Russia: looking to invest in the future

TURNAROUND: Moscow's new International Business Center reflects an expanding Russian econmy

IN PART ONE of *HFMWeek*'s two-part examination of Russia, George Nianias, MD of Denholm Hall Management Limited and Didier dos Santos, a consultant with Eurex's Institutional Investor Sales team, discuss the hedge fund market in the jurisdiction.

Denholm Hall, which was founded in 1992, has established a significant track record in corporate finance, debt placement and consulting in Russia, the CIS and Eastern Europe.

Eurex, the international futures and options exchange, offers global electronic access to a broad range of international benchmark products and operates the most liquid fixed income markets.

HFM: How is Russia's economy diversifying away from dependency on oil, gas and commodities?

George Nianias (GN): If you look at some of the growth figures for the various industry sectors outside oil and gas, they are quite impressive and they are often higher than the country average. Construction growth, for example, has averaged nearly 15% a year since 2000 and retail growth has averaged over 12%. The other thing is that you can expect Russia, unlike other oil economies, to diversify because of the fact that the people are very well-educated and they have been able to substitute imports successfully. Unlike a lot of the Middle Eastern economies, there are signs that they have moved away from steel to die-cast metal objects and from basic chemicals to speciality chemicals. Given that the stabilisation fund is there, even if the oil price drops I don't think we are going to see the growth of the non-oil sector affected that much. The stabilisation fund is huge and the economy would have time to adapt.

Didier dos Santos (DDS): Many critics claim the Russian economy is too dependant on commodities, arguing that without oil and the general commodity boom, Russia would sink back into the dark ages. Oil and commodities companies currently make up 65% of the Russian stock market. Their oil companies are highly profitable. For example, Lukoil, has managed to contain its costs while other, better-known companies such as BP and Shell have seen theirs rise exponentially.

Instead of exporting raw materials, Russia needs to be able to process them within the country and export valuable high-technology products. Therefore, massive investments to develop infrastructure in the petrochemicals, timber, coal and mining industries are required.

The creation of a development bank channelling $35bn into transportation infrastructure, power generation and other sectors is definitely going into the right direction. The development bank will oversee the state investment fund that will

George Nianias is founder and group chairman of Denholm Hall Group and managing director for Denholm Hall Management Limited. He is a well-known expert in capital markets and risk management, and advises sovereign and local governments, financial institutions and corporations in Western and Eastern Europe.

hold $14.4bn of budget money in 2009 and will aim to attract three roubles from the private sector for every rouble the government contributes.

There are other options being looked at, such as the creation of special economic zones offering tax incentives to attract businesses, federal programmes targeting specific industries, the development of information technology, aerospace and heavy machinery.

How does the stabilisation fund impact on the activities of hedge funds?

GN: It means that all the hedge funds are, to some extent, immune to a drop in the oil price. Our hedge fund is largely immune, because we are a credit fund. We see that not only are the companies able to service a strong domestic economy, but the sector has got nothing to do with oil and gas. The money in the stabilisation fund could be used for anything from pensions to supporting the development of the infrastructure. That is good for any hedge fund. That's a key thing.

DDS: What a turnaround the Russian economy has seen! In 1998 it defaulted on its sovereign debt and its stock market plunged to all-time lows. Russia now has foreign currency reserves in excess of $250bn. It is also looking to invest for the future. In 2004 the government created the stabilisation fund from royalty tax and the export duty on oil. The idea was to preserve economic stability and create an investment climate that was friendly to the influx of both labour and capital. This stabilisation fund is now over $77bn in size and has allowed the full early repayment of Russia's remaining $22bn of foreign debt, saving a fortune in interest payments.

In addition to acting as a safeguard against another '1998 crisis', the stabilisation fund can also be used to finance projects including: the pension fund, sterilising monetary emission through the accumulation of currency in the Bank of Russia, an innovation development fund that can be used to finance business ventures and reduce risks faced by investors (similar to the innovation fund in Chile), support for exporting high-technology products, the lease of investment goods through participating banks, and offering more investment credit through the Russian reconstruction bank.

