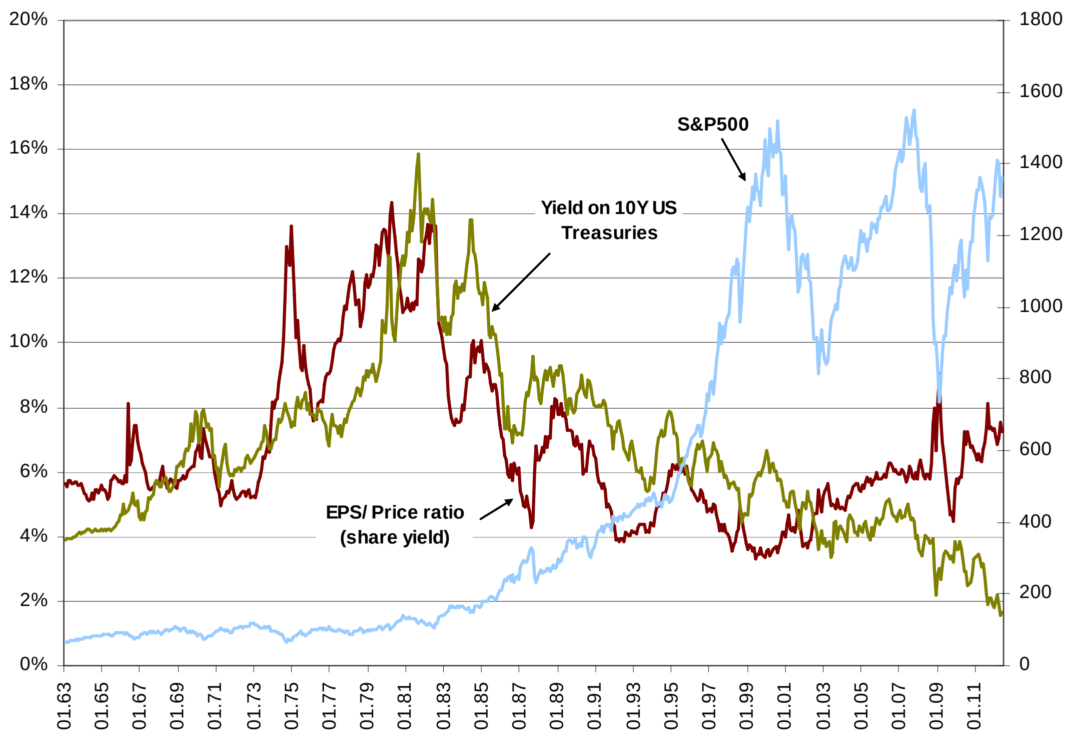
Low Interest Rates + Low Share Prices = Opportunities

Beginning from 2007-2008 international capital markets have seen a widening gap between yields on government bonds and shares, and the situation has become particularly dramatic in recent months. Current yield to redemption on most-traded 10Y US Treasuries has fallen to 1.5%, which is 5 times less than average 7.5% yield offered by S&P500 shares (measured as the inverse of current P/E, which is 13.5x). So an investor would earn 1.5 cents per dollar in government bonds vs. 7.5 cents per dollar in stocks at current market prices.

The situation contrasts with what was observed in the half century preceding the crisis, when yields on US Treasuries and S&P shares were usually about equal and any divergence was quickly overcome. The pre-crisis situation could be justified by the environment of steadily increasing corporate earnings, which prevailed until 2007: the extra risk associated with shares was compensated by anticipations of growing corporate earnings.

Yields on shares and government bonds were about equal until 2007



Source: Bloomberg

What, then, can account for the fivefold difference, which now obtains between yields on bonds and shares? It might be explained as follows: if yields on shares were as low as present yields on government bonds, the former would be hugely overvalued, since 1.5% yield on shares would entail P/E of over 60x!. Such high valuation would only be possible in case of explosive earnings growth, which is not in evidence today. At the same time, today's P/E ratio value of 13.5x (for the S&P500) suggests some measure of optimism about US corporate profits, Indeed, earnings per share have already exceeded the pre-crisis maximum of 2007 by 10%, after recovering from the 50% fall in 2009.

