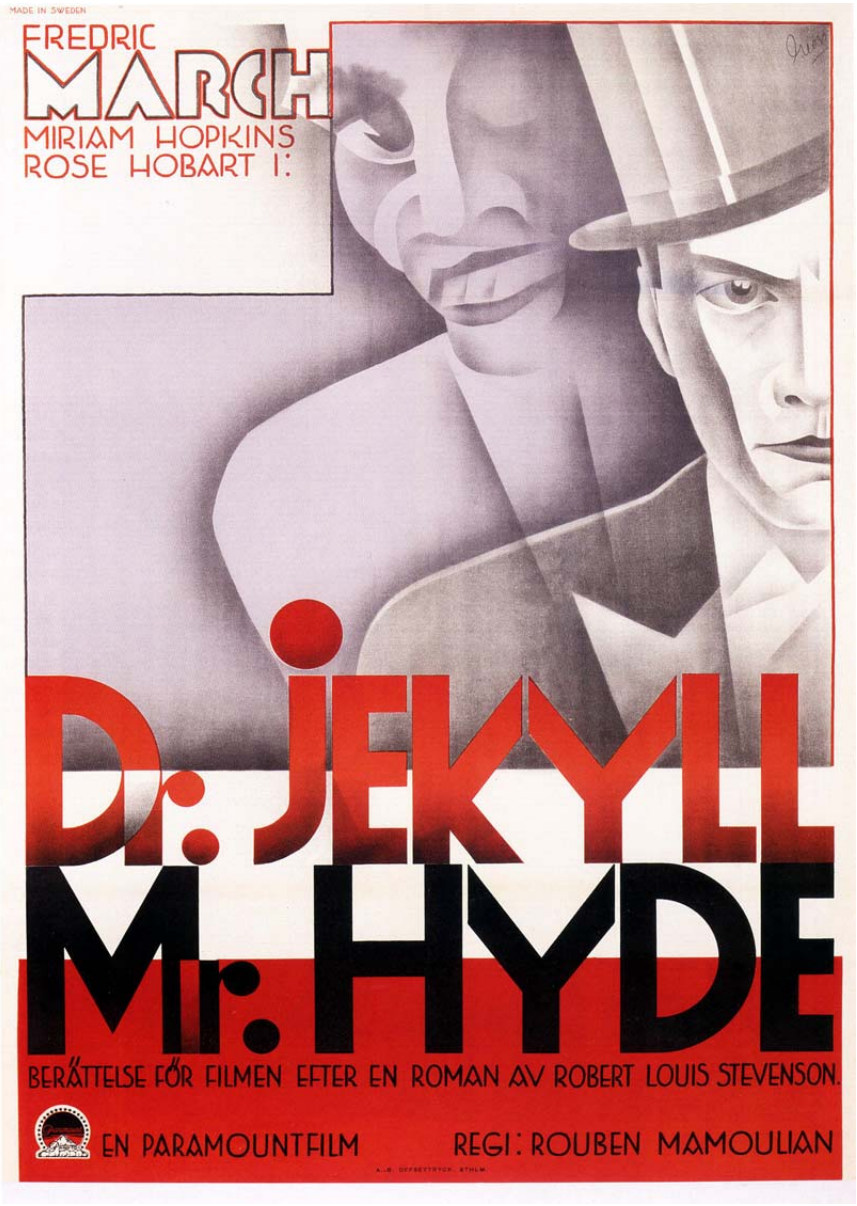
Troika Dialog

Strategy Quarterly

Russia's Conflicting Personas



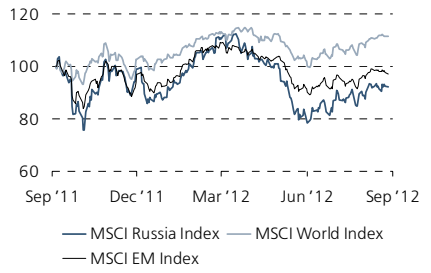
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In accordance with US SEC Regulation AC, important US regulatory disclosures and analyst certification can be found at http://www.troika.ru/eng/research/disclosure.wbp.

MSCI indexes – Russia, EM and World



Source: Bloomberg

Key equity market statistics*

RTS Index	1,470.8
MICEX Index	1,474.6
IOB GDR Index	855.9
RDX GDR Index	1,454.1
Market value, $ bln	$750
Free float	28%
2012 P/E – Total Market	5.7
2012 P/E – Domestics	7.1
2012 P/E – Extractive Industries	5.4
2012 P/E – EM Average	10.9
2012 P/E – World Average	13.3
2012 EPS Growth – Total Market	-2.0%
2012 EPS Growth – Domestics	8.0%
2012 EPS Growth – Extractive Industries	-6.0%
2012 EPS Growth – EM Average	5.0%
2012 EPS Growth – World Average	5.0%
2013 P/E – Total Market	5.7
2013 P/E – Domestics	6.5
2013 P/E – Extractive Industries	5.7
2013 P/E – EM Average	9.8
2013 P/E – World Average	12.0
2013 EPS Growth – Total Market	-1.0%
2013 EPS Growth – Domestics	15.0%
2013 EPS Growth – Extractive Industries	-8.0%
2013 EPS Growth – EM Average	10.0%
2013 EPS Growth – World Average	11.0%

* based on closing prices and index values on September 7

Source: Troika estimates

Top picks

	MCap, $ mln	2012E P/E
Surgutneftegaz pref	n/a	n/a
NOVATEK	36,162	14.3
KazMunaiGas EP	7,521	4.6
TNK-BP Holding	41,240	5.3
Yandex	6,836	25.6
CTC Media	1,338	9.4
MTS	18,119	8.9
Globaltrans	3,369	9.7
Global Ports	2,270	12.4
Federal Grid Company	7,976	5.9
MRSK Volga	385	44.0
Dixy Group	1,399	32.7
MMK	3,234	69.3
PhosAgro	534	0.7
Polymetal	5,916	11.5
Polyus Gold	9,025	12.1
Etalon Group	1,843	10.4
Vozrozhdenie Bank	432	6.1
Halyk Bank	1,851	5.3

Source: Companies, Bloomberg, Troika estimates

Strategy Quarterly
Russia's Conflicting Personas

Courage is often lack of insight, whereas cowardice in many cases is based on good information.

Peter Ustinov

- **Russia has become something of a bipolar investment market.** On one hand, there is the side of Russia than mandates a higher risk premium to that of EM peers. It is the Russia that provides the regular stream of negative international headlines and it is the portion of the stock market mainly perceived to be vulnerable to a global economic slowdown. On the other hand, Russia is quietly going about its business. It enjoys an expanding domestic economic base, a fast-growing consumer story and a stable economy.
- **Stick with long–term domestic themes.** Our core recommendation remains unchanged; investors with a medium to long-term investment horizon should use market volatility to add quality stocks with exposure to the steadily expanding domestic economy, as well as extractive-industry names offering more than just a high-beta play on global volatility (see our top picks in the margin).
- **Two global backdrop scenarios reviewed.** In this review of the likely market drivers, we set out two scenarios for the global market backdrop through this autumn and the coming winter and spring, and explain how we expect Russian indexes to perform under each. In the first scenario, we see a more determined effort by policymakers in the US, EU and China to tackle risk and boost growth. Here, we could see the RTS Index move into a higher range, though by year end the concerns about Eurozone debt would again be on the rise and the amount required by the European Central Bank (ECB) to buy debt would surely escalate. In the second scenario, investors view the policy proposals as weak and growth indicators in major economies continue to ease lower. Here, global markets would still see a relief bounce, but it would be of shorter duration and equity indexes would move lower into year end.
- **No rational basis to set an index target.** Because Russia's domestic story remains of secondary importance concerning where stocks trade, we are no longer setting a target level for the RTS Index. It is a meaningless exercise when the decisions made in Washington, Brussels, Berlin and Beijing are the dominant valuation drivers. We will instead indicate ranges where we expect the index to trade based on how we believe earnings and the risk premium would react under various global macro scenarios. Under the more optimistic scenario, we could see the RTS Index trade up to 1,750 through the winter but mainly stick to a range of 1,500-1,700. Under the less optimistic scenario, we could see an initial bounce to around 1,550 but settling in the 1,200-1,400 range.
- **Reviewing Russia's progress and risk factors.** We take a detailed look at how domestic factors are expected to evolve and what their longer-term impact will be; economic stability and greater resilience against global woes; political trends; reform progress, or the lack thereof; privatization progress; WTO entry; and Russia's oil vulnerability.

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Investment Case

Blessed is he who expects nothing, for he shall never be disappointed.

Jonathan Swift

- **Bad DNA has dominated.** Russia has become something of a bipolar investment market. On one side there is the Russia that mandates a higher risk premium to that of EM peers. This is the Russia that provides the regular stream of negative international headlines and it is the portion of the stock market mainly represented by extractive industry exporters, whose profitability and valuation is dictated by both the actual trend in global economics and investors' perception of the future trend. This has been the dominant side of the market's DNA for the past three years.
- **The good side remains in the shadows.** The other side of the Russia story is quietly going about its business. It is the expanding domestic economic base, the fast-growing consumer story and the stable economy. This side of the DNA is less pronounced in the overall makeup and, as a consequence, valuations here suffer negative contagion from the more troubled side and trade at a lower level than the stable domestic macro backdrop and earnings growth justify.
- **Looking through the winter period.** We look at the factors expected to drive the equity markets through the autumn and coming winter, and how the two sides to the Russia story are likely to interact during this period.
- **Stick with long-term domestic themes.** Our core recommendation remains unchanged; investors with a medium to long-term investment horizon should use the continuing volatility to add quality stocks that offer exposure to the steadily expanding domestic economy and stocks in the extractive industries that offer more than just a high-beta play on global volatility.
- **Market structure also hurts valuation.** Part of the problem for the high level of volatility and the ratings discount remains the fact that the market is heavily skewed toward the extractive industries and is underrepresented in the more long-term attractive domestic themes. With the exception of the Globaltrans SPO this year, there has been no new equity issuance from this side of the market for a long time. The other issue is that liquidity in the domestic themes is also a lot lower than for the extractive industries. There is too small a free float. This adds to investment risk under current market conditions. All of the new money flowing into Russia retail funds in 2012 has come via ETFs, and these funds only buy the top four to six liquid names.
- **Not enough equity or investors.** The overall free float is too small (28% of the total) and there is a tiny domestic investor base.

Key price and index performance

	Value*	Jan – March**	March – May***	May – Sept	YTD*
RTS Index	1,470.8	26.5%	-27.2%	15.6%	6.4%
MICEX	1,474.6	15.5%	-20.3%	14.3%	5.2%
IOB GDR Index	855.9	17.2%	-26.7%	17.9%	10.0%
MSCI EM Index	968.8	16.2%	-15.2%	7.4%	5.7%
MSCI World Index	1,312.1	11.6%	-10.0%	10.4%	10.9%
S&P 500	1,437.9	11.7%	-6.1%	10.6%	15.9%
Copper, $/lb	364.5	12.9%	-11.1%	10.0%	6.1%
Brent, Fwd, $/bbl	114.3	17.2%	-15.1%	16.1%	6.1%
Gold, $/oz	1,740.5	5.7%	-5.1%	7.3%	11.1%
RUB/USD	31.89	8.8%	-8.5%	0.1%	0.9%
USD/EUR	1.28	17.2%	-15.1%	6.9%	1.1%

* as of close on September 7

** market peaked at mid-March

*** market hit a bottom at end May

Source: Bloomberg

Global political–economic market scenarios and impact on Russia

	Effective policy actions			Muddle–through actions		
	Autumn	Winter	Spring	Autumn	Winter	Spring
Global events	German court decison on ESM on September 12. EU Leaders summit on October 18. China leadership changes on October 28. US election on November 6.	Final EU summit of 2012 on December 13. OPEC meeting on December 12. Inauguration of US president in early January.	New Chinese president and prime minister appointed in March. Parliamentary elections in Italy on April 13.	German court decison on ESM on September 12. EU Leaders summit on October 18. China leadership changes October 28. US election on November 6.	Final EU summit of 2012. OPEC meeting on December 12. Inauguration of US president in early January. Policy responses remain too little, too late.	New Chinese president and prime minster appointed in March. Parliamentary elections in Italy on April 13. Policymakers are finally forced
US	Fed announces a further round of stimulus at the September FOMC meeting; economic indicators stabilize or show modest recovery.	Election optimism may keep the economy buoyed. 3Q12 earnings come in line with consensus with comments leaning toward optimism.	Administration will have to take early and more forceful actions to tackle the deficit. Growth forecasts are no better than in 2012.	Fed only extends Operation Twist and continues to highlight the generally positive trend in the economy, i.e. not enough.	Negative contagion from the rest of the world hurts confidence and slows economic activity. Corporates are more cautious in their outlook.	Fed is forced into further, more significant action to try and stimulate the sluggish economy and new administration cuts spending.
Europe	ECB pushes ahead with bond purchases. German court approves ESM. and EU summit supports a new Greek deal.	Bond market is unlikely to be impressed for long. The December EU summit may have to agree to raise bond limits.	Growth forecasts will likely be scaled back for 2013 as activity remains sluggish. A political crisis is very likely within the EU.	No political agreement among EU leaders as to how to support the ECB plan – a real fudge. Greece gets only a small new deal.	Spanish risk increases. Greece faces internal political strife. EU leaders still cannot agree as Germany holds a tough line on spending cuts.	Spain gets a bailout and Greece is out of the Eurozone. This may then lead to more political unity, especially as Merkel faces an autumn election.
China	Macro indicators point toward 7.5% GDP growth. Government may time some stimulus measures around the October Party Congress.	Further measures and optimistic statements from Beijing during the final transition phase ahead of the new government in March.	New government probably has to deal with more political issues among the elite and with Japan. Economic pressures grow.	Slowing economic indicators but nothing dramatic – only small additional stimulus measures. Rumors of political instability.	Pessimism about the growth outlook for 2013. New government takes office with more obvious problems to deal with. Islands row worsens.	New government will be forced into taking larger stimulus actions. High risk of a currency battle with the new US administration and regional tensions.
Oil	Risk premium stays high for Brent as fears increase of a strike against Iran ahead of US election. Saudi Arabia may raise output to keep $110-120/bbl.	If no Iran strike, then Brent will end the year close to $100/bbl. If there is a strike, then a quick spike to $130-140/bbl before falling back to $100/bbl.	Iran issue should be resolved one way or the other; strike or embargo losses are compensated for. Brent is more likely to drift to $90-100/bbl.	If there is no strike against Iran and the threat level declines, then, against a muddle-through global backdrop, Brent may ease to $90/bbl.	An easing of the Iran threat (by any means) against a backdrop of growth and risk pessimism may see Brent in the $80-85/bbl range in early 2013.	A forced policy response should weaken the dollar and provide both currency and demand support. Brent closer to $100/bbl by early summer.
Global markets	Policy initiatives always boost markets with risk assets rising. US dollar fall will support oil and commodities (gold) and risk assets.	Rally is unlikely to last long, as investors will view the measures as just another band-aid. Markets likely to settle into a new range for winter.	More likely to see pessimism on global markets as problems in Europe and China reemerge. Drift back to safe haven of the dollar.	A very modest rally in early autumn, but with a high risk of a total reversal of the summer rally. The dollar would remain strong.	If markets do not fall in the autumn, then under a muddle-though (too little, too late) scenario, they will fall though winter. The dollar is a safe	Weak markets in winter and forced bigger policy response in spring would lead to a spring – early summer rally in equities and a weak dollar.
Russia – domestic	No major surprises in the economy and political protests fail to attract large momentum. Some progress in privatization with better global markets.	More of the same mainly. Some slower growth expected in 2013 as the effect of the boost to real wages and state salaries is lessened.	Differences between state officials and at the top of government over budget issues; privatization and pension reform become obvious.	No immediate impact on the overall macro trend, but forecasts for 2013 reduced. Weaker ruble might cut domestic confidence.	Policy differences in government would be more obvious and could lead to changes. Plan A response would be to "wait it out" and do little.	Slower growth than in 2012, but no dramatic fall. Muddle-through strategy would survive. Opinion polls show more public concern.
RTS Index range	1,500-1,750, led by extractive industry exporters – steels, mining and oil and gas. Better ruble with oil is good for banks.	1,600-1,750, with again low-volume activity as investors pull back from risk assets while waiting for further policy moves.	1,500-1,800. Initial nervousness gives way to more optimism. Possibly a BUY in May if EU gets its act sorted.	1,300-1,550, with the higher end seen quickly after any Fed policy actions and then fading. Risk-on would give rise to risk-off.	1,200-1,400, with low market volumes and tight range volatility dictated by moves on global markets.	1,300-1,800, with the upper end only likely in late spring or early summer as global markets rally and investors return to risk assets.

Source: Troika estimates

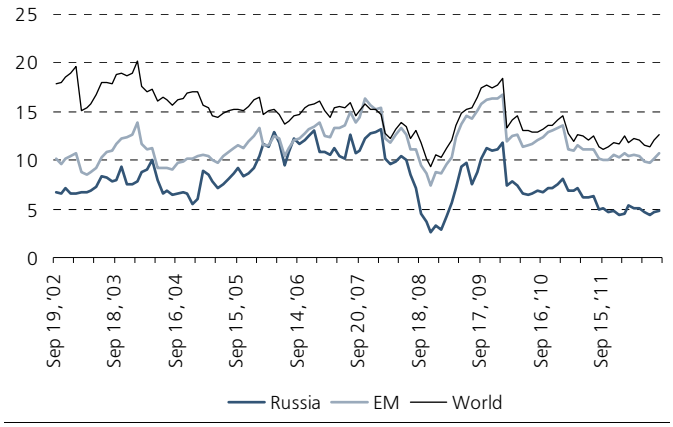
Market backdrop

- **Still a derivative of global trends.** It is very clear that the main driver of investor interest in Russian equities currently, and for most of the past three years, is the overall level of risk acceptance in global markets. EM equities have traded with greater volatility to developed markets and Russian equities have traded as a high-beta theme within the EM asset class. Russian equities (and the ruble) have moved with the global risk trend YTD, but at a faster pace. This dynamic is not expected to change through the coming months, as a structural fix to the Eurozone debt problem and sustainable buoyancy in the world's major economies still seems a very long way off. To that extent, the investment case over the coming months is fairly straightforward; asset prices will rise if investor confidence in the outlook for global growth and risk improves, while deterioration in growth and risk will send Russian assets lower.
- **Two main scenarios reviewed.** We set out two scenarios for the global market backdrop through this autumn and the coming winter-spring and how Russian indexes are expected to perform under each. The first scenario is where we see a more determined effort by policymakers in the US, EU and China to tackle risk and boost growth. In this case, we could see the RTS Index move into a higher range than we have seen this year, but it would be unlikely to break out too high, as the market reaction to expected policy initiatives would not be much more than a relief rally. By year end, concerns about debt in the Eurozone would again be rising and the amount required by the ECB to buy debt would surely be escalating.
- **Relief rally may be very brief.** The second scenario is where investors view the policy proposals as weak and growth indicators in the major economies continue to ease lower. Under this scenario, global markets would still see a relief bounce, but it would be of shorter duration and equity indexes would move lower into year end.

Market target range

- **No rational basis to set an index target.** Because of the fact that the domestic Russia story continues to be of secondary importance concerning where stocks trade, we are no longer setting a target level for the RTS Index. It is a meaningless exercise when the decisions made in Washington, Brussels, Berlin and Beijing are the dominant valuation drivers. We will instead point to ranges where we expect the index to trade based on how we expect earnings and the risk premium to react under various global macro scenarios.

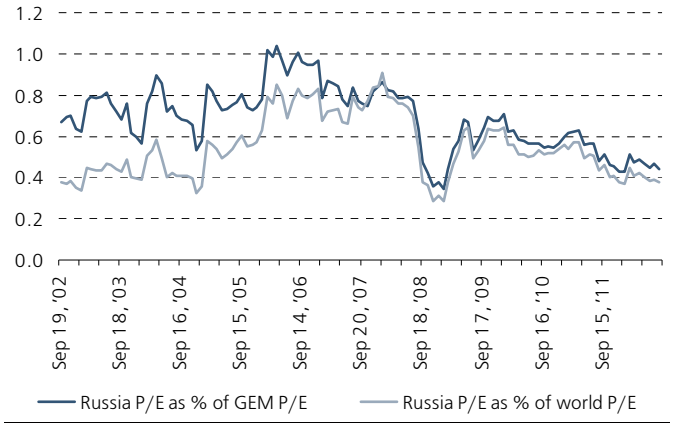
Forward P/E ratios



Source: Bloomberg

- **Market upside could be to 1,750 and support at 1,200.** Under the more optimistic Scenario 1, we could see the RTS Index trade up to 1,750 through the winter, but mainly stick to a range of 1,500-1,700. Under the less optimistic Scenario 2, we could see an initial bounce to around 1,550, but settling in the 1,200-1,400 range through the winter. We do not see a high risk of the market falling back much below that lower range, as earnings growth from the domestic sector stocks will be more resilient to that of the extractive industries and that will support the valuation base, and the economy is much better prepared to withstand a longer period of global uncertainty and slowing growth than was the case in 2008-09.
- **Steels are the most volatile**. The main dynamic will continue to play out via the extractive industry exporters, which are the most sensitive to global trends and sentiment. This was clearly illustrated with the stock performance just after the ECB announcement on September 6.

Russia forward P/E as % of GEM and world P/E



Source: Bloomberg

Domestic drivers

ECONOMY

The economy remains stable and is on track to deliver 4% GDP growth this year and a little lower in 2013. The only forecast we have had to change is for inflation, which is higher due to tariff hikes and food price growth. The Central Bank's ruble policy has helped create a positive balance in the budget, as lower oil revenues are offset by a weaker ruble/dollar rate and vice versa.

The government continues to make a virtue of Russia's relatively strong growth, fiscal and monetary position when compared with most developed and developing economies. This is certainly the case and Russia's economy and budget are in very good shape to withstand a prolonged period of global economic uncertainty and slowing (see our September *Russia Economics Monthly*). The concern is that the priority for stability will prevent economic reforms and, growth will eventually tail off.

POLITICS

We are moving into a more active political season, with a large protest march planned this month and quite a few regional elections in mid-October. There is no reason why either of these events should lead to any heightened concern about political instability or give cause for concern to investors. But, as with any political event, there is always the unpredictable factor.

REFORMS

The expected escalation in the reform process, i.e. as indicated in the election cycle, has not yet materialized. Expectations are very low that any significant progress will actually come over the

winter months. The government's priority is to maintain domestic social and economic stability and, so far, there appears to be no political unity or enthusiasm to push reforms.

PRIVATIZATIONS

Fast-tracking the privatization program was one of the reforms highlighted as the new cabinet was being firmed. Here the plan has quickly changed and been considerably diluted. The major part of the expected program is now on a much longer-dated time line.

WTO

Russia has finally been admitted to the WTO. This is a big positive for the country and economy, but longer-term rather than immediate. Membership provides a time line by which some reforms and industry changes should take place, and it incentivizes the government to provide financial and regulatory support for industries such as agriculture and food production. The benefits, however, will not start to become evident for several years.

OIL

The price of oil looks comfortable in terms of the budget requirement for the remainder of this year. The threat of action against Iran and the expected action from the US Federal Reserve, i.e. which will put downward pressure on the dollar, should keep Brent and Urals above $115/bbl. In the longer term, i.e. based on the trends in supply and demand now emerging, the Brent price is more likely to trade at $80/bbl in two years. Any medium-term oil forecast must always have a very lengthy list of caveats, but without further supply disruption or broadening of the risk in the Middle East, the favorable backdrop for oil budget revenues may only last another year.

Sector valuations and growth outlook*

	MCap	ADT	2012E				2013E		
	$ mln	$ mln	P/E	EPS growth	EV/EBITDA	P/BV	P/E	EPS growth	EV/EBITDA
Base metals	36,292	91	9.5	2%	5.6	1.3	10.0	-8%	5.7
Coal	11,569	29	6.7	-18%	5.4	1.3	6.9	-54%	5.9
Consumer	45,137	73	14.5	21%	7.9	2.4	12.5	16%	7.0
Fertilizers	29,002	70	8.2	16%	5.5	1.9	7.1	15%	4.8
Financials	96,128	675	5.9	5%	–	1.1	5.4	10%	–
Fixed lines	26,287	22	7.5	16%	3.4	1.2	7.1	6%	3.2
Gas	149,837	468	3.6	-14%	2.8	0.5	4.1	-12%	2.9
Media and IT	17,299	44	24.2	56%	13.5	4.1	18.0	26%	10.0
Mobiles	36,406	76	9.5	7%	4.0	2.3	8.5	11%	3.6
Oil	241,133	440	5.0	-1%	3.0	0.9	5.5	-7%	3.1
Other	52,161	36	3.6	18%	3.1	0.7	3.1	12%	2.4
Precious metals	28,582	23	10.0	28%	7.2	1.5	8.1	25%	5.8
Real estate	7,324	7	13.8	-12%	10.3	1.0	8.1	52%	7.5
Steel	51,146	75	8.5	-11%	5.2	1.0	8.8	6%	5.1
Transport	12,834	15	9.2	5%	6.2	1.3	7.5	21%	5.4
Utilities	55,342	70	6.8	-6%	3.2	0.4	5.2	29%	2.9
Russia	894,827	2,200	5.7	-2%	3.7	0.8	5.7	-1%	3.5
Russia – domestics	**339,455**	**1,003**	**7.1**	**8%**	**4.1**	**0.9**	**6.5**	**15%**	**3.5**
Russia – exporters	555,373	1,197	5.4	-6%	3.5	0.8	5.7	-8%	3.5
EM – all	**7,702,891**	**15,538**	**10.9**	**5%**	**5.7**	**1.4**	**9.8**	**10%**	**5.0**
DM – all	22,698,753	98,422	13.3	5%	6.8	1.4	12.0	11%	6.1

* as of close on September 7

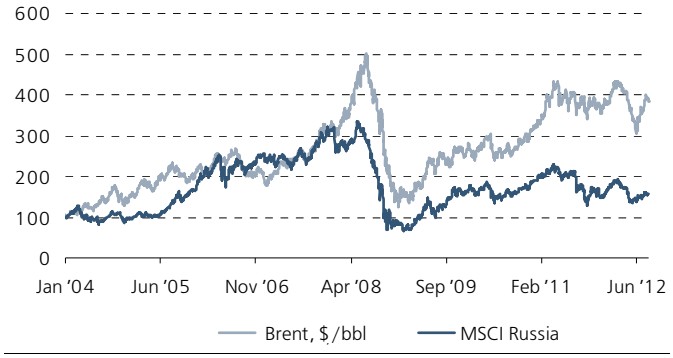
Source: Troika estimates

Risks

- **External trends still represent the main risk.** The main risk to our market outlook scenarios is that the relief rally is very brief and risk-off sentiment returns quickly. In that event, Russian equities would return to the sidelines and the extractive industries would remain in the sin bin.

