Russian investment market outlook for 2013

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Russian Eurobond returns are likely to be less generous after the stellar 2012. We believe that this asset class already discounts the most favourable low-inflationary scenario and we see limited upside going forward. Local government bond yields are now close to historical lows. At the same time, corporate credit spreads have a scope for tightening.

The scenario-weighted upside for Russian equities is close to 50% according to our estimates. Dividends and share buy-backs remain key forces that should unlock fundamental value. Following a strong rally on the fixed income side, risk appetite will likely spread to equities. Technically, Russian equities should double in order to close the accumulated five year performance gap with fixed income.

Macro outlook

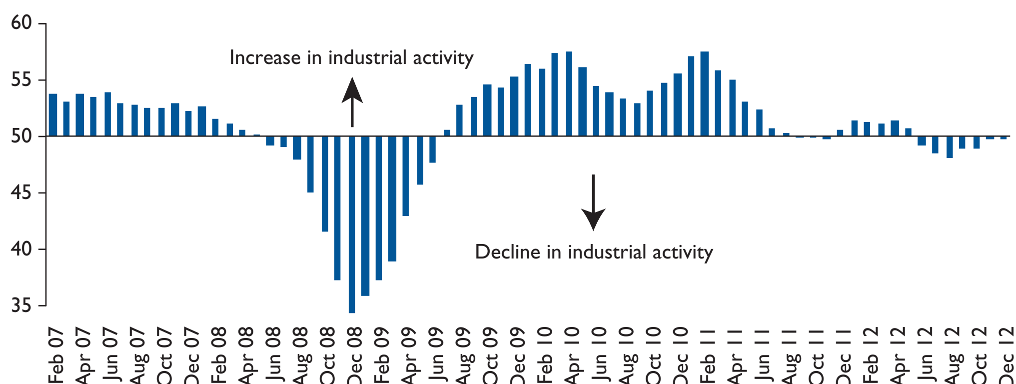
We believe the global economic cycle bottomed out in 2012 and has improved somewhat since then. The decline of the global manufacturing PMI has stopped and the gauge could move into positive territory soon. The G-10 Economic Surprise Index remains in an expansionary phase. Consensus expectations for global GDP growth and inflation show slightly negative revision momentum which will likely become positive in the near future.

Major central banks will likely continue to pursue accommodative monetary policies to support growth in 2013. G-3 central banks are expected to continue expanding their balance sheets at least through 1H13. QE measures have provided the real economy with positive momentum. PMI indexes and inflation expectations were "pumped up" after QE measures were announced in the fall of 2012. We believe that six-12 months following the announcements, inflation and industrial production will show positive momentum. In addition, inflation expectations in the US inched up after the Fed's QE announcements.

Russian GDP growth in 2013 could print 3-4% y-o-y should the oil price remain in the 100-115 US$/barrel range. Inflation in Russia is likely to be moderate, should the Russian central bank continue its current restrictive monetary policy. By 2015, inflation targeting will be fully adopted as a monetary policy framework, according to the 2013-15 Guidance on Monetary Policy of the Central Bank of Russia. Inflation targeting is likely to be accompanied by a fully free floating FX regime. We expect rouble volatility to increase as the CBR gradually moves towards a genuine free floating rouble. However, the Russian rouble is highly sensitive to oil prices and to the global economic cycle in general.

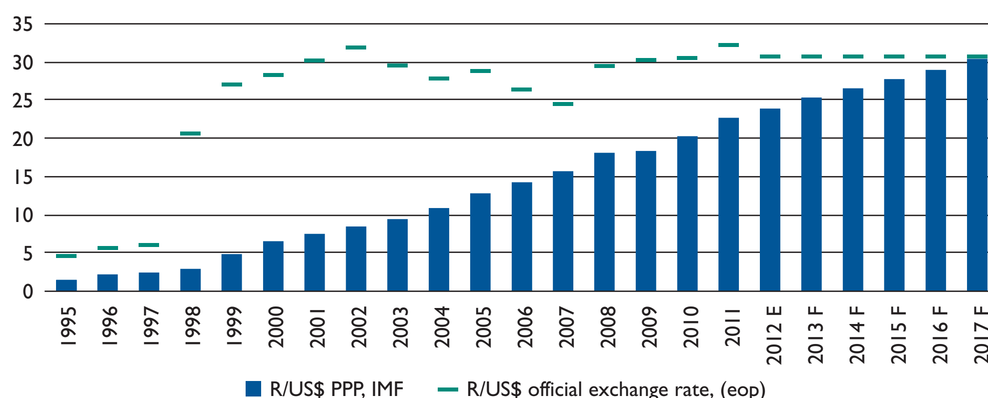
The rouble real exchange rate versus bi-currency basket (50% euro, 50% US dollar) is not far from

Figure 1: Global Manufacturing PMI



Source: Bloomberg, JP Morgan, VTBC IM research estimates

Figure 2: Russian rouble is modestly undervalued on a PPP basis



Source: IMF, CBR, VTBC IM research estimates

all-time highs. In the short term, the Russian rouble vs. US$ looks fairly valued given the US$110-115/bbl Brent price. In the long term, on a purchasing power parity (PPP) basis, the Russian rouble is modestly undervalued versus the US dollar. However, this gap should completely close by 2017 if we account for projected inflation differences in 2012-17.

