

HEDGE FUNDS

Russian gas fund sees challenges with outstanding opportunities

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Managing money

Russia's privatisation of its energy sector is throwing up some good prospects as well as challenges for Pharos Financial. Jamie Wynn-Williams talks to the investment company about how it has found ways to take advantage of the opportunities in the natural gas sector

When Russia began privatisation in 1991, the oil sector was divided into numerous companies. However, the gas ministry effectively left just one company, Gazprom. This behemoth remained the sole controller of exploration, reserves, production, distribution and everything associated with producing natural gas. Currently Gazprom is the major supplier of gas to Europe, delivering 28% of Europe's natural gas.

In 2009 Gazprom is set to be the most profitable company in the world. Its current market value is \$350 billion. It expects to surpass Exxon Mobil some time this year.

In market capitalisation terms, Gazprom is already one of the biggest companies in the world.

With a 51% state-owned share, Gazprom is often regarded as an integral part of Russia's foreign policy, domestic economic strategy and tax revenue raiser. Its former chairman, Dmitry Medvedev, is now president of Russia.

Gazprom shares, unlike any other company in Russia, can only be sold locally. There are heavy restrictions on foreign investment. Only a limited amount of American depository receipts (ADRs) has been issued and these trade at twice the price of a Russian share.

Peter Halloran, CEO and fund manager of Pharos Financial Group, saw a way to take advantage of the limitations on Gazprom's shares.

"Within the fund we established structures that allowed us to go in and buy the local shares. We were able to raise foreigner's money and buy shares at half the price of the ADR. The idea was that Gazprom dominated the gas sector, was incredibly cheap and we set up the fund to take advantage of that," says Halloran.

Pharos Gas Investment Fund, launched in May 2004, is designed to take advantage of the transformation of the gas sector in Russia and Eurasia. The two key drivers are the dramatic increase in Russia's domestic gas prices from subsidised levels to market prices - estimated to increase three-fold by 2011 - and the rapidly increasing demand for natural gas across Eurasia. The fund has a three year compounded annualised return of 55%. Since inception it has an annualised return of 46.5%.

The fund was launched initially to give access to local shares of Gazprom, at a time when Gazprom itself was significantly undervalued. Now the fund has branched out, taking advantage of the significant opportunities outside of Gazprom in the natural gas sector. These opportunities are increasingly compelling.

"It is changing for two reasons," says Halloran. "Domestic pricing is being globalised and is increasing on a cyclical basis, twice every three years. Also, the market itself is becoming more open to independent players. It started out as a good bet on Gazprom itself, but has opened itself to entire sector that is in the process of realigning."

The fund's stake in Gazprom is now roughly 25% of the fund, as the gas sector is no longer dominated by the behemoth. According to Halloran the number of companies getting involved in natural gas is growing. So, too, is the number of privatised and traded companies.

Novatek is a company Pharos has been working with since 2001. A Russian gas producer, it was privatised 2004-05. Its market cap then was \$2 billion; now it is \$26 billion. "These are the sorts of companies that we invest in," says Halloran.

Pharos claims to be the first Russian natural gas fund. Since its launch the company has assembled an extensive research team. "Going forward we expect returns to be in excess of 35%, and we've beaten that easily in the last six months. Our view is that things will get better and not worse. We see more opportunities and we don't see returns dropping. This is with a view that Russia will be one of the most exciting geographies in the next three to five years," Halloran enthuses.

He is keen to point out the greatest issues facing the fund are the Russian government and economic policy. Halloran is convinced there is no incentive for the government to change its policy at the moment. Nevertheless, this is the main risk exposure and this is what Halloran likes most about the strategy.

"Typically if you're investing in oil or gas or other commodities, one of the biggest exposures is the cycle. In Russia there is no cyclical for the commodity. The price of \$70 per 1,000 cubic metre (mcm) is already 20%-25% of the market price. The market can come down another 50% on a cyclical basis and have no impact on the pricing we look at," he explains.

According to Halloran if the current price falls to \$40/mcm in the next three years, it will be the government's decision and will be done for economic reasons.

As the Russian government looks to restructure the natural gas sector, the upside for the fund will be the emergence of more companies. This will not only bring more competition to the sector but should lead to enhanced liquidity. Pharos sees the sector at the beginning of its transformation.

Such calculations remove the cyclical pricing aspect of the fund's risk, claims Halloran. Instead the fund needs to calculate only a small political/economic policy risk factor that could affect gas or oil pricing.

As he points out: "The thing to be aware of in Russia is there is continuity in policy and politics remains roughly the same. Putin famously stepped down as President only to become Prime Minister and appoint a friend of his to be president. So there aren't many major changes happening to policy in the near future," concludes Halloran.

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IMPRESSIVE RESULTS FOR FUND

In June the Pharos Gas Investment Fund was down 4.5%; with 12 month annualised volatility at 23.5% compared with 24.4% for the MSCI Russia Index over the same period. For the first half of 2008, the gas fund was up 3.3% while the MSCI Russia Index was down 2.9% over the same period. Out performance, says Pharos, came from a combination of superior stock picking and risk management techniques.

First quarter 2008 Russian GDP growth was a solid 8.5%, making the country one of the top performers globally. Retail trade increased 14.6% year on year in May, giving growth in the first five months of the year to 15.6%. Even with record-breaking commodity prices, Russia's figures show a domestic economy that remains a strong engine of growth.

Inflation was a different story. The consumer price index increased 1% in June to bring year on year inflation to 15. Upward pressure on the producer price index could impact on retail margins if it accelerates over the second half of the year.

After economic growth of nearly eight-fold in US dollar terms over the past 10 years, Russia has embraced a market economy solution to ensure its growing energy needs. The country is creating one of the world's most open markets for electricity generation and distribution, says Pharos.

The big story on the equity side was the de-listing and final break up of UES, the Russian utilities giant, on June 6. This was the culmination of a thorough restructuring of the entire utility sector. As part of the restructuring, power prices are to be liberalised, with each year seeing less power sold at regulated prices and a greater proportion sold in the free market. At present 25% of power produced by older generators is sold in the free market. This proportion will be gradually increased until 100% of power is sold in 2011.

Foreign strategic players see the value opportunity created by these changes and have become aggressive in the sector. With the tacit approval of the government, they are competing successfully against local players for choice assets. E.ON, Enel, Fortum and Dubai World, among others, have taken sizeable positions in the sector. Other private investors have invested an additional \$15 billion. Valuations in the sector remain compelling. Pharos expects to see healthy gains in some of the most attractive assets as we exit the restructuring period.

FUNDAMENTALS OF PHAROS GAS INVESTMENT FUND

Name of manager: Pharos Financial Group

Full name of fund: Pharos Gas Investment Fund

Address of manager: Pharos Financial Group, c/o Pharos Service, Pozharskii Pereulok 15, Suite 500, Moscow 119034, Russia

Contact (for investment): John Papesh; +7 (495) 221 4991

Launch date: April 22, 2004

Portfolio size: \$50 million

Average annualised return: 46.5% (37.1% since inception)

Average annualised volatility: 23.5%

Share classes: US dollar

Administrator: Custom House (Dublin)

Auditor: Deloitte & Touche

Management/performance fee: 2%/20%

Minimum investment: \$500,000

Lock-in: None

Redemption period: Monthly on 30 days' notice.