There is no doubt that the hedge fund industry will benefit directly and indirectly from the above investment as a result of increased stability and liquidity in the country.

What is the chief concern of Western investors considering investment in Russia?

GN: At the moment, whichever way you look at it, the chief concerns are still politics and the application of law. The issue with the application of law has been there since the day the Soviet Union ceased to exist in 1991. The definition of what is strategic industry is something that only now has really hit the investors. They are starting to really look into what they should and what they should not invest in.

To us, it's been obvious, because we understand the mentality of the people who come to power. The 'wealth of the Russian people', as they call it, is always going to be controlled by the Kremlin. The oligarchs have been more like stewards of the companies as opposed to owners. We saw and understood that from the 90s onwards this was the case.

Now the situation is more black and white. Of course, the foreigners attach that to the current administration. In reality, it has always been there. The oil and gas resources and the strategic sector are always going to be difficult for the foreigners.

DDS: The legal framework in Russia still leaves many investors with some uncertainties. One of the major concerns is the missing insider law in Russia. This leads to a lack of trust in investments and as a result, in the overall size of foreign investment in Russia. And foreign capital is needed for the huge investments into Russia's infrastructure.

Another aspect in trading is the outstanding legalisation of derivatives trading. Financial derivatives still don't have a legal background and are classified as gambling. Though the Russian regulator is really supporting the legal foundation, the Federal Council rejected an amendment of the law in December that already has passed the Duma.

How will the forthcoming parliamentary and presidential elections affect Russia's investment climate?

GN: I think that Western investors are largely a weather-hardened lot. They have already discounted the elections. Even if the climate – with the West in particular, as well as with the opposition - gets worse (which it probably will over the summer months) I think that the investors are unlikely to run for the hills. They have been expecting this for the last year or even two years. But the headlines are going to get worse!

DDS: In general, we think that the climate won't change dramatically. However, depending on who will be the successor, the view on financial market regulation can change. This is where everybody will have to look at and evaluate the impact on its business. However, we are confident that the Russian market will become more open.

Should hedge fund investors consider debt or equity when investing in Russia?

GN: They already do. There are quite a few huge hedge funds in the equities sector such as Hermitage and Prosperity, which have got several billion dollars under management. The interesting debt – the stuff we do – is very esoteric. But publicly-traded debt yields very little, to be honest.

What advantages does Russia hold over other BRIC countries for emerging market investors?

GN: The BRIC countries are very different to each other, to some extent. They all depend on raw materials and energy, which comes from Russia. If the macro scene was to change dramatically – for example, if China and America went into a slowdown at the same time (which I don't see happening) – then you would definitely see the oil price coming off and therefore the equity investments in Russia looking a little pale.

On the other hand, you could well see the American economy slowing down without the Indian economy slowing down, but you could see the Brazilian economy slowing down at the same time. I think the four of them are increasingly decoupled. The old story that all emerging markets move up and down might still apply, but it is applying less now than it did five years ago.

DDS: Emerging markets are not correlated during a bullish period as each market grows at its own pace based on its own growth factors/indicators. But it seems that they tend to be correlated during a correction period or a crisis like the recent Chinese or Middle East crisis. Russia has evolved into a more mature environment that offers opportunities to hedge positions in rouble assets using futures and options and also arbitrage opportunities between the equity options and the cash market (local and international). Unless you have a specific strategy, such as arbitraging trades between Russia and China or South Africa for example, I do not see the benefit of diversifying into BRIC funds.

What are the main weaknesses in Russia's infrastructure for operating a hedge fund in the jurisdiction?

GN: One thing is the infrastructure of the exchange. It would be very nice if it was possible to short more stock. In terms of starting up a hedge fund, I think it's pretty good. If you go to one of the big brokers, they offer all the services you need to set up a hedge fund. I don't think there's an issue there. Anyway, you are not going to use a domestic prime broker. Even if they offered you a much more competitive service, I don't think it is something that people would do because one of the first boxes that investors tick is 'who's your prime broker?' They want a well-recognised name. The prime brokerage service and custody and so on are investor-driven requirements.