- **China still the wild card in commodities.** China is also a bigger factor for Russia in that it is the largest importer of commodities and its demand determines price levels. If the economy continues to slow and the government does not take effective action to stabilize it, then the effect would be felt in commodity prices and among commodity producers.
- **Political protests always unpredictable.** While we do not expect any escalation in political instability and risk in Russia, there is always the unknown factor that can escalate events quickly.

Investors remain wary of oil risk



Source: Bloomberg

Top picks

Top picks*

	Ticker	MCap, $ mln	Price, $	Target price**	Free float	P/E 2012E	P/E 2013E	EV/EBITDA 2012E	EV/EBITDA 2013E	Yield	Performance, YTD
Surgutneftegaz pref	SNGSP RX		0.69	0.70	86.9%					10.6%	34.0%
NOVATEK	NVTK LI	37,741	124	157	21.6%	14.9	13.9	11.0	9.8	0.2%	-1.0%
KazMunaiGas EP	KMG LI	7,799	18.25	28.00	22.8%	4.8	5.4	1.6	1.6	8.0%	22.0%
TNK-BP Holding	TNBP RX	42,545	2.76	3.60	5.1%	5.5	6.3	3.4	3.7	15.4%	3.0%
Yandex	YNDX LI	7,432	22.95	27.90	27.9%	27.9	21.6	16.5	12.3	0.0%	16.0%
CTC Media	CTCM US	1,420	8.98	12.85	37.1%	9.9	9.1	5.5	5.0	9.1%	2.0%
MTS	MBT US	19,959	20.07	25.40	26.5%	13.5	11.9	5.2	4.8	5.0%	37.0%
Globaltrans	GLTR LI	3,888	21.75	27.08	48.7%	11.2	10.6	7.8	6.3	1.7%	37.0%
Global Ports	GLPR LI	2,350	15.00	20.58	25.0%	12.8	11.1	8.1	6.8	2.3%	4.0%
Federal Grid Company	FEES RX	8,680	0.01	0.02	16.8%	6.4	4.9	3.1	3.0	1.7%	-22.0%
MRSK Volga	MRKV RX	415	0.00	0.01	24.5%	44.0	16.8	4.0	5.1		15.0%
Dixy Group	DIXY RX	1,436	11.51	14.00	32.5%	35.9	23.0	7.7	6.4	0.0%	26.0%
MMK	MMK LI	3,546	4.19	4.74	11.2%	75.9	19.2	5.2	4.7	0.0%	-14.0%
PhosAgro	PHOR LI	5,004	13.40	16.20	10.0%	7.0	6.9	4.9	4.5	25.1%	59.0%
Polymetal	POLY LN	6,400	16.72	18.90	45.6%	12.5	9.2	8.3	6.2	1.2%	-2.0%
Polyus Gold	PGIL LN	10,345	3.41	3.61	14.5%	12.1	13.8	12.8	8.7	0.5%	10.0%
Etalon Group	ETLN LI	1,917	6.50	9.00	27.9%	10.9	8.7	8.4	6.7	0.0%	38.0%
								P/BV			
Vozrozhdenie Bank	VZRZ RX	465	19.27	29.70	34.0%	6.5	4.5	0.7	0.6	0.1%	14.0%
Halyk Bank	HSBK LI	1,921	7.06	9.60	24.5%	5.5	5.4	1.0	0.8	0.0%	45.0%

* as of close on September 7

** target price calculated using DCF methodology

Source: Companies, Bloomberg, Troika estimates

Key dates ahead – international

2012

September 12 US Federal Reserve monthly FOMC policy meeting.

German Constitutional Court rules on legality of ESM.

Parliamentary elections in Holland.

Early October	Tripartite commission's report on Greece submitted to EU Commission – next tranche of bailout funds to be paid.
October 4	First TV debate between US presidential candidates; opinion poll days later.
October 18-19	EU Council meeting.
October 28	Ukraine parliamentary elections.
	National Congress of Communist Party of China to elect new leader.
November 6	US presidential election.
December 12	OPEC ministers meeting to review production.
December 13-14	EU Council meeting.

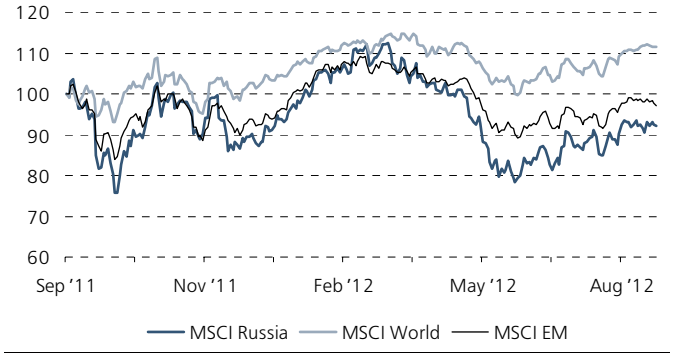
2013

January 20	Inauguration of US President.
March	National People's Congress in China to appoint new president and prime minister.
April	Italian parliamentary election.
June	Iranian presidential election.
Sep-Oct	German federal elections.
October	Georgian presidential election.
	Israeli parliamentary elections.

Key dates ahead – domestic

September 15	Planned opposition protests in Moscow and other major cities.
October 14	Series of elections in Russia (governor, regional administrations, mayor).
Mid-October	End of the exclusive lock-up period for BP-AAR negotiations (TNK-BP).
Year end	Central Depositary expected to start operations later this year or early 2013.

MSCI indexes



Source: Bloomberg

ADR/GDR performance in distinct market phases

Jan 1 – mid-Mar		Mid-Mar – end May		Jun 1 – Sep 10		YTD*	
RTS Index	26.5%	RTS Index	-27.2%	RTS Index	15.6%	6.4%
MICEX Index	15.5%	MICEX Index	-20.3%	MICEX Index	14.3%	5.2%
FTSE IOB GDR Index	27.2%	FTSE IOB GDR Index	-26.7%	FTSE IOB GDR Index	17.9%	10.0%
MSCI EM Index	16.2%	MSCI EM Index	-15.2%	MSCI EM Index	7.4%	5.7%
MSCI World Index	11.6%	MSCI World Index	-10.0%	MSCI World Index	10.4%	10.9%
S&P 500	11.7%	S&P 500	-6.1%	S&P 500	10.6%	15.9%
RUB/USD	8.8%	RUB/USD	-8.5%	RUB/USD	0.1%	0.9%
Brent, $/bbl	17.2%	Brent, $/bbl	-15.1%	Brent, $/bbl	6.9%	6.4%
LSR Group	76.5%	TransContainer	-2.0%	VimpelCom Ltd	59.8%	23.3%
AFI Development	51.0%	Raven Russia	-2.1%	PhosAgro	50.6%	58.8%
TMK GDR	50.0%	Chelyabinsk Zinc	-3.9%	Sistema	38.6%	34.4%
Mail.ru Group	48.4%	Global Ports	-5.5%	Magnit	36.5%	61.8%
Magnit	45.2%	NCSP Group	-5.9%	Tatneft	33.8%	39.1%
Tatneft	45.2%	X5 Retail Group	-6.2%	Etalon Group	31.3%	38.3%
NOMOS Bank	44.7%	Uralkali	-8.8%	Polymetal	30.3%	-4.6%
Etalon Group	44.7%	Globaltrans	-9.9%	Globaltrans	28.7%	58.2%
Surgutneftegaz	40.5%	Ros Agro	-10.3%	O'Key	28.5%	40.7%
VTB	38.1%	TMK	-11.1%	NOVATEK	28.1%	-0.7%
Globaltrans	36.4%	PhosAgro	-11.5%	TMK	27.1%	69.4%
Sistema	33.6%	MTS	-12.3%	Mechel	25.9%	-17.8%
HMS Group	32.5%	O'Key	-13.3%	TransContainer	21.8%	53.8%
RusHydro	30.3%	Cherkizovo Group	-14.0%	Gazprom Neft	21.4%	4.7%
Norilsk Nickel	30.0%	PIK Group	-14.4%	MTS	21.2%	36.7%
Sberbank	29.1%	HMS Group	-14.5%	NOMOS Bank	19.6%	33.7%
TransContainer	28.8%	Mail.ru Group	-14.8%	NLMK	18.9%	-2.9%
MTS	28.7%	Eurasia Drilling Company	-15.3%	LUKoil	18.5%	14.5%
Mechel	28.0%	CTC Media	-15.7%	Eurasia Drilling Company	18.0%	25.5%
CTC Media	26.5%	Polymetal	-16.7%	Sberbank	17.3%	18.4%
O'Key	26.3%	Yandex	-17.1%	LSR Group	16.8%	30.2%
Gazprom	25.9%	UC RUSAL (HKD)	-18.1%	Uralkali	16.4%	12.6%
Cherkizovo Group	25.8%	Magnit	-18.4%	Gazprom	15.5%	-3.6%
MMK	25.5%	Rosneft	-18.9%	Highland Gold Mining	13.8%	-35.1%
Eurasia Drilling Company	25.5%	Sberbank	-20.2%	Surgutneftegaz	13.6%	16.1%
Yandex	25.3%	Severstal	-20.3%	RusHydro	13.4%	-11.8%
Severstal	24.9%	LUKoil	-21.3%	Pharmstandard	13.2%	8.8%
Pharmstandard	24.8%	Gazprom Neft	-22.6%	Yandex	12.2%	16.5%
Integra	23.6%	AFI Development	-22.7%	MMK	10.8%	-13.9%
LUKoil	22.8%	NOMOS Bank	-22.8%	Severstal	10.6%	10.1%
Chelyabinsk Zinc	22.5%	Pharmstandard	-23.0%	Ros Agro	9.9%	6.1%
PhosAgro	19.2%	Integra	-23.2%	Mail.ru Group	9.5%	38.5%
NOVATEK	18.2%	Norilsk Nickel	-25.3%	Raven Russia	9.2%	25.0%
IRC (HKD)	17.0%	Highland Gold Mining	-26.5%	Rosneft	7.0%	-3.9%
Raven Russia	16.8%	Evraz	-27.1%	NCSP Group	6.6%	-4.7%
VimpelCom Ltd	16.6%	Etalon Group	-27.2%	Norilsk Nickel	5.3%	2.2%
NLMK	16.2%	Surgutneftegaz	-27.3%	VTB	4.5%	-1.4%
UC RUSAL (HKD)	14.8%	Sistema	-27.3%	PIK Group	3.2%	-8.8%
Rosneft GDR	12.1%	IRC (HKD)	-27.4%	Global Ports	2.0%	7.1%
Gazprom Neft	11.5%	Tatneft	-28.4%	Petropavlovsk	1.5%	-38.5%
Global Ports	11.1%	NLMK	-29.7%	HMS Group	1.0%	14.4%
Evraz	9.6%	VTB	-31.6%	CTC Media	-4.0%	2.4%
Ros Agro	7.6%	Gazprom	-33.7%	X5 Retail Group	-4.3%	-3.7%
X5 Retail Group	7.4%	VimpelCom Ltd	-33.8%	Cherkizovo Group	-5.0%	2.7%
Uralkali	6.1%	NOVATEK	-34.5%	UC RUSAL (HKD)	-10.8%	-16.1%
Petropavlovsk	3.5%	LSR Group	-36.8%	Evraz	-13.0%	-30.5%
PIK Group	3.2%	MMK	-38.1%	Chelyabinsk Zinc	-17.0%	-2.3%
NCSP Group	-4.9%	RusHydro	-40.3%	AFI Development	-19.4%	-6.0%
Polymetal	-10.7%	Petropavlovsk	-41.5%	IRC (HKD)	-35.6%	-45.3%
Highland Gold Mining	-22.3%	Mechel	-49.0%	Integra	-35.7%	-38.9%

* as of close on September 7

Source: Bloomberg

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Making a Virtue Out of Stability in an Uncertain World

That the birds of worry and care to fly over your head, this you cannot change, but that they build nests in your hair, this you can prevent.

Chinese proverb

- **It is obvious that global trends will dominate for some time...** In the section looking at correlations, we highlighted the fact that the Russian investment case is almost entirely predicated on investors' perception of global risk. The next steps in the US, EU and China will again be much more important factors in determining at what level Russian asset valuations finish the year and how global investors view Russian risk.
- **... but Russia's domestic factors are stable.** In this section, we look at what is happening on the domestic front and how solidly the investment case is being created. In other words, will Russia look attractive to global investors, in absolute and relative terms, when the perception of risk elsewhere declines? We believe that to be the case. In *YTD Review* (later in this report), we look at YTD trends on the equity market, the main influences on sector themes so far in 2012, and what investors have been doing in terms of fund allocations.
- **The key factors**. We also take a deeper look at the following trends.
  - **Economy.** The domestic economy remains stable and with strong consumer and domestic sector trends. Inflation is a concern but will not be far off last year's level. GDP growth will be close to 4.0%.
  - **Oil.** Brent and Urals look well supported for the remainder of 2012 because of the Iran-based risk-premium and the likelihood of Fed action weakening the dollar. But the Central Bank's currency policy has greatly reduced the impact of lower oil on the budget.
  - **Politics.** The headlines greatly exaggerate the reality, which is that while protests will continue through autumn and winter, a repeat of the big protests of last winter is unlikely so long as the economy remains stable.
  - **Privatizations.** There is now a two-track program with asset sales in the strategically important energy sector likely to be delayed for several years. Asset sales elsewhere will depend on global market trends and investors' risk appetite.
  - **Reforms.** Nothing major is expected over the next year. The government's priority is to maintain domestic economic and social stability. WTO membership is, however, a big deal for the longer term and progress in financial reforms, e.g. the Central Depositary, continues to be made.

Economic performance

- **On track for 4.0% GDP growth in 2012.** Real GDP growth slowed a little in 2Q12, falling to 3.9% from 4.9% in 1Q12. Over 7m12, the estimate is that GDP has grown by 4.4%. We are expecting a further modest slowdown in the current quarter but remain confident of our full year forecast of 4.0% real GDP growth. At this stage, some slippage is expected in 2013 but again nothing dramatic. Overall, our view of the domestic economy is that it remains within narrow bands as the government prioritizes domestic stability.

- **July data showed a small decline in some areas.** The July data (the most recently published) showed a pickup in industrial production (up 3.4% y-o-y from 1.9% in June), but other indicators reported a slowdown. For example, retail sales growth in July was 5.1% y-o-y, while in June it was 6.9%. We do not believe that this marks a new phase of economic deterioration, but more a lull in reaction to rising prices. Again, we expect a pickup or stability in the autumn.
- **Data support investment case for consumer themes.** From an investment theme viewpoint, the expected high levels of disposable income, spending and domestic sector expansion remain intact. In July, the level of real wage growth was 10.2% y-o-y, real disposable incomes grew 2.2% and unemployment remained at 5.4%. Residential construction, in terms of square meters completed, rose 15.5% y-o-y in July. Salaries in the state sector continue to rise. All of this supports the case for the consumer sectors in Russia and the industry groups that benefit from an expansion of services, e.g. transport and real estate.

Russian macro statistics

	7m12	2012	2013E
Real GDP, y-o-y*	4.4%	4.0%	3.5%
Industrial production	3.4%	3.8%	3.4%
Capital investment, y-o-y	3.8%	5.0%	4.7%
Trade surplus, $ bln	121.1	160.0	115.0
Current A/C, $ bln	58.5	80.0	50.0
Budget surplus, R bln	9.0	–	–
Budget surplus, % of GDP	0.9%	-0.4%	-0.1%
CPI, y-o-y	5.6%	5.6%	4.2%
CPI, YTD	4.7%		
PPI, YTD	5.9%	6.0%	5.0%
Retail sales, R bln**	56.5		
Retail sales, y-o-y	5.1%		
Average monthly wages, R	865.0		
Nominal wage growth, y-o-y	16.3%		
Real wage growth, y-o-y	10.2%		
Real disposable income, y-o-y	2.2%		
Unemployment rate	5.4%		

* for first half of year (up 4.9% for 1Q12, up 3.9% for 2Q12)

** retail sales $ bln for July only

Source: State Statistics Service

- **Oil is always a talking point concerning Russia.** The main talking point concerning the economy is the vulnerability to the price of oil, while actually the main area of concern is inflation.
- **More flexible ruble policy cushions against lower oil.** The Central Bank's less interventionist policy toward the ruble means that there is much more of a counterbalancing effect between where oil trades and the ruble/dollar exchange rate. If oil rises, then so too will the ruble rate. Conversely, as we saw in May, a fast-falling oil price leads to an equally sharp-falling ruble. That means the weaker the oil price, the weaker is the ruble, and blending the two together means that the budget's oil price balancing requirement is also lower. For example, at the current level of Urals and the current ruble/dollar rate, the federal budget will balance close to $110/bbl average Urals rather than the $115/bbl in the official budget.
- **Inflation will rise further into autumn.** Inflation has been a concern in recent months as it accelerated in early summer. Rising food prices, contagion from global price rises, and tariff changes have pushed inflation higher than had been expected at the start of the year. The mid-August YTD rate was 4.7% and just short of the 4.8% seen this time last year. Inflation last year was 6.1% for the calendar year (down from 8.8% in 2010) while this year's rate now looks to end not far off the 2011 level. Inflation may reach a high of close to 6.5% in the autumn before leveling off. The biggest unknown is the effect of global food inflation. The price of corn and wheat each jumped by almost 50% since the start of summer due to the worst drought in the US since 1956 and drier than usual conditions across Eastern Europe and Russia.

- **Limited contagion from the Eurozone crisis.** Externally, the Eurozone debt crisis and slowing economy have had a very limited impact on Russia thus far. The effect has mainly been in terms of global-risk perception and aversion, as investors hold back from making major new commitments in any global market. Russia remains a triple-surplus economy as the current account, trade balance and federal budget balance were all in surplus through to end July.
- **Triple–surplus economy in 2012.** Obviously, where theses balances end the year, and the effect on the economy overall, will depend on whether the global economy starts to pick up or if the pace of deterioration accelerates. Below is the latest growth outlook from the IMF. If these numbers are achieved, our forecasts will be delivered comfortably.

IMF global economic outlook

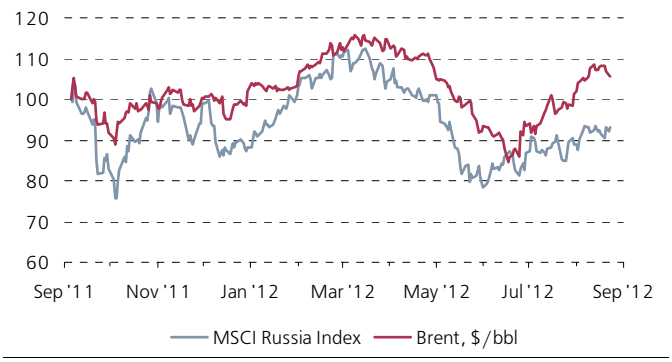
	2013E	2012E	2011	2010
World growth	**3.9%**	**3.5%**	**3.9%**	**5.3%**
US	2.3%	2.0%	1.7%	3.0%
Eurozone	0.7%	-0.3%	1.5%	1.9%
Japan	1.5%	2.4%	-0.7%	4.4%
Advanced economies	**1.9%**	**1.4%**	**1.6%**	**3.2%**
China	8.5%	8.0%	9.2%	10.4%
India	6.5%	6.1%	7.1%	10.8%
Russia	3.9%	4.0%	4.3%	4.3%
Brazil	4.6%	2.5%	2.7%	7.5%
Middle East	3.7%	5.5%	3.5%	5.0%
Developing Asia	7.5%	7.1%	7.8%	9.7%
Latin America	4.2%	3.4%	4.5%	6.2%
Central-East Europe	2.8%	1.9%	5.3%	4.5%
Developing economies	**5.9%**	**5.6%**	**6.2%**	**7.5%**

Source: IMF

Oil: perception worse than reality

- **Legacy of 2008 oil collapse remains a big factor.** It is fact that investors not active in Russia take the view that the country is only a little more than a petro-state, and because of the uncertainty in the oil market (an almost constant status), they are reluctant to accept economic risk. Investors familiar with Russia have been much more wary of the oil risk since the very quick collapse through the nine months from July 2008. That collapse completely turned what was a favorable Russia backdrop and outlook at mid-2008 to a debt crisis and recession by late 4Q08/1H09.
- **Recently strong oil has not helped equities.** Russian equities have actually been tracking the oil price for the past 12 months, albeit in recent weeks the oil price rally has not translated into a better equity market. As we show later in the section, looking at correlations, the equity market is now much more influenced by perceptions of global risk and a risk avoidance stance on the part of a majority of investors.

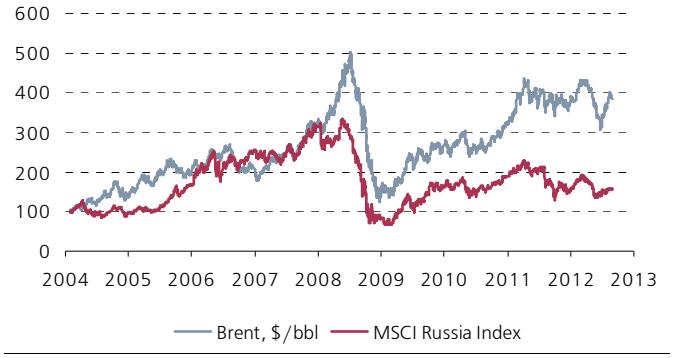
MSCI Russia Index and Brent, Sep '11 = 100%



Source: Bloomberg

- **The damage was done in 2008–09.** But, while the equity indexes have had a closer correlation with oil until recent weeks, the previously close correlation totally collapsed in 2009-11. Since the collapse of 2H08, investors have remained very wary of a repeat.

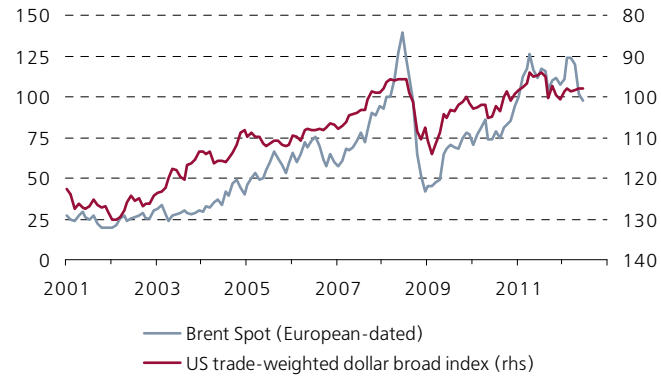
MSCI Russia Index and Brent, 2004 = 100%



Source: Bloomberg

- **Key factors affecting oil.** Although the NYMEX-based WTI contract grabs a disproportionate share of the financial media headlines, the gap between it and the Brent contract, to which the Urals contract is linked, has widened to over $18/bbl recently. Several factors have been driving the price of Brent-Urals this year.
  - **Iran.** The US and Europe extended the embargo against Iran from July 1, which increased fears that either Iran might retaliate, e.g. try to block the Straits of Hormuz, or that the cut in oil flows from Iran might squeeze supply. Neither has happened, but the threat has again boosted the risk-premium for Brent, especially as the IAEA recently reported that Iran is expanding its nuclear capability. Again, there is talk of a military strike against Iran's nuclear facilities, and that is sustaining the risk-premium.
  - **Dollar.** Historically, there has been a close relationship between where the dollar trades and the oil price. A weak greenback always provides support for oil, and vice-versa with a strong dollar. The Fed's low interest rate policy has dragged down the trade-weighted value of the dollar for several years, and prospects for another round of stimulus measures are again making traders fearful that the dollar faces further downward pressure. That is also one of the reasons why the price of oil is currently well supported.

Oil price supported by weak dollar, $/bbl



Source: Bloomberg

  - **Demand.** Despite the slowdown in the economies of the EU and sluggish growth indicators in the US, both the IEA and OPEC expected oil usage to increase in 2012-13 over the previous years. The IEA (see table below) expects demand growth of 800 kbpd in 2012 and 900 kbpd in 2013 (both y-o-y). The reason is because of expected demand growth in China, the other

fast growing Asian (ex-Japan) economies and from the Middle East. So far, despite weaker indicators in China, the country has held steady its increasing demand for imported oil. The numbers from the US and EU, unless they collapse, are not important.

Global oil supply and demand, mln bpd

	2010	2011	2012E	2013E
Demand				
North America	24.1	23.9	23.7	23.7
Europe	14.7	14.4	14.0	13.8
Pacific	8.1	8.1	8.4	8.3
Total OECD	**46.9**	**46.4**	**46.1**	**45.8**
FSU	4.2	4.4	4.6	4.8
China	8.8	9.2	9.5	9.7
Other Asia	10.8	11.0	11.3	11.5
Latin America	6.0	6.2	6.4	6.5
Middle East	7.1	7.4	7.6	7.7
Africa/Other	4.3	4.2	4.1	4.5
Total demand	**88.1**	**88.8**	**89.6**	**90.5**
Supply				
North America	14.1	14.6	15.7	16.2
Other OECD	4.8	4.4	4.0	3.8
FSU	13.5	13.6	13.7	13.6
Other non-OECD	16.3	16.2	15.8	16.1
Liquids, bio-fuels and gains	3.9	4.0	4.0	4.2
Total non-OPEC supply	**52.6**	**52.8**	**53.2**	**53.9**
Total OPEC including NGLs	34.6	35.7	36.0	36.3
Of which OPEC crude	**29.2**	**29.9**	**30.1**	**30.4**

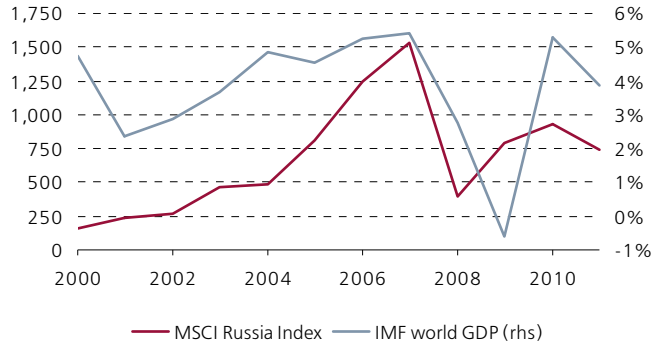
Source: IEA

- **Supply.** The other important factor is that there has not been any significant supply growth from outside of OPEC for several years, albeit that is now changing with the growth of supply from US shale oil, aka "tight oil". But for several years, the market has looked to OPEC and the organization has had a favorable period where it could regulate the market and the price. Saudi Arabia has been very vocal in its wish to see Brent average $100/bbl rather than to see a much higher price. The country's oil minister was very vocal in his view that oil at $120/bbl (in March) was a danger to the global economy and would ensure a high level of investment into competing energy sources.

