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### Relevance

*Equity market returns*

*Political risk*

*Privatization: Sberbank*

*SOE clean-up: Gazprom*

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## Should you continue to invest with Putin?

### *Rapidly falling political risk will likely contribute to positive returns from Russian equities in 2012*

The prospect of certain victory for Vladimir Putin in the March presidential election is overshadowed by the events of December 2011, which have laid bare his political decline. This calls into question the continuing validity of the previously successful Russian equity strategy of seeking alignment with Putin's policy goals and exposure to companies associated with him. The right answer depends on an accurate reading of political risk, which this report sets in the broad context of the entire Putin period before focusing on very significant developments since late December.

### Key judgments

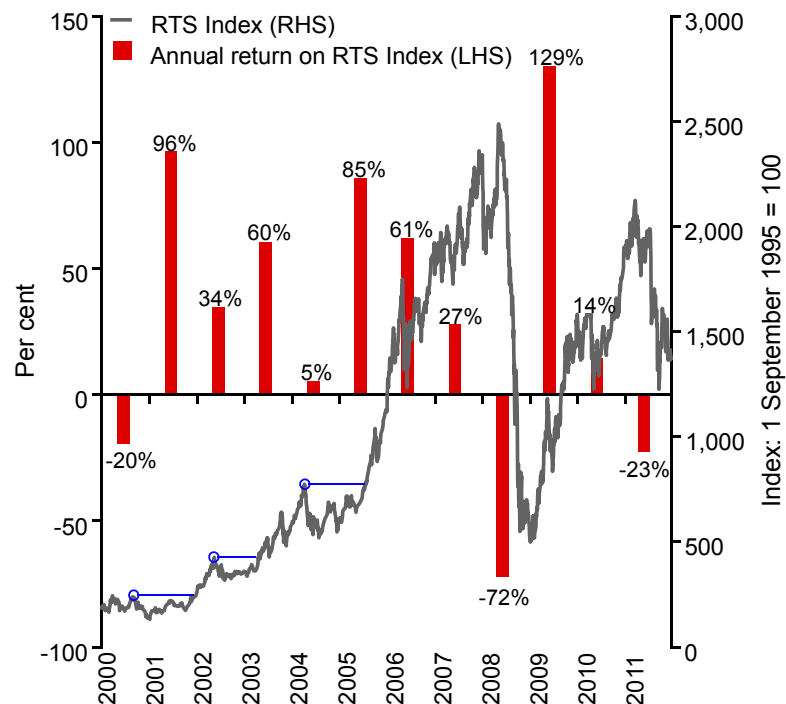
- ❑ The increase in political risk following the Duma election has been reversed, as that tremor has triggered a positive shift in the country's political dynamic.
- ❑ Legitimacy – hence stability – is being rebuilt through an immediate focus on a relatively clean presidential election (equity investors should keep some powder dry for a buying opportunity ahead of a possible second round) and, above all, through the introduction of much greater political competition in response to middle-class protest.
- ❑ The leadership's decision to move from "managed" to more competitive democracy is based on a cost-benefit calculation which looks attractive from the Kremlin perspective and which, in our view, is sound: the medium-term destination is coalitions, as for example in post-war Italy, rather than abrupt alternation.
- ❑ The new political openness will support the fight against corruption. Putin's campaign against theft by SOE managements is best understood as an attempt to corner the most fertile soil from which a rival national leader – such as Alexey Navalny – could emerge.
- ❑ Although the relative decline in Putin's political capital rules out the kind of radical reform drive necessary for a market re-rating, we believe that the improved political risk environment will contribute to positive overall market performance.
- ❑ Investors should look for specific politically driven opportunities among SOEs, including privatization (**Sberbank, MRSKs**) and capex/procurement clean-ups (**Gazprom, Transneft, FSK**) – and exploit recent underperformance in stocks with "Putin" associations.