Do Russian hedge funds continue to be serviced largely outside of the jurisdiction?

GN: Yes – I think what is going to happen is that they will depend on the jurisdiction for the Russian trading system, the equity trading system, the Moscow Interbank Currency Exchange (MICEX), the domestic bond and equity market. It seems to be perfectly adequate to raise several billion dollars and I don't think it is the thing that is holding investors back. I don't think if the service provision was better you would see twice as much money invested in the Russian markets by Western investors.

Do Western prime brokers offer enough services for Russian hedge funds?

GN: I don't see many people complaining about prime brokerage services provided by the large Western firms, other than the fact that you can't short stock easily and also a lot of the stock is traded offshore. The ADRs and the GDRs and all of the big, exciting stuff is listed in London or New York. But that's something that people can live with, given the size of the expected returns.

DDS: From our perspective, all major prime brokers are very active in Russia and provide the same services as in Western markets. If there is a demand for new services they will be capable of adapting to special market needs.

How has the environment for operating a hedge fund in Russia changed in recent years?

GN: It has improved because you've got more stocks. You had huge interest in second-line stocks and that has gone on for several years now, making spectacular returns. The development of the environment itself goes back three or four years. The ability of the MICEX to handle equities was something that brought a lot more liquidity to the market. Things like delivery versus payment (DVP) settlement have been very positive.

DDS: As an exchange we see the situation more from a market point of view. And what we see is that the state is still using its ownership in big companies as a way to influence the industry. Further changes in the financial infrastructure such as increased changes in corporate governance, increased transparency, dividends, independence of directors and less involvement from the government in the industry will definitely facilitate external investments.

A recent emerging markets survey conducted among institutional investors showed that an ever-growing pressure to secure double-digit returns has led them to seek out investment opportunities in emerging markets, where this is still achievable.

Following the Asian boom more and more pension funds, insurance companies, charities, endowments and private banks are becoming aware of opportunities in the Russian and CIS markets. The survey respondents considered investing in Russia and CIS worth the risks, but also indicated the need to obtain trustworthy information and impartial advice to assist them in their portfolio allocation.

Who are the main competitors in the Russian funds market?

GN: All our competition is domestic and there is plenty of it. They are not names that you would necessarily recognise – the oligarchs. We have some dealings with them and also with the family offices. Of the several billionaires in Russia, each one of these guys has got an operation that is quite similar – part financed, part direct equity. Then everyone in Russia who has got more than $10m has got one or two investment bankers working for them privately. They put a good half of their money offshore in international investments and then half of it they manage onshore with a team working for them.

What are the implications of Eurex for the Russian derivatives industry?

DDS: Generally, we think that the overall market will benefit from an additional source of liquidity. Derivatives have positive liquidity effects on the underlying markets. In the case of Russia we believe that not only the London Stock Exchange trading will benefit, but also the underlying market in Russia stands to benefit because both markets are linked. Depository Receipts (DRs) can also be seen as a kind of derivative. To be more precise we would like to give some more detailed examples.

First of all, by offering equity and index derivatives on Russian DRs Eurex enables more investors to participate in the Russian market either for investing or hedging. We have a significant number of participants who want to actively trade these products. If these investors step into the market, liquidity will increase – especially with Eurex offering a transparent market with tradable prices. Together, the pooling and the transparency should increase liquidity.

Secondly, Eurex expands the possibilities for Russian banks and brokers to trade with Western counterparties because Eurex's central counterparty guarantees the trades. As of today, these Russian houses are limited because their credit lines are not large enough for the wished trading volumes. Last, but not least, the overall costs will increase. This starts with the low fees per contract (also if compared to competitors and the OTC market) and reduced implicit costs because we think that the spreads will narrow if liquidity increase. ■

Didier dos Santos is a consultant for Eurex working within the institutional investor sales team and covering the hedge fund community in the UK. Didier has been in the industry for 20 years in different capacities (trading, broking, consulting, operations management) and more recently in charge of UK and Middle East sales for ABN Amro Futures.