

# EUROMONEY

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## Russia: Fairy tale ending or start of a nightmare?

by Guy Norton

**A stabilized currency and higher oil prices have given a welcome fillip to the Russian capital markets. But could slumping economic growth and soaring non-performing loans undermine the recovery? Guy Norton reports from Moscow.**

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THE RUSSIAN CAPITAL markets have witnessed a remarkable change of fortune in the course of the first third of 2009 that has taken even seasoned Russia watchers by surprise. By the middle of April the RTS stock index was up 50% on its late February lows, and credit default swap spreads on Russian sovereign debt had fallen by a similar margin over the same period to below 400 basis points.

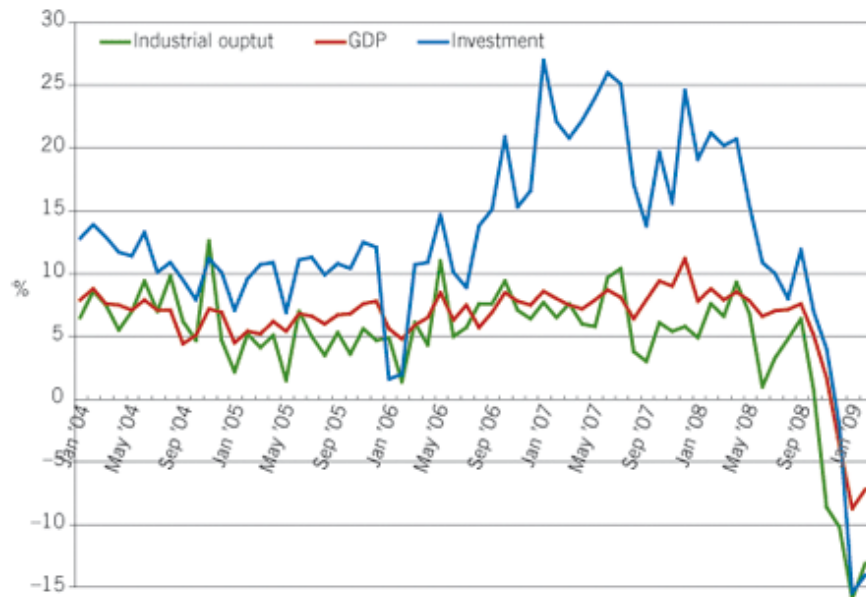
Having suffered a winter of discontent, are the Russian capital markets now set to enjoy a glorious summer? Although some participants have undoubtedly been cheered by recent market developments, others remain decidedly downbeat. "Russia tends to be either one of the best-performing or worst-performing markets in the world," says Kevin Dougherty, an equity portfolio manager at Pharos Financial Group. In 2008, Russia was firmly rooted in the worst-performing camp, with the RTS index slumping by 75%. This year, in contrast, Dougherty believes that Russian stocks could be among the best performers. "We could see the Russian market double in 2009, if oil prices keep on rising," he says, before adding the all-important rider: "But we're still cautious on the global environment on the back of the removal of leverage following the credit crunch." Much of the optimism among equity investors is based on the recovery in oil prices, from \$30 a barrel at the end of 2008 to \$50 a barrel by the end of the first quarter. "The Russian equity market is all about the oil price right now," says Dougherty. "At \$30 a barrel you don't want to be anywhere near Russia with the market trading at 18 times earnings, whereas at \$50 a barrel the market looks cheap at 3.5 times earnings." If oil remains around the \$50 a barrel level – above the \$41 a barrel level the government has budgeted for in 2009 – and there is a pick-up in global investor sentiment, Dougherty expects the market to perform strongly. "Russia is one of the markets that investors will come back to first – it's by far the most liquid market in the EMEA region and investors know the companies well," he says. Given the still uncertain outlook for both the Russian and global economy, Dougherty is under no illusions that there will be a smooth recovery in Russian stock prices. "We won't see any real stability in the next six months," he says. "There will continue to be a lot of volatility and if the oil price declines, the market may revisit its February lows."

### Shocks head

Roland Nash, head of strategy at investment bank Renaissance Capital, agrees. "After a 50% rise in seven weeks, the market will likely be reminded at some point in the second quarter that there remains considerable dislocation between Russia's financial sector and the real economy," he says. "Much of the adjustment cost associated with the twin shocks of the collapse in commodity prices and the increase in the cost of capital remains ahead."

