



**Your First Call...
For the Second Tier!**

Truth and Beauty... (and Russian Finance)

Slouching toward Lisboa (...to be born)

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Global Finance

LIVE CAT/DEAD CAT, SO LONG AS IT CHASES MICE...

As of this writing, equity markets are showing a powerful bounce; the 4-day rally in the US is reportedly the strongest since 1933, while the European indices are up dramatically. Whether this bounce is of what our friend Christopher Wood refers to as “of the expired feline variety” remains to be seen. Markets, of course, never drop in a straight line, and having thought a bear market correction was overdue for some time now (the DAX had fallen by precisely 50%, i.e. to the major Fibonacci point), we are strongly inclined to believe that the crash is not over. We would be seriously tempted to short a couple of European index futures whenever the current bounce runs out of steam (or out of Friskies?).

To further mix our metaphors, each week brings the hoof beats a bit closer. The German banking sector is suddenly looking distinctly yellow – as in, “going Japanese.” Commerzbank in trouble does not bode well for the sector. The **Japanese** banking system we try not to even think about. “*Walking dead*” seems too kind – we have not seen it walk recently. It is dead meat and sooner or later it is going to be nationalized. Another ratings downgrade is probably in the cards; T&B thinks this misguided (except, perhaps, as a prod to the Japanese to undertake reform) since, from a macro perspective, sooner or later Japan Inc. will find itself faced with precisely two alternatives: either default, or devalue, monetizing their huge debt load. We think it fairly obvious that they will elect for the second. Despite low dollar rates, the carry trade, i.e. short Yen to buy high-yielding debt (e.g. Russian Eurobonds) is looking compelling.

US Consumer spending is beginning to follow consumer confidence down the rat hole. Hardly a surprise! Profits of US companies have been coming in quite decent, and the market now rallies when earnings expectations are met (as opposed to beaten). Nevertheless, the underlying

theme remains the same. The market is expensive. It will not stay that way forever. The future is now. Sorry. T&B would not be surprised to see the current bounce continue a ways further, suckering in a few more innocents. We think that the posse will be waiting to short it, heading it off at the first Fibonacci point.

A trillion here, a trillion there... (continued)

The issue of underfunded pension liabilities is beginning to rear its ugly head. Merrill's estimates that 98% of S&P 500 companies with defined benefit plans will be underfunded by Q4 2002. The total underfunding is estimated at a cool 2/3 of a trillion dollars; GM alone is estimated to have a gap of almost \$100 bn. To get a sense of the trend, note that these same companies were overfunded by \$500 M in Q4 2001. It is estimated that total off-balance sheet liabilities (including retirement) will increase to 27% of book, i.e. \$592 bn by year-end. Debt-to-equity measures will thus have increasingly limited relevance.

The trap was set by bull-market assumptions regarding expected yield on retirement fund assets. These proved helpful during the bull market, allowing companies to reduce spending on pension liabilities, sometimes even writing back portfolio revaluation to the P/L. These same assumptions, of course, now seem a trifle optimistic after three years of net negative returns. Furthermore, the problem is being aggravated by declining treasury rates, simultaneously decreasing the yield on the fixed-income segment of portfolios while increasing the NPV of future liabilities.

Given our morbid interest in self-reinforcing phenomena, we would note in passing that, if the market were to take fright at these numbers, equity prices could fall further, pressuring the Fed to again decrease rates. Of course, falling equity prices and declining treasury yields would aggravate the problem, further driving down earnings and thus valuations. In a first phase, we expect that 2003 profits will be impacted, as companies are compelled to increase their

cash contributions to their funds. If this does not suffice, first liquidity, then solvency issues, may surface.

Errata: Fannie Mae, come home

One of our readers has kindly pointed out to us that the funding gap at Fannie Mae is down to 10 months. We stand corrected. Some of this rebalancing may have been accomplished by the purchase of 10-year treasuries, however there are reports that, given the accelerating pace of mortgage refinancing, some has involved diversification of risk into other high-yielding instruments. These non-mortgage instruments are high-yielding for a reason, representing a fundamental diversification out of the agencies' home sector. If we are correct, given the current economic environment, this would introduce a major new risk factor.