Fixed income

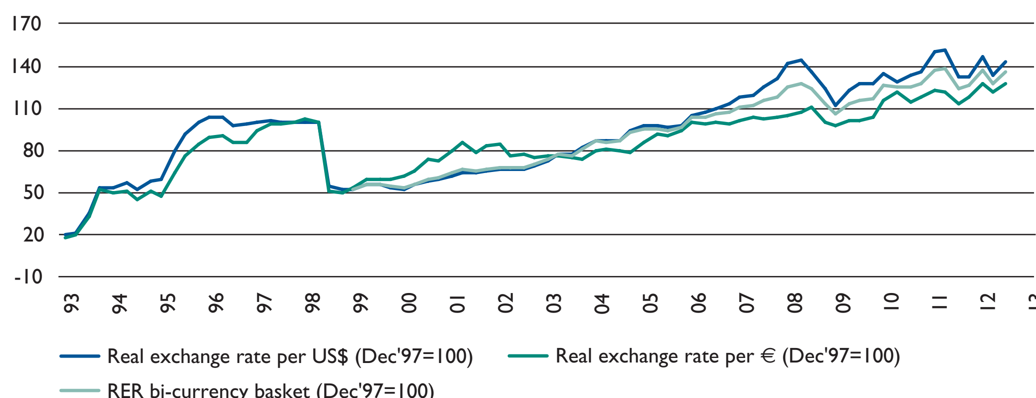
The pace of the domestic debt market liberalisation is set to be a crucial factor for investor returns on the local currency bond market in 2013. Euroclear and Clearstream have been officially approved to open nominal holder accounts with the Central Securities Depositary (CSD), which will be set up during the final stage of the reform. This could trigger up to US$40bn of fresh demand for Russian first tier issuers (present market size approximately US$100bn for sovereign and US$120bn for corporate segments). As a result, the OFZ curve has flattened and YTMs are near historical lows and long-term bonds are near fair value.

At the same time, corporate credit spreads have a considerable scope for tightening. Therefore, if inflation in 2013 remains subdued, we expect strong demand for corporate rouble bonds of solid credit quality. High-grade, non-financial corporate spreads appear undervalued relative to their fair levels.

The most attractive segment could be high-grade, long-term bonds. The Central Bank of Russia announced tightening of capital adequacy requirements for the national banking system. The latter could be implemented in 1H13 and impair the demand for high-yield issues from Russian banks.

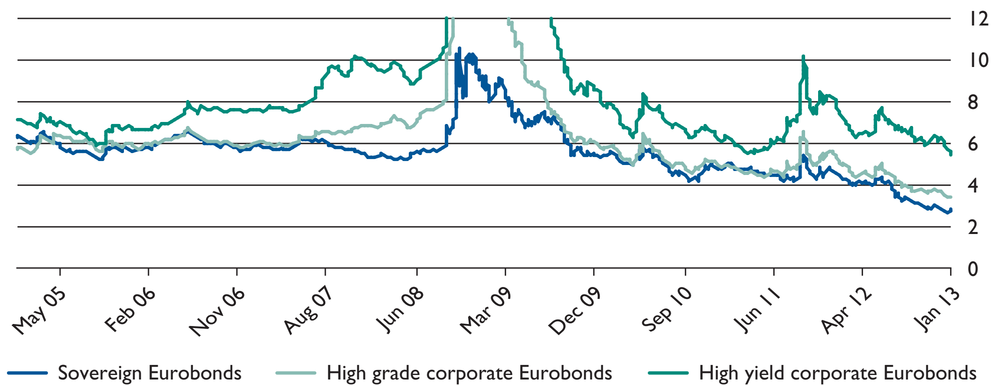
In the end, 2012 turned out to be a bumper year for the Russian Eurobond market. Spreads to UST narrowed by 180-300 bps depending on their quality bracket and total returns were 15-20% in US dollar terms. As a result, YTMs fell to new historic lows, which in our opinion fully prices in a relatively optimistic scenario. The rally in sovereign and high-grade corporate Eurobonds looks stretched. As for high-yield corporate Eurobonds, their spreads to USTs could decline in 2013 if risk appetite remains robust.

