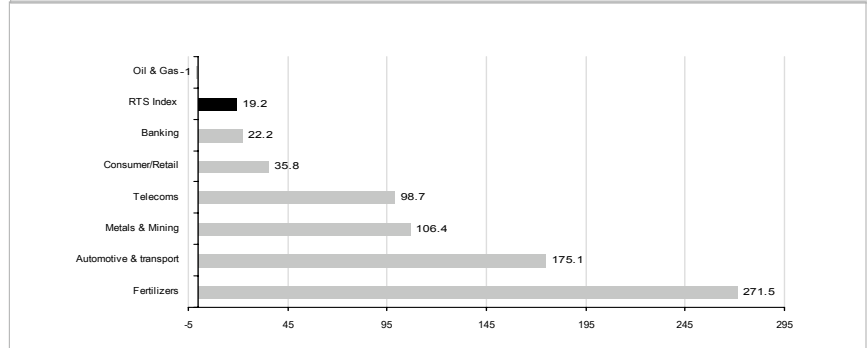
- **Russia has been the worst performing BRIC market in 2007** mainly due to weak oil prices last winter, the large supply of new shares issued in 1H2007 and political risk factors earlier in the year
- **We expect re-rating in 2008** driven by the sort of investment flows that have stimulated the multiples expansion seen in Brazil, India and China in 2007

GEM PERFORMANCE in 2007 in USD

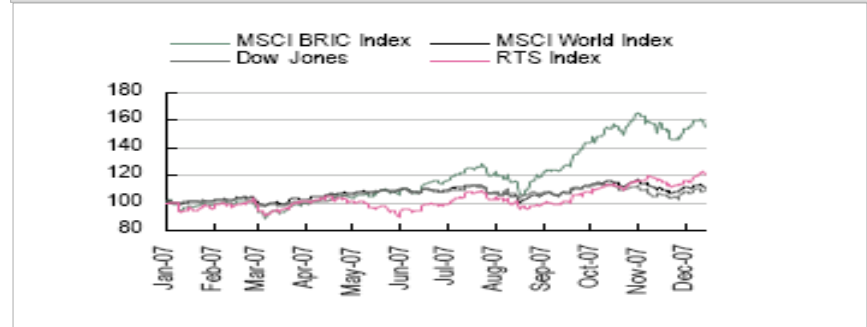


Source: Pictet / Bloomberg

RUSSIAN ENERGY UNDERPERFORMANCE IN 2007



PERFORMANCE OF BRIC, RTS, DOW and MSCI World

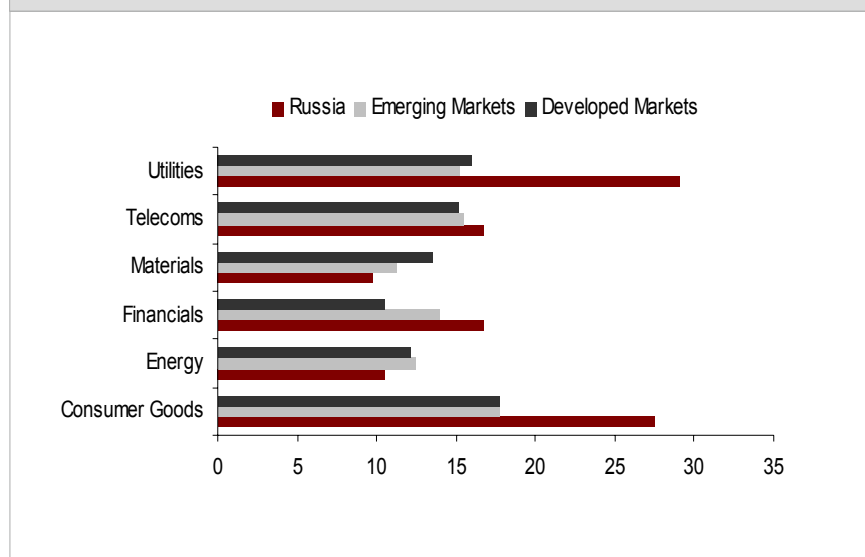


# Attractive valuations favour a catch-up



- Although Russia can be negatively affected by global liquidity risk, the risk of US slowdown holds little danger, especially with commodities negatively correlated to a weakening dollar
- Partly due to underperformance, and partly due to high commodity prices, Russian market has reverted to its traditional position as one of the world's least expensive large markets on a P/E basis
- On the sector basis, Energy and Materials now appear to offer relative value against EM and developed markets
- Although trading at a premium, Russian Financials offer a safe-heaven given their low exposure to global environment
- Sell side bottom-up models are predicting **c.30% upside** in USD terms for the RTS in 2008

