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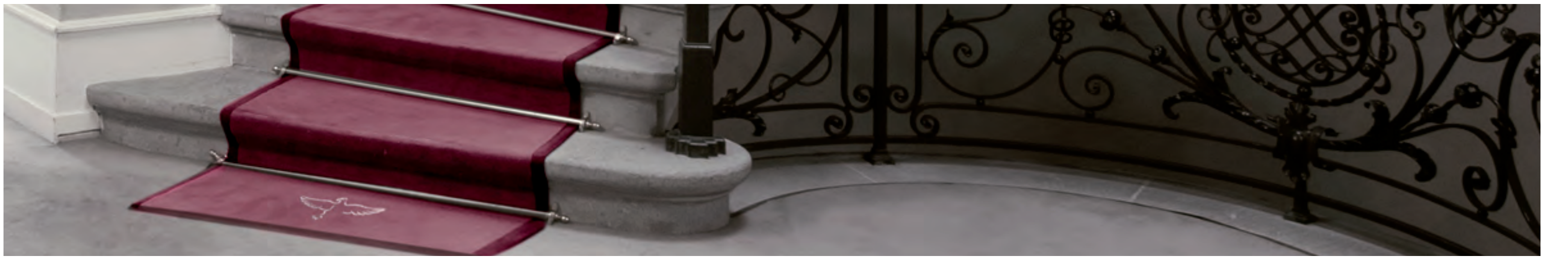
INVESTING IN RUSSIA: BUY THE CANNONS



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Russia and Eastern Europe as an investment destination

Despite many contradictory claims, investing in Eastern Europe over the last decade has represented a significant investment opportunity for the savvy investor. In the first stage, Central European economies transitioned from their soviet-driven model to the Western, liberal model. Integration into the European Community followed as members in their full right triggered the so-called Euro convergence trade, which resulted in massive infrastructure and financial investments accompanied by significant long-term structural reforms. This process enabled these countries to rapidly reach macroeconomic stability, prosperity, security and World Trade Organization (WTO) membership. Poland, the largest economy in Central Europe, witnessed its stock market skyrocket by 400% since 2002 while the Russian market, along with the rest of the former soviet block of countries, also rose by some 400% over the same period albeit exhibiting significantly higher volatility in the process. Russia was re-rated on the back of superior dynamics of its vibrant emerging middle class and its increased economic integration with the global economy, which led to the country gaining WTO membership in 2013.

Post the 2008 financial crisis, adjustments on a global scale have been painful, particularly in the periphery of the European Community. In 2011 Greece provided the first shock, rapidly followed by Spain, Portugal and, most recently, Cyprus in 2013.Whilst peripheral European economies appeared to be close to being flushed down the crisis drain, countries in Central Europe exhibited resilience, mainly due to the positive impact of structural reforms. Poland was the only European economy in broader Europe to grow in 2008 and, in doing so, was able to maintain a strong investment return profile.

The Russian duality

However one looks at it, most former communist countries continue to westernize. If free market and economic integration aspirations remain somewhat constrained by the respective governments, these forces are too anchored and powerful today to change course. The Internet has deeply revolutionized local societies and is now omnipresent. It has become an unavoidable tool for creating and developing businesses as well as enhancing social development and emancipating populations as well as governments. These elements of social and structural progress have had a rapid and significant impact on Russian society and on how business has developed across many emerging industry sectors outside of the traditional resource-based ones. Early investors have benefited from some business fairy tales such as Magnit, Russia's largest food retailer and, with 230,000 employees, among the largest employers in Russia. Magnit was IPOed in 2008 at USD 10 and is now worth a stunning USD 60. Its market capitalization is just shy of USD 30bn and is still growing at an annual rate of 30%.

Like its former communist peers, the Russian market is developing, albeit with its own rules and at its own pace. Embracing progress, emancipation and profound change whilst maintaining imperial and Soviet habits of controlling everything and everyone everywhere is a difficult if not an impossible task to achieve in today's globalized economy. Russia's duality is a key characteristic of the country and its ambiguous behavior

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then comes to the limelight. Like its flag symbol suggests, the double-headed eagle looking in two different directions is quite representative. The head looking west represents its natural disposition towards Europe and the western world, which has always fascinated and attracted Russians with its refinement, sophistication and level of development. Indeed a large percentage of the Russian population lives in the European part of the country. The other head looking east could represent Russia looking at the Siberian permafrost, where economic development is slow or absent. This duality is also palatable in the division that exists within the government between the St. Petersburg liberals, such as Alexei Kudrin and Anatoly Chubais, and the more hawkish entourage of Igor Sechin and Sergei Ivanov. These are individuals who are very close to President Putin and without whom he would not be able to govern. The business elite are divided along a similar line between the siloviki *(hard liners)*-run state-owned companies and private businesses owned and managed by the more liberal minded oligarchs. We can say with confidence today that one side is looking at the current Kremlin actions vis-à-vis Ukraine with anxiety and hoping that the crisis is temporary in nature while the other side fully supports the government's actions and its ideology with less forward thinking regarding the true costs and losses to the Russian people and Russian economic prosperity. Time is clearly on the side of investors. With economic costs likely to be overwhelming for Russia, maintaining the current status quo on Ukraine is unsustainable.

Russia has and continues to modernize, but mostly at inflexion points and after enduring maximum pain. One has simply to look back at the progress made since the 1990's. Without any doubt, Russia is today a connected, integrated and prominent member of global trade. But Russia is pursuing a different logic at the moment, one where politics and regional influence override its long-term global economic objectives. Eventually, Russia's concerns should revert to addressing economic reality. Despite the human, financial and reputation costs related to Russia's annexation of Crimea and the ensuing Ukrainian crisis, one has to cynically admit that this represents only a tragic glitch in the longer-term development in the region. In the context of this duality characteristic, Russia should continue to be viewed as an attractive investment opportunity where a period of reconstruction will undoubtedly re-emerge.