# CORE CASE

## The track record of equity investing with Putin

Investors in Russian financial assets since the year 2000 have been “investing with Putin” in a variety of senses – some obvious, others less so. To date, the returns have been handsome. The chart below – perhaps the most familiar exhibit in bullish accounts of Russian equity investing – captures the highlights: a total return of 950 per cent on the most widely used dollar benchmark index since Vladimir Putin became (acting) president on 31 December 1999, with average and median annual returns of 33 and 31 per cent. Particularly notable, in our view, is the track record of “worst-case” investing: this means how long an investor who had the misfortune to come in to the market at the top of each bull run would have had to wait before starting to make a profit. For the three material market corrections that occurred before the crash of late 2008 (each marked on the chart below), the answer is attractive: just under 15 months on average.

Chart 1: RTS Index performance since 2000



Source: Bloomberg.

The extent of Putin’s contribution to this performance is one of those questions that gets caught up in partisan debate. The economic history of contemporary Russia has followed the same broad pattern experienced by most other countries coming out of Soviet-style central planning. The collapse of the command economy triggered deep losses of output, but at the same time the building blocks of the market economy were put in place – above all, the introduction of the price signal (removal of price controls) and the establishment of private property. The resulting redeployment of capital and labour to more productive activities would lead, with a lag, to a strong

economic bounce-back. So Putin came to power just at the moment when the Russian economy was in any case poised to grow; and that growth was to be fuelled by the China-driven surge in global expansion, a highlight of which was the relentless rise in the price of oil.

### **Positive building blocks ...**

At the same time, Putin supplied some essential enabling elements for this growth surge. The most important and basic of these was confidence born of fundamental stability – very much including macroeconomic stability, an area in which Putin's early record compares favourably with most if not all his peer group. He also drove through important structural reforms such as overhauling the tax system and factor markets, including the banking system. Property rights were strengthened, and corporate governance duly improved.

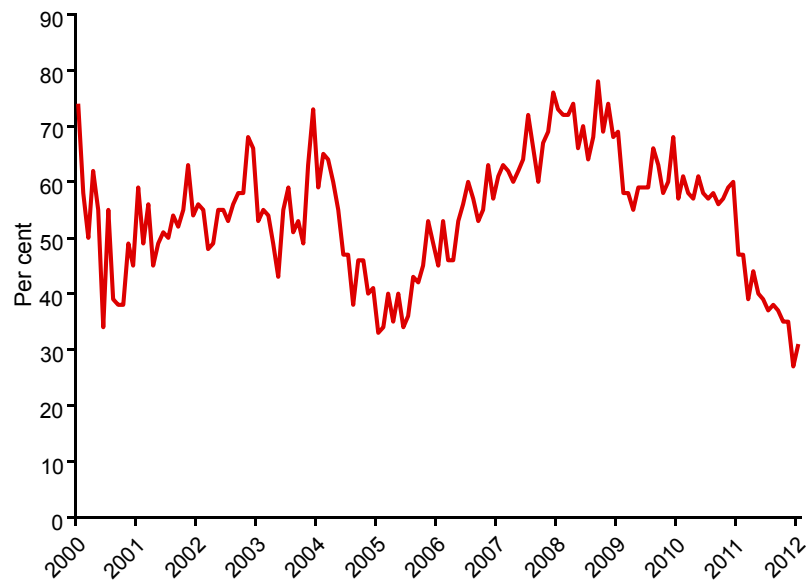
### **... the Yukos lesson ...**

The exception that proved this rule was the expropriation of the assets of an oligarch – Mikhail Khodorkovsky – who had used his controversially acquired wealth to challenge for power in the state. The correct lesson for equity investors to draw from the “Yukos affair” was that the serious risk posed by such internal conflicts could be managed by buying the shares of companies aligned with Putin – in the sense either of ownership (state or crony) or of strategic goals (supporting growth in non-sensitive sectors). In recent years, a prominent example in the former category has been **Novatek** (NVTK RU). Perhaps the ideal company spanning both categories would have been **Megafon** – but for the fact that the repeated stalling of its long-mooted IPO has kept it inaccessible to portfolio investors.

