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## FUNDS: Pharos looks to raise \$600m to take part in Russia's next phase

By Ben Aris  
bne

"How can we get off this autocratic path? You can't have democracy with no civic institutions," asks Peter Halloran, the founder and managing partner of Pharos Capital.

It's a question that was on everyone's mind the day after Russia's March presidential elections when Halloran talked to *bne*. President Vladimir Putin's chosen successor Dmitry Medvedev swept into office and, if you read the opinion pages in the likes of the *Washington Post*, you would conclude it is all over for Russia's market economy.

So it is a funny time for Halloran, who helped build Russia's equity markets from scratch, to choose to build up his \$150 million fund into a \$600 million one. It is even stranger that he actually expects to be able to raise the money without too many problems.

Like most investors who have actually spent most of the last 10 years working in Russia, Halloran sees the Medvedev victory as no disaster, which is not to say he thinks everything's perfect in Russia.



"If you look at the 2000 elections when Putin took over from Yeltsin and compare it to these elections, then the difference is enormous," says the slightly bookish Halloran, sitting eating porridge in the trendy Coffee Mania café in central Moscow. "When Putin took over it was all about power as he battled to take control from the oligarchs. This time it is all about policy and Medvedev laid out most of agenda two weeks before the elections [in a speech in Krasnoyarsk]. That is real progress."

Halloran highlights the growing disconnect between the perceptions of investors on the ground that have been working with the Russians for years and those that base their perceptions on what they read in the international press.

"There is an arbitrage to be done on the perception of Russia at the moment," says Halloran. "There are real problems in Russia, but the Western media has definitely overshot in its criticism of Russia. Three years ago the returns [from portfolio investments into Russian stocks] were stunning, but I wasn't sure the market was here to stay and these gains were not going to be more than a flash in the pan. Now I am."

### Yale to Yeltsin

Few have been in a better position to watch the emergence of the Russian capital markets. After he graduated from Yale in 1984, Halloran went to work on Wall Street for 10 years, cutting his financial teeth first at Salmon Brothers then later at Credit Suisse First Boston. It was while in New York that he had his first taste of Russia; CSFB was an advisor to the Russian government as it launched the privatization process.

CSFB was pulled into the voucher privatisation bonanza by the founder of Renaissance Capital Boris Jordan, who was working at CSFB in Moscow at the time. A green 26-year-old Jordan persuaded the bank to send brokers out around the country and trade bottles of vodka for factory workers' bundles of vouchers that could be converted into shares. In 1995, Jordan was more or less personally responsible for earning

CSFB \$100 million in profits (which it promptly lost in the 1998 crisis).

On the back of this success, Jordan left to set up Renaissance Capital with some financial backing from oligarch Vladimir Potanin. Halloran, meanwhile, was sent by CSFB over to Moscow the same year to pick up the pieces, as Jordan had taken almost all of CSFB's trading team with him.

"Jordan asked me to be one of Renaissance Capital's founding partners, but I decided to stay with the firm," says Halloran. "When I arrived in Moscow, the trading floor was completely empty except for one equity salesman that they had hired two weeks before I arrived."

Over the next two years, Halloran ran the shop and rebuilt CSFB's Russian operation into a leading investment bank in the market. He got off to a flying start as Russia's market was just at the start of a two-year-long bull run. His first ever equity deal tripled in two weeks giving him a taste of an experience he was to have many times over. As the momentum built, Halloran increasingly found himself involved with managing CSFB's \$300 million proprietary trading book and this meant dealing with a relatively small circle of big investors. It was big money in those days.

By 1997, the department was running well and Halloran decided to strike out on his own. Catering to the circle of investors he had built up over the years, he founded Pharos and became a founding stakeholder in Aton Capital, which was recently bought by Italian bank UniCredit.

### **The pharaoh of Pharos**

Pharos started off by offering investors exposure to the highly profitable, but difficult to access, government fixed-income market. The Russian government was living hand to mouth, running a budget deficit of about 7 to 8 percent of GDP and financing the gap with pricy treasury bills, the now notorious GKO's.

Technically, foreigners were barred from buying these ruble-denominated three- to six-month notes directly, but the Ministry of Finance was prepared to grant exemptions on a case-by-case basis. As the state eventually raised tens of billions of dollars from foreign investors with these notes, the exemptions were pretty easy to get, but someone still had to go down the ministry every week and do the paperwork.

Pharos set up a Russian legal entity to do the legwork and repackaged the bonds for sale to international investors. "You had to get approval from the MinFin and the trick was to walk in with a big stick," says Halloran. "There was a lot of demand for the GKO's so we could go to the ministry and say that we would buy all \$500 million worth of that week's auction. They would think about it and then write an exemption, a one-off permit to buy the bonds. At the end of the day, most international investors prefer dealing with Western brokerages."