Investment conclusions

The quandary of where to put one's money remains. We thank Barton Biggs (whose overall conclusions on US equities are at a sharp variance with our own) for pointing out that gold and silver prices can form bubbles too; indeed, price behavior in this situation was strikingly similar to that of both the NASDAQ and the Nikkei. Bubbles rarely form where you expect them. For now, we will stick with tradable instruments: Russian debt (where we would perhaps supplement our beloved Rf28s and 30s with some ruble-denominated instruments) and selected Russian equities, while keeping some cash to buy selected Asian markets when the bear relents.

Emerging markets

LAST SAMBA IN RIO?

Long-term readers will remember our repeated predictions of death and devastation in Argentina, long before it became the accepted wisdom amongst our bulge-bracket peers. Now, despite the odd moment of panic and the mockery of some of our peers, we are not quite ready to throw in the towel on Brazil. It COULD tank, it very

well MAY tank, but we are not convinced that a collapse is inevitable, at least in the near-term.

In the longer term, we believe that a restructuring of domestic debt, and possibly a relatively benign reprofiling of foreign debt (i.e. extension of maturities) may be necessary, yet even in our worst-case scenario, **we would exclude the possibility of an Argentina-type collapse.**

As Brazil struggles to roll maturing local debt, we think that the market is focusing on the wrong question. We agree with BVA Chief Economist Alexandre Schwartzman who argues that, unlike the situation in Argentina, financial markets cannot impose a default upon Brazil. Despite the dollar-indexation of much of the internal debt, the settlement currency remains Brazilian Reals; in theory at least, the roll-over could thus be sustained indefinitely by the simple expedient of monetization.

The problem with this approach is that, while the resulting monetary creation could be partially sterilized by overnight roll-overs, the ineluctable consequence would be a rise in inflation; if the overnight rate were lowered so as to reduce the nominal debt build-up, this would be more inflationary still. Whether or not this would turn into a catastrophic inflationary spiral remains an open question. The Brazilian central bank has just raised interest rates by 3% to 21%; despite a disingenuous statement claiming that they were targeting inflation, not the exchange rate, we think the hike was obviously aimed at supporting the Real; in a recession-stricken economy with a headline inflation rate of only 5.6%, real interest rates of 15% are simply not sustainable.

The Russian debt crisis of 1998 made its own unique contribution to economics by laying to rest the myth that countries need never default on their internal debt, since they "can always print more money." The Russian economy failed to go into a catastrophic inflationary spiral following the devaluation due solely to Russia's simultaneous default on its local currency debt, the notorious GKOs.

T&B believes that the fundamental question

is political: Given the real debt/GDP ratio revealed by the devaluation, as well as the impossibility of refinancing maturing debt in international markets, although Brazil could theoretically tighten its belt sufficiently to stabilize the debt ratio, we see no realistic prospect of their substantially decreasing it. The question of whether the Brazilian body politic will durably accept a situation wherein the entire function of the economy is to service international creditors is a question likely to receive much attention in the coming weeks and months.

If your memory serves you well...

From the historic perspective, we note that, while virtually none of the factors advanced to render Argentina culpable of her own undoing are operant in Brazil, and there is no currency peg, the contours of the debt crisis are broadly similar. T&B believes that the ravens of currency overvaluation hatched early in the Real plan are only now coming home to roost. If so, we are confronted with a situation eerily reminiscent of virtually every major emerging markets crisis of the past decade: once again, advice by the IMF and adherence to the then-current economic orthodoxy have created a basis for disaster: overvaluation of the currency in an attempt to strangle inflation inexorably leads to the creation of an inherently unstable debt-pyramid.