### **... Putin's post-2008 decline ...**

The key question for investors must be whether this hitherto successful strategy of investing with Putin remains valid now that his political decline has become fully apparent. The first relevant observation is that, in hindsight, the apogee of Putin's authority (taking his public approval rating as a proxy measure – see Chart 2 below) coincided with the equity market peak. The pattern noted above of relatively quick recovery from quite deep corrections in the period from 2000 to 2005 (when the last of those corrections was reversed) has not been replicated in the aftermath of the market's collapse in 2008. In the 43 months since the last RTS Index peak of 2,488, the return is still negative (-37 per cent), even though real GDP in constant prices has meanwhile recovered almost to the level reached before the recession that began in late 2008.

Chart 2: Putin's public approval rating throughout his rule



\* Net approval rating (those approving minus those not approving).

Source: Levada.

By the time of that market peak in May 2008 when Dmitry Medvedev took over as president, Putin's sky-high public approval rating had a twin foundation: the image of "saviour" from the turbulent 1990s now combined with "deliverer of plenty" (these findings emerge from detailed opinion surveys and focus group exercises conducted by the country's leading polling organizations). The feel-good factor stemmed from an accelerating consumption-led boom, with dollar-denominated GDP having risen tenfold in the previous decade.

Unsurprisingly, coming from such a lofty peak, it was downhill from there. The boom contained the seeds (inflation, financial repression) of a bust, which duly germinated following the external shock of the global financial crash. The social impact of the resulting deep recession (real GDP contracted by 8 per cent in 2009) was cushioned by the stabilization fund that Putin had prudently accumulated during the boom years and by his decision to go for an aggressive fiscal expansion. But, as today's polling and focus groups reveal, this was not enough to preserve the perception of Putin as "saviour". Dashed expectations of rising living standards weighed more heavily on the public mood. At the same time, real incomes had risen high enough for aspirations to begin broadening – from the purely material to a desire for voice and a demand for greater accountability on the part of the state and its predatory bureaucracy.

As any political science textbook would predict, this shift in social attitudes originated in the more educated and affluent urban population. This is Russia's new middle class, chafing at the negative side-effects of Putin's stability agenda: minimal political competition, slavish pro-government news media (especially in the national and regional television networks) and the epidemic of corruption. Although the corruption problem is far too deep and multi-faceted to be cured by political changes alone, more political pluralism and a freer press remain necessary conditions for improvement on this crucial front. Put another way, the level of corruption in Russia is abnormally high for a country so wealthy (Russia is ranked 120th out of the 183 countries covered in the World Bank's latest annual Doing Business survey; the countries on either side of it have a per capita GDP in a range 18 per cent to 88 per cent lower than

Russia's); and the political system has likewise fallen behind the pace of the country's social and economic development.

### ... leading to the political turning point of late 2011

All this background is necessary to understand the political tremors coming out of Russia's present election season. As we argued in our initial take on the protests following the December 2011 parliamentary election ("[Who'll invest in a country that sways in the wind?](#)"), Putin is largely responsible for these tremors through his failure to bring about the top leadership rotation that is the best way to refresh public support for the kind of "big tent" ruling establishment that he leads. His decision, instead, to return to the presidency was determined – as Putin himself has indicated in some glancing public comments – by his fear that the stability which is indispensable for the country's successful development is precarious (particularly given the threat of further severe external economic shocks). This rationale betrays the delusion so common among successful political leaders that their continuing personal hold on power is essential. The immediate result of Putin's succumbing to this delusion has been the opposite of his stated aim: far from buttressing Russia's stability, he weakened it.

The mechanism of this destabilization is clear from the titular slogan of the protest movement that has formed since the December 2011 parliamentary election: "For honest elections!" To spell this out more fully: the key to stability is legitimacy, and the source of legitimacy in post-Soviet Russia – in terms of both (constitutional) law and social expectations – is popular assent, expressed in elections, to the holders of state power. It follows that legitimacy is eroded by election abuses such as vote rigging and falsification of vote counts.

