



Russia – the hidden dividend gem

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News on Russia tends to be one-sided – sanctions, scandals – to such an extent that good news ends up being ignored. Overall sentiment towards Russia remains driven by geopolitics. Yet today's Russia differs markedly from the Russia of 10 years ago.

A change in fiscal policy – and in culture

First of all, the macro-economic picture continues to be moderately positive. In particular, Russia's finances and currency are better managed than a few years ago. This shift to more prudence is an unexpected result of the sanctions imposed by Western governments and the oil price collapse which caused a severe recession in 2015/2016. As the country risked access to foreign capital drying up, the Russian government started bulking up its National Wealth Fund (NWF) and imposed a new "fiscal rule": any incremental tax revenues from oil prices exceeding USD 40 per barrel are converted into foreign currency and flow into the NWF, which is held by the central bank, instead of bolstering the budget.

Many analysts believe that this rather cautious strategy may dampen growth somewhat (GDP growth of 1.4% expected in 2019 and 1.7% in 2020), and endanger President Vladimir Putin's aim of becoming

one of the world's top five economies by 2024. Yet President Putin's "May Decrees" set ambitious macro targets and are aimed at switching the country's growth model from a consumption-driven to an investment-driven one. The government sketched a reform agenda that calls for increased investment in infrastructure, education and health care as well as for structural reforms of the pension and taxation systems and to bring the shadow economy into the official economy.

A second important feature of the new "fiscal rule" is the stabilisation of the ruble, as oil dollars are now kept in reserve instead of fueling consumption and, with it, imports, which historically have led to a rise in the Russian currency (the reverse was true when oil prices dropped). A more stable currency reduces uncertainty for all companies, and, given the relatively low level of the ruble currently observed, the Russian economy dominated by exporters has become more competitive in a global context. Earnings expectations for the Russian market are therefore looking more positive than in the past.

We therefore take a more benign view on the Russian macro-economic picture, and believe that this more circumspect approach and the accompanying reforms will ultimately benefit Russia's economy over the long term. So far, the strategy is



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paying off, as Russia's economy looks more robust and more immune to possible external shocks.

This more rosy outlook is compounded by another beneficial change, this time in the Russian attitude towards financial markets in general, and towards minority shareholders in particular. The interests of majority shareholders, including the state, have never been better aligned with those of minority (and often foreign) shareholders – the realisation has grown that in the long term both stand to benefit more from increasing share prices and dividends rather than from ill-fated investment or expansion projects. Dividends in particular are now seen as a disciplining factor, increasing the governance of Russian companies.

Attractive valuations, and attractive dividends

These various developments have changed the landscape for investors in Russia – and contrast very favourably with changes in other Emerging Markets, such as Turkey, which face increasing political and economic head-winds.

Valuations of Russian equities have recovered from previous lows, but are still attractive (MSCI Russia still trades slightly below its five-year average on a P/E basis), as overall sentiment towards Russia remains affected by geopolitics.

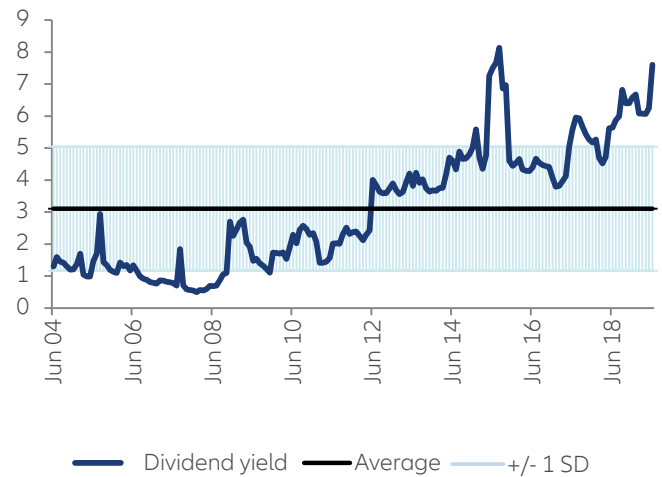
Figure 1: MSCI RUSSIA – 12 month forward P/E ratio



Source: Bloomberg Consensus. Past performance is not a reliable indicator of future results. Index performance does not reflect fees, brokerage commissions or other expenses of investing. It is not possible to invest directly in an index.