Figure 3: Real exchange rate is not far from all-time highs



Source: Bloomberg, VTBC IM research estimates

Figure 4: YTM on Russian Eurobonds, %



Source: Bloomberg, VTBC IM research estimates

Equities

Global uncertainty has forced investors to hoard defensive assets. In the current environment, most of these assets may result in a slow and certain wealth destruction process in real terms.

The strongly suppressed appetite for risk assets (especially, equities) appears to have leaded US fixed-income funds to hold around US$1 trillion of excess investments.

The resolution of the US "fiscal cliff" may be a starting point that will reverse flows in favour of equities, especially at emerging markets where perceived risks are more pronounced.

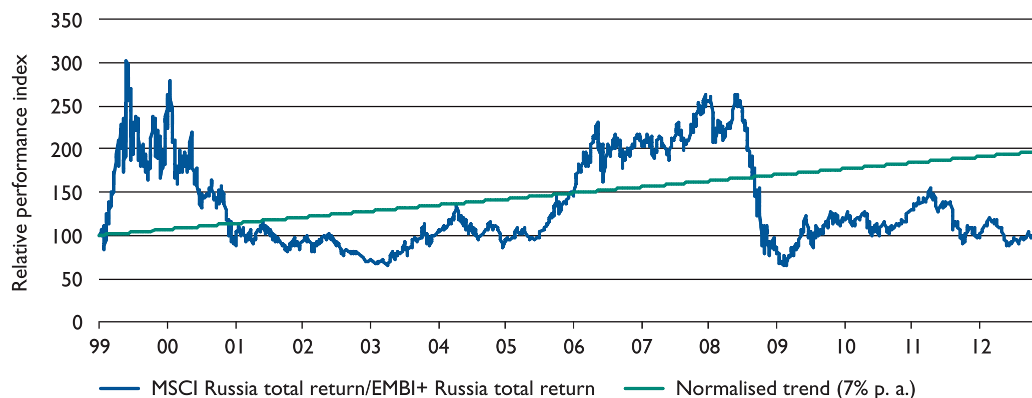
The last five years proved to be exceptionally favourable for fixed income investors and vastly disappointing for equity investors. Equities should double in order to compensate for the gap in relative performance, assuming that bond yields will remain flat. Public companies continue to perform equity buybacks, which reduces the amount of shares available for portfolio investors. For the first time in many years, the balance of cash distributions in favour of minority shareholders and equity issuance becomes significantly positive. The total amount of share buy-backs in Russia for 2012 totaled roughly US$10bn or -5% of market freefloat.

Russia's fixed income market capitalisation is now 2x larger than the equity market free float. Should investor preferences reverse at some point in the future, too much money will begin to chase too few assets.

We think that the downward EPS revision cycle for Russian stocks which has started in the middle of 2011 is over and the possibilities for positive surprises begin to outweigh potential disappointments. However, our 2013 EPS expectations for the RTS index are quite restrained, as the most heavily weighted sectors in the index (oil and gas, banks) have limited long-term growth potential from the current base.

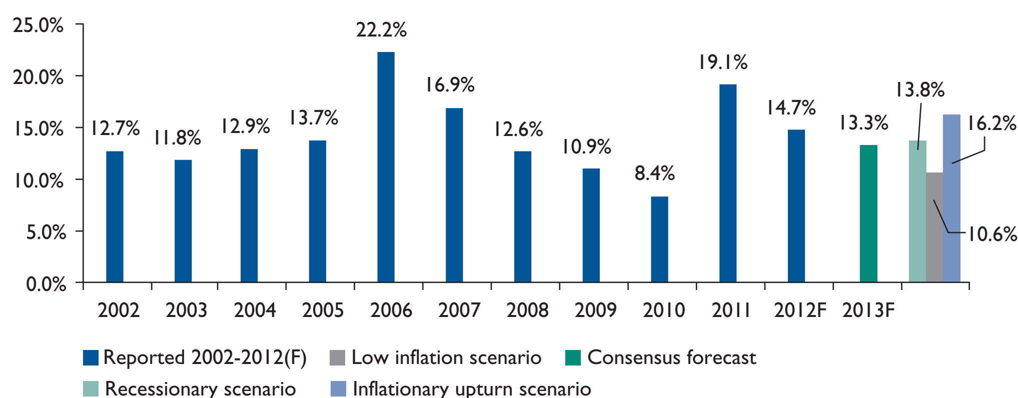
According to our estimates, the aggregate ROE for the RTS Index in 2013 will be: 16.2% in the global inflationary scenario (+20% vs. 2012), 13.8% in the low inflationary scenario (+4% vs. 2012), and 10.6% in the recessionary scenario (-20% vs. 2012). For comparison, our estimate of long-term

Figure 5: Russian equities total return/bonds total return



Source: Bloomberg, VTBC IM research estimates

Figure 6: RTS Index ROE



Source: Bloomberg, VTBC IM research estimates

sustainable ROE for the RTS Index is 15%, while the consensus expects 13.3% for 2013.