More precisely, the damage to legitimacy stems from visible public evidence of such abuses. The effect is enhanced when the victims of falsification – that is, those whose votes have been stolen – come from the most active and educated part of the population. This point can be illustrated by a simple comparison. The 1996 presidential election, in which Boris Yeltsin defeated the Communist candidate (then, as now, Gennady Zyuganov) to win a second term, was rigged. The evidence for this available at the time was inconclusive, but the reality was confirmed to us by a perfectly placed source with whom we discussed the matter in 2007. But the liberal intelligentsia and new business elite – hence also the media – were so relieved to have avoided a Zyuganov presidency that they did not denounce the electoral abuse. In the December 2011 Duma election, by contrast, activist anti-government middle-class election observers exposed votes being transferred from the opposition parties to the ruling United Russia (UR) party. As in 1996, the mass news media remained silent; but unlike in 1996, protest can now be mobilized through the internet and social networks.

To sum up the story so far: the erosion of legitimacy has impaired stability (as evident most obviously from public demonstrations attended by tens of thousands of people), and all this has made for increased political risk – which the Russian equity market immediately began to price in by underperforming its EM peers by 5-10 per cent in December. In our December [report](#) on this subject we concluded that the legitimacy of Putin's rule, although weakened, had not been fatally undermined. We based this view on analysis of the evidence of electoral abuse, which suggested that UR's real vote share could not have been much lower than 40 per cent (that is, around 10 percentage points below the party's official score). Because 40 per cent still represents a

substantial plurality, even had the election been completely fair UR could have comfortably controlled the Duma through tactical alliances with small parties such as Vladimir Zhirinovskiy's Liberal Democrats and/or the left-leaning A Just Russia led by Sergey Mironov.

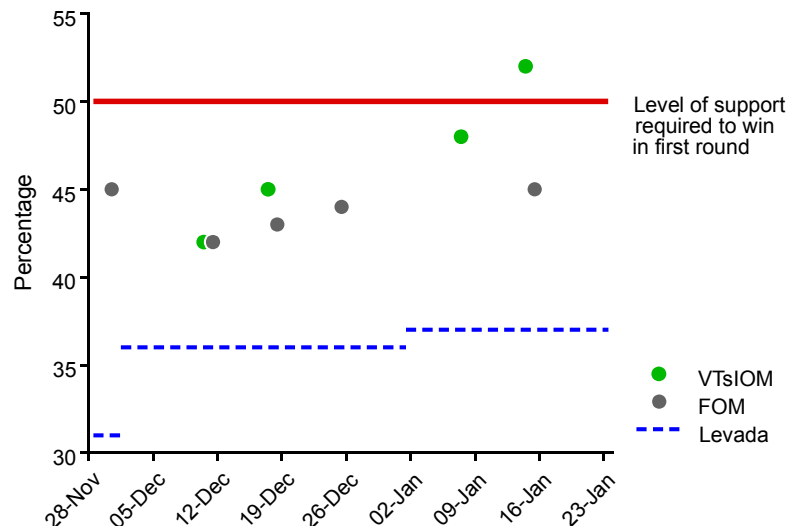
## Three reasons why the political risk outlook is improving

None of the further evidence and studies of election abuse that have appeared since then prompt a change in this view. Moreover, and more important, a series of other developments have improved the outlook for legitimacy, stability and political risk. These new factors are set out below in ascending order of importance.

### 1. Putin rising in the polls

As in any election, the outcome of the Russian presidential race on 4 March will be determined not by the public approval rating of Putin (or of any of the other candidates) in absolute terms, but rather by voters' relative preferences among the choice of candidates on offer. The Levada Centre, an authoritative independent polling organization, reports that the headline results of its latest surveys showing improvements in Putin's share of firm voter intentions signify not so much hope and enthusiasm about the prospect of a new Putin presidency but rather the lack of better alternatives. The chart below shows the results of the latest surveys of voting intentions by Levada and other leading pollsters.

**Chart 3: Voting intentions for Putin in the March 2012 presidential election**



\* Levada data are for one month only. The lower scores compared to the findings of the other two pollsters result from Levada recording the voting intentions only of respondents declaring that they will definitely cast their vote.

Source: VTsIOM, FOM, Levada.