Having lived through crashes in inter alia Thailand, Russia and Argentina we had sincerely hoped that we would never need return to this theme again. Alas, it was not to be. In every case, currency overvaluation in developing countries creates unbearable moral hazard while distorting the major debt indicators. Local institutions borrow cheap dollars in order to purchase high-yielding assets in Rubles, Baht, Reals, Pesos or whatever. They do so with an implicit guarantee from their own central bank that the currency will remain stable and convertible – i.e. it becomes a “risk-free” trade, the size of which is limited only by their capacity to borrow – yet another Magic Money Machine! In parallel, deluded by a falsely reassuring debt-to-GDP ratio based upon a whimsical exchange rate, foreigners rush to lend, buying up the increasingly high-yielding dollar debt. In the meantime,

as the termites gnaw at the foundations of the financial system, the industrial fabric crumbles, as manufacturers are increasingly priced out of export and domestic markets alike. Excepting the special case of the Eastern European convergence economies, countries which could never be properly described as “developing”, the above is a sure-fire recipe for disaster.

Some like it cold...

Many of the financial crashes of the past decade were blamed upon “hot money,” i.e. capital which rushed in to take advantage of high short-term rates, then flooded back out at the first sign of trouble. In fact, this is something of an epiphenomenon. In the Mexican and Russian crises, it was local money which fled first. In Brazil, domestic investors are by far the biggest players in the local currency markets, and the country has benefited from huge inflows of FDI, supposedly far “healthier” than hot money (since fixed assets cannot readily flow back out at the first hint of crisis). Nevertheless, from the macroeconomic standpoint, since this capital account item is used to balance a gaping current account deficit, the end result is very much the same. Like a junkie living for his next fix, once a developing country becomes dependent upon foreign inflows to balance what has become a structural current account deficit, it gives hostages to fate: with even a minor shift in perceptions the drip-line is severed, leading to an acute withdrawal syndrome. When, as in the case of Brazil, the current account deficit is entirely attributable to debt service, the outlook is not cheerful.

In summary, we believe that Brazil may well survive the current bout of volatility but that a subsequent restructuring of domestic debt, and possibly, a reprofiling of foreign debt remain very likely. Nevertheless, T&B believes that the market has priced in an unjustified default premium, and that risk-tolerant investors could take some exposure to the foreign currency debt, buying either the cheapest instruments (DCBs, NM 92, etc) for default protection, or those with the longest duration (40s) for greatest potential upside.

TANGO OR SAMBA: DOES RUSSIA REALLY CARE?

Superficially, as concerns Russia, the decorrelation with Latin American markets is becoming pretty much total. Recent years have shown that, sufficiently well anticipated, the cross-border impact of financial shocks can be muted; witness the lack of short-term contagion from the Argentine meltdown. As the C-bond thrashes about like a pressurized garden hose, Rf 30s trade up within a narrow range. Indeed, the turmoil in Brazil may now actually be benefiting Russian bonds, the beneficiaries of a flight-to-quality among emerging market investors. Similarly, as many dedicated investors have already written off the Latam markets, events in Brazil no longer drive market action in New York. Although this turbulence has probably driven many cross-over investors out of the asset class entirely, Russian bonds benefit from sufficient domestic demand to thrive in their absence.

The global systemic impact of a Brazilian crisis could be severe. Given Brazil's size and economic weight, it would almost undoubtedly involve the entire continent. US and European banks have problems enough without having to write down their entire Latin American loan books, which run into the hundreds of billions. A Latam meltdown would have a substantial impact upon US economic activity, leading to a further decrease in US exports and a deterioration in the already-dire US balance of trade.

Flight to quality:

One of our readers has challenged our reference to Russia as increasingly becoming a "safe-haven credit". We agree that the idea takes getting used to, but, forget the Philippines, Peru and the other exotics. We note that the 10-year notes of Ford Motor Company are now yielding 10.01%, i.e. 585 basis points over treasuries. For the same duration, Russia is paying an interpolated yield of approximately 460 over, i.e. 125 points inside of Ford!