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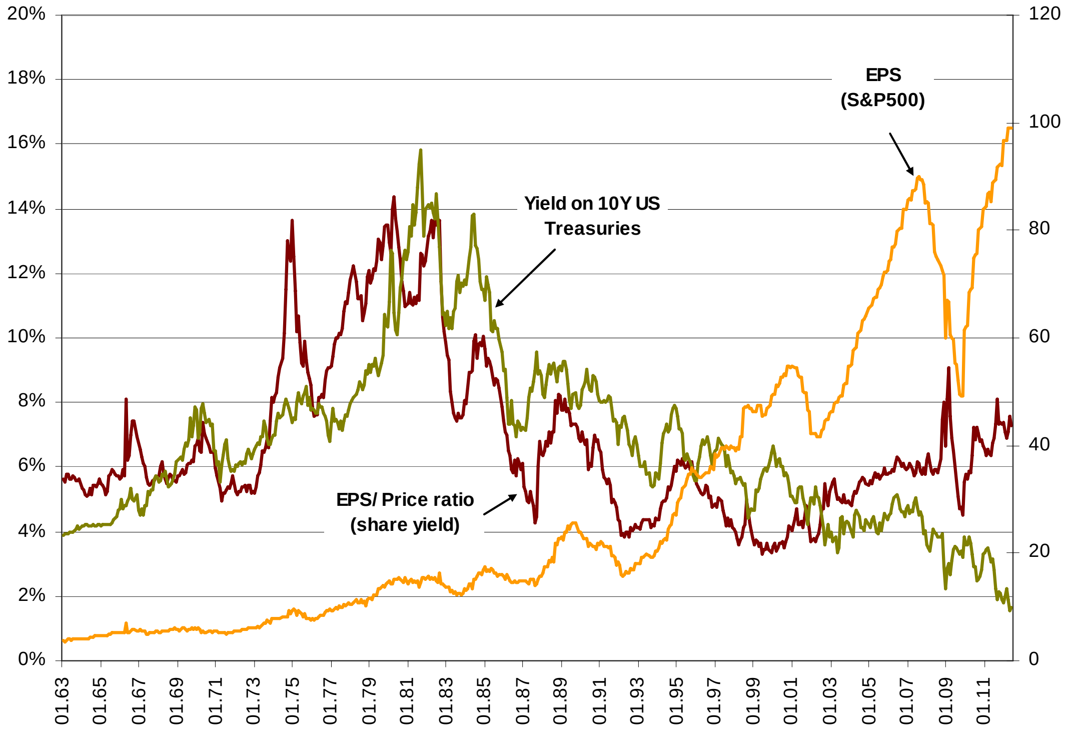
Earnings have recovered from 2009 lows and have exceeded pre-crisis maximum



Source: Bloomberg

So share yields cannot be as low as current yields on government bonds. However, when we try to explain the extremely low return on bonds, matters are more complicated. The superficial explanation is that low yields on government bonds mirror the economic crisis, since bonds offer a safe haven in a sea of risk. We should remember, though, that bonds, and specifically government (not corporate) bonds, are at the root of today's environment of uncertainty and high risk: countries are now the largest debtors in the world and their debt levels are approaching critical levels.

If returns on the world's best-established and most popular government bonds – US Treasuries and UK government bonds, to take obvious examples – are unusually low at present, this is not because the respective governments are in a particularly strong financial position. Quite the reverse. But, whereas in "normal" circumstances lending rates are determined by the lender, not the borrower, this is not true when the borrower is a government, which has the power to manage its debt and interest rates through many and various mechanisms. The US or UK governments have that power and can therefore continue to issue new bonds which are successfully placed, even at falling interest rates. At the same time, Greece and other penniless EU members have faced soaring borrowing costs because they cannot manage own internal debt, and are therefore at the mercy of lenders. Another factor behind continuous interest to bonds US Treasuries and some other government bonds is the size of the market – the amounts traded on this market are too large to switch to alternative investments (trading in bonds is several times greater than in shares).

Those who trade shares are hostages in this situation. Corporate earnings are rising (although not smoothly), and that should attract share buyers. This has not happened, because the perception of risk is too great. Who is interested in maintaining that perception? Not least, surely, governments of the leading developed countries, who desperately need to go on placing large volumes of bonds at low rates.

We see at least two groups of share investors, for whom the present situation offers an excellent opportunity: large shareholders of corporates and potential buyers of businesses. Low interest rates and low share prices mean that the first group can now borrow funds and raise stakes in their firms cheaply. The same logic applies to the second group, who can now borrow and buy on excellent terms. Both groups are most interested in future prospects for corporate earnings, not for share prices (unlike minority investors), so the enduring share market doldrums are of no great concern to them.

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Certainly, this is a simplified approach: in reality interest rates for corporates are higher than government bonds rates, and cheap borrowing is especially problematic in Russia where Central Bank core rates are relatively high (8%). A key factor when picking stocks on the Russian market, therefore, is ability of the major shareholder or potential buyer to access cheap loans from global banks.

Based on the above, we have several tactical recommendations for minority investors in current conditions. Firstly, we recommend companies which have a history of share buybacks, whether out of good corporate practice or due to shareholder conflicts. Most stocks that have such a reputation are well-known, and most of them are quite highly valued, so occasional market drops offer the best opportunities to buy them. Current debt levels (affordable debt or net cash) are an important consideration, since indebtedness will discourage buybacks. Access to international lending markets is also important, for the reason explained above, so companies with market cap in excess of $1b look preferable.

Identifying likely M&A targets is a more difficult task, but potentially more profitable. We recommend looking for companies with relatively high E/P and small volatility of earnings from year to year, as such businesses should be most attractive to potential buyers and the purchase price may be well above the market. Commodity stocks are to be avoided, as a rule, due to volatility on commodity markets. We also recommend staying away from stocks with major government presence, unless the (potential) buyer has a strong lobby in government.