This trend of increasing support for Putin coincides with the start of his active campaign, so should intensify as the election day approaches. Not only would Putin win a fair election: even if his vote share on 4 March falls short of 50 per cent + 1 vote, necessitating a second-round run-off against the next placed

candidate (who will be Zyuganov), his share will be close enough to 50 per cent to remove any need to dilute his political authority by entering into a formal political pact with one of the minor candidates in return for that candidate urging his supporters to vote for Putin in the second round. Sufficient numbers of first-round supporters of Zhirinovskiy and Mironov (and even of the oligarch candidate, Mikhail Prokhorov) would switch in any case to Putin in the second round in preference to Zyuganov. In short, the election will not have to be rigged for Putin to win. This is the key to rebuilding fundamental legitimacy.

## **2. The presidential election will be more honest than previous elections in Russia**

This evidence of voting intentions for Putin means that the fundamental precondition exists for adequate legitimacy during the next political cycle. But the moderate damage to legitimacy resulting from the Duma election would not be repaired if the same abuses were to recur in the presidential election. As we have seen, such habits run deep. Although they are irrational in the sense that Putin would be comfortably elected without such “support”, there has always been an incentive hitherto for governors to rig elections or fiddle vote counts for fear of being disgraced or even dismissed if the election result from the Kremlin’s point of view was worse in their region than in other regions. This time around, the Kremlin is trying to change that incentive. Vyacheslav Volodin, who in December replaced the long-serving Vladislav Surkov as Deputy Kremlin Chief of Staff responsible for domestic political management, instructed governors on 18 January to ensure that the presidential election passes off without scandal and that allegations of abuse are promptly and properly investigated.

This implies that the Kremlin regards a second round run-off as a lesser evil than the further impairment of legitimacy that would result from standard practice – which, in this election, could mean “massaging” Putin’s vote share from its actual level of, say, 45 per cent to above the 50 per cent required for immediate victory. The *Financial Times* wrote on 23 January that “failure to get 50 per cent in the first round would sap Putin’s authority”. This analysis obscures the crucial point that Putin’s authority depends crucially now on the perceived fairness of his (inevitable) election as president. The Kremlin’s apparent preference for a transparent victory over two rounds rather than a dubious first-round win would repair much of the damage done in December to Putin’s authority and, more important, to the overall legitimacy of the ruling establishment.

We expect that preference to prevail over routine corrupt habits. That is, Putin will not be declared the winner after the first round if this entails the risk of a repeat of the scandals that came out of the Duma election. We should add that many Moscow commentators would disagree on this key question – that is, they would view official promotion of a scandal-free presidential election as a sham and/or a chimera, and they would expect the central and regional leadership to balk at the risk to the regime’s power inherent in allowing a genuinely fair election (even if that risk is negligible in reality). Either way, this will be a key risk driver for investors to watch in this presidential election.

## **3. Accelerated political development**

One striking detail should be highlighted from Volodin’s pep talk to governors on the conduct of the presidential election. He reminded them that from mid-

2012 their jobs will become elected offices, so they should think twice about inflaming public opinion in their regions by presiding over blatant election abuses. This statement reveals more than just the above-noted turnaround of incentives as regards elections, important and positive as that is. It also reflects the profound shift in the political dynamic of the country catalysed by the events following the Duma election.

The reintroduction of direct elections of regional governors (with 16 such races due in 2012 alone) was the centrepiece of the political reform announced by Medvedev in his annual state of the nation address on 22 December. The other measures likewise promote political pluralism and competition, in particular by reducing barriers to entry. In each of his three previous state of the nation addresses Medvedev took some baby steps in this same direction, but these latest reforms are more radical. After the relevant enabling legislation is adopted (and Medvedev stated that he wants to see this happen before his term expires in May), the existing high hurdles to registering new political parties and getting onto election ballot papers will all but fall away. (Incidentally, the 27 January decision by election officials to exclude the veteran liberal leader Grigory Yavlinsky from the ballot – and thereby deal a blow to the Kremlin's goal of improving the image of this election – was based on formal grounds that would not in practice arise after the adoption of this latest Medvedev reform package.)