All Things Russian

FINANCE

Trading Ideas: Debt

Follow up – Russia: Straddling the Latam rift

The "covered" straddle trade discussed last time has worked out rather sooner than expected, as the Rf30s have shifted up to a new range on the back of Moody's upgrade of Russia's outlook. We had expected a further rally, but only after the second round of the Brazilian election. Apparently, the current rally in the capital markets is triggering a feeding frenzy. We would ride this one up, then think about selling short duration calls when it runs out of steam. Although we remain net sellers of the vol, it is becoming too cheap – 60 day ATM Rf30 calls were quoted yesterday at \$1.20. We currently like the cash, and would feel safe with a relatively high degree of leverage. Our switch out of Ukraine into Russia is giving joy. The Nigeria P/N trade off a few points given the utter confusion in the Nigerian government's public pronouncements. Although they may eventually restructure, at 24, think the P/Ns are cheap. Our Air Canada 5 s SF perpetuals

trade is winging along nicely.

Equities and inequities

In brief, price action on TNK continues to disappoint; their share swap with Sibneft values the company well below the expected \$5bn. This is compensated for by our Megioneftegaz call, which has gone ballistic, and Tatneft, which continues to rock 'n' roll! There is nothing particularly new on the Slavneft privatization, but expect it to provide much news in coming weeks. UES shares should be seen as an option; we loved them at 8, are neutral at 10, and would

want out at 12. For Mosenergo T&B continues to have difficulty finding ANY level at which we would want in. Luzhkov thinks it's his!

Rostelecom we continue to like, especially the Prefs. Norilsk we would look for a bounce above 20 to bail out. Sberbank should continue to grind inexorably higher. Surgut has provided some good fun: silly even by local standards, Russia's unreconstructed oil major surged on mad rumours that the government had agreed to rig the Slavneft auction in Surgut's favor. Investors were reportedly buying, not because they believed the rumour, but because they thought that everyone else did!

Surgut is becoming Russia's cheapest oil major, and *intentional* long-term investors (i.e. not the class of investors who bought beauties like Kazan Helicopter in 1996...) may want a piece. For them, we would clearly favor the Prefs. The new law on corporate accountancy may well force Surgut to pay a fair dividend at last. If so, they will almost undoubtedly convert the Prefs to Ords. Given the 75% approval of Pref holders required, this should be a 1:1 conversion. Our preferred oils remain "Yukneft" (the successors to "Lukgut"). Finally, we agree with Reny: the concern with Gazprom solvency is overdone; we think it cheap below one dollar.

(Please note: Sovlink has corporate finance or other relations with TNK, Gazprom and Sberbank)

POLITICS

Towards l'apres Putin?

Vladimir Putin has maintained an amazing popularity rating with broad approval ratings; combined "Good" and "Satisfactory" run to 85%. Bear in mind that this is Russia, a country not known for its love for politicians. Except at the beginning of their terms, his two predecessors rarely saw their rating rise into the double digits! The polls similarly demonstrate the total absence of any real competition. The runner-up is Zyuganov, whom, despite a relatively strong rating of his party ahead of the Duma elections, is seeing his personal rating slowly decay, from ~15% at this time last year, to just above 10% now.

Although we hear occasional stories about "The Oligarchs" threatening to come together to select a credible competitor to

Putin' it in perspective: Happy Birthday, Vladimir!

Much has been made of the adulation showered upon President Putin on the occasion of his 50th birthday. Always delighted to find some excuse to warn of the return of Stalinism, foreign pundits pounced upon the lavish gifts, public praise, and the flood of letters and cards. The fact that adults' birthdays are a major event in Russian society, and that Putin himself seemed embarrassed and faintly irritated by what appears to have been an initiative of overzealous underlings, donating all gifts to the State Museum, was conveniently overlooked. Putin himself ignored the whole thing, spending his birthday out of Russia at some CIS meeting. Too bad...T&B sent a card, too!