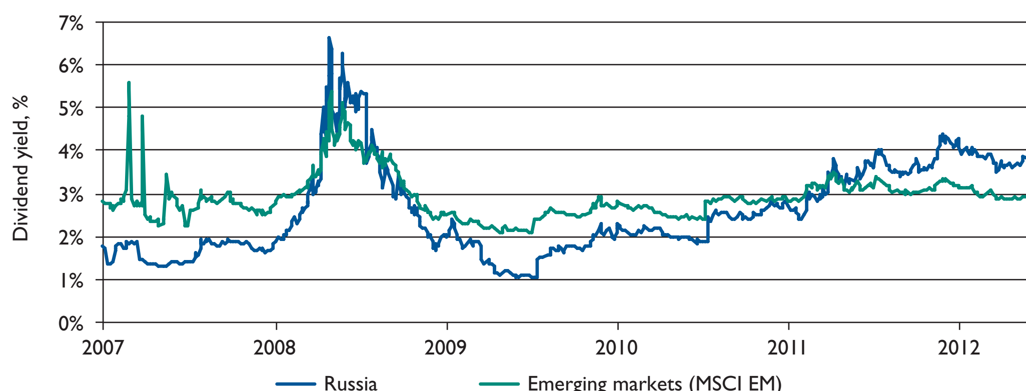
All key industry sectors now trade with significant discounts to historical average cycle-adjusted P/E ratios (i.e. ratios that use a long-term EPS trend in the denominator). Normalisation of sector ROEs toward long-term sustainable levels could provide a huge earnings boost for metals and mining as well as electric utilities. However, profitability in banking and retail names look vulnerable in the long term.

In a low interest rate environment, even under the assumption of zero long-term growth, a fair P/E multiple should be in the range of 8x-12x. According to our estimates the probability-weighted upside for the RTS index is 48%. Our target P/E ratio assumptions for Russian equities (RTS Index) range from 4.8x in a recessionary scenario to 10.5x in a low-inflationary scenario (most favorable for equities). We attribute a 20% probability to the recessionary scenario, 30% to the low-inflationary scenario and 50% to the inflationary upturn scenario. We expect Russia's P/E discount to emerging markets to narrow from the current -50% to 20-25%, which is justified given the sector structure of the Russian market.

The catalyst for a sustained re-rating of Russian equities should come from increased dividend payouts. Dividend yields for the broad market are -4%, making the payout ratio -20% – one of the lowest in the EM universe. In the past, Russian companies generated returns on equity in excess of 20%, so the -90% reinvestment of net income was justified. As growth matures and ROEs decline a rise in dividend payouts is a natural development. Over the next three-five years, Russian companies are likely to raise dividend payout ratios to 35-50% of net income.

We see financials, utilities and consumer staples (with the exception of retail) as potential outperformers. The outperformance of the oil and gas sector since the beginning of 2011 has made it considerably less attractive. The sector's relative value no longer warrants an overweight stance. Metals and mining names as well as mobile telecoms look less attractive considering their risk-reward tradeoff.

Figure 7: Russia now offers a dividend yield premium to emerging markets



Source: Bloomberg, VTBC IM research estimates

In addition, we believe that Russian small-cap stocks have lagged behind the large-cap names for too long. Their underperformance cycle has actually started in April 2011 (based on respective MSCI indices) and was in place at least till late 2012. During this period the sector suffered from a pronounced sell-off/de-rating with some market dislocations as a result. We believe the underperformance was mostly a function of general risk aversion and not a reflection of poor fundamentals. The small-cap theme is most likely worth revisiting now. The small-cap performance cycle as it unfolds in Russian equities universe can be described as follows:

- Recovery/bull market: P/E multiples expand. Small caps outperform.
- Mature bull market: P/E multiples flatten/start to contract. EPS expectations become stretched. Small-cap performance flattens/reverses.
- Bear market: P/E multiples contract. Small caps suffer badly during the sell-off.

We have already seen a remarkable recovery in quality large-cap names along with an expansion in multiples, which should be replicated by small-cap names in the near future.

The electric utilities sector particularly look like a deep value opportunity presently mispriced due to investor defensive positioning and high perceived risks. The relative performance chart for Russian electric utilities sector is at the bottom of historical range since the beginning of 1999. Political tensions have been detrimental for investor confidence.

Since early 2011, Russian utilities have been under regulatory pressure due to the presidential/parliamentary election campaigns of late 2011- early-2012. This pressure should abate in 2013. Consensus earnings expectations came down considerably (-10% to -50%) from the 2011 peak and now have scope for positive surprises coming from improved cost efficiency and better electricity pricing. Key valuation multiples are close to the bottom of their historical ranges and are 40-70% lower compared to international peers.

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