RUSSIAN 2008 P/E VS. EMERGING AND DEVELOPED



Source: Renaissance Capital

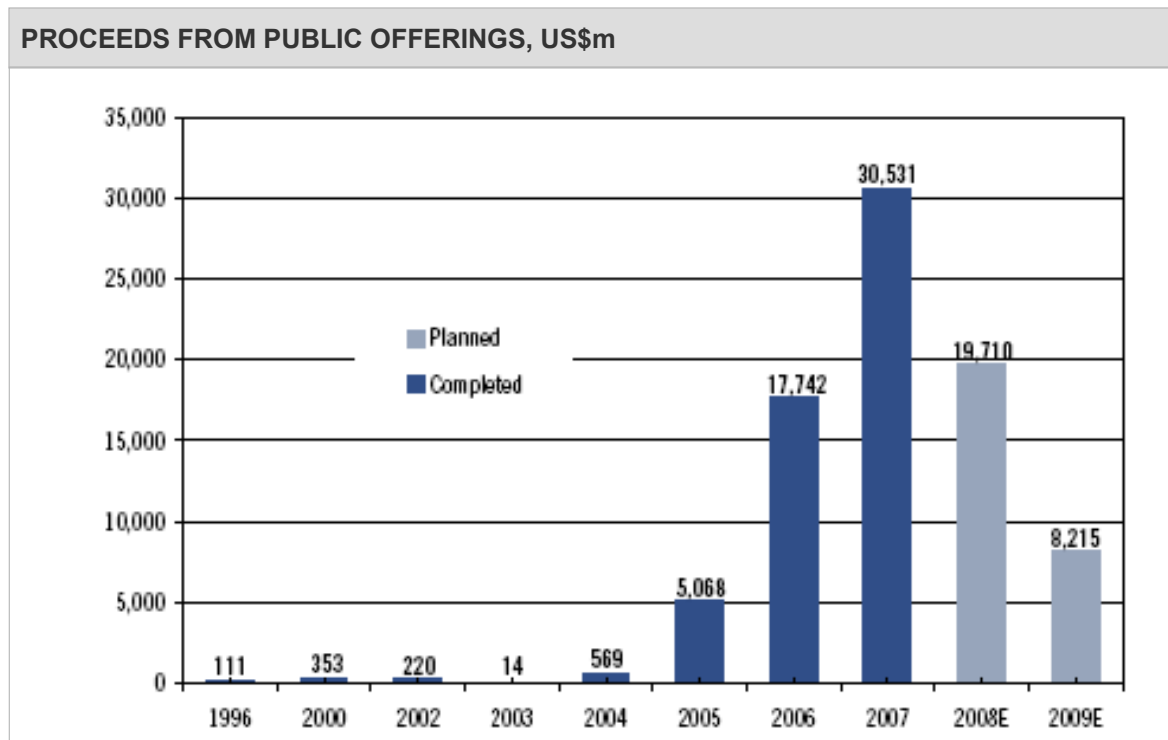
RUSSIAN P/E VS. GEMS

Country	2006 P/E	2007 P/E	2007 EPS growth	2008 P/E	2008 EPS growth
Argentina	11.0	22.5	na	20.0	13.8
Morocco	19.3	22.9	26.4	15.1	8.6
India	20.5	24.3	12.7	20.3	20.1
China	15.2	23.4	26.9	19.4	20.9
Chile	20.5	19.4	31.4	17.5	11.0
Philippines	16.4	18.0	2.6	15.8	13.8
Malaysia	15.8	16.7	22.2	15.4	8.3
Israel	13.9	16.8	10.5	14.4	16.5
Jordan	16.4	17.8	-3.7	--	--
Egypt	14.3	16.8	32.4	14.7	14.1
Poland	13.1	14.3	14.4	12.6	13.6
Taiwan	15.1	14.0	30.1	12.1	16.4
Indonesia	14.4	17.4	49.2	15.7	10.5
Korea	12.0	14.1	9.5	12.2	15.7
South Africa	14.5	14.7	20.2	12.3	19.6
Hungary	10.5	12.3	-15.8	11.2	9.6
Thailand	10.8	13.1	1.1	11.6	12.3
Pakistan	12.1	12.6	5.9	11.0	14.2
Peru	8.6	14.1	18.9	12.0	31.1
Brazil	9.4	13.3	31.5	12.2	9.0
<b>RUSSIA</b>	<b>12.5</b>	<b>12.7</b>	<b>18.0</b>	<b>11.8</b>	<b>7.8</b>
Turkey	11.1	11.7	40.7	11.0	6.7

# IPO Pipeline to Ease in 2008



- **2007 a record year for IPOs:** total proceeds from public placements reached astonishing \$31bn. Sectors which contributed most were banking and real estate
- **Less busy IPO activity should be supportive for the broader market performance.** Going forward, the total volume of new offerings expected to drop to \$20bn in 2008 and \$8bn in 2009



Source: Citi Investment Research

## Conclusion : Russia – Best of BRIC's?



- Macro story is still highly appealing
- Strong investment and consumption growth to provide a cushion against global slowdown
- Clarity on the political front to fuel fixed investment
- IPO pipeline to ease in 2008 providing support to the broader market
- Equity market is attractively priced



# Eastern European Equities



**Agne Zitkute**

**Senior Investment Manager**  
Global Emerging Markets  
Equities team

Agne Zitkute joined Pictet Asset Management in 2004 and is a Senior Investment Manager in the Global Emerging Markets Equities team.

Before joining Pictet she was a Senior Research Analyst at Cathay Financial, a specialist investment brokerage, where she covered European merger arbitrage and special situations for hedge funds. She began her investment career with Invesco Asset Management as an investment analyst in 1997. From 1999 she co-managed Invesco's Central and Eastern European portfolios with a peak of over USD1bn under management. From March 2001 she spent two years on the sell side, initially as a Senior EMEA and later Western European Telecoms analyst with SG Securities.

Agne holds an MBA from Georgetown University in Washington DC and a Bachelors Degree in Business from the Kaunas University of Technology in Lithuania. Agne is also a Chartered Financial Analyst (CFA) charterholder and holds the Investment Management Certificate. She is fluent in Lithuanian, Russian and English.



**Peter Jarvis**

**Senior Investment Manager**  
Global Emerging Markets  
Equities team

Peter Jarvis joined Pictet Asset Management in 2006 and is a Senior Investment Manager in the Global Emerging Markets Equities team, specialising in the EMEA markets.

He began his career in 1993 with INVESCO Asset Management where he spent 13 years and managed Global Emerging Markets, Latin American and Eastern European portfolios.

Peter graduated from Oxford University with a BA (Hons) in Mathematics in 1993. He holds the Investment Management Certificate and is a Chartered Financial Analyst (CFA) charterholder.



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