However, the key feature of Russian equities is the very attractive dividend yield. At 7-7.5% estimated for the MSCI Russia Index in 2019-2020, Russian dividend yields are among the most attractive in world. And, in contrast to other markets, we believe they are sustainable, as they are underpinned by a more disciplined attitude to investment, a steady ruble that maintains low costs and boosts exports, and the aforementioned cultural shift in attitudes towards shareholders.

Figure 2: MSCI Russia annual dividend yield



Source: Bloomberg Consensus. Past performance is not a reliable indicator of future results. Index performance does not reflect fees, brokerage commissions or other expenses of investing. It is not possible to invest directly in an index.

Some Russian dividend stocks*

The Russian equity market mainly features stocks in the energy, finance and materials sectors – and these are also the sectors in which we are mostly invested in our portfolio. Our preference is towards well-managed companies with secular growth drivers or high sustainable dividend capacity.

Three core holdings* in Allianz Emerging Europe that offer strong cash return to shareholders:

Lukoil (energy):

Russia's largest independent oil producer Lukoil profits from the robust oil price and a rising share of higher margin barrels within its overall output. Its new strategy outlines a clear and minority-friendly path for capital allocation: on top of a progressive dividend policy, a significant portion of "excess" free cash flows, generated from elevated oil prices and an undervalued ruble, is intended to be used for share buybacks, while the remainder will be invested in Russian upstream projects aiming to support the company's value over time.

Sberbank (financials):

Russian behemoth Sberbank constitutes almost half of the Russian banking system. The bank is expected to continue to show a robust operational momentum: strong loan growth and stabilising margins are driving net interest income, with good cost and risk controls positively impacting returns. Sberbank is also a global leader in the digital transformation of the financial sector and is on track to develop its own digital ecosystem. Finally, in line with the official government policy, the state-owned bank intends to increase its payout ratio to 50% from 2020 onwards.

Norilsk Nickel (materials):

Norilsk Nickel is Russia's largest metals miner and among the world's largest producers of nickel, copper and metals from the platinum group. Among other important uses in industrial production, its metal basket is of high importance for reducing emissions in the automobile sector. Given the quality of its asset base and its low operational cost, the company sits at the very low end of the global cost curve in its market segment. The company has for years been one of the highest dividend payers in Russia, based on its stringent dividend policy that mandates a payout of 60% of EBITDA below a certain leverage threshold (net debt/EBITDA).

Risks and outlook

It goes without saying that investing in Russia is not without risks. Raw material prices may fall (especially if the global economy were to weaken significantly), geopolitical fault lines may widen, further sanctions may be imposed on Russia and its economy. All of these would lead to increased risk premia and/or falling earnings. An active management approach that realistically weighs the opportunities and risks associated with individual investment opportunities in Russia is therefore key.

Given Russia's rather gradual progress in economic diversification, the wellbeing of the economy and its equity markets still depends on the performance of the extractive industries. In that context, higher oil prices on the back of the re-introduced OPEC+ production cuts in combination with the weak ruble should support Russia's economic prospects at least in the short term, given it runs a high current account surplus. The longer-term prospects will depend on Russia continuing its current prudent approach in setting monetary, fiscal and economic policy, while avoiding further deterioration in its relationship with the Western World. We like the supportive fundamentals and attractive valuations of Russia compared to other large Emerging Markets, but without ignoring the inherent (geo-)political risks for Russian equities.

* The information is provided for the purpose of demonstrating the fund's investment strategy only. It should not be considered a recommendation nor investment advice to buy or sell any particular security.

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