In retrospect, investing into GKO's looked like a train wreck waiting to happen, but at the time it wasn't obvious. Yields were slowly coming down, dropping to the low teens by the start of 1997, as the Russian government appeared to be slowly getting its act together. However, after oil prices collapsed in the wake of the Asian crisis in the second half of 1997, yields shot up to more than 200 percent on three-month bills and the whole house of cards finally came crashing down on August 17, 1998.

### **New funds**

Fast-forward to today and Pharos is ramping up for the next few years. The fund survived the crisis and built up about \$150 million worth of money under management going into the Putin era. After Putin took office in 2000, oil prices quickly recovered and by 2003 stocks were rising fast again as the leading RTS index gained over 50 percent every year.

Halloran says with these kinds of returns there was no need to have a big fund. As Medvedev takes over, the terms of the Russian investment story have changed dramatically again; returns are down, but it's increasingly obvious these returns are going to be around for years as the government starts a systematic investment program worth more than \$1 trillion.

"The returns were huge [between 2003 and 2006], but it wasn't clear if the economy had taken off. I was not convinced that it would do," says Halloran. "Now it is clear that Russia is over the hump and on a path to long-term sustainable growth. The daily volumes [on the stock exchange] are \$2 to \$3 billion and the economic growth has taken hold. It is clear that the Russian growth story is going to run for at least the next decade and that the market is here to stay."

Pharos now has three equity funds - the Pharos Russia Fund, the Pharos Small Cap Fund and the Pharos Gas Investment Fund – as well as one private equity fund, which it's now actively marketing. The funds already have \$150 million under management and can already boast a five-year annualized return of 33 percent. The target is to broaden the customer base and gather some \$600 million under management by the end of the year.

"The funds are amongst the only pure hedge funds in existence in Russia at the moment, in that we make use of the all the tools – derivatives, futures and shorting as ways to trade the market. Long funds used to be the way to do it, as Russian equities have been through several re-ratings – and another one is due – but now they are not enough," says Halloran.

Even so, the sophisticated products are still largely unavailable. It is possible to short stocks in Russia, but there are only about 15 names that are liquid enough to short properly and even then these trades are expensive, says Halloran. The volatility of a share price of assorted stock would have to be large to make this kind of hedge worthwhile.

The first two of Pharos' funds are Russian small cap, or illiquid stock funds. The third fund focuses on companies involved in the gas and its derivatives business. "Gazprom dominates the sector, but around this company there is a lot going on," says Halloran. Indeed, every investment bank in Moscow has Gazprom marked down as a 'buy' with a target price on the order of \$19, against the \$12.50 the stock was trading around at the start of March.

The really exciting fund is the private equity vehicle that's an oil prospecting company and has bought licenses in various regions. It's now prospecting for deposits, but the idea of the fund is to finance exploration and production of small fields that lie below the Kremlin's radar screen. "The big players are not looking at this stuff as it's too small, but we can," says Halloran. "It is real wildcatting and very exciting."

### **Betting on business**

There is little argument about the health of Russia's economy; the Kremlin's hard currency reserves and GDP growth are the stuff of fantasy for most Western European governments. But what worries most would-be investors is the politics.

Halloran believes the very economic success ensures continued growth, but the evolution of Russian politics still needs to be watched closely.

"Going forward, we are going to see a consolidation amongst the business elite," says Halloran. "All these people are currently on the same page, but that is not going to last forever. There is going to be a natural divergence and this will probably be expressed via the Duma, so we need to watch the whole political process very carefully over the next four years. The changes will be led from the top."

In the short term, the most important factor will be what those in power under Putin will do once they lose their influence under Medvedev. "What can the losers for the handover do? Brood?" ask Halloran. "Their only route to affect the course of politics going forward is through the Duma."

The stage is set for a potential clash, but Halloran says the clash will happen in the Duma and that's not necessarily a bad thing. However, the irony of Russia-watching is that it is a fairly straightforward skill; the difficulty that Western observers have is not guessing what the Kremlin intends to do next, but believing the Kremlin when it lays out its plans.

"There are lots of metrics showing corruption in Russia and the like, but if you were to have one measuring political honesty then Putin would come out on top. He doesn't have to politic like Blair, Brown or Bush as he doesn't have a diverse constituency to cater to. Unlike politicians elsewhere he usually means what he says," says Halloran. "The odd thing is that no one believes him. No one believed it when he said he was going to step down. To the last minute you have a lot of highly paid Washington analysts who thought he would change the constitution at the last minute. He didn't. Just like he said he wouldn't. Now Medvedev has spelled out his program for reform and I don't see any reason to believe that he won't attempt to implement it."

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