## Green shoots?

### Change in output, GDP and investment, year on year



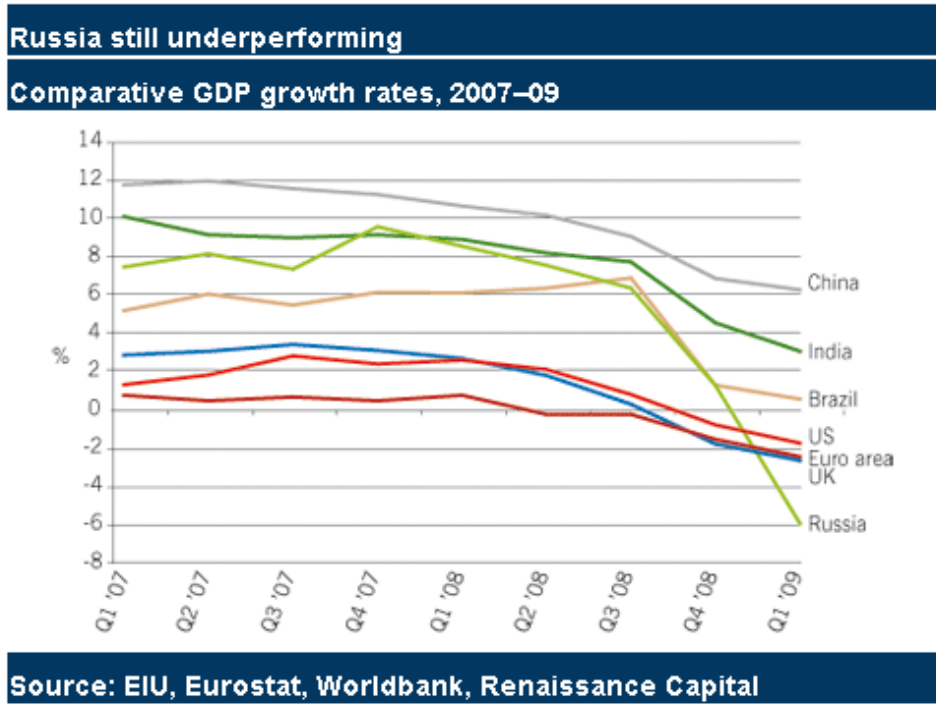
Source: Rosstat, Renaissance Capital

As well as higher oil prices, another key positive for market sentiment in recent months has been the so far successful managed devaluation of the rouble. "The general nervousness around the rouble has been removed for now and the devaluation has restored the competitiveness of the real economy," says Thies Ziemke, managing director at Paruskreml Capital Management.

Mikhail Shlemov, a banking analyst at investment bank VTB Capital, says: "The biggest risk in Russia right now is uncertainty and so with the devaluation of the rouble one major uncertainty has been removed."

Although the step-by-step devaluation was criticized in some quarters for using up \$200 billion of precious foreign currency reserves, the Russian authorities have so far successfully avoided a meltdown in the financial sector as occurred in August 1998 when the rouble was last devalued. "We haven't seen a run on the banks like we did back in 1998," says Bruce Bower, portfolio manager at Kazimir Partners, adding that because the Russian government saved money during the economic boom in the early part of the decade, it now has the financial means to support the banks. "Government efforts to fix the real economy depend a lot on the banking sector," he says.

However, although the government measures have helped to restore public confidence in the banking sector – retail deposit inflows in the first quarter of this year offset the outflows in the fourth quarter of 2008 – there are growing concerns about the ability of Russian corporates to repay loans and bonds. "Defaults are almost becoming fashionable," says Neil Smith, managing director at Florin Investment Management, adding that the authorities in the Kremlin should consider creating a 'bad debt' bank in response to the problem. Non-performing loans were running at 3.8% at the end of 2008 but finance minister Alexei Kudrin has admitted that they could reach 10% by the end of 2009. Even that is viewed as an optimistic prognosis in some quarters. German Gref, head of the largest state lender, Sberbank, and Petr Aven, head of Alfa Bank, Russia's leading private bank, have both stated recently that NPLs could go as high as 20%.



Shlemov at VTB Capital says that one beneficial side-effect of the growing NPL problem will be to add impetus to the long-overdue consolidation of the banking sector in Russia, which still has more than 1,100 institutions. "Worsening asset quality will drive the consolidation process," he says.

The lack of progress on reforming sectors such as the banking industry is one of the key concerns of Bernie Sucher, head of Merrill Lynch Securities in Russia. "Russia needs to address critical issues at a microeconomic level. The most obvious example of this is the local capital markets, which are underdeveloped relative to the size of the economy. Russian companies have borrowed \$50 billion domestically but \$500 billion internationally." He adds that lack of a domestic source of long-term money and the lack of access to foreign cash is forcing financial institutions to remodel their businesses. Among those companies that have been forced by the seizing up of credit markets to review the size and scope of their businesses are sector specialists such as City Mortgage Bank, whose core housing loan business has come under pressure from the economic downturn.

"We've shrunk the mortgage side of the business, tightening our lending criteria and focusing on the quality not quantity of our portfolio. As a result, our delinquency rate is only 3% versus 10% to 20% at some other banks," says City Mortgage president Nicholas Chitov. "We've stopped disbursing mortgage loans in roubles because there is no long-term rouble financing available currently on the market. Meanwhile we've had to raise the rates on our lending in dollars because of our increased cost of funds."

He adds that the bank is considering entering other segments of the consumer finance market with a view to expanding the range of products and services it offers. "We are looking to shorten the maturity of our lending and to have higher margins," he says.

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