What's next?

- **Risk-premium should remain high.** Over the short to medium term, the main driver for Brent is likely to be the width of the risk-premium, which, in turn, will continue to be a reflection of the perceived threat of a military strike against Iran. Very likely that perception will increase coming up to the US presidential election (November 6) and as Iran continues to add additional centrifuge capacity. Apart from the risk-premium, there will likely be a supportive backdrop to all commodities from a weaker US dollar, and the odds of the US Fed injecting additional liquidity into the economy are high. The only questions are the following.
  - **To what extent will the Chinese economy slow, and what will be the effect on oil imports?** Plus, whether a slower Chinese economy has a negative contagion to the rest of the region and slows oil usage there.
  - **What will Saudi Arabia do if oil again moves above $120/bbl?** Will it add more oil supply or does it even have that spare capacity over the short to medium term? Saudi Arabian Oil Minister Ali al-Naimi will certainly warn against the high price, as he did in the spring, and promise/threaten much higher volumes.

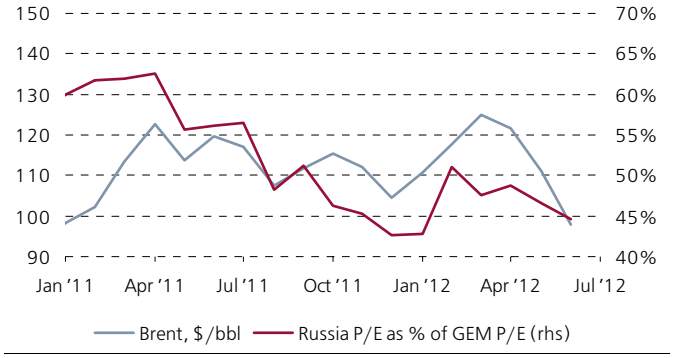
MSCI Russia Index and global growth



Source: Bloomberg

- **The longer term outlook for oil remains less favorable.** Beyond the medium term, the outlook for the oil price is less favorable. Of course, it is well understood that forecasting oil is an exercise fraught with the unexpected. But, based on what we know today, the more likely trend in oil is lower on a three to four year view. The reasons for that are the following.
  - **Iraq.** The country's supply is rising steadily as it is more stable. The target is to add 2.0 mln bpd within three to four years and, at least geologically, that is very feasible.
  - **Kashagan.** Phase 1 of Kazakhstan's Kashagan field is due to go live in 1Q13 with about 350 kbpd. The planned increase in phase 2 would bring the total up to over 1.0 mln bpd and is expected in about three years
  - **Rising US supply.** US shale oil supply is increasing steadily and, along with the expected completion of the Keystone Pipe upgrade that will take an additional 1.0 mln bpd of Canadian sands oil into the US, the US is expected to be able to cut its current oil imports from elsewhere by about 3 mln bpd also in about three years.
  - **More gas and coal.** Shale gas has already caused big pricing pressure for gas prices in Europe. Even though the US is not yet exporting LNG, the availability of cheap gas in North America has hit the coal industry hard and it has rapidly increased exports. Cheap coal, on the back of cheap US gas, is undermining the gas market elsewhere.
  - **Base effect in China and Middle East.** Demand from China and the Middle East is expected to start tailing off in the coming years. This is because of the base effect: economies cannot sustain high growth for many more years as the base is already much bigger. The same goes with oil usage. Second, gas and cheap coal are becoming more formidable competitors to oil in the developing economies and will limit the future pace of growth in the latter.
  - **Greenback in 2014.** The dollar will not stay weak for many more years. The Fed may reverse its low interest rate policy in two or three years as well, which would sustain a rally in the trade-weighted value of the currency. A stronger dollar will be a negative factor for oil.
  - **Better Iran relations?** Iran may by then be "rehabilitated" and the embargo against investing in its oil industry ended. If so, there is also, like Iraq, considerable scope for higher volume production and exports.
  - **Brazil.** Brazilian deep-water production is likely to be closer, if not calculable.
- **How will Saudi Arabia react?** All of this will then throw the onus back to OPEC, and Saudi Arabia in particular. Will it cut enough production to match the rising supply and lower import demand? Even if it wanted to manage supply to achieve an average price of $100/bbl to balance its budget – which may be higher as social and defense costs rise every year – would it be able to achieve an internal agreement and deal adherence discipline within OPEC?

Russia P/E as % of GEM P/E and oil



Source: Bloomberg

Politics: a background threat rather than real

- **Russia news has been dominated by politics...** Political events have dominated the headlines from Russia since Vladimir Putin and Dmitri Medvedev announced a job switch almost one year ago. The emergence of the well-supported protests between the Duma election, in early December, and the presidential election, in early March, greatly contributed to investors' more cautious stance toward Russia, which persists today. It is, however, wrong to assume that the expanded valuation discount and modest investor inflows are associated with a perception of political risk. The more important reasons for the risk-premium in Russian valuations are because of global risk avoidance and a concern that the economy is overly vulnerable to an escalation of the Eurozone crisis, to a slowdown in China and to a sub-$100/bbl Urals price.
- **... and will remain so this autumn.** Still, the more prominent headlines from Russia continue to be about politics, and that will carry through this autumn and winter.
- **Next major protest event is September 15.** After a quiet summer, the protest group organizers plan the next major event for September 15 in Moscow and across other cities. The indications are that the number of people expected may be closer to the May or June events rather than to the much bigger crowds that turned out in the December-March period. Opinion polls show that while a much larger number of people are now aware of the protests and their aim, only a relatively small minority are currently willing to take an active role. Hence, the government's main priority is to keep the economy stable, to keep raising state sector salaries and pensions, and to pursue generally populist policies rather than major reforms. Inflation control, for example, is a greater priority than privatization today.
- **Big election test in mid–October.** The real test may come on October 14, when Russians go to the polls to elect five new governors, legislative assemblies in six districts and some mayors, including for Kaliningrad. In elections held during June and July, the voter turnout was between 20-25% and United Russia candidates just scraped in. The opposition parties are planning to focus on boosting the voter turnout in the hope that the greater the vote, the more likely it will be that United Russia or other pro-government candidates will lose.
- **Lots of changes since May.** Since the March election, a number of important events have taken place in the political arena.
  - Libel laws have been toughened to raise the stakes against attacks on government or pro-government officials.
  - Foreign-funded NGOs must now register as a foreign agency and state publically that it is foreign funded.

- The law against public assembly (without prior approval) has been greatly toughened so that even small groups may now be disbanded.
- The list of prohibited internet sites has been expanded and the courts have expanded powers to ban undesirable sites.
- Political activist Alexei Navalny has had an old criminal case, previously dropped, reopened against him.
- Over 60 new political parties have now been registered under the new legislation adopted as a result of the protests. People's Freedom Party (aka PARNAS) is included on the list.
- Alexei Kudrin is running a civil initiatives group that is training people to take a more active role in politics.
- Mikhail Prokhorov's new party remains very low-key amid reports of internal disagreements over strategy.
- The Pussy Riot trial, and verdict, dominated coverage of Russia in the international media through most of August.

- **Putin and Medvedev have lost public support.** Against this backdrop, opinion polls show a steady deterioration in public support for both President Putin and Prime Minister Medvedev. The table below shows the long-term trend and how it started to fall just after the protest movement started last December. There was, however, a spike in May, just after the inauguration, before the decline again started. The latest opinion poll shows the lowest level of public approval recorded for both.
- **Still, worth noting.** But, before making any dramatic conclusions from the latest poll, there are two points to highlight.
  - August polls tend to always show "odd" results because people are on vacation and this year the Pussy Riot trial was very much to the forefront. The September poll will provide a much better indicator of the trend in how the public views both Putin and Medvedev.
  - After more than 12 years in charge, Putin's approval rating is still above 50%, or closer to 60% if August does turn out to be a stray poll. By any measure, in other countries where independent polls are conducted (the Levada-Center is widely respected and regarded as independent), to sustain that level of popular support for so long is exceptional. Most elected leaders struggle to return to power after only one term in office.

Public support for president and prime minister

	May '08	Sept '09	Aug '10	Jan '11	Jan '12	June '12	Aug '12
Vladimir Putin							
Approve*	84%	76%	78%	70%	63%	67%	57%
Disapprove**	12%	18%	16%	22%	29%	–	30%
Dmitri Medvedev							
Approve*	66%	67%	71%	65%	61%	55%	50%
Disapprove**	19%	24%	21%	26%	30%	–	36%

* combining "strongly approve" and "approve"

** combining "strongly disapprove" and "disapprove"

Source: Levada-Center

Privatizations: two-tier approach – both dependent on global market trends

- **Privatization was expected to be a major reform priority.** Before the formation of the current government, there was a lot of hope that pushing ahead with the privatization of state assets would be one of the immediate priorities for the new administration. Putin, in his pre-election essay published in the Vedomosti newspaper in late January, also committed to an expanded and

more urgent program. He specifically said that he wanted to see the state out of most of its equity holdings by 2015 or 2016. Medvedev and the reform minded ministers in his cabinet also highlighted the urgency of the program.

- **That has clearly changed.** But, what has actually happened over the past two months is that the privatization plan appears to have been split into two categories: stocks in the fast-track program; and a second program with a much longer and vague timeline for sale.
- **The state seems intent on consolidating energy assets.** The basic difference is that Plan B (the longer program) is comprised of stocks in the strategically important energy sectors. For these sectors, it appears to be more of a case of taking a step back to greater state control and some sector consolidation before then proceeding with privatization at a later date. It is now assumed that the fully state-owned Rosneftegaz holding company will absorb all of the state's existing equity holdings in its portfolio. Currently, it holds the state's full equity holding in Rosneft and approximately 11% of the equity in Gazprom. If it were to expand the portfolio to the other state holdings, currently mainly in the Federal Property Fund, then its portfolio would expand to include the following.
  - Majority control in Gazprom.
  - More than 75% of Rosneft.
  - Full ownership of Transneft common shares.
  - A 100% stake in Zarubezhneft.
  - More than 75% of Federal Grid Company.
  - A 66% stake in InterRAO UES.
  - Majority interest in RusHydro.
  - And equity in the MRSK electricity distribution companies.
- **Not out of the question that private sector assets may be added.** There is also a lot of speculation that the state may also look to expand its energy portfolio by acquiring some additional assets. To that extent, there is a lot of talk about a state company role in acquiring equity in TNK-BP as a result of the declared intention of both core shareholders to sell. The exclusive lock-up period between the shareholders, after which either side may talk with any other bidder, is mid-October.

Fast-track program

- **Stocks to be sold when markets improve.** The table below shows the stocks that are assumed to be in the fast-track program. Stocks in this list may be sold whenever market conditions improve and investor interest returns. The current value of the equity assumed to be on this list is just under $13 bln. That would satisfy the budget program outlined by the government for the remainder of this year. In addition to the stocks with an existing market listing and, hence, a calculable value, the government has undertaken to sell its holding in United Grain Company by year end as part of the entry terms to the WTO.

Fast-track sale list, 12-18m

	Market value* $ bln	State holding	Initial sale**	Value $ bln
Existing listed stocks				
Sberbank	$65.5	57.6%	5.8%	$3.8
VTB	$17.7	85.5%	25.0%	$4.4
Sovcomflot	$3.1	100.0%	25.0%	$0.8
ALROSA****	$6.0	50.9%	50.9%	$3.1
Aeroflot	$1.5	51.2%	26.0%	$0.4
Federal Grid Company	$8.0	79.1%	4.1%	$0.3
Potential from existing listed priority sales				**$12.8**
Not listed* **				
Apatit				
RosAgro Leasing		100.0%		
Russian Agriculture Bank		100.0%		
Russian Railways		100.0%	25.0%	
Sheremetyevo Airport		100.0%		
United Grain Company		100.0%	50.0%	
Murmansk Port		100.0%		
Arkhangelsk Port		100.0%		
Vanino Port		100.0%		

* as of close on August 30

** the equity portion to be initially sold - where disclosed

*** or, where the listing does not show an accurate valuation

**** based on the value implied by the last sale in early 2011

Source: Government, Troika

Strategic privatization list

The table below shows all of the state's holdings that are ultimately subject to privatization. It is assumed that Gazprom will never appear on this list. Putin has stated that he has no objection to the full sale of most assets but that the state should retain a blocking minority stake in those companies most important to the economy. Therefore, making the assumption of which blocks may be sold entirely, and in which either majority control of a strategic stake held, the total value of what may eventually be sold is approximately $84 bln based on current market values. Over the 5y timeline in which it is assumed (based on an optimistic timeframe) these equity blocks may be sold, the total realized would comfortably reach the $100 bln target set for the budget.

Privatization program, 5y

	Market value* $ bln	State holding	Full sale**	Value $ bln
Sberbank	65.5	57.6%	32.6%	21.4
VTB	17.7	85.5%	85.5%	15.1
Sovcomflot	3.1	100.0%	100.0%	3.1
ALROSA****	6.0	50.9%	50.9%	3.1
Aeroflot	1.5	51.2%	51.2%	0.8
Federal Grid Company	8.0	79.1%	29.1%	2.3
Rosneft	58.8	75.2%	50.2%	29.5
RusHydro	8.2	57.9%	32.9%	2.7
InterRAO UES	6.8	66.0%	41.0%	2.8
Transneft	11.5	–	25.0%	2.9
Potential from existing listed priority sales				**83.6**
Not listed* **				
Apatit				
RosAgro Leasing		100.0%		
RusNano		100.0%	25.0%	
Russian Agriculture Bank		100.0%		
Russian Railways		100.0%	25.0%	
Sheremetyevo Airport		100.0%		
United Grain Company		100.0%	49.0%	
Murmansk Port		100.0%		
Arkhangelsk Port		100.0%		
Vanino Port		100.0%		
Zarubezhneft		100.0%		

* as of close on August 30

** the equity portion to be initially sold - where disclosed

*** or, where the listing does not show an accurate valuation

**** based on the value implied by the last sale in early 2011

Source: Government, Troika

WTO: a game changer, but not immediately

Russia started negotiating WTO membership on June 16, 1993, when the Working Party on accession of the Russian Federation to the WTO was established. On August 23, over 19 years later, Russia was formally admitted as a member.

- **No instant solutions.** It has become something of a cliche by now to state that accession to the WTO is not a magic wand – it will not instantly improve Russia's business climate or immediately change how investment skeptics view country risk. It is nevertheless a game changer that has significant medium to longer-term investment implications.
- **WTO membership most positive for consumer and service sectors.** For investors, the more important impact from WTO membership is that it will likely sustain and expand growth in the consumer and service sectors. Imported goods (finished and components) will be cheaper, and World Bank studies show that WTO membership usually drives wage growth, especially among the lower-wage earners. Companies such as M.Video will be able to import consumer appliances cheaper and sell to a customer base with rising disposable income.
- **Construction spend may also benefit.** Construction companies will also eventually benefit from being able to buy cheaper materials and machinery. Those likely to benefit from this are Mostotrest and some of the real estate developers.
- **Importing equipment will be cheaper.** Companies that buy expensive imported equipment will also benefit as costs come down and leasing terms turn more advantageous. The cost of buying imported aircraft, for example, will be a longer-term saver for Aeroflot and other Russian airlines
- **No energy sector implications.** The banking sector is also a good way to play the long-term benefit of WTO membership. There is no obvious impact on the oil, gas and energy sectors, while the outlook for steel and mining stocks is much more dependent on global demand.



We issued a separate report on the implications of Russia joining the WTO in mid-August under the title "Somewhere Over the Rainbow". This is part of our Director's Cut series of strategy reports in which we examine the long-term implications of game-changing events.

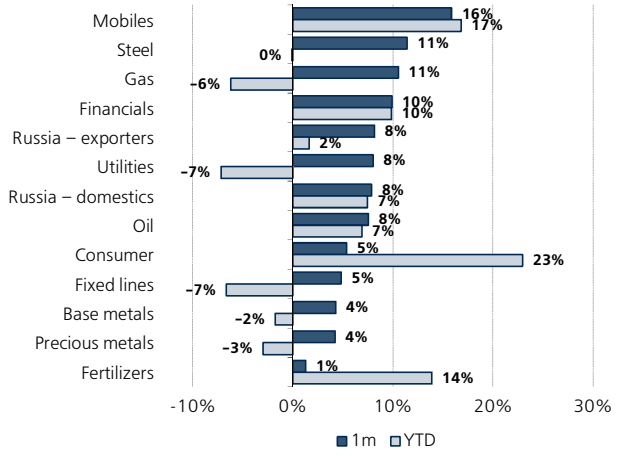
- **WTO has already forced state to support some industries.** WTO membership has already forced the state to stop procrastinating and create some real protectionist measures in socio-economically sensitive sectors. These measures, and others to follow in similar sectors, may help those industries become more competitive and more solidly based by the end of the WTO compliance period. Investors will also gain by participating in this restructuring. Examples include Sollers in the automotive sector, fertilizer producers in the agriculture sector and Pharmstandard in pharmaceuticals.
- **What you put into it determines what you get out.** World Bank studies also show that membership changes alone contribute only a small part of the long-term gains to the economy and to industry. The main gains come from the improvement in the investment and business climate, and the accelerated reform process that usually ensues from membership.

Chris_Weafer@troika.ru

Strategy Tables

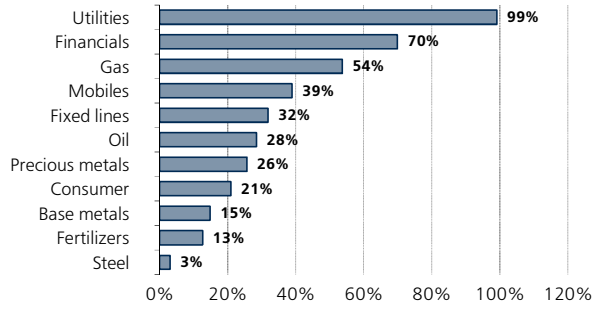
Strategy summary

Sector performance: Russia



Source: Bloomberg, Troika

Sector 12m upside



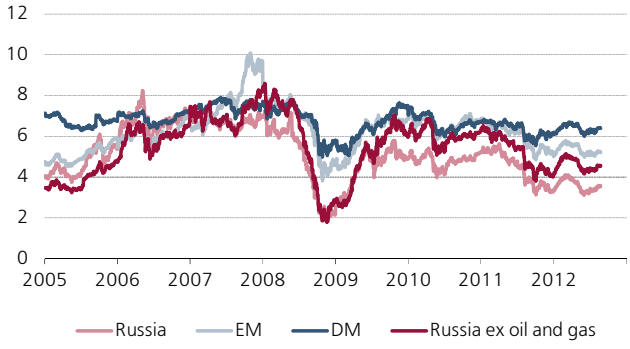
Source: Troika

Russia versus global markets



Source: Bloomberg, Troika

EV/EBITDA Russia, GEM and global



Source: Thomson, Troika estimates

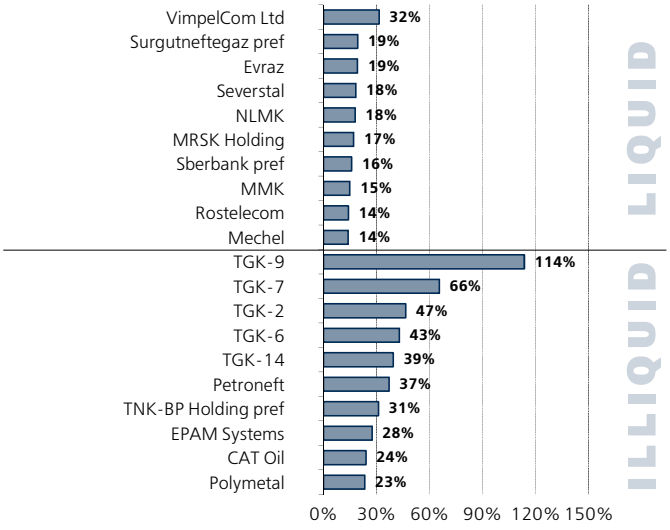
Sector valuations

	MCap $ mln	ADT $ mln	2012E P/E	2012E EPS, y-o-y	2012E EV/EBITDA	2012E P/BV	2012E Net debt/EBITDA	2013E P/E	2013E EPS, y-o-y	2013E EV/EBITDA
Oil	241,133	440	5.0	-1%	3.0	0.9	-2%	5.5	-7%	3.1
Gas	149,837	468	3.6	-14%	2.8	0.5	41%	4.1	-12%	2.9
Steel	51,146	75	8.5	-11%	5.2	1.0	196%	8.8	6%	5.1
Base metals	36,292	91	9.5	2%	5.6	1.3	187%	10.0	-8%	5.7
Financials	96,128	675	5.9	5%	–	1.1	–	5.4	10%	–
Mobiles	36,406	76	9.5	7%	4.0	2.3	71%	8.5	11%	3.6
Fertilizers	29,002	70	8.2	16%	5.5	1.9	66%	7.1	15%	4.8
Precious metals	28,582	23	10.0	28%	7.2	1.5	90%	8.1	25%	5.8
Utilities	55,342	70	6.8	-6%	3.2	0.4	92%	5.2	29%	2.9
Consumer	45,137	73	14.5	21%	7.9	2.4	108%	12.5	16%	7.0
Fixed lines	26,287	22	7.5	16%	3.4	1.2	70%	7.1	6%	3.2
Coal	11,569	29	6.7	-18%	5.4	1.3	251%	6.9	-54%	5.9
Real estate	7,324	7	13.8	-12%	10.3	1.0	496%	8.1	52%	7.5
Media and IT	17,299	44	24.2	56%	13.5	4.1	-16%	18.0	26%	10.0
Transport	12,834	15	9.2	5%	6.2	1.3	267%	7.5	21%	5.4
Other	52,161	36	3.6	18%	3.1	0.7	112%	3.1	12%	2.4
Russia	**894,827**	**2,200**	**5.6**	**-2%**	**3.7**	**0.8**	**67%**	**5.6**	**-1%**	**3.5**
Russia – domestics	**339,455**	**1,003**	**6.9**	**8%**	**4.1**	**0.9**	**106%**	**6.0**	**15%**	**3.5**
Russia – exporters	**555,373**	**1,197**	**5.1**	**-6%**	**3.5**	**0.8**	**48%**	**5.5**	**-8%**	**3.5**
Emerging markets			**8.7**	**5%**	**5.7**	**1.4**	**115%**	**7.9**	**10%**	**5.0**
Developed markets			**12.4**	**5%**	**6.8**	**1.4**	**111%**	**11.2**	**11%**	**6.1**

Source: Bloomberg, IBES, Troika estimates

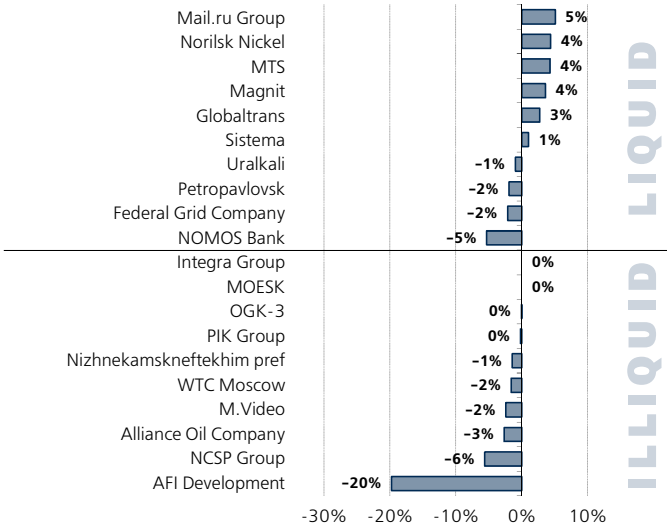
Stock summary

Top performers, m-o-m



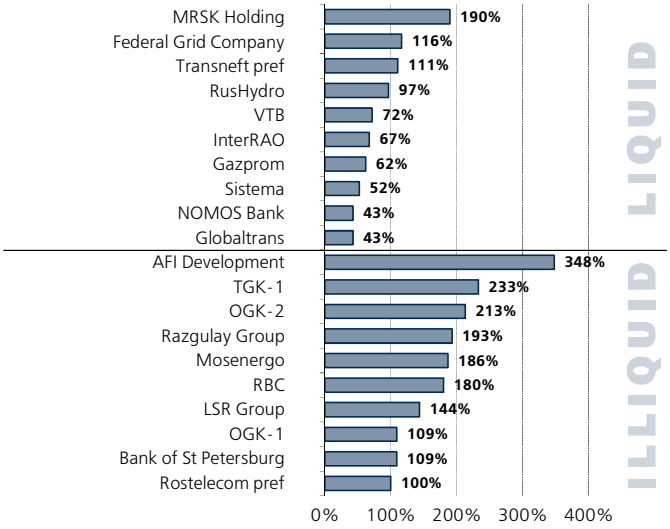
Source: Bloomberg

Top underperformers, m-o-m



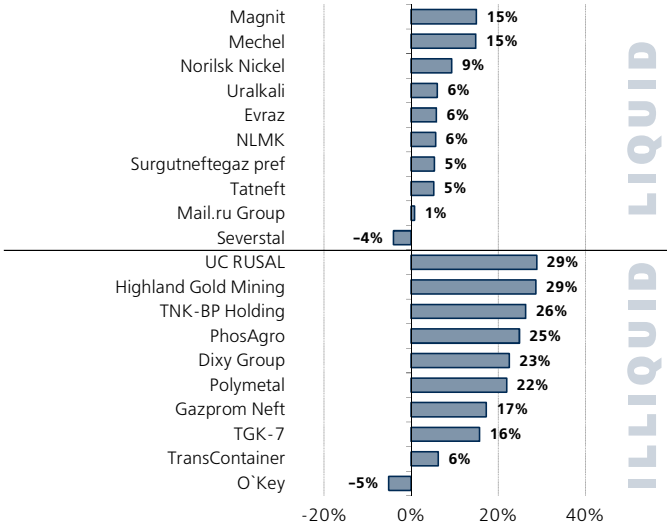
Source: Bloomberg

Highest upside to Troika target price



Source: Troika

Lowest upside to Troika target price



Source: Troika

Major upgrades this month

	Recommendation		Target price, $		Change
	From	To	From	To	in TP
PhosAgro	BUY	BUY	11.88	16.20	36%
Rusagro	BUY	BUY	9.10	10.50	15%
Acron	BUY	BUY	4.92	5.66	15%
Uralkali	HOLD	HOLD	38.41	43.05	12%
O'Key	HOLD	HOLD	9.20	9.70	5%
Halyk Bank	BUY	BUY	9.20	9.60	4%

Source: Troika estimates

Major downgrades this month

	Rec		Target price, $		Change
	From	To	From	To	in TP
OGK-3	BUY	BUY	0.043	0.042	-3%
Polymetal	BUY	BUY	19.64	18.90	-4%
E.ON Russia	BUY	BUY	0.126	0.119	-6%
Mechel	HOLD	HOLD	7.52	7.08	-6%
Polyus Gold	HOLD	HOLD	3.87	3.61	-7%
NOMOS Bank	BUY	HOLD	15.01	14.00	-7%
Norilsk Nickel	HOLD	HOLD	18.64	17.20	-8%
UC RUSAL	BUY	BUY	0.81	0.72	-10%
TGK-7	HOLD	HOLD	0.069	0.060	-13%
Petropavlovsk	BUY	BUY	9.12	7.83	-14%
CTC Media	BUY	BUY	15.10	12.85	-15%
Severstal	HOLD	HOLD	14.33	11.84	-17%
NLMK	BUY	HOLD	23.49	19.30	-18%
ENRC	BUY	BUY	11.41	9.16	-20%
RusHydro	BUY	BUY	0.053	0.041	-23%
InterRAO UES	BUY	BUY	0.00139	0.00104	-25%
Raspadskaya	BUY	HOLD	3.66	2.71	-26%
MMK	BUY	BUY	6.51	4.74	-27%
Evraz	HOLD	HOLD	5.90	4.14	-30%
Highland Gold Mining	BUY	BUY	3.61	2.36	-35%
KTK	BUY	HOLD	8.17	5.25	-36%
OGK-1	BUY	BUY	0.0401	0.0249	-38%
Enel OGK-5	BUY	HOLD	0.100	0.061	-39%
Kazakhmys	HOLD	SELL	15.75	9.13	-42%
Mosenergo	BUY	BUY	0.114	0.065	-43%
TGK-1	BUY	BUY	0.00070	0.00027	-61%
OGK-2	BUY	HOLD	0.0440	0.0155	-65%

Source: Troika estimates

Correlation: Looking More to Europe

I'm neither an optimist nor a pessimist. I am a dyed-in-the-wool possibilist! By this, I mean with an open mind, we see that everything's connected and change is the only constant.