Companies that make buybacks and companies that could be acquisition targets are attractive to minorities due to the direct gains for minorities when (if) these events occur, but also due to the interest the companies will attract when such events are expected or rumored, and additionally because the stocks of such companies are, on the whole, less volatile than the overall market.

Brief investment cases

MTS (MTSS RX) is low-valued despite stable and rising earnings. With P/E'12 at 6.6x the shares offer 15% yield on equity (twice more than S&P Index yield). Although the Russian mobile market is already saturated, the development of 3G-4G technologies and devices should drive further growth of MTS financials. The company (or its main shareholder AFK Sistema) has previously carried out share buybacks in periods of market decline and MTS (unlike Sistema) has fairly low leverage. The stock also offers attractive dividend yield, which we estimate at 7.5% for 2012 based on 50% payout ratio (the ratio in 2011 was 72%).

Norilsk Nickel (GMKN RX, MNOD LI) remains at the centre of a corporate conflict between its two major shareholders, Interros and RusAl, which has made both of them raise their share stakes, including through buybacks. The stock offers high return on equity (E/P'12 is 13%), and debt is minimal. Volatility of prices for underlying commodities (nickel, copper) is compensated by the company's large share of the world market for these metals and by low cash costs. Norilsk recently announced a buyback worth up to $2b to support the share price.

Transcontainer (TRCN LI, TRCN RX) is a mid-cap ($1.5b), undervalued (P/E'12 is 10x) developing asset. The company carries out container transport of various goods by rail, supported by terminal and logistics services. The government has plans to privatize the 50% stake in Transcontainer owned by Russian Railways, probably this year. The stake is of much interest to Summa Group, which has good access to capital markets and is believed to have close links to government. Summa is already taking a 21% stake in Transcontainer through acquisition of the shipping company, FESCO, which owns the stake.

Lukoil (LKOH RX, LKOD LI) has announced a share buyback worth $2-3b (sufficient to purchase 5% of equity) before the year end, in addition to regular purchases by its major shareholders. Lukoil is one of the most generous dividend payers on the Russian market. Net debt is less than EBITDA. Current P/E'12 is remarkably low at 3.7x, which translates as 27% yield on equity! Such low valuation can only be explained by exaggerated fears about oil price decline and current tax policies of the Russian authorities. Extremely high yield and friendly attitude to minorities should make the stock interesting for large institutional investors with a long-term horizon.

Uralkali (URKA LI, URKA RX) has seen occasional share buybacks by the main shareholder, seeking to avoid margin-calls on credits obtained earlier to finance Uralkali acquisition. The company itself is well positioned to borrow, having low debt and access to international capital markets. Current valuation is rather high (P/E'12 = 12.5x), which translates as 8% yield on equity. However Uralkali is aggressively investing in expansion of output, so prospective yield is much higher. The dividend payout ratio is at least 50%. Low production costs suggest large scope for keeping margins positive, even in a crisis scenario.

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O'Key (OKEY LI) could be an acquisition target for a global retail chain such as Wal-Mart. The company is focused on hypermarket and supermarket formats, which are traditionally most popular with foreign strategic buyers. The Russian retail industry still has much potential for growth and consolidation, and O'Key's relatively low debt level means that it can continue to expand. P/E'12 of 16.4x (6% yield) is not low, but this reflects sector growth prospects. However, a potential buyer may use high P/E as justification for offering only a small premium to the market.

Evraz Group (EVR LN) has announced a buyback of 10% of equity to support its share price. The buyback will be worth about $500m, which is less than forecast FCF in 2012 and easily affordable for the company, even though its business is highly cyclical and relatively leveraged (net debt-to-EBITDA is 2x). We think that Evraz might be interested in a merger with Magnitogorsk Steel (MMK), as the companies make an excellent fit in terms of production and raw materials. However, this is a very speculative idea.

Rostelecom (RTKM RX) is a stable business with earnings growing at the rate of inflation, although some of its tariffs remain regulated by government. The stock has been among worst performers on the Russian market in recent years following a price bubble in 2008-2009 due to share purchase by structures close to the majority owner (the State Property Agency). Prices are now low enough to justify interest. P/E'12 of 7.3x offers share yield of 14% and we think that Rostelecom may decide to support the shares through buybacks, particularly since the company is a good cash generator and has no obvious M&A targets in sight. We also note that some large minorities (e.g. Marshall Capital, which owns 10%) may be interested in raising their stakes.

VSMPO-Avisma (VSMO RX) is a unique business producing titanium for various industries (aircraft, cars, machinery, etc.). In 2011 the company obtained a license for a routile and ilmenite deposit (the substances used to produce titanium) and intends to increase production of products with high value-added. Media have reported that the major shareholder, state-owned Russian Technologies Corporation, wants to sell its 45% stake in VSMPO in order to reduce its own huge debt. Unofficial sources have said that company managers (who are close to the main owner) are purchasing shares on the market. Earnings are highly volatile but uniqueness of the company's production compensates this. We view current valuation (P/E'12 is 10x) as attractive for strategic investors to build their stake and bid for Russian Technologies' controlling stake, possibly at a premium to market price.

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