Putin, with Berezovsky safely out of the way (even *Liberal Russia*, a party he created with his own gnarly hands, has just voted to expel him, after his desperate, humiliating overtures to the Communist Party) we think none of them quite mad enough to try. Abramovich, anointed by the pundits as the new capo di capi and Putin's supposed favorite, appears to have suffered a stinging defeat in the Presidential Administration's response to the attempted manipulation of results of the Krasnoyarsk elections (*vide infra*). Similarly, the reported "*fronde*" in the military and the conservative elements within the security services could be a drag on policy-

making, but, given Putin's overwhelming popularity, will likely remain barren. Baring "acts of God" we currently see no threat to Putin's reelection.

The vital question is to what extent Putin can transform his personal support into a political organization capable of winning the upcoming parliamentary elections, returning a compliant Duma.

This issue is both trickier, and more substantial – given considerations of space and timing (i.e. this is supposed to be strategy, not history...) we will return to the issue of whether a Presidential Party which is something other than an opportunistic political “*Krishna*” can be built, and how to neuter the Communist Party, in our next issue.

Heavy Metal in Krasnoyarsk

For anyone still subscribing to the “Russia never changes” school of thought, the outcome of the Krasnoyarsk elections must be yet another bitter disappointment. It all started out so well. The two largest employers in the Krasnoyarsk region are Norilsk Nickel and Russiskye Aluminum (RusAl). RusAl has a wondrously friendly tax deal, whereby they contribute some 7% of the regional budget, vs. 52% for Norilsk, a substantially less-profitable company.

Alexander Uss, a shady character backed by even shadier local interests, many of which are associated with the aluminum industry (among others, the notorious Bykov), was defeated in the second round by the former CEO of Norilsk Nickel, Taimyr governor Alexander Khloponin. Khloponin was strongly backed not only by the Kremlin but – given the alternative – by even the candidate of the Communist Party, the thoroughly decent Glaziev (who was eliminated in the first round voting.) Apparently shocked by the results, and furious that someone should try to take away “their” region, the aluminum barons put in some fairly pressing calls to the local bureaucracy, which took serious fright. Within hours, the local election commission had been prevailed upon to annul the election on the basis of numerous minor irregularities, almost all of which had been committed against the winner of the election, Alexander Khloponin.

Moscow was outraged. A court promptly overturned the election committee, which

then appealed, setting the stage for a protracted battle through the judicial system. In the “good old days” this would have led to secret negotiations, possibly punctuated by gunfire, certainly by horse-trading, culminating in a deal whereby everyone got a slice of pork, and a compromise candidate was parachuted in. In fact, furious at the attempts of the regional oligarchy to steal the elections, Putin promptly cut the Gordian knot, naming Khloponin acting governor; it is expected that the “acting” will quickly fall away, as the courts reject the outlandish challenge, and a few culpable bureaucrats set out on new careers (in the aluminum industry, perhaps?)

As an interesting footnote, the widespread belief that RusAl’s Roman Abramovich is Putin’s pet oligarch, and has been selected to fund his reelection campaign, sits rather poorly this story.

ECONOMY – STILL SOLVENT, AFTER ALL THESE YEARS

Slouching toward Lisbon (and the magic of exchange rates)

A great deal of outright nonsense has been written regarding Putin’s stated desire for Russia to overtake Portugal in terms of per-capita GDP. Several commentators have suggested that, with Russian GDP only some 20% that of Portugal (per capita GDP \$10,500, vs. \$2,100 for Russia), even were she to grow at a fiery 8% per annum, (a tough hurdle, if you don’t happen to be Chinese) Magellan would have come sailing back around the far end of the globe, and your great grandchildren would be worried about their unfunded pension liabilities, before the gap closed.