Frances Moore Lappe

- **RTS Index used to be more closely aligned with S&P 500.** We have looked at the trend in the correlation between the RTS Index and several other important global indicators. The key message is that while the RTS Index was historically closely aligned with the trend in global equity markets, over the past 12 months the correlation with the S&P 500 has fallen off sharply, while that with currencies has risen.

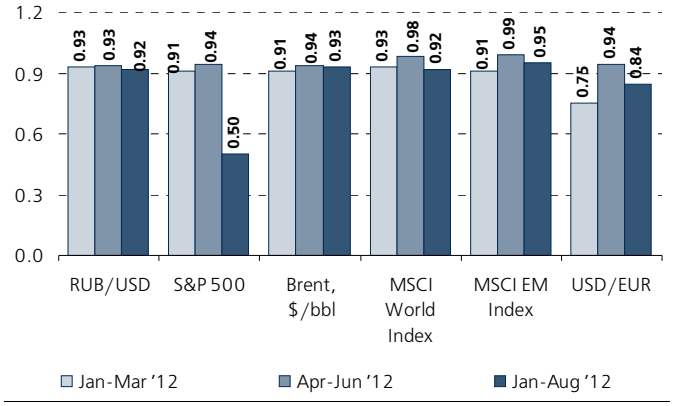
RTS Index correlation, 2005–11

	RUB/USD	S&P 500	Brent, $/bbl	MSCI World Index	MSCI EM Index	USD/EUR	VIX Index
2005-08	0.86	0.91	0.94	0.94	0.93	0.57	0.43
Sep '07 – Mar '08	0.31	0.40	0.15	0.55	0.75	0.19	0.19
2009-11	0.05	0.82	0.53	0.73	0.79	0.33	-0.68
Feb '10 – Nov '11	0.63	0.90	0.68	0.89	0.81	0.53	-0.59
Jan '11 – Dec '11	0.71	0.77	0.31	0.86	0.86	0.40	0.69

Source: Bloomberg

- **Collapse in 2H08 changed everything.** During the pre-crisis years of 2005-08, there was a close correlation between the RTS Index and global equity markets. With the S&P 500 and the MSCI EM Index the reading was consistently above 0.90. But as the crisis in the global economy grew, and especially as Russian equity values collapsed so quickly in 2H08 along with the falling oil price, the link with risk assets started to emerge.

RTS Index correlations, 2012



Source: Bloomberg

- **RTS Index now much more aligned with euro/dollar rate and risk assets.** In 2012, that trend has become very pronounced. There is a clear decoupling between the trend in the US equity market and with the category of assets described as "risk-assets". The correlation between the RST Index and the S&P 500 has fallen to 0.50 YTD. In its place, the link with the euro/dollar rate, which best reflects investor attitude toward risk, has jumped to 0.83.

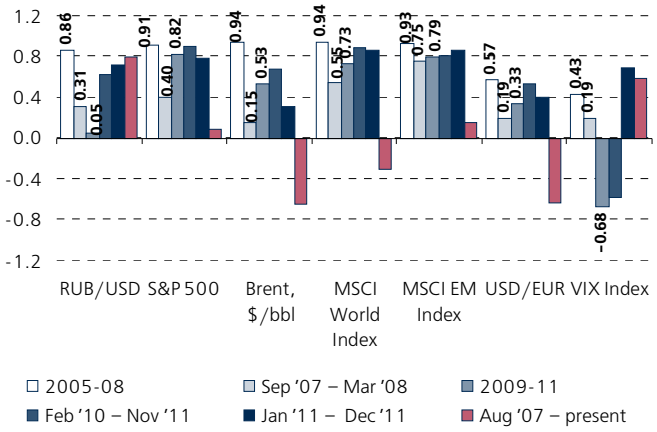
RTS Index correlation, 2012

	RUB/USD	S&P 500	Brent, $/bbl	MSCI World Index	MSCI EM Index	USD/EUR	VIX Index
Jan-Mar '12	0.93	0.91	0.91	0.93	0.91	0.75	-0.72
Jan-Apr '12	0.89	0.82	0.83	0.88	0.94	0.78	-0.71
Apr-Jun '12	0.93	0.94	0.94	0.98	0.99	0.94	-0.92
Apr-Aug '12	0.80	0.65	0.85	0.83	0.95	0.73	-0.49
Jan-Aug '12	0.92	0.50	0.91	0.87	0.95	0.83	-0.84

Source: Bloomberg

- **Emerging markets considered more at risk from Eurozone collapse.** The major concern hanging over emerging markets – and, in particular, the commodity producers – is that the crisis in the Eurozone will impact global economic growth and push risk tolerance lower for longer. Hence, the main driver of sentiment toward Russia in 2012 is the evolving crisis in the region, which is reflected in the euro/dollar rate, specifically. Hence, there is currently a higher correlation with that rate than with the S&P 500.

RTS Index correlations, long-term

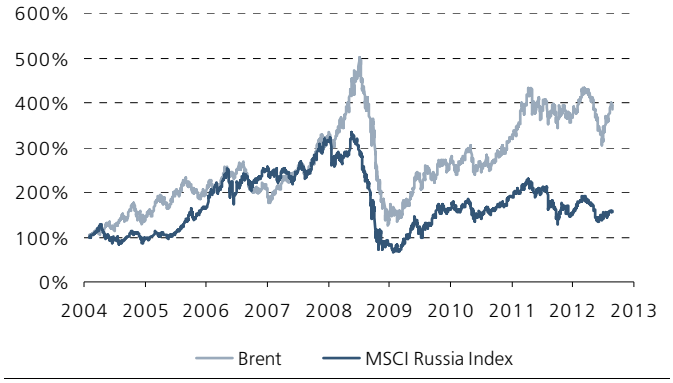


Source: Bloomberg

Oil correlation has increased

- **Before 2008, oil link was less pronounced.** During the pre-crisis years, Russian equities had only a modest correlation with the oil price. At that time, the best link was with global equities. The reason for that low oil link was because once the price of oil rose "high enough" to cover the budget, then it ceased to be a driver. In other words, equities did not follow oil higher beyond the budget breakeven point.
- **Everything changed in 2H08.** That changed when oil collapsed from July 2008. Once the oil price fell below the budget breakeven level, then equities followed it lower immediately. This trend is very clear when we compare the oil price with the MSCI Russia Index from 2004.
- **Correlation remained low in 2011, as investors did not believe oil rally.** We also see that the equity market did not rally with oil in 2011; the correlation stayed low at 0.31. This is because investors had little confidence in the oil price rally and expected it to fall back. Hence, they avoided Russia risk because of the memory of 2H08. In 2012, the correlation has risen above 0.90, as Brent is also trading with the general move in risk assets.

Brent vs MSCI Russia Index



Source: Bloomberg

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Quantitative Russia

The competition has improved tremendously. In 2003, I could teach a guy how to play poker in an hour and he could win some money. Today, it would take days. The game has gotten so much tougher.

Chris Moneymaker

Valuations and risk premium – investors about to be compensated

Russian stocks remain the cheapest among emerging markets on almost any financial metric: relative to earnings, EBTIDA, book value, assets and debt.

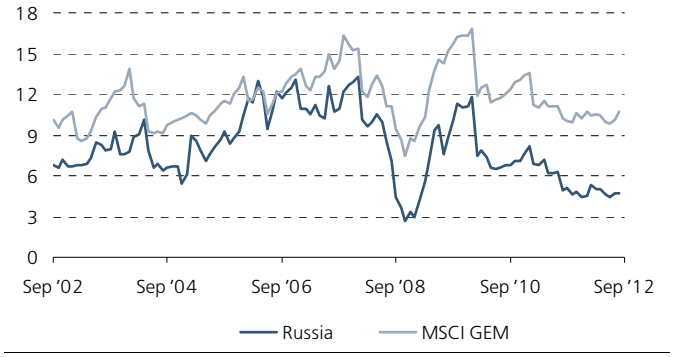
Consensus valuation, Russia versus the world

	P/E 2012E	P/E 2013E	P/BV 2012E	EPS growth 2012E	EV/ EBITDA 2012E	EV/ EBITDA 2013E	Dividend yield	ROE 2012E	Payout ratio	YTD perf
MSCI Mexico	19.2	15.7	2.8	22.2%	8.7	7.9	1.9%	20.6%	19.9%	13.8%
MSCI Philippines	16.8	15.1	2.5	11.7%	9.9	8.9	2.4%	17.5%	39.5%	17.9%
MSCI Chile	16.5	14.5	1.9	14.1%	10.1	9.3	3.3%	15.9%	38.0%	3.5%
MSCI Malaysia	15.1	13.7	2.0	10.6%	8.5	7.9	3.3%	22.3%	49.3%	4.9%
MSCI Hong Kong	14.8	13.5	1.2	9.5%	12.5	11.3	3.1%	14.3%	32.3%	10.8%
MSCI Taiwan	16.5	13.2	1.6	25.4%	8.9	7.5	3.5%	14.1%	59.7%	2.6%
MSCI Colombia	15.8	12.5	n/a	25.9%	9.5	7.7	2.9%	20.6%	44.7%	13.4%
MSCI USA	13.8	12.3	2.1	12.0%	9.3	8.6	2.1%	40.1%	42.3%	12.2%
MSCI Indonesia	13.9	12.2	3.1	14.1%	6.8	6.2	2.9%	29.2%	41.3%	0.7%
MSCI India	13.4	11.8	2.1	13.6%	10.0	9.0	1.7%	23.7%	33.8%	13.6%
MSCI World	13.0	11.6	1.6	12.3%	10.2	9.4	2.9%	29.5%	101.4%	8.5%
MSCI Morocco	12.0	11.1	2.9	7.5%	8.9	8.5	4.4%	26.9%	45.9%	-11.5%
MSCI Peru	11.8	10.9	2.8	8.0%	8.7	7.8	2.9%	27.6%	26.3%	1.4%
MSCI Czech Republic	10.8	10.8	1.7	-0.3%	5.6	5.6	6.8%	16.1%	93.3%	2.2%
MSCI South Africa	12.4	10.7	2.2	15.8%	7.6	6.8	3.7%	23.5%	53.1%	10.7%
MSCI Poland	10.0	10.3	1.2	-3.1%	4.8	4.9	5.4%	14.1%	27.9%	4.3%
MSCI Thailand	11.9	10.2	2.0	17.4%	7.2	6.3	3.6%	26.2%	65.0%	13.9%
MSCI UK	10.9	9.9	1.6	10.2%	8.1	7.5	4.2%	23.7%	164.9%	3.2%
MSCI Germany	10.4	9.6	1.3	8.2%	8.5	7.8	3.7%	15.5%	66.2%	15.0%
MSCI Turkey	10.8	9.6	1.6	13.0%	8.9	7.9	3.0%	19.7%	11.8%	27.9%
MSCI EM	10.8	9.5	1.5	13.3%	7.1	6.4	3.0%	19.4%	40.4%	4.0%
MSCI Brazil	10.9	9.4	1.3	16.0%	7.6	6.8	4.1%	21.8%	47.8%	-8.3%
MSCI Korea	10.4	9.0	n/a	15.8%	n/a	n/a	1.2%	16.6%	17.8%	6.9%
MSCI China	9.2	8.3	1.4	10.4%	5.4	4.8	3.5%	18.2%	44.4%	1.0%
MSCI Frontier Markets	9.4	8.3	1.3	12.5%	n/a	n/a	5.2%	18.8%	52.9%	-2.2%
MSCI Hungary	8.9	7.3	0.9	21.8%	5.6	5.2	4.1%	9.5%	0.0%	2.3%
MSCI Egypt	9.5	7.2	1.3	32.6%	4.1	3.7	4.4%	18.4%	47.0%	49.9%
MSCI Russia	5.0	5.1	0.7	-1.7%	3.5	3.4	4.0%	18.3%	22.0%	2.2%

Source: Bloomberg

This is nothing groundbreaking; Russia has almost always been undervalued, though the degree of the market's discount to GEM and DM has varied.

Russia historic forward P/E versus GEM

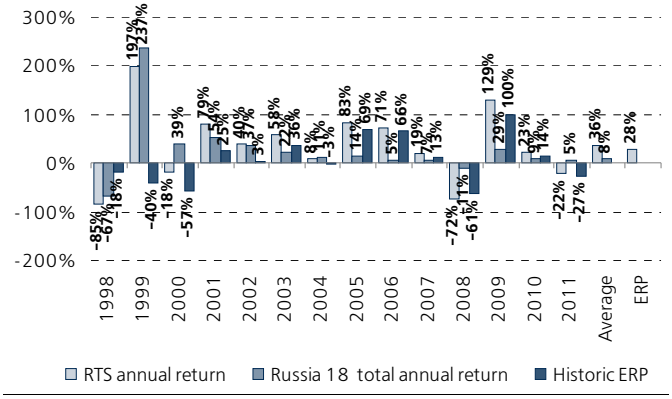


Source: Thomson

Despite the fact that Russian stocks have appreciated an average of 36% a year since 1998, versus 13% for EM stocks, they are still undervalued and offer substantial upside. In a sense, they are like the "unspendable penny" (неразменный пятак) of Russian folk tales, which always returns to your pocket after you spend it.

Those investing in Russian stocks have always expected substantial compensation. While Russian bonds have at times also been profitable, especially in the beginning of last decade, their average historic annual total return since 1998 is only 8%. Therefore, the historic risk premium, which is simply the difference in historic returns between the RTS Index and Russian bonds, has been one of the most attractive on emerging markets, offering investors 28% over risk-free investment based on historic returns. This historic risk premium creates an attractive incentive for investors to buy Russian stocks. Based on past returns on the RTS Index, investors could expect a chunky premium had they allocated money to the Russian market.

RTS Index returns, Russia 18 yield and estimated historic equity–risk premium



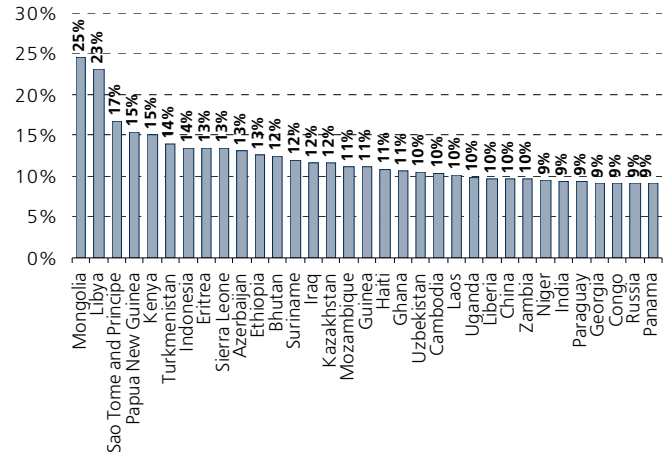
Source: Bloomberg

While the equity-risk premium has historically offered substantial returns, the implied equity-risk premium for Russia has been much more modest. The implied premium is calculated using the Gordon growth model, also called the dividend discount model, and is a sum of implied total returns: earnings growth or nominal GDP growth and dividend yield corrected for a risk-free rate. As Russia has never been regarded as a dividend country, the implied Russian equity risk premium in the past was just a reflection of future nominal dollar GDP growth, which was good in the 2000s. The earnings growth contribution has shrunk recently as economic growth has moderated on the back of the crisis. The implied equity-risk premium has been maintained at attractive levels, as dividend yields have been increasing in Russia while bond yields have been contracting. According to the Gordon growth model, the market risk premium is the spread between potential equity market returns and the benchmark risk-free rate. The model estimates potential equity market returns as the sum of long-term earnings growth plus dividend flows. Thus, the higher the earnings growth and dividend yield, and the lower the bond yields, the more attractive equities become.

Russian earnings have rarely been expected to grow more than 25%, while the Russian dividend yield has very rarely exceeded 2.5%, so the average historic equity-risk premium has been at most the maximum level for the risk premium implied by a Gordon growth model. In reality, even when the market was at very depressed levels, such as at end 2008, the implied risk premium has rarely risen above 16%. We estimate that the implied risk premium for Russian stocks was more like 8% on average, but the recent move by state companies to pay higher dividends is pushing this higher.

Russian nominal earnings growth is already among the most attractive globally. According to the IMF's world outlook database, the country's 5y GDP CAGR in nominal dollar terms is 9%. This is the third highest rate among the MSCI EM countries after Indonesia and China.

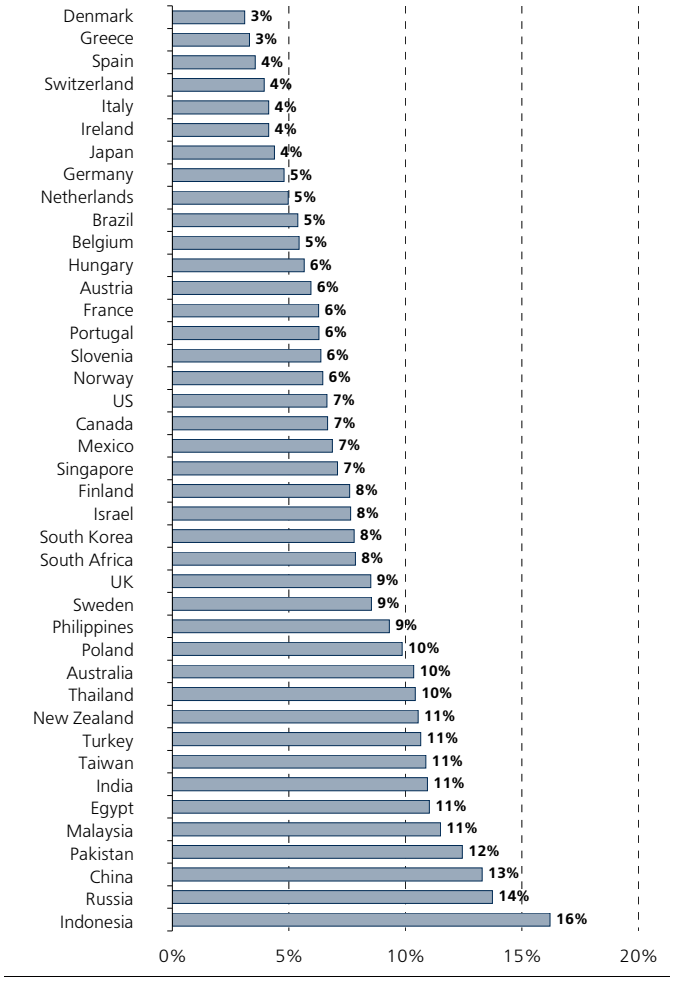
5y CAGR of nominal dollar GDP



Source: IMF

However, when you combine this 9% nominal growth rate with a 4% dividend yield, Russia's expected market return moves it into the top three countries globally, even ahead of China.

Returns based on 2012 expected dividend yields and 5y nominal GDP growth in dollar terms



Source: Troika estimate, IMF, Bloomberg

Finally the Gordon growth model yields a Russian equity-risk premium of roughly 10%, implying that the country has the most upside among EM peers, only lagging Indonesia. The high equity-risk

premium rates should eventually stimulate investment in Russian stocks. The game changer this year was the dividend yield, and the payout ratio is now at 21.5% for MSCI Russia, versus only 11% a year ago but still much below the 35% average payout for EM. The move by key state enterprises, such as Gazprom and Sberbank, to increase dividends helped improve the risk premium versus valuations.

The discussion of Russia's risk premium has always been fairly vague. While the historic and implied risk premiums have been more transparent, the issue with required risk premium has been less so, and much more empiric. We started this discussion in order to get a feeling of where exactly various risk premiums are in Russian stocks. According to one definition that builds an intuitive path toward a required risk premium, the required premium is the implied premium assuming target prices rather than market prices. There has rarely been a time that Russian valuations have offered less than 40% upside to their target prices, and at times the upside has been over 100%. This means the required equity-risk premium for Russian stocks has been to the tune of 50-70% of the implied equity premium, so the required risk has been between 7.5% and 5.0%, and in fact it is now around 5.0%. Interestingly, this value is about the same for DM and EM investors.

Equity–risk premium based on Gordon growth model

	Div yield, 2012E	Average nominal GDP growth (USD), 2011–16E	Payout ratio	Expected market return	Risk–free rate (USD)	ERP
Indonesia	2.9	14%	39.61%	16.40%	3.36%	13.04%
Pakistan	8.2	6%	45.78%	14.38%	3.02%	11.36%
Russia	4.0	9%	**21.55%**	13.12%	3.14%	9.98%
China	3.5	10%	29.18%	13.19%	3.37%	9.82%
Taiwan	3.5	7%	54.31%	10.69%	1.18%	9.51%
Malaysia	3.3	8%	48.52%	11.74%	3.46%	8.28%
Turkey	3.0	8%	32.66%	11.08%	3.66%	7.42%
Australia	5.1	4%	58.18%	9.32%	2.03%	7.29%
Sweden	4.3	4%	51.19%	8.55%	1.35%	7.20%
UK	4.2	4%	44.29%	8.59%	1.46%	7.13%
India	1.7	9%	21.40%	11.07%	4.00%	7.07%
Philippines	2.4	7%	36.65%	9.48%	2.59%	6.89%
Poland	5.4	5%	53.29%	9.99%	3.12%	6.87%
Singapore	3.6	4%	42.30%	7.93%	1.36%	6.57%
Canada	2.9	4%	38.52%	6.52%	0.84%	5.68%
Brazil	4.1	4%	42.64%	8.28%	2.79%	5.49%
Egypt	4.4	6%	49.26%	10.59%	5.15%	5.44%
Norway	4.8	2%	39.03%	7.10%	1.88%	5.22%
South Africa	3.7	4%	46.42%	8.14%	3.00%	5.14%
Finland	4.1	2%	57.79%	6.57%	1.48%	5.09%
US	2.1	4%	**28.11%**	6.53%	1.61%	4.92%
South Korea	1.2	7%	15.50%	7.79%	3.18%	4.61%
Austria	4.1	3%	35.53%	6.63%	2.04%	4.59%
Mexico	1.9	5%	30.61%	7.08%	2.73%	4.35%
France	4.1	2%	45.79%	6.26%	2.13%	4.13%
Germany	4.1	1%	31.97%	5.42%	1.32%	4.10%
Japan	2.6	2%	27.93%	4.75%	0.79%	3.96%
Switzerland	3.6	1%	49.73%	4.18%	0.45%	3.73%
Netherlands	4.1	1%	41.36%	5.18%	1.73%	3.45%
Israel	3.4	4%	32.14%	7.62%	4.20%	3.42%
Belgium	4.1	2%	54.29%	5.81%	2.56%	3.25%
Denmark	1.9	1%	34.20%	2.88%	1.06%	1.82%
Hungary	4.1	3%	26.89%	7.23%	5.48%	1.75%
Ireland	4.1	2%	31.74%	6.33%	5.78%	0.55%
Spain	4.1	1%	63.92%	4.80%	6.52%	-1.72%
Italy	4.1	0%	44.44%	4.15%	6.15%	-2.00%
Portugal	4.1	1%	57.73%	4.63%	9.09%	-4.46%
Greece	4.1	0%	28.82%	3.64%	23.13%	-19.49%

Source: IMF, Troika estimates

Earnings revisions

The trend in consensus earnings revisions on emerging markets is negative. Overall, analysts downgraded 264 stocks in August, following 186 stock downgrades in July. Emerging markets have been in this mode since January 2011, while stock downgrades on developed markets began in May 2011. There was a brief pause in April 2012 on developed markets, when 558 net upgrades were recorded.

