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Russia's stocks rally as Putin passes the presidency to Medvedev

Jason Corcoran in Moscow
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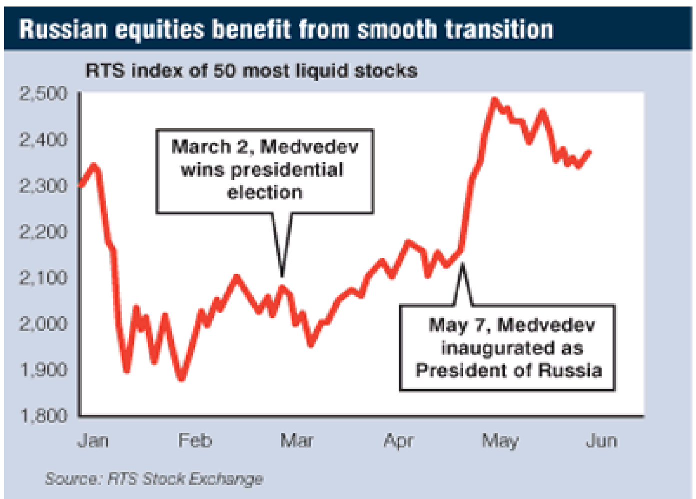
Investment climate is steady as new leader continues reform agenda

Russia's equity markets are enjoying the country's honeymoon period under its new leadership, but investors remain wary of how the power-sharing arrangement will evolve.

Graphic



The changing of the guard on May 7 saw Vladimir Putin hand over the presidential mantle to his protégé Dmitry Medvedev. Within hours, Medvedev had nominated his mentor Putin as Prime Minister.

The smooth choreography proved to be a fillip for Russia's main stock markets and sparked a buying spree by foreign funds.

The MSCI Russia Index was the best performing emerging equity market last month, rising 15.7%, and outperforming the MSCI EM Emea index, which rose 7.3% in the same month. Inflows recorded in the third week of May of $542m (€350m) were the highest in Russia for more than two years, according to data provider Emerging Portfolio Fund Research.

Peter Halloran, chief executive of Russian hedge fund group Pharos Financial, said: "So far, their partnership has been smooth. There has been no discord and they are moving ahead with the reform agenda, which is the trick with emerging markets. It will take at least a year if we are going to see any friction between the two."

Most investors agree the new order has yet to result in any tangible change to the investment climate due to the continuity in policies and the Government's team.

Putin unveiled his new cabinet, handing key roles to heavyweight economic liberals, while keeping several hardliners with a secret services background on board.

Yulia Tseplayeva, chief economist at Merrill Lynch in Russia, said the early running indicated Putin was focusing on geopolitics while Medvedev was taking care of institution-building.

She said: "The transfer from Putin to Medvedev hasn't taken place yet. It's been a transfer from Putin to Putin-Medvedev. Putin is the main decision-maker and his significant presence is very obvious through the mass media, and the public doesn't see any difference. It's essentially the same team, the same policies without any major revisions."

The best-performing sector over the past month has easily been energy, which was fired up by Putin's statement that the tax regime in the oil sector would be eased by August. Russian Energy giants Rosneft, Surgutneftegaz, Lukoil, Gazpomneft, Transneft and Novatek rallied by between 23% and 26% last month, after the sector had failed to be swept up by the boom in global oil prices.

Tseplayeva added: "The Government could no longer afford to ignore the oil lobby as its main taxpayer. The plan to cut mineral extraction taxes for the oil sector was announced a year ago but Putin dressed it up in a very investor-friendly way and the markets responded in kind. The 100bn roubles (€2.7bn) a year will be good for the industry but it's only 0.2% of overall GDP."

Goldman Sachs reacted by raising its 12-month estimate for the RTS index by 12% to 2750, recommending energy blue-chips. Oil and gas stocks are expected to continue to thrive on the back of the decision to cut taxes, although it might mean other sectors have to take up the slack.

Chris Weafer, chief strategist at financial services group UralSib, believes the mining industries such as coal and metals could be most at risk. He said: "This year, there is less pressure to levy higher taxes to compensate the budget as the oil price is well above the average assumed in the budget. We believe the finance ministry could easily afford to give up $20bn to the oil industry.
"But the ministry will not want to have to bet on the oil price every year and will undoubtedly push hard for the oil tax reduction to be balanced with higher taxes on other parts of the country's extractive industries."