The problem is that, valuing output in terms of PPP (price purchasing parity) yields vastly different numbers. Much as the Russian economy “shrank” by about 2/3 in dollar terms following the devaluation, and Brazil has very recently accomplished this same miracle (with a devastating effect on its debt/GDP ratio) the nominal value of an economy is a linear function of the currency in which one chooses to express it. Since, in fact, an economy should be valued in terms

of the wealth it generates for its own citizens, PPP is the only rational criterion. The most recent available PPP numbers date back to the end of 2000, at which time (expressed as a percentage of the US level, arbitrarily set at 100) Portugal came in at 49.8, vs. 23.5 for Russia. Given the rapid increase in Russian per capita income since that time, we would estimate that the corresponding numbers for end-2002 should be 49.8 vs. 30. This is still a long stretch, but nothing that could not be bridgeable within a decade or so, especially given the fundamental problems within the European economic block. We only wish we could look forward to a similar convergence of climates!

RUSSIA RESTRUCTURES

Phase shifts: Russia changes gears

Continuing with a theme we first broached in October 2000 in our report “...but, Can She Dance?” (available upon request) we note that the Russian bear has convincingly demonstrated that she can walk, developing an “improved African-model” economy – i.e. a functional but primitive mineral export-based economy, but graced with sustainable macros as well as a semi-adequate mechanism for the redistribution of wealth to the populace. Since that time, we have seen great progress in the migration of the Russian economy towards a consumer and services-driven model. This predicted migration is still in the early stages, however there is sufficient evidence for it not to be taken as merely a twinkle in the eye of a Russophile strategist: it is gradually becoming a reality.

We believe that 2002 marked the end of the recovery phase (in which relatively simple measures aimed at broad-brush rationalization yielded major increases in output and wealth) to a more advanced model, but where further statistical gains will be hard won.

Despite the widespread view that Russia exports oil, and imports everything else, in fact, Russia now produces a surprising range of consumer goods, notably very good refrigerators (Stinol), very competitive computers and good televisions – though

unfortunately, many of the high-tech components (chips, picture tubes, etc.) are still imported. In terms of foodstuffs and consumer consumables, the shift toward domestic production is virtually complete. A few years ago, television advertising for consumer non-durables was overwhelmingly for foreign brands. Now, a good 75% is for local brands (albeit, some of which are controlled by foreign multinationals), while a large proportion of foreign-branded consumer goods are now actually produced in Russia.

A digression: Waiter, More Caveats!

...or, you can take the society out of the Soviet Union...but can you take the Soviet Union out of the society?

Despite our aggressively bullish stance, we have repeatedly warned of three major failings of Russian reform: agriculture, banking and “new motors for growth”, i.e. small businesses and FDI. There has been great (and frankly unexpected) progress in agriculture, substantial reforms are at last underway in banking, but where is the third? Is it as bad as generally believed? If so, we believe that the prime impediment may be not the corrupt judicial system, the predatory bureaucracy or the bankless economy, but rather, a vestigial mentality left over from the days of the USSR. Any Westerner who has worked in a Russian institution, could tell tales to make your hair curl! T&B’s experience at our previous home, NIKoil, did much to enlighten us as to the dysfunctionalities of many Russian corporate structures:

The Soviet Union was characterized by an extreme formalism. As the early revolutionary enthusiasm drained away, what remained was a complex system where survival itself was not always a given. People learned to comply with outward forms and procedures, giving little attention to their ultimate purpose or function. Authority was not to be questioned, and outward signs of obeisance were prized above all else. It was vital to get to work on time, accomplish allotted tasks, while making no obvious mistakes. Organizations were extremely hierarchical and

communication strictly top-down. Not only was the taking of initiatives to better the operation of the system not encouraged, it carried substantial risk. Similarly, there was an overwhelming motivation not to assume responsibility. To independently take decisions offered very limited upside, but sometimes-terrifying downside. One result of this was a tendency to dilute responsibility by relegating it to committees, commissions, etc.