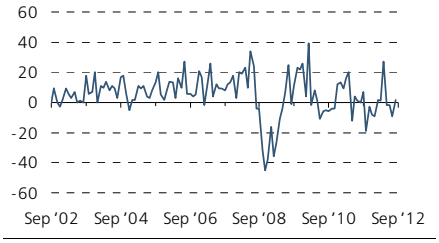
Net EPS upgrades in August for MSCI GEM stocks/sectors

	Technology	Industrial	Basic materials	Consumer, non-cyclical	Financial	Consumer, cyclical	Energy	Communications	Diversified	Utilities	Grand total
Taiwan	(63)	(41)	(1)	–	4	4	1	(3)	–	–	-99
China	(1)	(10)	(19)	(1)	(3)	(8)	1	–	–	3	-38
Malaysia	–	1	–	(20)	3	(3)	(8)	–	(9)	(1)	-37
Brazil	–		(11)	(4)	(15)	1	(2)	(5)	–	1	-35
South Africa	–		(8)	–	(13)	(5)	–	(1)	5		-22
Hong Kong	–	1	(3)	–	(10)	(2)	(3)	–	–	1	-16
India	1	(3)	(1)	(1)	(2)	(4)	–	(1)	(1)	3	-9
South Korea	–	(2)	–	–	(3)	–	–	(1)	–		-6
Poland	–	–	–	–	(3)	–	(4)	1	–	–	-6
Chile	–	–	–	(2)	(1)	1	–	(1)	(2)	–	-5
Peru	–	–	(1)	–	(1)	–	–	–	–	–	-2
Hungary	–	–	–	–	–	–	(2)	–	–	–	-2
Czech Republic	–	–	–	–	(1)	–	–	–	–	–	-1
Indonesia	–	–	–	(2)	2	–	(2)	1	–	–	-1
Morocco	–	–	–	–	–	–	–	–	–	–	0
Ukraine	–	–	–	–	–	–	–	–	–	–	0
Turkey	–	(1)	–	(2)	3	0	1	–	(1)	–	0
Thailand	–	–	1	–	2	0	(2)	–	–	–	1
US	–	–	1	–	–	–	–	–	–	–	1
Mexico	–	1	(1)	(1)	3	1	–	(1)	–	–	2
Russia	–	–	(1)	–	(1)	–	4	–	–	–	2
Philippines	–	1	–	(1)	2	(2)	–	1	–	1	2
Colombia	–	1	–	–	2	–	–	–	–	–	3
Egypt	–	(1)	–	–	5	–	–	–	–	–	4
Grand total	(63)	(53)	(44)	(34)	(27)	(17)	(16)	(10)	(8)	8	(264)

Source: Bloomberg

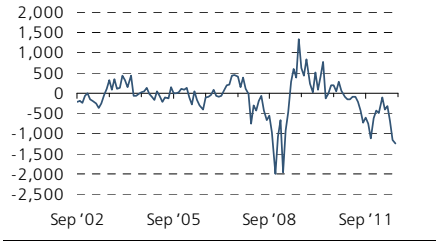
While on the trend on emerging and developed markets is obvious in stock revisions, the picture with net upgrades is quite volatile for Russia. On the positive side, upgrades exceeded downgrades in Russia in August, albeit by a very slim margin. There were only six upgrades versus four downgrades. There were four net upgrades in the Russian oil and gas sector, and one downgrade each in the financials and materials sectors. Although the overall numbers are small, they highlight the current economic reality in the country, with the higher oil price driving oil and gas sector stock earnings (Brent has averaged $113/bbl in 2012, versus $112/bbl in 2011), while the cyclical weakness in Europe and in China are hurting metals and mining stocks.

Historic net EPS upgrades, Russia



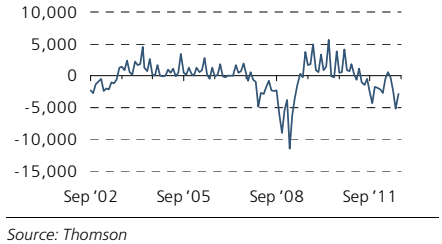
Source: Thomson

Historic net EPS upgrades, GEM



Source: Thomson

Historic net EPS upgrades, DM



Source: Thomson

Fundamental-based weightings of baskets

It is an interesting exercise to calculate the best way to balance stocks in MSCI Russia based on fundamental parameters. For example, the best set of returns was achieved for stocks in the MSCI Russia Index when they were given weights according to their 2012 earnings growth projections (i.e. stocks with high earning growth multiples are given higher weights than those with lower or negative growth, and all weights are kept positive, imitating a long-only portfolio). The MSCI Russia basket weighted by earnings growth has risen 18% YTD, versus 2.2% for the actual MSCI Russia basket. We also see outperformance of this EPS-weighted basket on 1y and 1m basis. Even in periods when the MSCI Russia Index's overall performance was negative, the EPS weighting has produced positive results.

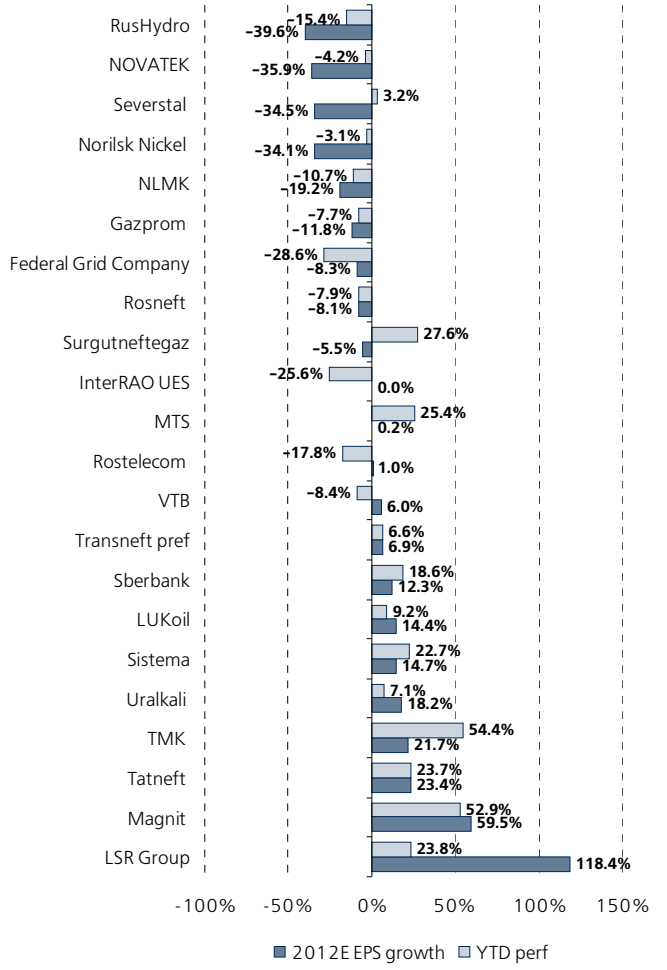
MSCI Russia basket performance weighted by various fundamentals

	YTD change	1y change	1m change
MSCI Russia (free float)	2.2%	-13.3%	-0.5%
EPS growth weight	15.0%	-0.9%	3.1%
P/E weight (earnings yield)	11.3%	-0.2%	3.9%
ROE weight	11.5%	-2.6%	4.0%
P/BV weight	0.1%	-10.6%	2.3%
Consensus upside	0.1%	-0.1%	0.0%
EBITDA growth	14.60%	0.50%	3.10%

Source: Bloomberg, Troika estimates

In fact, almost any fundamental weighting for Russian stocks produced better results than the benchmark MSCI Russia Index performance. The only small exception is the YTD result when stocks in the basket are weighted by P/BV. This in itself is a very interesting result.

Troika EPS growth projection vs YTD performance among Russian stocks



Source: Bloomberg, Troika

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2012 – The Story So Far

Do not stand in a place of danger trusting in miracles.
Arabian proverb

- **International events have been more important this year.** It is stating the very obvious that the Russian equity market has been mostly driven by external rather than domestic factors this year, especially since the election cycle ended with the March 4 presidential election. Since then, it has been a case of watching the news flow from Europe, the US and China rather than from Moscow.
- **Risk perception from oil is very high.** The relatively good macro and fiscal position in Russia compared with most other EM and DM economies, generally positive earnings reports and, on average, discounted asset valuations have not helped the market to sustain the outperformance recorded in 1Q12. Investors consider Russia to be at high risk of negative contagion from either an escalation in the crisis in Europe or a slowdown in economic growth in China. The reason for this is the high budget dependence on oil and gas revenues and the fact that approximately 80% of the value of the country's exports is made up of commodities. Even though the main growth driver in the economy is actually expansion outside the extractive industries, for example the consumer sector, investors consider this to be at risk if commodity prices fall.
- **Investors treating Russia almost as derivative play in global markets.** For this reason, investors view Russia almost as a derivative of global markets – an asset to be bought when optimism is high and rising, and to be avoided when there are concerns about the global environment. Russia saw good outperformance in 1Q12 when global markets and oil were rising, but this was followed by a much sharper correction in 2Q12, when optimism also failed.

Markets in 2012*

	January–mid-March**	March high**–end May	May	June–August***	May–Sept***	YTD*
RTS Index	24.6%	-27.8%	-21.9%	15.6%	-9.7%	3.9%
MICEX Index	14.6%	-18.7%	-11.3%	11.3%	-1.3%	3.8%
IOB GDR Index	25.8%	-26.6%	-20.0%	15.7%	-7.4%	6.8%
RDX Index	24.3%	-21.8%	-14.4%	14.0%	-2.4%	10.8%
MSCI EM Index	15.7%	-14.5%	-11.9%	6.5%	-5.9%	5.4%
MSCI World Index	9.2%	-8.8%	-9.0%	9.2%	-0.6%	8.7%
S&P 500	9.0%	-4.4%	-6.3%	7.7%	0.9%	12.2%
Copper, $/lb	12.3%	-12.6%	-12.1%	3.5%	-9.0%	1.6%
Brent, $/bbl	17.3%	-19.1%	-14.7%	11.5%	-4.9%	5.8%
Gold, $/oz	9.2%	-9.1%	-6.5%	7.5%	0.6%	6.8%
RUB/USD	8.2%	-12.2%	-12.9%	3.9%	-8.5%	1.1%
USD/EUR	-1.2%	5.9%	6.9%	-2.2%	4.9%	2.8%

* as of close August 24
** market peak for 2012 was mid-March
*** to August 24 close
Source: Bloomberg

- **Summer has been quiet everywhere.** Since the start of the global markets rally from June 1, Russian equities and the ruble have again outperformed, but much more modestly, as investors across all markets have mostly adopted a wait-and-see approach. Traded volumes have remained low and fund investors have preserved cash.
- **Sell in May was right.** This has been a year when abiding by the adage of selling in May has been correct, provided one sold very early in May, and despite the preceding big fall in April. Despite the rally since June 1, the Russian markets have remained negative since May 1 until end August.

Main influences – international

1Q12

- General optimism that Europe had contained the debt crisis with the Greek agreement.
- US quarterly earnings reports slightly above consensus.
- China data pointed to a soft landing for the economy.
- Oil price rose with economic optimism and expanding risk premium on Iran.

2Q12

- First "failed" Greek election rattled markets and started fears of a Eurozone breakup.
- Leadership change in France also raised fears that political consensus in Europe would be difficult to achieve.
- US monthly payroll reports, from April to June, fell below consensus, and several other economic updates also missed consensus.
- China's government talked down growth expectations for this year.
- The oil price fell, partly because Saudi Arabia pumped more oil to get Brent back to its target of $100/bbl and partly because of increased global economic fears.

3Q12

- Most investors decided to take the summer off and to wait until the risk outlook became clearer – most markets drifted higher but only on low volumes.
- The prevailing mood among investors was that policy initiatives would have to come because the consequences of not doing so were so serious. This also allowed valuations to drift higher but again on low volumes.
- US 2Q12 earnings reports were good, supporting the valuation base.
- There was greater political consensus in Europe – proposals for the ECB's ESM mechanism also boosted optimism.

Main influences – domestic

1Q12

- Political protests continued but were no worse than in December. That led to a recovery after underperformance in December.
- Putin released a series (seven) of political essays outlining his program for government.
- The March presidential election was uneventful.
- Macro and budget performance was good – the ruble rallied with rising oil.
- Russian equities attracted relatively strong investor inflows.
- A law on the creation of a central depositary came into force.

2Q12

- The external environment again became the dominant driver – Russian equities fell harder than EM peers because of the threat to commodity prices and global risk aversion.

- The ruble fell as oil weakened – a reflection of the Central Bank's new policy.
- The new government brought few surprises.

3Q12

- Inflation picked up in early summer.
- Russia finally joined the WTO.
- Hopes for fast-track progress in the privatization process faded as the government adopted a different medium-term agenda for the energy sector.
- Politics again emerged as a factor of concern for investors – opinion polls showed initial enthusiasm for the new administration was waning and the Pussy Riot trial generated unwelcome headlines around the world.

Stock performance

- **Good domestic themes outperformed early.** The table below shows the leaders and laggards among the most liquid Russian stocks during 1Q12, when optimism was high and Russian assets outperformed. The political risk perception had moderated considerably and the rising oil price added a comfort factor to the macro backdrop.
- **Rising disposable incomes boosted some sectors.** The best performing themes were domestic-oriented sectors such as real estate, consumer and infrastructure. These benefited from the expectation that the new government would add more spending to social projects, to infrastructure and would also continue to boost public sector salaries and state pensions. Low inflation also meant a considerable boost to real wage growth and disposable income.
- **Gold stocks lagged.** The sectors that did poorly in this period were those mostly associated with haven assets, such as gold producers, as investors felt no need to buy these. The expectation that a Sberbank SPO was close contributed to the poor performance of that stock in the period.

Leaders and laggards, Jan to mid-March*

	Share price move
LSR Group	54%
TMK	54%
Mail.ru Group	51%
RusPetro**	48%
Etalon Group	48%
NOMOS Bank	46%
AFI Development	45%
Tatneft	39%
VTB	36%
Magnit	36%
Surgutneftegaz	35%
RusHydro	34%
UC RUSAL (HKD)	33%
Globaltrans	31%
TransContainer	31%
Chelyabinsk Zinc	28%
Cherkizovo Group	27%
Severstal	27%
Sistema	27%
Norilsk Nickel	26%
Gazprom	26%
CTC Media	25%
VimpelCom Ltd	25%
Pharmstandard	25%
MMK	25%
O'Key	24%
MTS	23%
PhosAgro	23%
Mechel	21%
LUKoil	21%
NLMK	21%
Integra	19%
Yandex	19%
NOVATEK	19%
IRC (HKD)	18%
HMS Group	17%
Raven Russia	14%
Global Ports	14%
Gazprom Neft	14%
Rosneft	14%
X5 Retail Group	10%
Uralkali	8%
Evraz	7%
Petropavlovsk	6%
Ros Agro	5%
Sberbank***	4%
PIK Group	-1%
Polymetal	-8%
NCSP Group	-12%
Highland Gold Mining	-18%

* as of mid-March market high

** from IPO listing price

*** Sberbank is based on MICEX listing

Source: Bloomberg

- **Extractive industries took a hit as global markets fell.** The second market phase (the decline from the mid-March high to the end-May low) saw the most damage inflicted on the extractive industries. Mechel led the retreat, with other steel names, such as MMK, and the gas producers not far behind. The latter were also affected by proposals for higher MET in the sector. The utilities sector took a hit from fears of changes to the tariff regime and an emerging proposal to consolidate ownership under the Rosneftegaz umbrella. The court ruling blocking the VimpelCom dividend payment accounted for that stock's poor performance.

Leaders and laggards, mid-March* to end May

	Share price move
Mechel	-48%
Petropavlovsk	-44%
RusHydro	-43%
MMK	-42%
VimpelCom Ltd	-38%
VTB	-36%
NOVATEK	-36%
Gazprom	-35%
NLMK	-33%
Highland Gold Mining	-33%
UC RUSAL (HKD)	-30%
Surgutneftegaz	-29%
IRC (HKD)	-27%
Integra	-27%
Evraz	-27%
Etalon Group	-26%
Tatneft	-26%
Gazprom Neft	-25%
Pharmstandard	-24%
Severstal	-24%
Polymetal	-23%
Norilsk Nickel	-23%
RusPetro**	-22%
Cherkizovo Group	-21%
LSR Group	-21%
Mail.ru Group	-20%
NOMOS Bank	-20%
Sistema	-20%
AFI Development	-19%
CTC Media	-19%
LUKoil	-19%
Rosneft	-18%
O'Key	-18%
Sberbank***	-17%
Global Ports	-16%
Yandex	-15%
Magnit	-15%
PhosAgro	-14%
Chelyabinsk Zinc	-13%
X5 Retail Group	-12%
Globaltrans	-12%
Uralkali	-11%
TMK	-11%
PIK Group	-11%
MTS	-8%
Ros Agro	-8%
HMS Group	-4%
TransContainer	-3%
NCSP Group	-1%
Raven Russia	0%

* as of mid-March market high

** from IPO listing price

*** Sberbank is based on MICEX listing

Source: Bloomberg

- **Summer has been more of a mix.** Performance since the start of the summer rally has been more of a mixed bag. Stocks such as VimpelCom Ltd, NOVATEK and the utilities were oversold in the April-May rout and joined some of the quality domestic theme stocks in outperforming the indexes. At the other end of the table, metals featured more than other sector names as, despite the market recovery, concerns still linger about the strength of the global economy. Other names lagged due to stock-specific issues, e.g. X5 Retail Group's poor numbers and the proposed equity stake sale in NOMOS Bank.

Leaders and laggards, June–August*

	Share price move*
PhosAgro	46%
VimpelCom Ltd	41%
O'Key	39%
Tatneft	32%
Magnit	31%
NOVATEK	28%
Polymetal	27%
TransContainer	25%
Federal Grid Company	24%
Etalon Group	22%
Surgutneftegaz	19%
TMK	19%
Globaltrans	19%
Gazprom Neft	18%
Sistema	17%
Global Ports	4%
Mail.ru Group	2%
PIK Group	2%
Rosneft	1%
HMS Group	0%
X5 Retail Group	-4%
CTC Media	-4%
NOMOS Bank	-5%
UC RUSAL (HKD)	-6%
RusPetro*	-8%
Evraz	-16%
Chelyabinsk Zinc	-17%
IRC (HKD)	-21%
Integra	-23%
AFI Development	-26%

* from June 1 until August 24

** from IPO listing price

Source: Bloomberg

- **Domestic themes outperforming extractive industry exporters.** The table below shows the YTD picture for ADRs and GDRs. The picture is familiar in that good-quality, well-placed domestic consumer and infrastructure themes are at the top, while gold producers and other extractive industries fill many of the bottom positions.

Leaders and laggards, YTD*

	Share price move
TMK	64%
TransContainer	58%
PhosAgro	54%
Magnit	52%
EPAM Systems**	50%
O'Key	42%
Globaltrans	38%
Tatneft	35%
Etalon Group	32%
LSR Group	29%
MTS	25%
Mail.ru Group	24%
Raven Russia	22%
Eurasia Drilling Company	21%
Sistema	19%
Sberbank***	17%
Surgutneftegaz	14%
HMS Group	12%
LUKoil	11%
Cherkizovo Group	11%
NOMOS Bank	11%
Uralkali	10%
VimpelCom Ltd	10%
Severstal	8%
RusPetro**	7%
Yandex	6%
Ros Agro	6%
Norilsk Nickel	4%
Pharmstandard	4%
Gazprom Neft	0%
Global Ports	0%
NOVATEK	-3%
CTC Media	-3%
VTB	-4%
Polyus Gold	-4%
Rosneft	-6%
NLMK	-7%
NCSP Group	-7%
Chelyabinsk Zinc	-7%
X5 Retail Group	-7%
Gazprom	-8%
PIK Group	-10%
Polymetal	-11%
UC RUSAL (HKD)	-12%
RusHydro	-13%
AFI Development	-14%
MMK	-16%
Mechel	-28%
IRC (HKD)	-32%
Integra	-33%
Evraz	-34%
Petropavlovsk	-38%
Highland Gold Mining	-38%

* as of mid-March market high

** from IPO listing price

*** Sberbank is based on MICEX listing

Source: Bloomberg

Fund flows so far in 2012

- **Investors have stuck with EM funds this year.** The flow of investor money into EM funds also reflects the pattern of optimism giving way to pessimism and then to stoicism. The only difference is that investors did not significantly reverse out of EM funds in April-May but instead switched from higher-risk country funds into the relatively safer GEM balanced funds.

- **A lot of switching into ETF funds.** Despite net redemptions through 2Q12, the YTD total of $17.5 bln in new allocations is surprising given the very poor market performance YTD. Fund investors remain more hopeful that the various governments will take the necessary action to both stimulate growth and ease the crisis risk in Europe. More particularly, ETF investors are taking that risk as, YTD, over two-thirds of new money allocations have now come via EM ETFs. For sure, a lot of that is because of switching from the less flexible and more expensive traditional funds.
- **Staying close to the exit.** The bottom line is that investors are playing the EM theme via the safer GEM balanced category and playing that theme via flexible ETFs. This is sort of like having one foot near the exit at all times.

Weekly fund flows – EM funds

	1Q12		2Q12		3Q12*		YTD*	
	$ mln	% of AUM	$ mln	% of AUM	$ mln	% of AUM	$ mln	% of AUM
EM balanced funds	20,358	6.0%	902	0.3%	3,999	1.1%	25,259	7.5%
Asia region	1,680	0.8%	(6,199)	-2.8%	(156)	-0.1%	(4,675)	-2.0%
LatAm region	9	0.1%	(1,986)	-4.7%	(361)	-1.0%	(2,337)	-5.6%
EMEA region	651	1.5%	(1,401)	-3.7%	(51)	-0.1%	(800)	-2.4%
Total EM Funds	**22,699**	**3.6%**	**(8,684)**	**–1.3%**	**3,431**	**0.5%**	**17,447**	**2.7%**
China country funds	1,055	2.7%	(2,884)	-5.1%	(407)	-1.9%	(2,236)	-5.6%
India country funds	376	1.6%	(653)	-2.9%	(106)	-0.5%	(382)	-1.8%
Brazil country funds	(471)	-2.3%	(919)	-5.1%	(91)	-0.6%	(1,481)	-7.9%
Russia country funds	1,264	9.0%	(486)	-3.6%	90	0.7%	868	5.8%
Turkey country funds	63	3.9%	(70)	-4.4%	147	8.3%	141	7.6%

* up until Aug 25

Source: EPFR Global

- **Modest inflows to Russia funds.** Russia retail funds have been among the few to attract new money from investors in 2012, albeit all of that came in during 1Q12, when the equity market and the ruble were outperforming. Here also the bulk of new money has come in via ETFs with, as at mid-August, over 85% of the net inflow accounted for by ETFs.
- **Investors remain fearful of a repeat of 2H08.** The table below shows the trend in the weight of Russian equities held within GEM balanced and the bigger-money global ex-US equity funds. Most of the "decline" came in 2H08, when the market collapsed with the oil price. Investors have remained fearful of a repeat ever since.