The steel sector has also been hit by suggestions the Government is considering higher export duties on steel to compensate for lost revenues from lower oil taxes.

Producers have enjoyed a surge in steel prices, pushing up costs in industries that use the metal in their production. Analysts said the losers would be companies such as Severstal, Magnitogorsk Iron & Steel Works and NLMK.

With the restructuring of the electricity grid UES almost complete, several Russian funds are betting that hydro-electricity company RusHydro will become the new proxy for the sector.

Last month, the RTS was up 15.9% while the Micex exchange's index was ahead by 15.5%. While the lion's share of the upside came from oil and gas, financial stocks also powered ahead with the financials index up 10.2%. Fund managers are bullish on banking blue-chips VTB and Sberbank, which have both flagged in value since their combined $18bn listings last year.

Listed construction and real estate developers have also shown signs of life after the Government approved a $570bn programme to overhaul and expand the country's transportation infrastructure over the next seven years.

The latest GDP data shows household consumption up 13.6% in real terms during late 2007, which helps explain the continued boom in the consumer economy. Investors are keen on Russia's second-largest retailer Magnit, which raised $490m in an April listing on the London Stock Exchange to fund expansion.

Tseplayeva said: "The consumption boom is shifting away from Moscow to regional cities such as Ekaterinburg, Novosibirsk, Krasnoyarsk and St Petersburg. Food retailers such as Magnit are primed to do well."

All signs are that the drought of flotations experienced in the first quarter is over. Last month there was the $449m listing by freight operator Globaltrans and the $1.2bn flotation by retail group X5.
In the global capital markets, Russian companies are eyeing an expanding role. Medvedev has called on business leaders to embark on a foreign acquisition spending spree to boost technological expertise and to diversify into new markets.

Russian business conglomerate Sistema has opened its cheque book in foreign markets by taking a majority stake in Indian telecoms operator Shyam Telelink. Russian companies in the metal and steel sectors such as Severstal and Evraz have also begun to invest globally and extend their reach.

Stephen Cohen, chief executive of Troika Dialog's fund management business, warned this trend could be to the detriment of capitalising on domestic growth. He said: "Return on equity remains high in Russia and as domestic growth remains very strong it may not be easy for Russian companies to find investment opportunities outside Russia that are as attractive as the domestic opportunities.

"Plus buying foreign companies per se does not necessarily reduce reliance on foreign technology. The solution to that problem is probably more to do with greater expenditure at home on research and development and on education and direct hiring of foreign personnel to work in Russia."

Medvedev's call has been answered by state-controlled companies such as savings giant Sberbank, which is looking to acquire banks in the Commonwealth of Independent States, eastern Europe and China.

Alexander Kotchoubey, managing director of Renaissance Investment Management, which has more than $6bn in assets under management, said: “Sberbank and VTB are immune to the international credit crisis because of their minimal exposure to sub-prime and they might be able to pick up distressed assets on the cheap in foreign markets.”

Alexei Miller, chief executive of state-controlled Gazprom, announced in late May that the energy giant is aiming to have the largest market capitalisation in the world. Gazprom, which recently overtook China Mobile to become the third-largest global company, is believed to be interested in taking control of TNK-BP, the Anglo-Russian venture.

TNK-BP’s Russian shareholders are embroiled in an ownership dispute with their British counterparts, which analysts say has been caused by Kremlin pressure on both groups to sell out to a state-controlled company. Investors believe events surrounding TNK and Shell’s surrender last year of the Sakhalin-2 project contribute to the wariness among European and US legislators about Russian investment in their countries.

Weafer said in a note: “Prime Minister Putin late last year said the Government believes approximately $50bn of potential Russian investment into Europe is being blocked because of these worries.”

At the economic forum showcase in St Petersburg at the beginning of June, investors were looking for specifics on how the Government plans to progress reforms and investment plans declared before the parliamentary and presidential elections.

Kotchoubey said: “There hasn’t been a clear delineation of how power should be shared between Putin and Medvedev. Investors are aware that the immaculately turned out double-headed eagle hasn’t had its feathers preened yet.”