This mentality is slow to change. In our experience, many Russian institutions faithfully reproduce the Soviet pattern: The boss (especially when he is the major shareholder) is God; he tends to surround himself with courtiers and sycophants, chosen not for their competence but for their total loyalty and adulation. Enormous energy is expended on infighting and intrigue, neglecting attempts to actually add value. Executives managing profit centers frequently find themselves in a relationship of inferiority vis-a-vis those managing support and administrative functions within their institutions analogous to that of the consumer in Soviet society. Consumers were in a position of perpetual inferiority vis-a-vis the producers; while he held arbitrary and somewhat useless currency, the producer controlled scarce, vital goods. In retail trade, there was no reward for the seller to increase his turnover, since the supply of goods was anyway limited while demand was, for all intents, unlimited. More broadly, the citizen served the state. Similarly, in "Soviet-style" organizations, the requirements of the organization itself take absolute priority over its supposed finality; the needs of the "customers" (clients, public service users, citizens, etc) are of very secondary importance.

These organizations thus tend to be characterized by support departments developing their own (infernal) logic whereby their formal function, set by supposedly immutable rules, is seen as more important than facilitating the tasks of those interfacing with the outside world. While this may also be a problem in companies in more developed economies, it can reach truly Kafkaesque proportions in some Russian businesses.

The oft-repeated complaint about the dearth of middle managers in Russia may thus have its roots in this problem. People who function with a Soviet mentality cannot be expected to reform their organizations, while Russians coming home from abroad after working in more Western-style organizations often encounter serious problems fitting back in, and are frequently rejected by their peers. It is NOT, as often thought, purely a generational issue; work practices and attitudes are easily handed down over generations, indeed, in our experience, older managers can, in some cases, actually prove more flexible than their younger counterparts. At issue is the need for a thoroughgoing reform of mentalities, along with an explicit change in the incentive structures.

Village life in Potemkin: What, exactly, is for real?

Over recent weeks, T&B has undertaken an informal survey of Russian and Western businessmen, IFIs, and direct equity players in an attempt to try to gain some sense of what is actually happening, in reality, not in the statistics.

FDI: The mystery of the disappearing investor

We are puzzled: according to the official statistics, foreign direct investment is lagging badly, with Russia receiving only some \$4bn dollars last year, i.e. foreign participation remains on a par with Guatemala! Explanations tendered include a poor legal framework, criminality, bureaucratic torpor, exacerbated global risk aversion, and political worries. While all of the problems cited are real, the reported absence of foreign interest fails to tally with our day-to-day experience in Russia. The Moscow business-class hotels are booked solid, Western mass-market retailers are springing up all over, several large foreign-owned white goods plants are going up, and we have been seeing a new wave of immigration: expatriate managers of European consumer goods companies!

T&B will thus float an alternative working hypothesis: The quality of Russian statistics

is notoriously bad; the former head of the statistical agency was arrested some years ago, along with seven of his cronies, all accused both of doctoring the numbers and of selling confidential data to competitor firms (thus ensuring the enduring distrust of Russian companies, who intentionally provide false data in the hopes of it falling into competitors' hands...).

The EBRD has informed us that they signed commitments for \$850M last year alone (and are on track to invest \$1bn this year, with the same amount annually for the next few years). Of course, not all of this money was disbursed, but equally, this sum neglects disbursements from the backlog of signed deals from previous years. More importantly, EBRD typically co-invests with other foreign players – we estimate that, for one dollar from EBRD, another \$2-3 comes from its partners. Several large deals have been announced in consumer goods, oil, forestry, automobiles, etc. and there is a veritable explosion of European retail chains opening in the Moscow region. Anecdotally, our friends in the real estate business tell us they are seeing substantial foreign inflows. Although we accept that, like many of the good things in Russia, this remains largely confined to the main cities, primarily Moscow and St. Petersburg, nevertheless, the numbers simply do not add up.

T&B suggests that, although foreign direct investment still remains limited, it is substantially greater than the headline numbers suggest, and that, given recent changes in the legal, land and tax codes, as well as the gradual diffusion of a more constructive view of Russia internationally, a great deal more is on the way. Deals are expected not just in oil, but also in automobiles, telephones, real estate, consumer goods and foods, transport and services. Furthermore, we believe that, if anything, the expected delay in WTO accession will increase foreign investment, since the domestic market would remain protected for a few years more.