Russian equity exposure in large EM and DM funds

	Weight in GEM funds	Weight in global ex-US funds
Jan '07	10.0%	0.4%
Jul '07	9.0%	0.4%
Jan '08	10.8%	0.7%
Jul '08	12.1%	1.1%
Jan '09	5.6%	0.3%
Jul '09	6.6%	0.7%
Jan '10	7.2%	0.7%
Jul '10	6.6%	0.3%
Jan '11	6.8%	0.4%
Jul '11	7.2%	0.4%
Jan '12	6.5%	0.5%
Jul '12	6.6%	0.3%

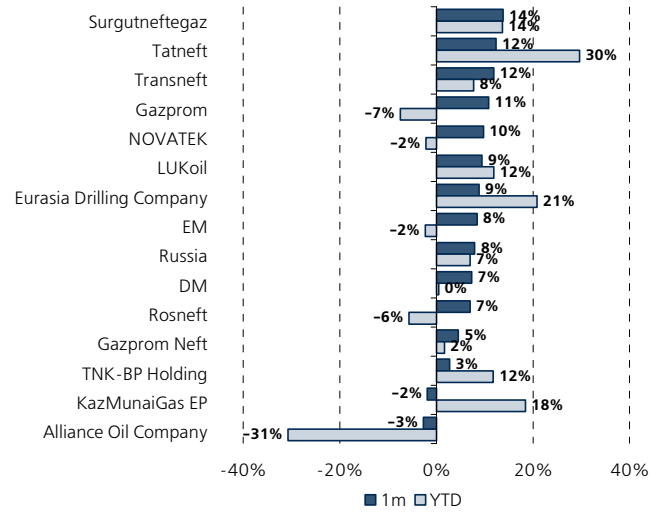
Source: EPFR Global

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Sector Data

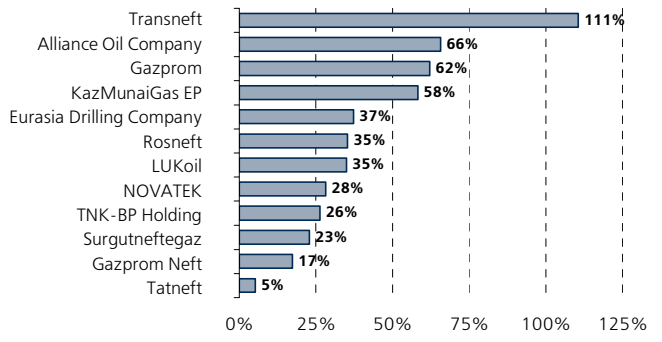
Oil and gas

Performance



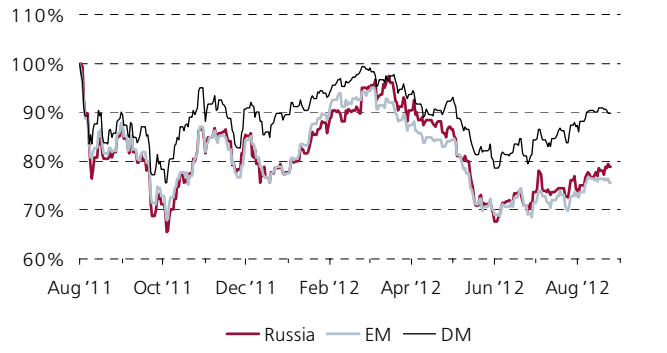
Source: Bloomberg, Troika

12m upside to Troika target price



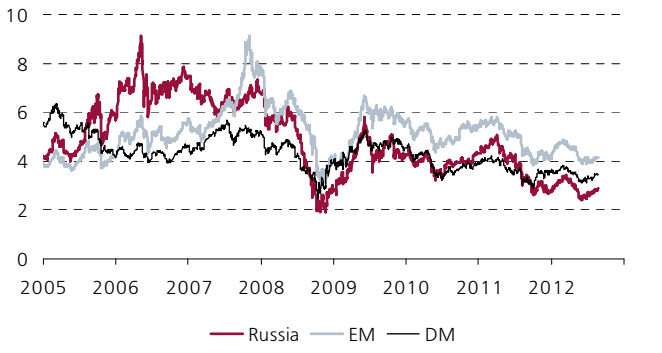
Source: Troika

Russia versus global peers



Source: Bloomberg, Troika

EV/EBITDA Russia, GEM and global



Source: Thomson, Troika estimates

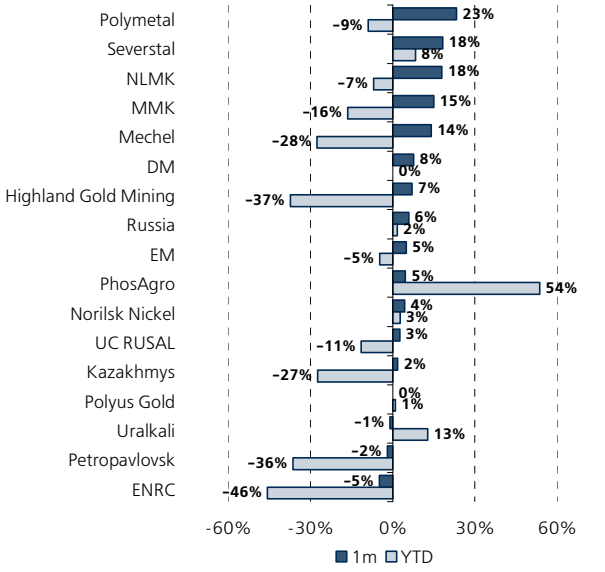
Valuation ratios

	Price $	Target price $	MCap $ mln	ADT $ mln	Rec	2012E P/E	2012E EV/EBITDA	2012E EPS growth	2012E P/BV	2012E Net debt/EBITDA	2013E EV/EBITDA	2013E EPS growth
Gazprom	4.93	8.00	112,642	426	BUY	2.9	2.3	-14%	0.4	41%	2.4	-13%
LUKoil	59.28	80.00	48,704	213	BUY	3.8	3.1	14%	0.6	34%	3.0	-6%
Rosneft	6.28	8.50	60,277	112	HOLD	5.2	3.6	-8%	0.8	69%	3.6	-3%
Surgutneftegaz	0.90	1.10	37,096	72	HOLD	6.0	0.7	-6%	0.8	-278%	0.6	-11%
NOVATEK	123	157	37,195	42	BUY	14.7	10.9	-36%	4.0	33%	9.6	8%
Tatneft	6.42	6.75	13,523	30	HOLD	5.4	4.0	23%	1.0	50%	4.0	-1%
Transneft	1,662	3,500	10,339	20	BUY	1.8	1.6	7%	0.3	71%	1.0	13%
Alliance Oil Company	8.62	14.29	1,479	4	HOLD	3.0	3.7	54%	0.6	192%	3.3	-10%
KazMunaiGas EP	17.70	28.00	7,887	4	BUY	4.6	1.7	14%	0.8	-156%	1.6	-12%
Gazprom Neft	4.69	5.50	22,231	4	BUY	4.0	2.9	4%	0.8	30%	2.8	-16%
TNK-BP Holding	2.85	3.60	46,356	4	BUY	5.7	3.7	-16%	1.7	6%	4.1	-12%
Eurasia Drilling Company	28.40	39.00	4,145	2	BUY	13.6	6.3	10%	2.7	31%	4.9	39%
Russia	–	–	**410,689**	**930**	–	**4.2**	**2.9**	**-6%**	**0.7**	**21%**	**2.9**	**-8%**
EM	–	–	–	–	–	**7.5**	**4.3**	**0%**	**1.1**	**78%**	**4.1**	**5%**
DM	–	–	–	–	–	**8.3**	**3.6**	**-4%**	**1.2**	**38%**	**3.4**	**5%**

Source: Bloomberg, IBES, Troika estimates

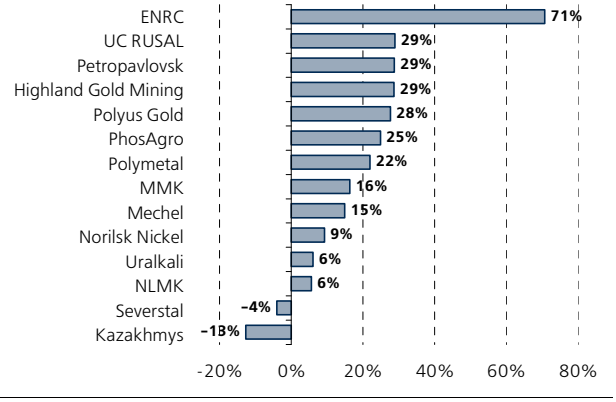
Metals and mining

Performance



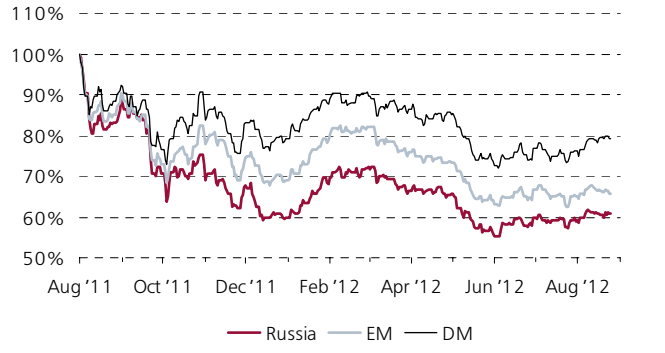
Source: Bloomberg, Troika

12m upside to Troika target price



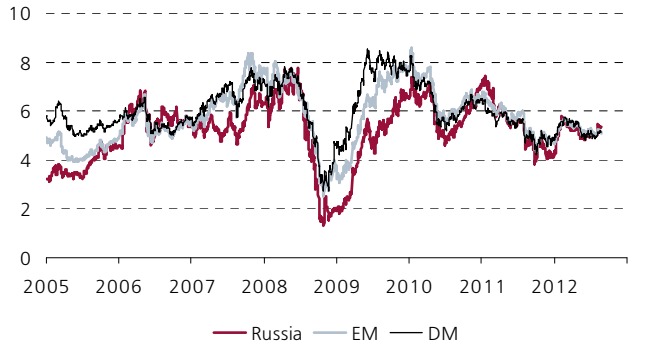
Source: Troika

Russia versus global peers



Source: Bloomberg, Troika

EV/EBITDA Russia, GEM and global



Source: Thomson, Troika estimates

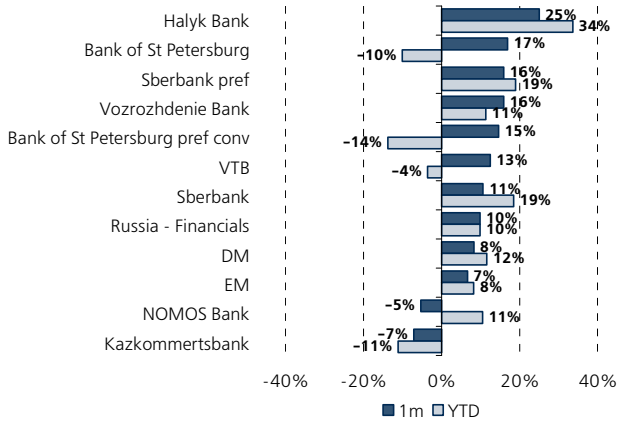
Valuation ratios

	Price	Target price	MCap	ADT		2012E					2013E	
	$	$	$ mln	$ mln	Rec	P/E	EV/EBITDA	EPS growth	P/BV	Net debt/EBITDA	EV/EBITDA	EPS growth
ENRC	5.37	9.16	6,909	17.6	BUY	7.6	4.7	-55%	0.6	181%	4.2	28%
Highland Gold Mining	1.83	2.36	596	1.2	BUY	4.9	3.3	17%	0.7	-4%	2.6	16%
Kazakhmys	10.46	9.13	5,597	20.4	SELL	11.5	4.5	-9%	0.6	80%	7.3	-18%
Mechel	6.16	7.08	2,764	26.5	HOLD	13.1	7.3	-68%	0.6	554%	7.3	5%
MMK	4.07	4.74	3,499	6.6	BUY	73.8	5.3	-70%	0.4	299%	4.8	295%
NLMK	18.27	19.30	10,950	21.4	HOLD	10.0	7.5	-19%	1.0	205%	6.5	18%
Norilsk Nickel	15.73	17.20	24,906	72.4	HOLD	9.0	5.1	-13%	2.1	41%	5.3	-4%
Petropavlovsk	6.08	7.83	1,143	10.2	BUY	5.3	3.7	-9%	0.6	236%	2.9	24%
PhosAgro	12.97	16.20	4,143	1.4	BUY	0.8	3.3	19%	0.3	7%	3.0	2%
Polymetal	15.50	18.90	5,931	4.7	BUY	11.6	8.0	59%	2.8	81%	5.8	43%
Polyus Gold	3.03	3.87	8,392	6.7	HOLD	12.3	7.2	62%	2.4	-19%	6.6	8%
Severstal	12.34	11.84	12,435	32.9	HOLD	9.3	6.9	-34%	1.4	158%	7.1	-30%
UC RUSAL	0.56	0.72	8,489	1.9	BUY	neg	11.1	240%	0.7	1034%	9.9	14%
Uralkali	40.60	43.05	17,250	67.7	HOLD	13.2	7.2	28%	2.8	84%	5.7	27%
Russia	–	–	**148,697**	**260.0**	–	**8.6**	**5.5**	**3%**	**1.2**	**151%**	**5.1**	**7%**
EM	–	–	–	–	–	**8.6**	**5.4**	**-9%**	**1.2**	**124%**	**4.8**	**9%**
DM	–	–	–	–	–	**10.0**	**5.6**	**-1%**	**1.6**	**104%**	**4.8**	**17%**

Source: Bloomberg, IBES, Troika estimates

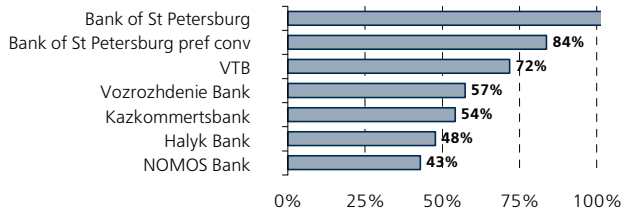
Financials

Performance



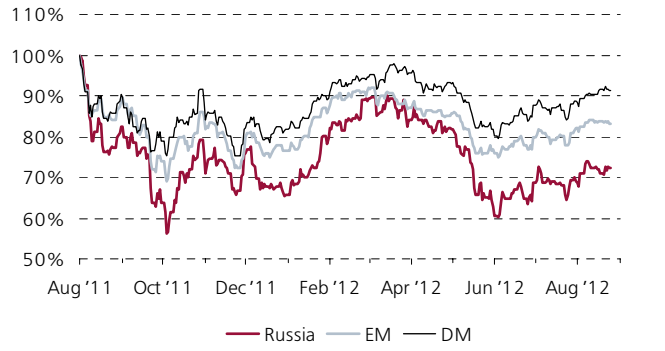
Source: Bloomberg, Troika

12m upside to Troika target price



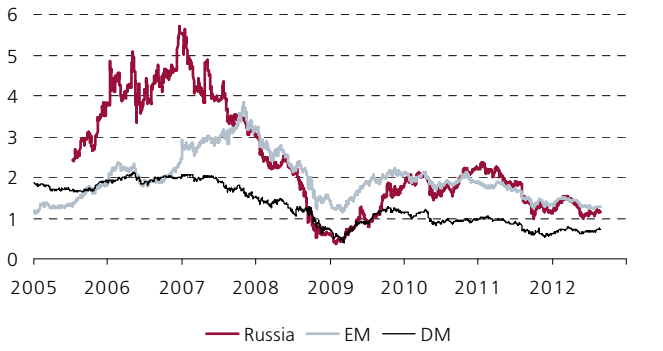
Source: Troika

Russia versus global peers



Source: Bloomberg, Troika

P/BV Russia, GEM and global



Source: Bloomberg, Companies

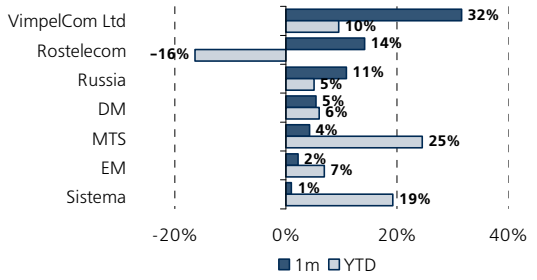
Valuation ratios

	Price	Target price	MCap	ADT		2012E				2013E			
	$	$	$ mln	$ mln	Rec	P/E	EPS growth	P/BV	ROE	P/E	EPS growth	P/BV	ROE
Sberbank	2.93	–	65,362	578.8	NR	6.4	0%	1.3	21%	5.9	8%	1.2	20%
VTB	3.48	5.98	18,201	89.0	HOLD	5.0	6%	0.8	16%	4.2	20%	0.7	16%
NOMOS Bank	10.50	15.01	1,941	7.0	HOLD	4.9	13%	0.8	17%	4.3	14%	0.7	16%
Halyk Bank	6.50	9.60	2,183	1.6	BUY	5.1	79%	0.9	18%	5.0	2%	0.8	15%
Vozrozhdenie Bank	18.87	29.70	456	0.3	BUY	6.4	37%	0.7	11%	4.4	45%	0.6	13%
Kazkommertsbank	2.40	3.70	1,057	0.2	HOLD	6.1	11%	0.3	5%	4.4	37%	0.3	6%
Bank of St Petersburg	2.03	4.24	736	0.2	BUY	4.2	-16%	0.5	13%	2.9	46%	0.5	16%
CIS	**–**	**–**	**89,935**	**677.1**	**–**	**5.8**	**4%**	**1.1**	**19%**	**5.4**	**9%**	**0.9**	**18%**
EM	**–**	**–**	**–**	**–**	**–**	**6.5**	**11%**	**1.2**	**19%**	**5.7**	**13%**	**1.1**	**19%**
DM	**–**	**–**	**–**	**–**	**–**	**11.7**	**8%**	**0.7**	**6%**	**10.6**	**16%**	**0.7**	**6%**

Source: Bloomberg, IBES, Troika estimates

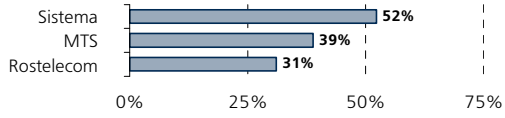
Telecoms

Performance



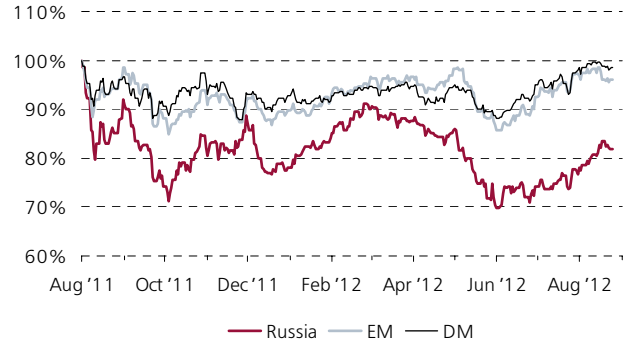
Source: Bloomberg, Troika

12m upside to Troika target price



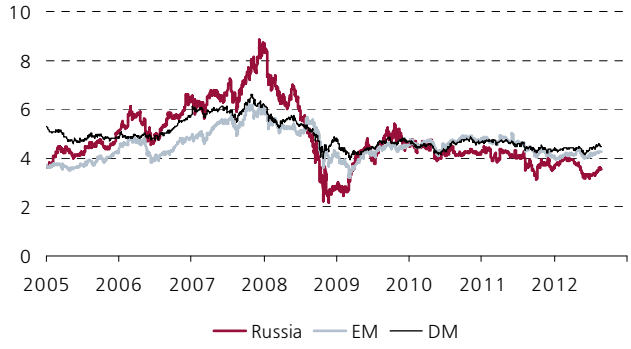
Source: Troika

Russia versus global peers



Source: Bloomberg, Troika

EV/EBITDA Russia, GEM and global



Source: Thomson, Troika estimates

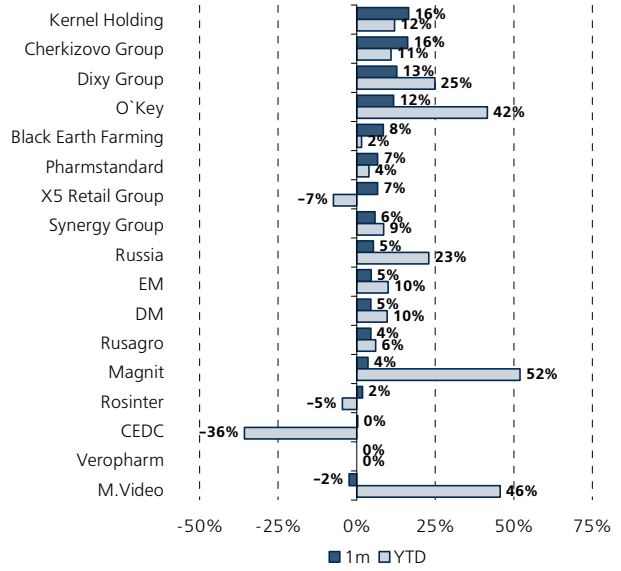
Valuation ratios

	Price	Target price	MCap	ADT		2012E					2013E	
	$	$	$ mln	$ mln	Rec	P/E	EV/EBITDA	EPS growth	P/BV	Net debt/EBITDA	EV/EBITDA	EPS growth
MTS	18.29	25.40	18,189	55.9	BUY	12.3	4.9	2%	4.6	130%	4.5	13%
Rostelecom	3.97	5.20	10,197	21.9	HOLD	9.1	3.9	1%	1.6	127%	3.6	4%
VimpelCom Ltd	10.37	–	18,217	20.3	NR	5.7	3.3	10%	1.2	22%	2.8	11%
Sistema	20.05	30.54	9,389	10.8	BUY	8.1	4.5	424%	2.2	182%	3.6	2%
Russia	**–**	**–**	**62,693**	**98.1**	**–**	**8.6**	**3.7**	**11%**	**1.7**	**70%**	**3.4**	**9%**
EM	**–**	**–**	**–**	**–**	**–**	**11.3**	**4.6**	**7%**	**1.9**	**89%**	**4.1**	**10%**
DM	**–**	**–**	**–**	**–**	**–**	**11.9**	**4.6**	**1%**	**1.4**	**117%**	**4.4**	**5%**

Source: Bloomberg, IBES, Troika estimates

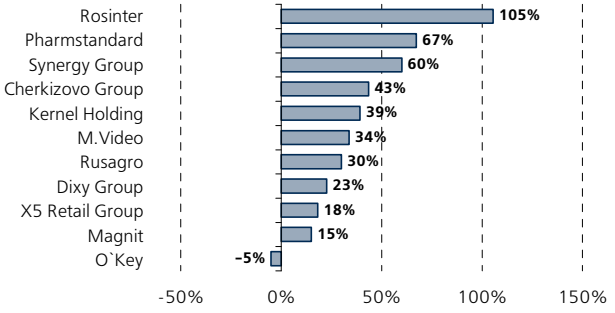
Consumer

Performance



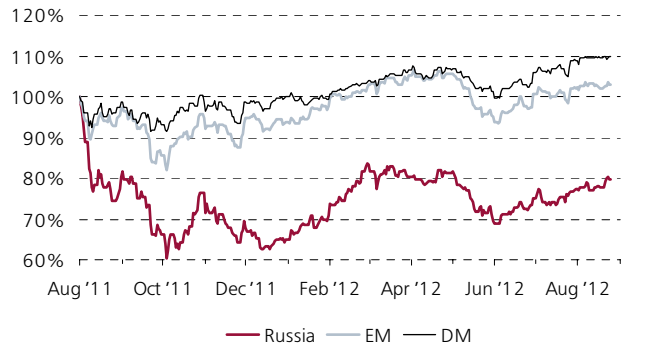
Source: Bloomberg, Troika

12m upside to Troika target price



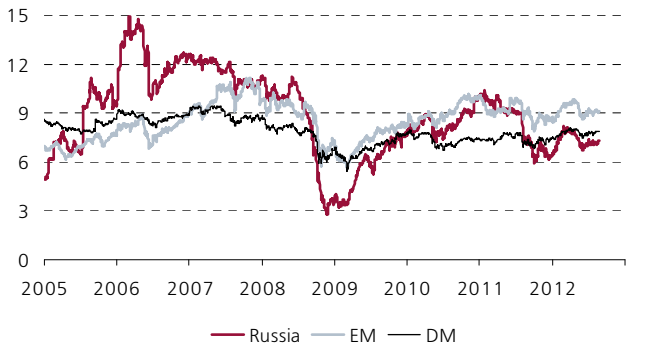
Source: Troika

Russia versus global peers



Source: Bloomberg, Troika

EV/EBITDA Russia, GEM and global



Source: Thomson, Troika estimates

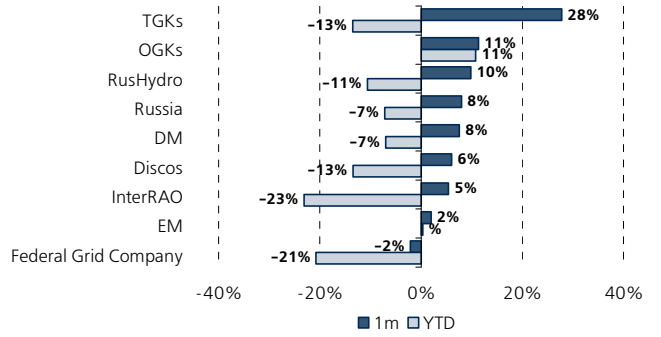
Valuation ratios

	Price	Target price	MCap	ADT		2012E					2013E	
	$	$	$ mln	$ mln	Rec	P/E	EV/EBITDA	EPS growth	P/BV	Net debt/EBITDA	EV/EBITDA	EPS growth
Magnit	32.17	37.00	15,210	34.6	BUY	22.8	12.0	60%	5.2	109%	10.4	18%
X5 Retail Group	21.16	25.00	5,746	16.5	HOLD	18.5	7.7	3%	2.3	291%	6.7	36%
Pharmstandard	14.65	24.50	2,215	1.7	BUY	8.9	5.6	-17%	1.9	-101%	4.6	10%
CEDC	2.81	–	198	1.6	–	–	–	–	–	–	–	–
Kernel Holding	22.59	31.43	1,800	1.5	BUY	8.4	6.5	3%	1.5	117%	4.4	51%
O`Key	9.70	9.20	2,602	0.8	HOLD	21.7	10.1	9%	4.6	131%	9.1	12%
M.Video	8.22	11.00	1,477	0.5	BUY	12.2	5.1	6%	3.0	-134%	4.4	14%
Cherkizovo Group	12.20	17.50	788	0.5	BUY	2.6	5.8	36%	0.6	312%	5.8	0%
Rusagro	7.00	9.10	840	0.3	BUY	7.4	6.5	10%	0.9	345%	5.6	20%
Dixy Group	11.42	14.00	1,425	0.3	BUY	33.3	7.5	14%	1.8	251%	5.8	81%
Black Earth Farming	2.04	–	253	0.3	–	7.9	8.2	–	0.9	198%	5.4	67%
Veropharm	29.19	–	292	0.0	NR	7.4	3.3	7%	1.1	-138%	2.6	7%
Rosinter	3.89	8.00	63	0.0	BUY	6.6	3.1	–	1.7	101%	2.5	18%
Synergy Group	15.18	24.30	278	0.0	HOLD	6.0	4.2	20%	0.7	169%	3.5	14%
Russia	**–**	**–**	**45,137**	**72.7**	**–**	**14.5**	**7.9**	**21%**	**2.4**	**108%**	**7.0**	**16%**
EM	**–**	**–**	**–**	**–**	**–**	**17.0**	**9.8**	**12%**	**3.0**	**75%**	**8.6**	**16%**
DM	**–**	**–**	**–**	**–**	**–**	**14.7**	**8.3**	**4%**	**2.5**	**90%**	**7.6**	**9%**