The leadership's response to the middle-class protest sparked by the abuses exposed in the Duma election amounts to saying: "you want more political competition: well, you can have it." Putin made a revealing comment in his annual Q&A session with the public on 15 December, taking credit for and even pride in the spectacle of young and upwardly mobile people participating in peaceful demonstrations calling for political accountability and openness: "If this is the result of the 'Putin regime', I have reason to be satisfied." This image of the Putin prosperity generation growing to maturity is consistent with the terms in which he presented his previous and contrary policy of what became known as "managed democracy". His message back then (from around 2003 onwards) amounted to saying that Russia's immature and fragmented society made it all too easy for criminals and demagogues to get themselves elected to the Duma or regional governorships. His solution was to make the governors in effect presidential appointees and have the Duma elected on a party list system from which new parties were in practice excluded. The framework of a competitive party system had been built, but was left largely devoid of real content. As Russian society matured, that content could easily be supplied. Medvedev's political reforms are akin to pouring water into an empty vessel.

## **Political competition will modify, but not supplant, the Putin establishment**

In practice, the new opening up of the political system has resulted not from Putin getting out of bed one morning and deciding that Russian society had outgrown managed democracy. We believe that the latest reforms are driven rather by pragmatic calculations of political advantage in the specific circumstances of the aftermath of the Duma election. The alienation of Russia's new middle class poses an obvious threat to stability and economic development – and hence also to the power of the ruling establishment. So Putin's response to the political tremors of December 2011 is not an altruistic gesture towards political opponents. Instead, it is now in his interest to re-enfranchise the middle class. The desired stabilizing effect will not even carry much of a political cost for Putin such as a serious electoral threat to the power

and influence of the present ruling elite. Instead, the informal, opaque and unstable coalitions characteristic of the existing “big tent” system will evolve over the next couple of political cycles into more formal and visible parliamentary coalitions.

To make this prediction more concrete, the leaders of the present protest movement can now (re-)enter mainstream politics. On past form, they will soon fall out among themselves. But were they to get their acts together, they could forge a single party appealing mainly to the new middle class (estimated in the government’s new draft “2020 Strategy”, based on measures of discretionary purchasing power, at around 20 per cent of all voters). During the political cycle now just beginning, UR’s slim overall majority in the newly elected Duma will sustain the government led by Dmitry Medvedev as prime minister. Medvedev will take increasing control of the party and, reflecting his government’s reform agenda (on which more below), position the party more explicitly than hitherto on the centre right. This, in turn, will spell further declines in UR’s vote share, with the result that in future political cycles it will no longer have undivided control of the Duma. At the same time, UR will most likely remain the largest single party for many years to come (and changes to the election law mooted by Medvedev in his December 2011 state of the nation address could result in UR gaining a higher proportion of Duma seats relative to its vote share than under the present system). UR will then be able to choose its coalition partner from between a strong new liberal party or A Just Russia – rather as Angela Merkel’s CDU party has led coalition governments first with the SPD and now the FDP. Alternatively, and perhaps even more plausibly, UR will anchor a motley coalition of minor parties in the manner of Italy’s Democrazia Cristiana during the post-war decades.

By way of caveat, the above prediction of how Russian politics will develop in the next one-two decades is too detailed to be taken literally: any number of real-life imponderables could modify one or another aspect of this picture. We nevertheless outline this long-term scenario not only as, in our view, a plausible base case, but also to illustrate the main point that out of the escalation of political risk in December 2011 a lower risk outlook is already emerging. Russia is getting onto a fresh stability path that is more sustainable because it is less prone to the kind of blows to legitimacy dealt by the last Duma election.

## The policy effects of political liberalization

Our standard two-part framework for assessing stability (political risk) moves from checking up on legitimacy as the precondition for any stability to looking at the quality of the resulting stability: is it more on the dynamic or the stagnant side? The two aspects are always linked in a variety of ways, and the most powerful link at present stems from the effect of increased political competition in triggering much more dynamic action against corruption.