The "Russia Discount"

The investment community constantly refers to Russia as being cheap…forever cheap. Sporadic anti-market policies, bad publicity, mismanagement of state-owned companies and the slow pace of core structural reforms have led to this famous discount. If numerous occasional and tactical investors have been discouraged by the apparent inability to extract a profit from this market, the truth is that long-term investors have reaped significant returns from this structural market characteristic by regularly taking advantage of the discount when at irrational levels.

As shown in the following tables, Russia is very cheap on almost all accounts. It has also become less profitable than its long-term history – *currently by a magnitude of at least 50%* – as measured by return on equity.

As at 15th of August 2014

Stock Index Returns (In USD)	2002-2014		2011-2014		2004-2014
	Total return	Ann Eq ret	Total return	Ann Eq ret	10 years
Russia RTS	410.40%	14.60%	-11.80%	-4.10%	29.0%
Poland WIG	413.90%	14.60%	19.10%	6%	18.0%
GEM	397.50%	14.30%	19.90%	6.30%	11.0%
MSCI World	180%	8.95%	51.50%	18.20%	8.30%
SPX	168.50%	8.60%	74.00%	23.00%	10.50%

Source: Elbrus capital, Bloomberg

As at 15th of August 2014

Valuation & profits to shareholders	PE 2014	RoE 2014	PE Long term	RoE Long term	PE to Hist	GDP Growth 2015
Russia RTS	5.2	6.70%	7.2	16.40%	-27.8%	0.00%
Poland WIG	15	8.10%	16.1	12.10%	-6.8%	2.00%
Emerging markets (MSCI)	13.8	10.40%	13.3	15.60%	3.8%	3.00%
MSCI World	15.9	11.10%	16.9	12.60%	-5.9%	2.00%
SPX	16.5	17.20%	16.2	13.50%	1.9%	3.00%

Source: Elbrus capital, Bloomberg

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This situation has developed as a consequence of recent policies, which have proven to be particularly detrimental. We believe these policies are cyclical in nature. Russia's ultimate change in priorities, away from ideology and towards market principles, implies a turnaround in returns for shareholders, in ROE terms, which is what ultimately drives markets. Indeed, Russia's ROE history has more to do with corporate efficiency or the lack thereof, when corporate monies are redirected into unprofitable projects or vanish in transition through myriad obscure subsidiaries or affiliates. It is of course difficult to time this market but the current pressure on Russia's economy has perhaps never been so great since its independence. Nonetheless, the asset base, the resources and vast potential remain intact. As elsewhere, proper business execution and sound management capabilities mark the difference between a highly successful business and a losing business. At the corporate level, Gazprom and Novatek are two distinct examples of the duality described above. In Russia, at times, rather than reforming a company that is in bad need of restructuring, the government will opt for new layers of efficient companies. The key point is that profits in Russia can prove to be of stellar magnitude by carefully picking the right company.

When will the tide turn?

The question for investors today is when will the tide turn? Well, we may be closer to that time than we think. From an economic perspective, President Putin's actions in Ukraine will most probably be labeled a failure with the costs of an increasingly sanctioned business environment likely to be too high for the Russian economy to bear. This implies changes in the order of the Kremlin's current priorities, which should ultimately compress the current discount of 67%, at the time of writing, which represents a discount on top of the usual, long-standing "Russia discount" to global equities.

Like the Phoenix, Ukraine may emerge from the current dire situation in much better shape than most observers expect. How many investors are aware that the local stock market is one of the best performers this year, up 49.5% through July 31st? Profound tectonic changes are awaiting the Ukraine economy and we believe it has good chances of rising as a new tiger economy, possibly the last one left in Europe. This view is realistic if one considers the enormous resources of the country, its numerous, young and well-educated urban workforce, its strategic location within Europe, its largely untapped consumer market and a highly undervalued currency. History shows that post war recovery has always been significant as national unity and the base effect act in synchrony. Ukraine is progressively reasserting its territorial integrity and re-establishing control over its Eastern provinces. Strong financial and political backing by Europe and the U.S. has now deeply anchored the country to the west. More importantly, the formal divorce between Ukraine and Russia is now unavoidable and will be positive for both; political and economic ties will be rebuilt, without which no common prosperity can be achieved, and eventually they will resume mutual trade and cooperation as normal neighbors do. In the mold of Poland, the Ukrainian economy will likely increasingly develop independently from that of Russia, thus creating a larger, more diversified and less correlated regional market in which investors may participate. Interestingly, and meriting a highlight, Russia and the region have always represented a profitable trade when they were thought to be a least desirable investment destination.

In the current environment, we believe in the investment adage "buy the cannons and sell the trumpets". This may be as good an opportunity as it gets.

Anton KHMELNITSKI

Anton Khmelnitski is the CEO and Chief Investment Officer of E.C. Elbrus Capital Investments Limited ("Elbrus Capital"). Elbrus Capital is a Swiss owned company with over 15 years of experience managing investment portfolios focused on Russia, Ukraine and the FSU countries as well as Emerging Europe on behalf of institutional clients. Elbrus Capital is investment advisor to Banque Morval in its capacity as investment manager of Willerequity Russia & Eastern Europe (WE Russia&EE). WE Russia&EE is a sub-fund of FCP Willerfunds, A Luxembourg UCITS IV compliant umbrella fund of Willerfunds S.A. that serves as a dedicated instrument for Banque Morval to offer investors a diversified range of specialist equity, fixed income and absolute return investment funds.

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