Source: Bloomberg, IBES, Troika estimates

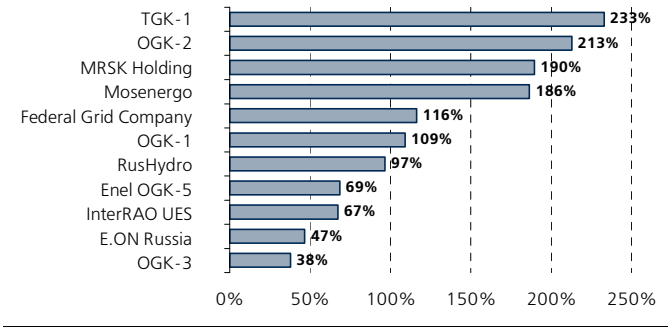
Utilities

Performance



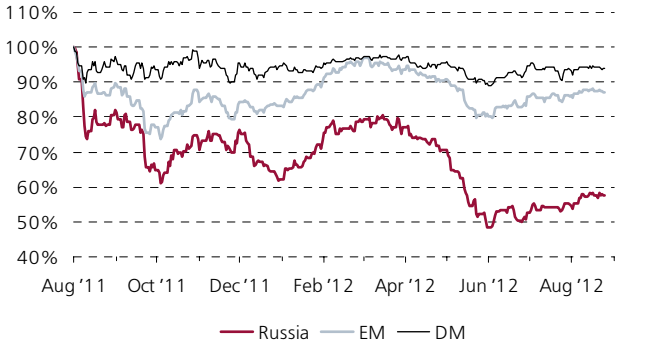
Source: Bloomberg, Troika

12m upside to Troika target price



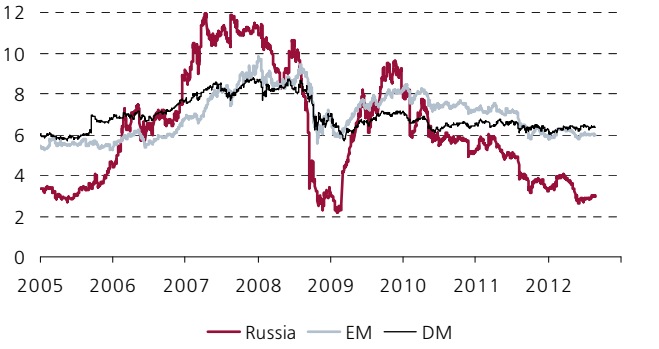
Source: Troika

Russia versus global peers



Source: Bloomberg, Troika

EV/EBITDA Russia, GEM and global



Source: Thomson, Troika estimates

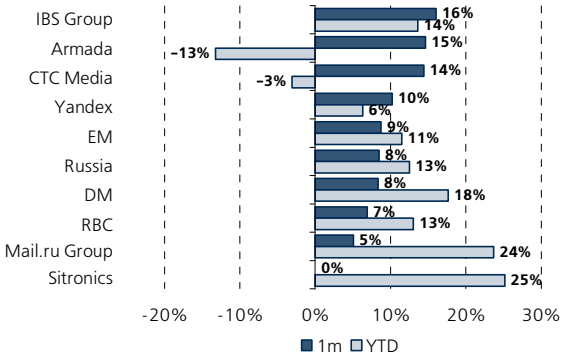
Valuation ratios

	Price	Target price	MCap	ADT		2012E					2013E	
	$	$	$ mln	$ mln	Rec	P/E	EV/EBITDA	EPS growth	P/BV	Net debt/EBITDA	EV/EBITDA	EPS growth
RusHydro	0.027	0.053	8,644	22.9	BUY	9.4	4.3	-26%	0.5	84%	3.7	24%
Federal Grid Company	0.00695	0.01503	8,571	18.7	BUY	6.5	3.1	-8%	0.3	52%	2.9	30%
MRSK Holding	0.0604	0.1749	2,556	11.0	BUY	10.3	3.3	-73%	0.2	250%	3.7	-4%
InterRAO UES	0.001	0.001	1,890	6.1	BUY	9.7	neg	6%	0.6	-134%	neg	50%
MOESK	0.040	–	1,948	2.1	–	3.0	2.1	9%	0.3	58%	2.1	-6%
OGK-2	0.014	0.044	461	2.1	BUY	3.3	3.6	-7%	0.2	281%	3.9	3%
Mosenergo	0.0397	0.1138	1,579	1.0	BUY	4.8	1.2	-6%	0.2	-67%	0.8	44%
E.ON Russia	0.086	0.126	5,415	0.6	BUY	9.0	4.9	19%	1.3	-102%	3.5	29%
TGK-1	0.0002	0.0007	811	0.5	BUY	2.9	2.9	24%	0.3	169%	2.1	53%
OGK-1	0.019	0.040	1,587	0.4	BUY	4.9	3.3	8%	0.5	-42%	2.4	38%
OGK-3	0.03143	0.04332	1,430	0.3	BUY	8.0	3.0	45%	0.4	-200%	2.2	79%
Enel OGK-5	0.060	0.100	2,108	0.2	BUY	6.2	4.2	26%	0.8	73%	3.2	27%
Irkutskenergo	0.68	–	3,218	0.1	UR	6.9	4.5	39%	1.3	13%	3.3	26%
Russia	**–**	**–**	**55,342**	**70.0**	**–**	**6.8**	**3.2**	**-6%**	**0.4**	**92%**	**2.9**	**29%**
EM	**–**	**–**	**–**	**–**	**–**	**10.4**	**6.4**	**6%**	**0.9**	**288%**	**5.7**	**17%**
DM	**–**	**–**	**–**	**–**	**–**	**11.0**	**6.7**	**-2%**	**1.0**	**382%**	**6.1**	**6%**

Source: Bloomberg, IBES, Troika estimates

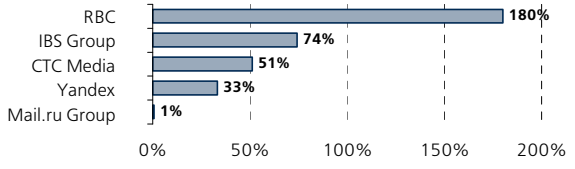
Media and IT

Performance



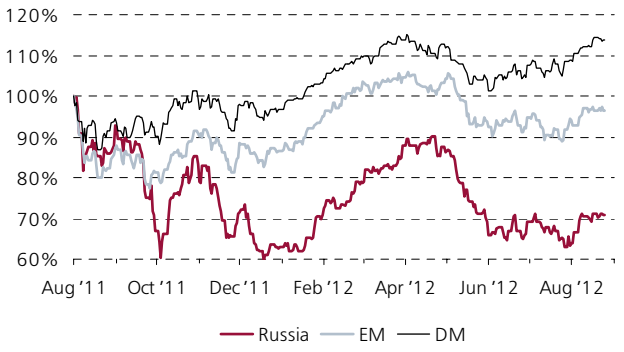
Source: Bloomberg, Troika

12m upside to Troika target price



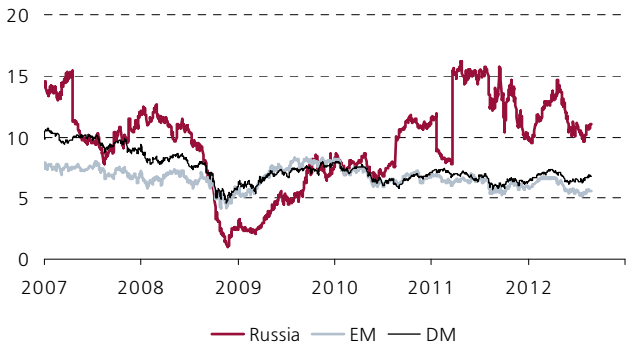
Source: Troika

Russia versus global peers



Source: Bloomberg, Troika

EV/EBITDA Russia, GEM and global



Source: Thomson, Troika estimates

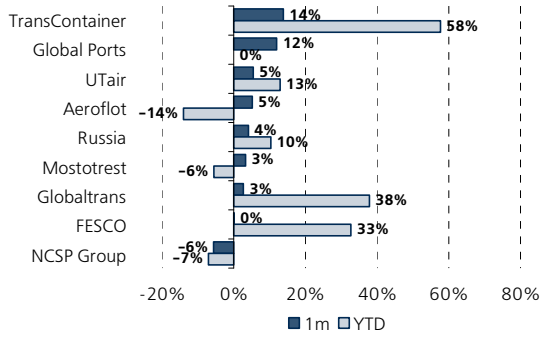
Valuation ratios

	Price	Target price	MCap	ADT				2012E				2013E	
	$	$	$ mln	$ mln	Recom	P/E	EV/EBITDA	EPS growth	P/BV	Net debt/EBITDA	EV/EBITDA	EPS growth
Yandex	20.94	27.90	6,727	27.2	BUY	25.4	14.8	32%	6.0	-133%	11.0	29%
Mail.ru Group	32.15	32.40	6,311	8.9	HOLD	33.8	22.8	30%	3.5	-227%	17.5	27%
CTC Media	8.50	12.85	1,293	4.6	BUY	9.4	5.0	167%	1.8	-44%	4.5	9%
RBC	0.48	1.35	153	0.4	HOLD	12.8	8.4	346%	neg	371%	6.2	54%
IBS Group	22.38	39.00	515	0.0	BUY	11.7	7.3	46%	2.5	-8%	5.1	45%
Armada	8.47	–	102	0.0	–	–	–	–	–	–	–	–
Sitronics	0.75	–	143	0.0	–	neg	7.6	–	–	638%	4.8	–
Russia	**–**	**–**	**17,299**	**44.0**	**–**	**24.2**	**13.5**	**56%**	**4.1**	**-16%**	**10.0**	**26%**
EM	**–**	**–**	**–**	**–**	**–**	**13.9**	**6.3**	**29%**	**2.1**	**-12%**	**5.2**	**17%**
DM	**–**	**–**	**–**	**–**	**–**	**13.7**	**7.5**	**11%**	**2.7**	**-44%**	**6.4**	**11%**

Source: Bloomberg, IBES, Troika estimates

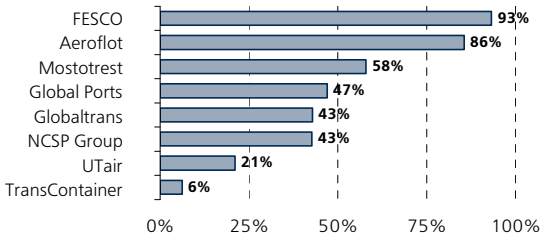
Transport

Performance



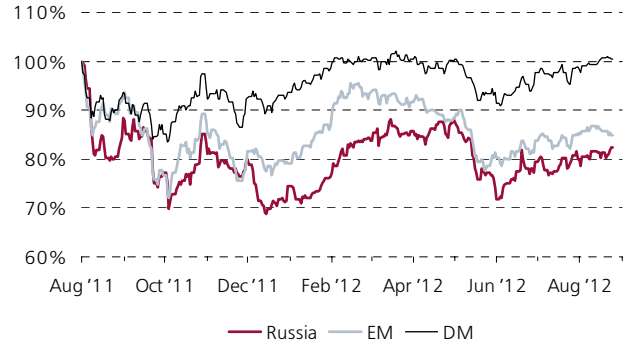
Source: Bloomberg, Troika

12m upside to Troika target price



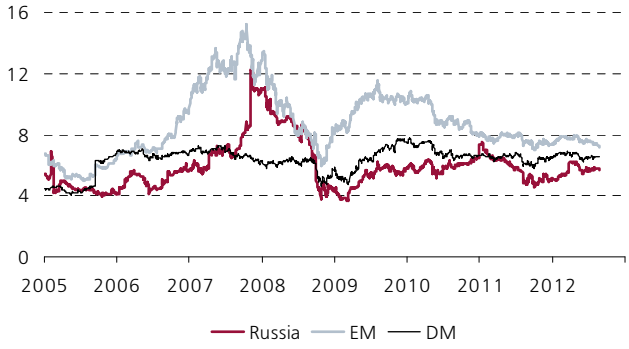
Source: Troika

Russia versus global peers



Source: Bloomberg, Troika

EV/EBITDA Russia, GEM and global



Source: Thomson, Troika estimates

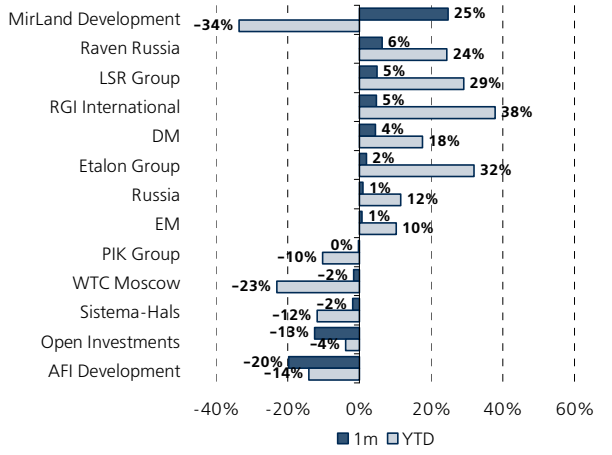
Valuation ratios

	Price	Target price	MCap	ADT		2012E					2013E	
	$	$	$ mln	$ mln	Rec	P/E	EV/EBITDA	EPS growth	P/BV	Net debt/EBITDA	EV/EBITDA	EPS growth
Globaltrans	18.95	27.08	3,387	10.1	BUY	9.8	6.5	15%	2.4	123%	5.2	6%
Aeroflot	1.35	2.51	1,434	2.0	BUY	9.3	5.2	-67%	1.0	315%	4.5	78%
Global Ports	14.00	20.58	2,193	1.0	BUY	11.9	6.9	34%	2.0	6%	5.7	15%
TransContainer	12.30	13.07	1,709	0.9	BUY	10.6	5.8	25%	2.1	43%	5.1	14%
NCSP Group	6.97	9.94	1,789	0.7	BUY	5.5	6.5	156%	1.3	361%	6.2	-2%
Mostotrest	5.48	8.66	1,547	0.6	BUY	8.7	3.8	42%	1.9	-106%	3.2	26%
FESCO	0.34	0.65	993	0.1	BUY	10.7	5.2	71%	0.5	30%	4.4	26%
UTair	0.63	0.76	362	0.0	BUY	6.5	7.7	758%	1.3	664%	6.9	104%
Russia	**–**	**–**	**13,414**	**15.4**	**–**	**9.1**	**6.0**	**9%**	**1.5**	**213%**	**5.2**	**22%**
EM	**–**	**–**	**–**	**–**	**–**	**13.2**	**8.1**	**2%**	**1.2**	**368%**	**6.7**	**21%**
DM	**–**	**–**	**–**	**–**	**–**	**14.5**	**6.9**	**12%**	**1.7**	**196%**	**6.3**	**14%**

Source: Bloomberg, IBES, Troika estimates

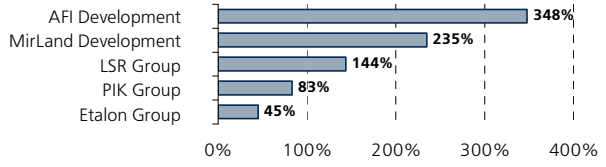
Real estate

Performance



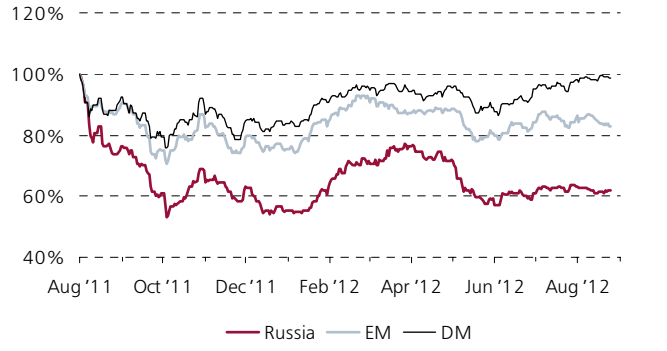
Source: Bloomberg, Troika

12m upside to Troika target price



Source: Troika

Russia versus global peers



Source: Bloomberg, Troika

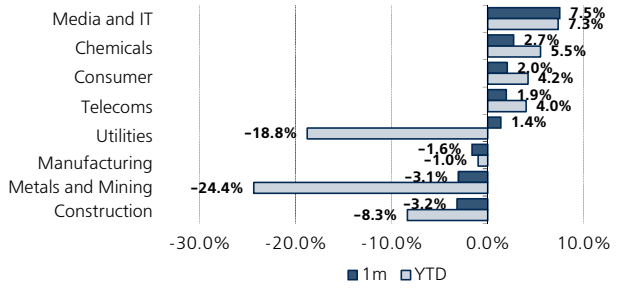
Valuation ratios

	Price	Target price	MCap	ADT				2012E				2013E	
	$	$	$ mln	$ mln	Rec	P/E	EV/EBITDA	EPS growth	P/BV	Net debt/EBITDA	EV/EBITDA	EPS growth
LSR Group	4.35	10.61	2,242	2.8	BUY	12.2	7.5	118%	1.2	2.2	5.3	69%
Etalon Group	6.20	9.00	1,829	2.1	BUY	10.4	8.1	23%	1.7	0.2	6.4	25%
PIK Group	2.22	4.06	1,093	1.3	BUY	53.0	12.5	-25%	neg	7.0	9.0	278%
Raven Russia	1.01	–	540	0.2	–	35.4	12.7	–	0.8	7.2	10.1	179%
AFI Development	0.36	1.62	381	0.2	BUY	3.5	7.3	-63%	0.2	4.6	5.7	15%
WTC Moscow	0.30	–	349	0.2	NR	–	–	–	–	–	–	–
MirLand Development	1.50	5.01	149	0.0	HOLD	5.9	10.3	-58%	0.4	7.2	7.5	55%
Sistema-Hals	0.35	–	79	0.0	NR	neg	37.0	–	neg	35.6	17.7	–
RGI International	1.68	–	271	0.0	–	–	–	–	–	–	–	–
Open Investments	17.50	–	267	0.0	NR	–	–	–	–	–	–	–
Russia	**–**	**–**	**7,324**	**7.0**	**–**	**13.8**	**10.3**	**-12%**	**1.0**	**5.0**	**7.5**	**52%**
EM	**–**	**–**	**–**	**–**	**–**	**9.8**	**7.7**	**21%**	**1.1**	**2.9**	**6.6**	**19%**
DM	**–**	**–**	**–**	**–**	**–**	**19.3**	**16.0**	**-12%**	**1.2**	**6.3**	**15.0**	**8%**

Source: Bloomberg, IBES, Troika estimates

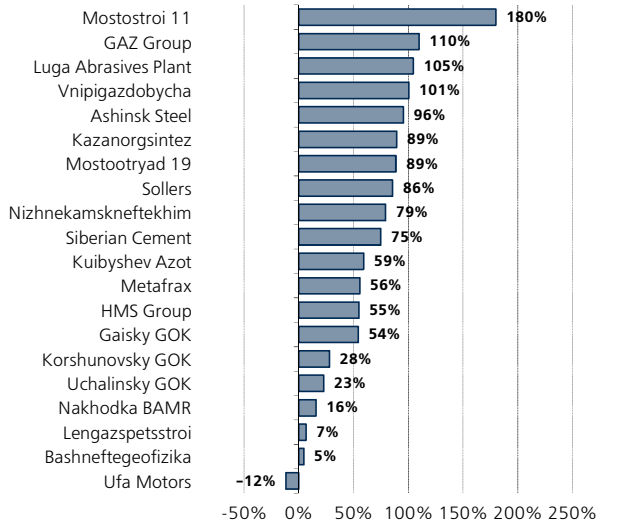
Small caps

Performance of small-cap subsectors



Source: Bloomberg, Troika

12-month upside to Troika indicative value*



* mid-value of indicative range

Source: Troika

Valuation ratios

	Price $	MCap $ mln	ADT $ mln	2012E P/E	2012E EPS, y-o-y	2012E EV/EBITDA	2013E P/E	2013E EPS, y-o-y	2013E EV/EBITDA
Ashinsk Steel	0.217	108	0.01	5.0	460%	1.4	4.5	0.1	1.0
Arzamas Instrument Plant	77.50	25	0.00	3.0	18%	2.8	2.6	13%	2.7
Bashneftegeofizika	215	116	0.00	8.6	3%	5.7	8.5	1%	5.7
Gaisky GOK	405	250	0.00	2.9	-21%	2.1	2.7	9%	1.6
Kuibyshev Azot	2.32	556	0.01	3.3	-20%	2.4	3.0	10%	1.8
Korshunovsky GOK	1,834	459	0.08	6.7	-60%	1.0	6.4	4%	0.2
Kazanorgsintez	0.135	250	0.03	3.2	424%	3.7	2.1	57%	2.9
Lengazspetsstroi	3,518	177	0.00	4.4	-29%	2.2	4.1	8%	2.9
Luga Abrasives Plant	5,500	129	0.00	4.8	7%	1.7	4.5	6%	1.5
Mashinostroitelny Zavod - ORD - RTS	100	147	0.00	8.8	-7%	1.7	9.0	-2%	2.7
Metafrax	0.64	210	0.02	3.4	46%	0.6	3.3	3%	0.0
Mostootryad 19	795	60	0.00	7.6	457%	5.4	7.0	9%	4.9
Mostostroi 11	750	65	0.00	3.2	94%	2.2	2.3	35%	1.8
Nakhodka BAMR	121	288	0.01	4.6	-10%	6.0	4.2	9%	5.8
Nizhnekamskneftekhim	0.89	1,594	0.19	2.6	24%	1.8	2.5	6%	1.3
Sollers	13.51	452	0.22	7.3	721%	4.6	6.0	21%	4.3
Uralelectromed	60.50	307	0.00	2.2	-0.3	1.4	2.0	0.1	0.8
Ufa Motors - ORD - RTS	0.85	263	0.00	3.7	141%	5.5	3.3	11%	5.0
Uchalinsky GOK	9.38	357	0.00	7.0	-31%	3.4	6.4	9%	3.1
Southern Kuzbass Coal Company	63.49	2,293	0.05	4.3	8%	2.4	3.8	14%	2.4
RKK Energia	125	117	0.00	3.7	24%	1.9	2.8	36%	1.8
Vnipigazdobycha	823	107	0.00	5.4	34%	n/m	5.0	9%	n/m
Siberian Cement	12.95	393	0.01	5.8	42%	4.2	4.8	22%	3.6
HMS Group	4.95	580	0.42	6.4	-22%	6.0	5.6	14%	5.0
Volgomost	27.00	230	0.00	48.0	8%	7.8	23.0	109%	7.0
Chelyabinsk Zinc	2.10	114	0.00	6.5	-56%	1.3	6.0	9%	0.8
Soda	18.75	374	0.00	3.6	24%	2.8	3.3	8%	2.5
GAZ Group	30.05	488	0.07	2.6	-32%	n/m	2.6	-2%	n/m

* Bloomberg consensus

Source: Bloomberg, IBES, Troika estimates

Oil and Gas: The Wonderland

Over the past five years, Gazprom has been the worst stock in the large-cap energy sector globally. Earnings have nearly doubled, but the share price has halved since 2007. While a sub P/E of 3.0 screens well, the stock does not chase paper profits but follows value destruction on the cash-flow side. The market is pricing in another $100 bln in losses, though we doubt Gazprom has the greenfield reserves sufficient to wipe out so much money. Should Gazprom be pressed to follow Rosneft's payout example, the stock would yield 8.5%, creating at least a solid floor. It was the collapse in the share price that introduced a close to 6% dividend yield, and not our faith in reforms, that made us upgrade the stock to a BUY recommendation in late May. Since its listing in 2005, TNK-BP Holding has returned three quarters of its market cap in dividend distributions, more than any other global major. We cannot bet on the same stream of outsized 2010-11 dividends being sustained beyond this year unless the company takes a modest $6.5 bln in leverage, but we see attractive payouts continuing, almost regardless of the change in its parent company's shareholding structure. Over the next six years, the company should generate almost as much cash as in the previous six, assuming an oil price of $95/bbl. Despite market concerns, there is nothing binary about this classic buy-and-hold story, which has delivered one of the best returns in the sector globally, and we highlight it among our best ideas, along with NOVATEK, Bashneft and Eurasia Drilling Company. We continue to see Transneft as a potential turnaround case.

While the IFRS accounts next year may create some speculative run-up in Surgutneftegaz stock toward their publication, we argue that the company's $34 bln market cap already factors in the $25 bln value of the oil business, as well as over a third of the cash pile that accounts for one tenth of the entire national corporate deposit base. The market seems to price the remaining two thirds of the liquid asset base at zero, but this is not unique or remarkably impressive. The remaining cash is likely trapped supporting the liquidity of Russia's banking system, and not readily available for investments or dividends – similar to the much more transparent and dividend-paying KazMunaiGas EP, where an eventual deployment of cash is more visible. We see Surgutneftegaz prefs as the main viable exposure and favor KazMunaiGas EP over the Russian company's common stock.

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Financials: Managing Margins as Funding Pressures Rise

KEY DEVELOPMENTS

As Russian banks continue reporting 1H12 numbers over the next few weeks, the hot topic is how they can manage to fund – at an acceptable price – what remains fairly healthy loan demand, particularly in the retail and SME segments. Vozrozhdenie Bank was the first to report 1H12 numbers, and managed to defend and even increase its NIM despite surging funding costs. The key was strong loan growth in higher-yielding segments – retail loans up 16% YTD, SME 12%, large corporate just 6% – and being able to allocate liquidity to loans rather than becoming embroiled in the expanding deposit price wars. With no imminent changes in Central Bank policy rates expected, the big question will be the extent to which banks can re-price loans upward, particularly corporate, without dampening demand and degrading asset quality, with indicators for the latter still tentatively moving in the right direction, helped by strong volume growth. The other challenge banks need to negotiate is the ongoing tightening of risk-weightings for capital requirements, which has prompted banks to look at subordinated debt issuance and/or existing shareholders to dip their hands in their pockets, given that still-low multiples for most traded banks hardly makes dilution through IPO or private placement an attractive option. The sector (by which we tend to mean the top 100 banks, which account for 85% of assets) looks in pretty good shape overall, with retail deposit and loan growth likely to come in at about 20% this year, and profitability still strong, with over 20% ROAE. That said, we would welcome some softening in retail credit growth in 2H12, even if penetration remains modest by international standards (11.7% of GDP).

STRATEGIC VIEW

We maintain our strategic view that the banking sector remains fundamentally one of the best ways to play the increasing prominence of domestic demand as a driver of Russia's economic growth. We think the margin issues that banks are facing are symptomatic of what is to come, as we maintain that Russia is becoming a more "normal" country in terms of steady (and relatively robust) economic growth and stable (and rather low, particularly in a historic context) inflation. The tighter liquidity environment over the past year or so has been something of a wake-up call to banks in terms of appreciating the benefits of a strong deposit funding base, and the cross-selling potential this brings. The catch is that to effectively compete for deposits, banks need scale (distribution), access to payroll funds, and an ability to absorb higher funding costs through improving asset and loan mixes. As capital and funding pressures rise, scale through consolidation will become much more of a desirable facet, but the Russian banking sector's track record of large-scale integration is patchy at best.

TOP PICKS

- **Vozrozhdenie Bank.** We like the bank both as a result of its own virtues (sticking to what it knows it can do, SME/retail exposure, defending its margins well) and others' vices (Bank of St Petersburg is not yet out of the woods on asset quality or capital, NOMOS Bank looks on the path to delisting, and VTB's business model continues to leave it exposed in tough and volatile market conditions).
- **Halyk Bank.** This is our pick in Kazakhstan. The bank's growth and profitability are steadily improving, and it is making good progress on the corporate governance front with the state's exit to be followed by a new dividend policy.

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Telecoms: Capex Reduction a Primary Catalyst

KEY DEVELOPMENTS

Broadband services are the locomotive force behind Russian telecom companies. In the wireless segment, growth is driven by mobile broadband services, which are in turn driven by subscriber base expansion and increasing mobile data traffic as smartphone penetration increases and users become accustomed to using mobile devices to access the internet. At the same time, revenues from voice services remain stable, with Russian carriers focusing on promoting on-net calling. In the fixed line segment, operators are focusing on increasing the uptake of fixed line broadband services. With carriers undertaking cost-saving initiatives, and the competitive environment unlikely to intensify, we believe that operating expenses will expand in line with revenues, which implies sustainable profitability.