Small Businesses: Still in the shadows?

At least in the Moscow region, we are seeing a steady expansion of the number of

small businesses, generally turning over \$2-5 million per year, with profits 5-7% of turnover. While this is largely based on the service sector, the industrial parks being built around Moscow are filling up with small manufacturing companies who manufacture a wide range of equipment, some of it surprisingly high-tech.

By way of example, and as unlikely as it may sound, Russia now builds Internet routers in competition with Cisco! They are not as technically sophisticated, nor do they offer the “5 nines” reliability of their American cousins, but they are priced at about one-third the price, and they do their job. Indeed, the present paper may well be reaching you thanks to Russian routers (so please blame their manufacturers for any typos!)

Stock picking – Shopping with our feet!

Although import substitution is proceeding apace, there is no appreciable export industry outside of the traditional sectors: minerals and hydrocarbons, metals, weapons, and some heavy capital goods. The problem is largely the absence of adequate quality controls, consistency in production and reliability of order fulfillment. Russians have historically risen to Herculean tasks, shooting rockets into space, building huge industrial kombinats in the polar circle, damming great rivers and leveling mountains. Mundane, day-to-day tasks of management and production seem rather more a challenge.

Bill Browder once told us that he preferred to buy shares in companies whose products he would buy. Strictly applied, this would reduce the investible universe rather sharply – T&B has always loved the smell of Russian oil and gas! As for listed, liquid manufacturers of consumer goods, while we have heard many good things, as shoppers we remain somewhat skeptical.

Oddly enough, although the products and services of smaller Russian companies frequently surprise us to the upside, the majors still have a long way to go. A quality-control issue with our last case of Wimm-Bill-Dann *Rio Grande* (top-of-the-line) orange juice left us with 12 litres of slurry

best eaten with a fork. Our last flight to Siberia on Aeroflot could be most charitably described as "8 hours in Hell" – leaving us sympathetic with earlier, less willing, travelers to Russia's nether regions. Our Avtovaz Niva jeep is truly reliable, i.e. can usually be relied upon **not** to start, at least when you really need to get somewhere in a hurry...

Only our MTS mobile phone is gradually becoming acceptable. We no longer seem to disappear off the network, nor are we still billed for "phantom calls" to places where we know no one. Alas, like their stock, we find their service overpriced, and only the lack of portability of numbers keeps us faithful to the once-dominant service provider.

Needless to say, one of the drivers for the mobiles boom is that the alternative – fixed-line MGTS telephones – is just about up to African standards. Exchanges in the central districts of Moscow reportedly date back to the late 1930s...after 12 years of economic reform, we still have trouble getting a line on our home phone during peak hours!

As specialists in the second tier assets, we are confronted with a dilemma: we believe that the strongest growth in the coming years will be in the consumer, service, and light manufacturing sectors, yet finding a way for portfolio investors to play these sectors is a challenge. At present, the energy consolidation is underway, and can be played. The phones are already largely spoken for. Oil still has some interesting mispricings, with the last phase of consolidation nigh. Metals and industrials are starting to offer some compelling stories. Forestry, chemicals, pharmaceuticals, retail services, building materials and real estate all beckon, but lack traded instruments. Similarly, finance and insurance are set for a vertical take-off; unfortunately, there is currently precisely one bank stock to play! We hope to see this change sooner rather than later.

Russia is perhaps the sole market literally crying out for new issuance. The two recent IPOs were blow-outs; despite high valuations and weak global markets, both Wimm-Bill-Dann and RBC were vastly oversubscribed; RBC, a purely Russian service company, continues to make

monkeys of the skeptics! Given the logic peculiar to the Fund management industry, there is a tremendous need to acquire Russian assets outside of the Oil/Gas, phones, and energos sectors. Russian money is flooding back in, looking for a warm domestic home, oil prices remain high, while Russia has once again given global equities investors their best-performing components of the year. Some day we shall perhaps be confronted with a market as broad and deep as Russian geography, though hopefully neither so gray nor so cold!

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