## The fight against corruption: An immediate beneficiary of increased political competition

The anti-corruption drive that Medvedev has placed at the heart of his presidency is founded on a perception that the corruption epidemic poses a systemic danger to the Russian state and hence the leadership. The various policy initiatives in this area since 2008 have been serious, determined and widely underestimated ([Russian corruption revisited](#)). But, as in the field of political reform, the political tremors of December 2011 have triggered a step

change in this policy. Since December, Putin has targeted the class of regime-connected rent seekers, focusing in particular on top SOE managers who loot capex and procurement budgets by, for example, awarding contracts (typically overpriced) to suppliers incorporated offshore and owned by themselves or their families. This campaign started in the electricity sector and has since seen the dismissal of the senior executives with responsibility for procurement at **Gazprom** (GAZP RU), **Rosneft** (ROSN RU) and **Transneft** (TRNFP RU). At the same time, SOE managers have been ordered to produce personal income declarations (including those of immediate family members) and disclose the beneficial owners of all suppliers and contractors used by their companies.

Much commentary has presented this campaign as an election stunt that will be abandoned after March. Another view is that Putin has realized that theft in SOEs has reached levels that are completely incompatible with the country's vast infrastructure investment needs, especially given the impossibility of extra financing for such programmes from the increasingly hard-pressed federal budget. There is some truth in both these interpretations. But in our view, the main motivation for this striking escalation of the fight against corruption is to reduce political vulnerability.

We noted above that the likely potential support base for any new liberal political movement would be around 20 per cent of the population. But by campaigning against corruption a liberal opposition leader might succeed in striking out beyond that base and build a mass following from which to mount a serious political challenge to Putin. Boris Yeltsin's successful struggle to supplant Mikhail Gorbachev in 1988-91 began with an analogous campaign against the corrupt privileges of the Communist Party "nomenklatura". The present leader with the most potential here is Alexey Navalny, whose popular blog exposes embezzlement and kickbacks in the bureaucracy and SOEs. Putin's presumed motive of political self-preservation does not lessen the objective benefits of this new crackdown on theft in SOEs for the investment climate and economic growth as well as for shareholder value.

## **Broader policy outlook and the Medvedev government agenda**

In comparison with this galvanizing impact of recent political events on the specific (though very important) area of the fight against corruption, the politically driven prospects for the broader policy outlook seem less enticing. The main problem here is that while, as discussed above, Putin will win the presidency in a way that secures legitimacy, his political capital will be relatively depleted. More precisely, having lost the support of a large part of the middle class, Putin's political base will be that much more concentrated among the lower income groups, especially in the public sector. As all surveys of social attitudes reveal, most such people expect a paternalist state to take care of them. This will heighten the already serious social and political obstacles to essential structural reforms that, by definition, entail up-front pain. The most vulnerable reforms in this perspective are those involving higher electricity prices and user charges for housing and communal services.

We believe that the creative tension generated by political competition will, at the same time, maintain an overall reform impulse. Most progress can be expected in those policy areas that do not give rise to immediate social sensitivities. While a detailed survey of the policies of the prospective Medvedev government is beyond the scope of this report, we conclude by picking out some plausible policy highlights which would directly benefit the

equity market and where we expect to see substantive progress in the first year of the new government which will take office in May 2012.

**Pensions.** In contrast to the sensitive questions of raising the pension age and changing existing early retirement privileges, we would expect to see faster moves to enhance the defined contribution (investment) pillar of the state pension system – in particular by an initiative to channel a larger portion of higher earners' pay into their individual pension accounts.

**Capital market.** The “Moscow financial centre” agenda will be pushed forward this year, starting with the long-awaited establishment of a central depository and clearing house.

**Privatization.** The dispute within the government about the outright privatization of major SOEs will remain in practice unresolved for the next two-three years, during which the government will aim to sell minority stakes in the public market.

**Gas sector.** All domestic gas consumers, both residential and industrial, would benefit from increased competition and free pricing (as opposed to the present policy of ratcheting up regulated tariffs towards the European netback level). The timing on this point is particularly uncertain, and market expectations of such initiatives are low to non-existent. But we expect serious signals in this field no later than 2013.