That said, scaling down capex is a more important value driver for telecom companies, as the heavy investment cycle expected to come to an end. While capex likely peaked in 2011, we do not forecast a reduction this year, as carriers are still completing the rollout of their 3G networks. However, we think investment could start to gradually decline in 2013, as the LTE network rollout will not be as capital-intensive as that for the 3G network – it only requires a software upgrade to switch to the new technology, as most installed 3G base stations are LTE enabled.

Reducing capital investments will increase free cash flow generation, which can be spent on either deleveraging or increasing dividend payments (or both), which we think will act as the primary catalyst for telecom companies.

STRATEGIC VIEW

We do not expect the competitive environment to intensify in the short term. The only risk we see is Rostelecom launching 3G services, especially in regions where the company has no prior presence. However, this should not take place before next year, and thus we do not see competition changing in the next six months or so. It remains to be seen what strategy Rostelecom will apply starting from 2013 to gain market share and whether it will prove successful.

On the regulatory side, we do not anticipate any changes this year, either, though talks about introducing mobile number portability (MNP) and canceling national roaming fees are likely to continue. The former measure has a greater chance of being implemented, though it will not take place until 2013 at the earliest.

There should be a lot of news on LTE licenses over the next six months (or rather on refarming frequencies that were allocated this summer to the Big Four operators). While the auction has taken place and winners been determined, operators cannot launch services because the frequencies are being used by the military. Thus, the cost and timing of clearing these frequencies still need to be sorted out; although some amounts have been mentioned, the final cost that operators will incur is still unknown.

TOP PICKS

- **MTS.** We think MTS has proven to be a defensive stock, outperforming the broader Russian index YTD by rising 25%, versus 4% for the RTS Index. Although upside is limited and we think there might be better options for bulls, we think MTS is worth owning for bears, as it is a dividend play and a defensive story.

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Consumer: Food Inflation Chasing Growth and Margins

Russian food retail turnover rose 4.8% y-o-y in 1H12, up from just 1.2% in 1H11. Such an impressive start to the year was fueled by record low food inflation (1.9% y-o-y) in the period. Favorable macroeconomic dynamics supported key players' performances: Magnit posted a 32.5% y-o-y surge in revenues during the period, while Dixy Group reported 34% y-o-y growth, both beating their selling-space expansion rates. However, the 10% indexation of utilities tariffs in July and booming soft commodity prices (up 35-60% since early summer) pushed up food inflation in July, when the monthly figure totaled 5.5% y-o-y compared with just 1.7% in May. This immediately slowed food retail growth from 4.8% in May to 1.3% y-o-y in July.

The firm dependence of Russian food retail expansion on inflation makes the latter one of the key drivers for the sector. We believe that price growth trends and their impact on retailers' top-line evolution, LFL sales and profitability will be key areas of interest in the following months.

Historically, retailers have gradually transferred increased producer prices on to customers. However, the scale and timing of sales price growth are crucial in such situations. On one hand, retailers preserve margins by increasing prices, which strengthens LFL ticket growth. This should support overall LFL sales growth, which has been suffering from slow inflation this year (in 2Q12 it stood at 3.2% y-o-y for Magnit and 3.4% for Dixy Group, while X5 Retail Group disappointed with a 1.1% correction).

On the other hand, the sharp deterioration of LFL growth versus double-digit growth in 1H11 is explained not only by slow price growth, but also by the fragile nature of traffic increases. Market leaders' selling space expansion at a 30% 2007-11 CAGR intensified competition and even created a cannibalization effect in several regions. This primarily affected LFL traffic (key players have seen it below the waterline for the past 12 months) and increased customer sensitivity to price fluctuations. We expect that Russian food retailers may be very careful transferring price growth on to customers, considering the risk of traffic deterioration and sacrificing profitability for top-line expansion. However, it may not be very painful for X5 Retail Group and Magnit, as both players improved their purchasing terms materially in 4Q11, lifting their gross margins by several percentage points, so they may either push suppliers to minimize price increases or sacrifice part of this margin gain for top-line growth.

We believe the key triggers for food retail stories in the next six months will be operating and financial results showing a balance between sales expansion and profitability. The market will pay special attention to any news flow on X5 Retail Group, especially 3Q12 operating figures. The market leader has been disappointing investors with poor operating performance, in contrast to its peers (likely due to company-specific reasons) for a year already. So, with the company struggling to reach 15% y-o-y revenue growth, it will likely have to acknowledge its inability to meet this target. However, any positive news flow – especially on a new CEO appointment or a step-up in sales dynamics – may trigger a recovery in the story. Meanwhile, X5 Retail Group's performance raises another issue on timing of the slowdown in Russian food retail expansion – a key question for the sector in the long term.

Russian non-food retail outperformed food retailers in 1H12, delivering 9.3% y-o-y growth despite 6.0% inflation. Neither forex fluctuations nor global macroeconomic turbulence have affected customers' propensity for discretionary spending. We do not expect any material slowdown in non-food retailers' growth rates, looking for a 13% y-o-y increase in revenues and over 9% y-o-y improvement in LFL sales.

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Utilities: "Rosneftegaz-ification", Or Not?

KEY DEVELOPMENTS

In the genco space, the main issues driving the sector are the trend in the free-market electricity price and possible changes to prices for new capacity constructed under capacity supply contracts (Russian abbreviation: DPM). Free-market electricity prices were weak in 1H12 (down 10% y-o-y in the Europe and Urals price zone) on the back of new capacity commissioning and very moderate capacity decommissioning. However, in July-August, the average in the zone climbed 15% y-o-y following a 15% gas tariff hike from July 1. Siberian prices are strong y-o-y. There is a risk of DPM-capacity price cuts if the regulator reduces electricity sales adjustment coefficients.

For power network companies (Federal Grid Company, MRSK Holding and the MRSKs), as well as for RusHydro and InterRAO UES, the key issue is whether Rosneftegaz will, as it has proposed, gain large stakes in these (in some cases even control) and if so, on what terms. The government (Economics Ministry and Deputy Prime Minister Arkady Dvorkovich) is against these plans and the market is uneasy about them, which is reflected in the current share prices.

In July, 33 MRSK branches (out of 69) had their RABs rebooted and the total average RAB cut was 18%. Most of the remaining ones are under long-term indexation for now.

STRATEGIC VIEW

By November 1, a few more MRSK branches should have their RABs rebooted (we expect a total of at least 44 branches to be under RAB as a result of the reboot). Around 10 branches will probably have moved from the RAB system to long-term indexation, we anticipate, representing circa 8% of the aggregate RAB of MRSKs (if excluding the very large Tyumenenergo, or even more if it also moves out of RAB). We expect our top picks in the space (MRSK Center, MRSK Center-Volga and MRSK Volga) to stay largely in the RAB system, though.

A final decision has yet to be made on Rosneftegaz's participation in the sector. We would not be surprised if it gains minority stakes in InterRAO UES and RusHydro , at least. With regard to the potential consolidation of Federal grid Company and MRSK Holding under Rosneftegaz, the government must review the issue before a proposal on different scenarios is submitted for revision by the president. The government energy commission meeting is likely to take place toward end September, Dvorkovich has said. In October, we expect President Vladimir Putin to make a final decision on whether to merge FGC and MRSK Holding (single share conversion; or FGC gaining the state's stake in MRSK Holding; or FGC continuing to manage MRSK Holding, as it does now) and whether to do so under Rosneftegaz's umbrella. If there is no merger, the swap ratio risk would be lifted, and if Rosneftegaz will not be involved, the market would likely feel more comfortable. This would be positive news for FGC, MRSK Holding and the other MRSKs, in our view. For MRSKs, this would pave the way to privatization – an important trigger. The Energy Ministry has proposed privatizing one MRSK Holding subsidiary in 1Q13.

TOP PICKS

- **E.ON Russia.** This is the most defensive Russian genco, which remains a BUY even if prices on new capacity under DPM are cut by 20%, we estimate. Also, it is a real dividend play in the space.
- **FGC.** If it is not transferred under the umbrella of Rosneftegaz, the market could regain optimism toward the stock and it could bounce back. Its psychological level used to be R0.30 per share.

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Transport: Global Stocks Look Better

KEY DEVELOPMENTS

Rail operating performance has been rather positive this year. Rail transportation volumes increased 3.5% y-o-y in 7m12, while rail freight turnover rose 5.4%, versus 3.2% growth in industrial output. Turnover at Russian ports also showed positive dynamics, up 5.4% y-o-y in 1H12, driven by an increase in general and bulk cargoes. Container cargo volumes performed better than the industry average, adding 8.9%. Container transport via rail was not far behind with 8.6% growth.

Most transport companies, namely Globaltrans, NCSP Group, Aeroflot and FESCO, have already reported 1H12 IFRS results.

Globaltrans turned in a solid set of 1H12 IFRS numbers, posting $328.6 mln in EBITDA, which beat market consensus by 4%, while its EBITDA margin jumped to an impressive 49.4% thanks to the substitution of leased cars with newly acquired railcars and improved pricing. The consolidation of Ferrotrans in May added 15% Q-o-Q to the company's EBITDA in 2Q12. Following the results, Globaltrans' management stressed that it is not going to buy new railcars for the foreseeable future, instead focusing only on M&A deals, with a particularly advanced interest in captive metallurgical operators. With $400 mln in proceeds from the SPO in July, the company's current debt level is slightly below $1 bln (net debt/EBITDA of 1.7), which is a fairly comfortable level for new purchases.

NCSP Group also reported decent 1H12 IFRS results. Although a decline in volumes handled led to weaker profitability in 2Q12, we were surprised to see fairly strong free cash flow, which the company generated at the expense of lower capex. Net debt therefore fell 10.5% to $2,130 mln, implying net debt/EBITDA of 3.4. It seems that NCSP Group has revised its investment program to be less expansive and delayed to later years. We admit that the government's intention to sell a 20% stake on the market this autumn will overhang the stock.

We expect a decision to soon be made on Russian Railways' stake in TransContainer – whether it should be privatized or contributed to a new logistics operator.

TOP PICKS

- **Globaltrans.** Despite strong price performance YTD, Globaltrans remains our top pick in the transport universe as we still see upside in the name. We are pleased with its strong 1H12 IFRS results, which, as usual, delivered good cost control, margins and cash flow generation. In light of the reported numbers, we see upside to our 2012 EBITDA projection. The 2H12 financials should be even stronger given the substantial fleet expansion. Following its summer SPO, the company accumulated a $400 mln cash pile on its balance sheet, which we believe will be spent on M&A before year end.
- **Global Ports.** The company will publish 1H12 IFRS financials in mid-September, which promise to be strong and generate interest in the stock. Though there are not many events or triggers for the stock, Global Ports is definitely one of the best stories in the transport space – the company boasts excellent profitability (an EBITDA margin of almost 60%) and cash flow generation. Some interim dividends could be paid based on the 1H12 results.

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Real Estate: Good Value for Growth

KEY DEVELOPMENTS

The real estate market has been upbeat YTD, though more so in the residential segment than in the commercial space. Public homebuilders have seen sales volumes rise 18-69% (presales up 38-90% in rubles), with LFL prices up 6-12% y-o-y. We think 2H12 is also likely to be strong notwithstanding tighter bank liquidity, which pushed mortgage rates up 80 bps in 1H12 but has had little effect thus far on new mortgage lending (up 57% y-o-y, with the regions seeing higher growth than the two capitals).

In the residential space, we expect quite a few new project launches from the listed homebuilders, having a positive effect on presales in 2H12. LSR Group plans to offer new projects for sale starting in September, while most of Etalon Group's launches will start in October, delaying the positive effect until 4Q12. PIK Group launched nearly half of its new projects planned for the year in 1H12, so its presales trend should be smoother over the four quarters. That said, the traditionally strong sales season in 3Q12 should be supportive for all homebuilders. Price growth already runs above inflation, so we would not count on further meaningful price appreciation.

In the commercial space, office space uptake in 1H12 was at last year's levels, reflecting rather anemic rent growth, with Class A office space seeing flat y-o-y rents and Class B rents actually falling 10% Q-o-Q to mid-2011 levels. While uptake has exceeded new deliveries, having a positive effect on occupancy rates, more completions over the next two to three years will inevitably increase supply, keeping rents under pressure. Retail and warehouse space enjoy the lowest vacancy with flat rents, although uptake of quality shopping center space is lagging new construction, which means rent rates will not see much of an improvement in the near term.

STRATEGIC VIEW

Homebuilders, in our view, are a good way to play the expected credit and consumption growth at a reasonable price. Strong mortgage loan growth YTD and a buoyant job market with positive real wage growth (2.7% in 1H12) are fueling demand for economy-class housing, benefiting all homebuilders. Coupled with flat-to-expanding margins and de-leveraging, Russian homebuilders offer 29-76% 2012E-14E EPS CAGR, trading at an average 2013E EV/EBITDA of 6.0, a discount of 47% to international peers and 27% to Russian consumer stocks, which we believe is a good value. Higher risk and low liquidity are the only two impediments to better performance from Russian real estate stocks, in our view, so we would expect the sector to perform well once the market gets a clear direction and desire to own risk, given strong underlying fundamentals.

TOP PICKS

- **Etalon Group and LSR Group.** In the residential space, we continue to like these two stocks, which both have strong fundamentals. Etalon Group, which is trading at a discount to LSR Group, is our preferred name in the short run, as it will maintain momentum on an impressive project pipeline over 2012-13, has an excellent management team and a strong balance sheet.
- **AFI Development and MirLand Development.** In the commercial space, we see the most value in these two stocks, which are trading at respective discounts of 52% and 60% to NAV of completed projects (and projects under development for MirLand Development). That said, shares of the relatively small and illiquid commercial developers are still likely to be a quest for the brave, and their performance will depend on investors' willingness to dig deeper into the Russian market.

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Industrials: All Quiet

KEY DEVELOPMENTS

Investors have been uninterested in industrial stocks lately due to their low liquidity. TMK is perhaps the exception, having gained 69% YTD, making it one of the top performers in Russia. The main reasons for its outperformance are its low valuation versus peers, the high oil price (which encourages drilling and boosts demand for OCTG pipes), and its high beta.

Russia's WTO entry raises many questions about the implications for the sector, particularly for automakers. We discussed this issue in detail in our report "Russian Automotives – Playing in the Major Leagues" of July 2012. Although passenger car manufacturers (Sollers and AvtoVAZ) are better protected than manufacturers of commercial vehicles (GAZ and KamAZ) from global majors via import tariffs, we like Sollers and GAZ, albeit for different reasons. Sollers is up 42.9% YTD, while GAZ has gained just 10% due to worse liquidity.

HMS Group has climbed 12% YTD and remains very volatile due to poor liquidity and its overpriced M&A deals, although fundamental factors remain attractive for the company's strategic development (e.g. high oil price supports oil companies' capex).

Surprisingly, Mostotrest has turned in an unimpressive YTD performance, down 5%, despite a significant increase in spending from federal and municipal budgets on transport infrastructure.

STRATEGIC VIEW

We do not expect any important events in the sector, at least until year end. Although most companies in the sector are fundamentally undervalued (as is the Russian market), investors are paying little attention to this, and the main driving forces are currently the overall market trends and moods, which are changing very fast. Industrial stocks are rather volatile, as many of them suffer from high leverage and are moving together with the market, with beta well above 1.0.

Mostotrest and Sollers will report 1H12 IFRS results next week.

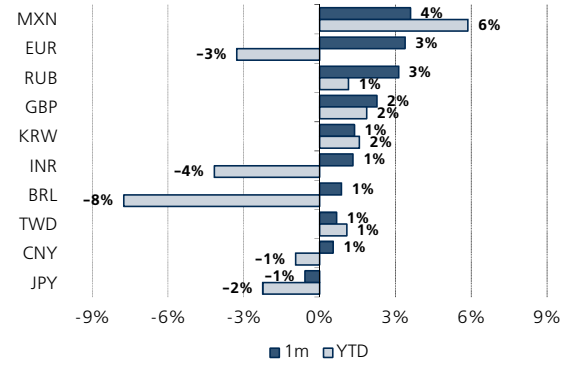
TOP PICKS

- **Mostotrest.** Despite its unimpressive YTD performance, Mostotrest still offers the only exposure to the growing Russian transport infrastructure story. With a mammoth $10 bln order book and high-quality managers and engineers, the company sits atop the sector. This year, it will boost revenues by roughly 30%, though margins will drop due to an increasing share of subcontractors. Although the free float is $500 mln, the stock is illiquid ($0.2 mln ADT), as most portfolio investors consider the stock a long-term play. The main near-term catalyst is the publication of 1H12 IFRS results on October 1. The stock is trading at a 2012E EV/EBITDA of 3.7, versus its historical average of 6.0.
- **Sollers.** The stock is more liquid than Mostotrest, but also more volatile due to the company's high leverage and currency risk. However, sophisticated management and an exciting partnership with Ford make Sollers attractive as a long-term investment. The current price does not factor in additional value from the company's 50% stake in the JV with Ford, which we conservatively estimate at $338 mln ($10.00 per share). We believe investors will come to appreciate this fact over time, leading to a stock re-rating.

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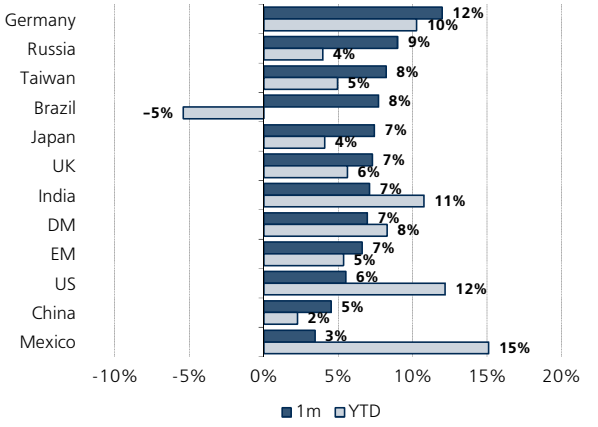
Global Drivers: Russia is Cheap on Risk Perception

Currency performance



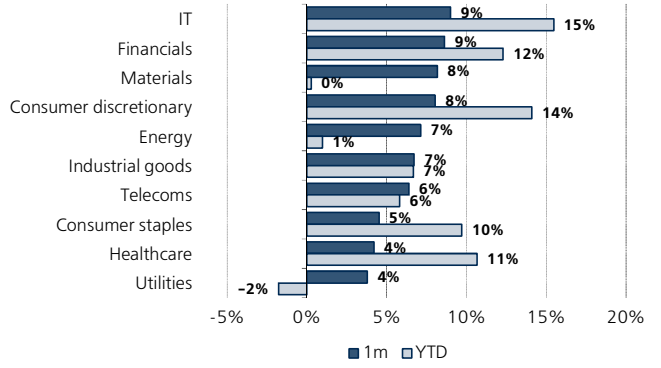
Source: Bloomberg

Country performance



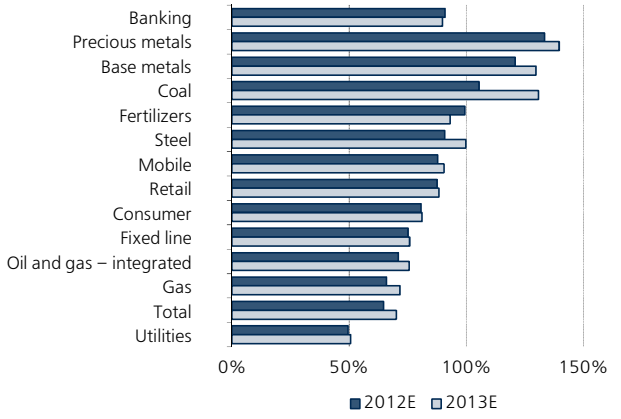
Source: Bloomberg, RTS

Global sector performance



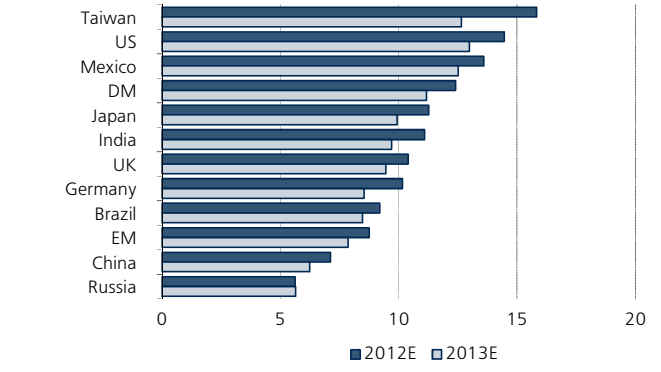
Source: Bloomberg

Russian sectors EV/EBITDA as % of GEM



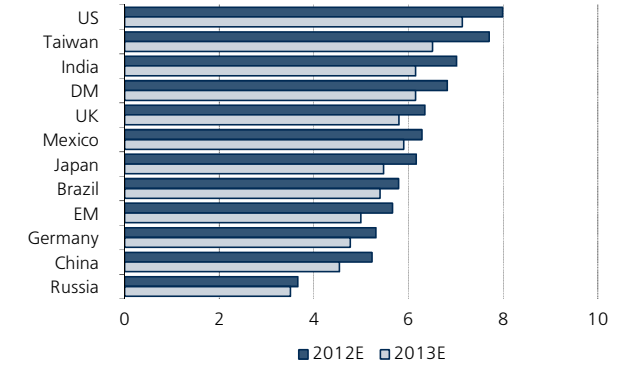
Source: Thomson, Troika

P/E



Source: Bloomberg

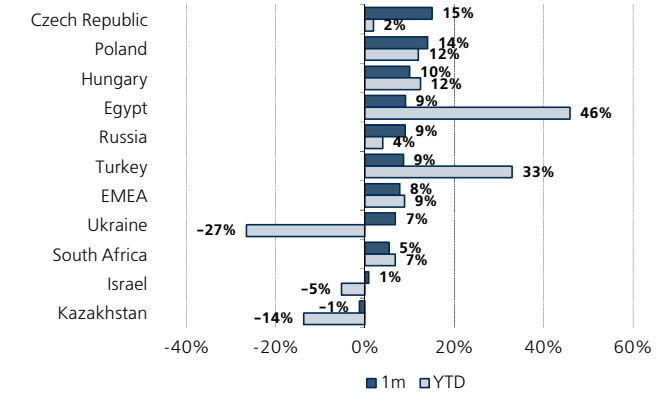
EV/EBITDA



Source: Bloomberg

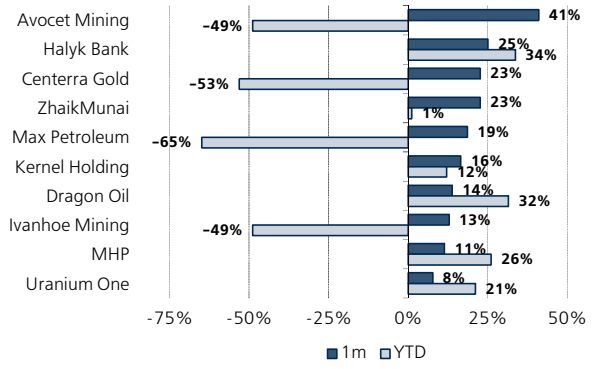
EMEA Watch: Russia CDS Spread is Still too High

EMEA country performance



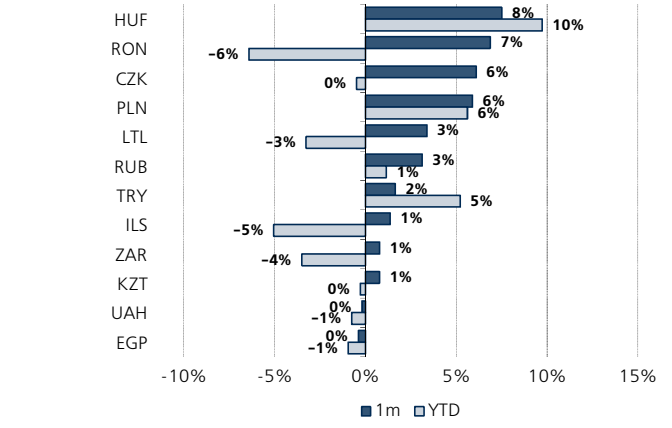
Source: Bloomberg

Performance of liquid stocks in CIS, m-o-m



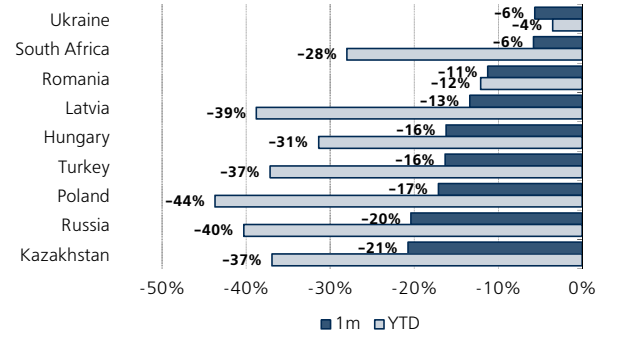
Source: Bloomberg

EMEA currency performance



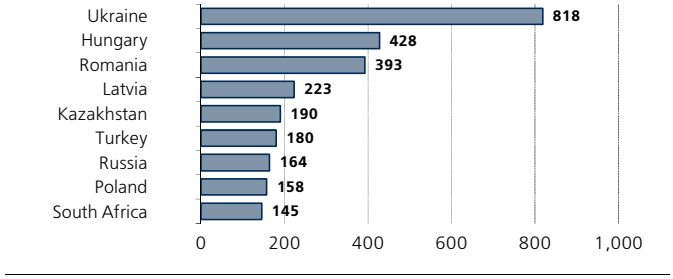
Source: Bloomberg

Five-year CDS trends by country



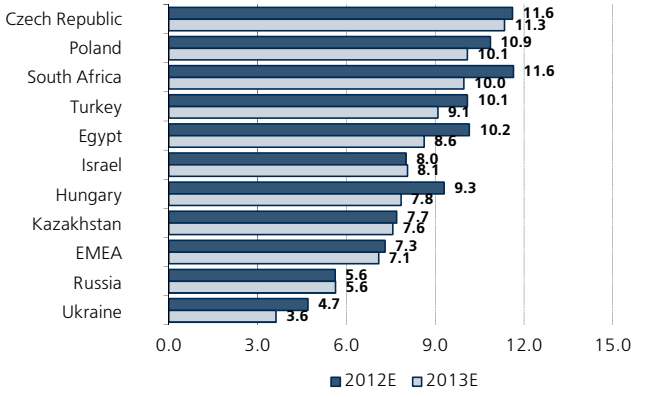
Source: Bloomberg

EMEA CDS levels



Source: Bloomberg

EMEA P/E ratios



Source: Thomson

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