



Nikitsky Fund

Bullish – On the Bear!

ERIC KRAUS
Krausmoscow@yahoo.com

STRATEGY

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Truth and Beauty

(... and Russian Finance)

Flash Note

Eleven Reasons to Buy Russia

(though not necessarily today)

1. Russia has not had a single debt-funded LBO. Zero. None.
2. Russia does not have a single sub-prime mortgage bond. Russian banks continue their old-fashioned practices such as investigating borrower's declared earnings and requiring down-payments of at least 20%. Though there has been some risky consumer lending, it is covered by the outrageous spreads they charge (above 50%!)
3. Russia has an insignificant trade relationship with the US, and is not exposed to the US consumer in any meaningful way. It is substantially exposed to the Asian economies which (so far) have shown no signs of slowing on US economic concerns.
4. While a number of emerging currencies have plunged, the rouble is holding rock solid. Current turbulence relieves some of the pressure on the Russian Central Bank which has been struggling to hold the rouble down, but the fundamental drivers for rouble appreciation are unchanged.
5. Russia enjoys enormous trade and budget surpluses, and can thus survive quite nicely without sovereign borrowing.
6. Russian IPOs will most likely be on hold for a while...**and thank God, for it!** The excessive and egregiously-mispriced IPO pipeline was one of the major factors pushing the market down.
7. Against a background of absolute carnage in the high-yield markets, Russian fixed income is holding remarkably strong – markets are differentiating between deeply impaired credits in the high-yield and structured finance universe, and fundamentally strong ones such as Russia.
8. Oil prices hit (yet another) a historic high in the US today...Commodity prices are all over the place, but generally remain surprisingly strong, despite the US housing implosion.

9. While it would be a challenge to get off a substantial Russian corporate dollar bond issue in this environment, we are not aware of any major Russian company with a pressing need to raise international finance. Mostly, they can afford to wait. Certainly, the Sovereign has no conceivable need to raise debt finance.
10. It remains our view that the Fed will be forced to lower rates – sooner rather than later - and while credit spreads will undoubtedly widen further in the near term, in the medium term, we would expect considerable liquidity to flow back into the market.
11. The Russian equity index missed the global emerging markets rally of the first half of 2007, underperforming the asset class quite substantially. It thus has far less to fall. Valuations are cheap by almost any criterion – only a small fraction of those for its main peers - India and China.
(and, a bonus point)
12. Russia is the only country on earth to be an unambiguous beneficiary of global warming!

Caveats:

As we all know, in a crisis, correlations initially go to **one**, as people sell not what they should sell, but what they can sell (i.e. catching falling kitchen utensils in this environment is a very risky undertaking.) The wild volatility in global financial markets currently renders short-term predictions unduly hazardous.

It should, however, be borne in mind that in the aftermath of financial crises, investors quickly begin to seek out any babies which may have been inadvertently pitched out with the bathwater – i.e. the better quality assets invariably float back up to the surface.

Given that the short-term trading activity of the dominant Russian proprietary books is notoriously difficult to predict, the market is likely to whipsaw over the coming days. If the global carnage continues, Russian blue chips will inevitably show further damage. That said, bear in mind that the current volatility has nothing whatsoever to do with Russian fundamentals.

Thus, with the proviso that the current global turbulence does not develop into a global economic (as opposed to a financial) meltdown – in which case all bets are off – episodes of market contagion tend to be nasty but short-lived, and are accompanied by extraordinary opportunities to acquire undervalued assets. Perhaps some shelter will be afforded by the second-tier equities which trade less on global liquidity flows, more on their fundamentals.

Discussion:

After discussion with one of our colleagues, we are cautioned about the substantial foreign borrowings by the Russian corporate sector. In response, we would note that these borrowings are generally several times covered by EBITDA, and are medium/long term, i.e. do not require rapid roll-over. Furthermore, liquidity in the local market remains excellent (at least, in relative terms) and companies are increasingly funding themselves domestically, in roubles.

We are also challenged as regards point 1. Yes, leverage has been used in Russia, including to finance consolidation of corporate ownership, but this has not been of the US/European variant, i.e. leverage the company up 25 times, then sell the shares and run like hell. Share valuations are cheap, and finance has been very conservative.

While there will certainly be less easy money on offer, we are not convinced that this is necessarily a bad thing for Russia; the last thing we wish to see is the country becoming over-leveraged.

While a few of the international banks are going to be left holding some bridge loans rather longer than they had expected, with due respects, that is their problem – not the problem of Rosneft at all. Indeed, were, say, Rosneft be seriously squeezed for finance, no prizes for guessing who would come riding to its aid (hint: its main owner – the Russian State – is currently sitting on something in the range of a half-trillion dollars in reserves).

Of course, in the nightmare scenario: the US melts down, causing both China and India to go into recession, thus driving down global commodity prices and economic activity – Russia would suffer; so too would virtually every other financial market. Canned food, fire-arms, and perhaps land in New Zealand would then become the preferred asset classes.

Thus far, we have not seen any indication that any of this is happening, indeed, the global economy is growing above trend, and we do not believe that either the US or “Chindia” are threatened with economic extinction.

Conclusions

The US consumer will no longer provide the major global growth driver, and the hypothesis that Asian growth has become self-sustaining will now be tested.

Provided that one does not believe that a sudden collapse in the Asian/BRICs story is at hand, Russia's fundamentals remain rock-solid. While she is far less exposed to the spreading global credit crisis than are the G7 markets, there is and will continue to be a short-term contagion effect from falling global equity markets.

Despite some obvious weaknesses on the microeconomic front, Russian equities remain unjustifiably cheap to their fundamentals, and we thus far see no signs of any substantial disruption of economic growth in the major emerging markets – *a fortiori* Russia.

While we are cautious by nature, and expect substantial volatility over the coming days, equally, we believe that some truly compelling buying opportunities are opening up.

Those investors not sharing our constructive view on the equity market may wish to consider the purchase of Russian Rouble corporate bonds, one of the precious-few asset classes to have emerged unscathed from the current train-wreck.

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Like cats and horses, markets – whether emerging or emerged, are apt to do as they damned-well choose, and a considerable measure of luck is required to come out in one piece. Exercise caution in all things. Good Luck!