# INVESTMENT CONCLUSION

The outlook for investors in Russian financial assets has taken a strong positive turn in the month since mid-December, when the protest movement against election falsification burst onto the streets of Moscow and other big cities. As argued in detail above, the reason for this is that the same events that so clearly increased political risk after the Duma election have triggered changes to the political system – mainly increased competition – that will have the effect of repairing legitimacy and galvanizing some important policies, notably the fight against corruption. As a result of this turnaround, the prospect now is one of more sustainable systemic stability. Political risk is therefore back on a downward trajectory.

## Short-term equity play on the March presidential election

Between now and the outcome of the presidential election in March, the Russian equity market will likely reverse the underperformance relative to peers seen in December (nearly 10 per cent vs China and Brazil and 5 per cent vs Turkey and India). Investors should keep some powder dry until the first round of the election on 4 March in case Putin is forced into a second-round run-off. The market reaction would likely be negative. But since, as we have argued, this would be a fundamentally positive scenario, an attractive buying opportunity would arise.

We reiterate here the caveat stated in the preceding (“Core Case”) section. Both this particular recommendation and the main general conclusions of this report would be invalidated if, as several commentators appear to expect, Putin is declared the winner of the presidential election in the first round on the basis of another blatantly rigged vote or falsified vote count. But to repeat: in our judgment, this will not happen.

## Russian equities likely to outperform peers in 2012 ...

Looking further out to 2012 as a whole, the prospect of reduced political risk will complement one of the other two major top-down drivers for this market in helping to improve the chances of overall relative outperformance. The other positive driver we have in mind here is Russia’s reduced financial vulnerability – relative to 2008-09 – to crisis-bound Europe (see our November 2011 report: [Russia’s vulnerability to a Eurozone crash](#)) and the consequent prospect of continued, if slower, growth (we expect real year-on-year GDP growth in the range of 2-4 per cent). The last major top-down driver – the oil price – will, by contrast, create a negative overhang because of perceptions that the price has been kept artificially high by the latest Middle East tensions and the related expectation of weakness down the road on the back of slowing demand.

Pulling these threads together, we believe that Russian equities are well placed for outperformance in 2012. The distinct contribution of the newly positive political risk driver analysed in this report will likely be felt in Q1/12 as regards the whole market (especially if the oil price continues to hold up). As for the rest of the year and beyond, while in our view political capital will be insufficient to support the kind of radical reform drive that would be necessary to support an overall market re-rating, the general policy agenda and

performance of the Medvedev government should generate some positive surprises relative to present low expectations.

## ... with SOEs benefiting from the new political driver

On a one-year view, political factors could have their strongest effect on particular sectors and stocks. The first place to look here is among SOEs. The delayed public market privatization offering of 7.58 per cent of **Sberbank** (SBER RU) has a strong chance of happening this year – not least because lower inflation and gradual Central Bank policy easing will support profitability and hence the share price. In the electricity sector, even assuming (as we do) that political concern about end-user prices continues to hamper reform progress (though will not cause regress as in 2011), the campaign against capex theft provides a favourable backdrop for implementing the declared policy of privatizing the **MRSKs** to strategic investors – an obviously attractive prospect for minority shareholders in those companies.

This leads to a final thought on the implications of Putin's anti-corruption drive in the SOEs. It is too early to draw any definitive conclusions about the investment implications of this campaign. And there are certainly no grounds for excitement about really radical value-creating measures such as the internal restructuring of **Gazprom**. On the contrary, Gazprom will continue to be used for geopolitical projects – such as the South Stream Pipeline project – which will generate the usual corrupt rents for managers and favoured suppliers.

Yet something does appear to have changed. The growing political imperative for Putin of stepping up the fight against corruption may now trump the traditional interests of well-connected groups that feed parasitically on the SOEs. Further very senior management changes, again starting at Gazprom, are likely. All this must be good for shareholder value at the SOEs, including **Transneft** and **FSK** (FEES RU). And even on a sceptical view of the motives of the power brokers and business leaders closest to Putin, their equity interest in the companies they control would allow them to continue prospering despite rent-seeking opportunities beginning to be squeezed. In particular, there seems no fundamental case for the recent underperformance of Novatek to persist. Alignment with the shifting priorities and policies of Putin – even now that he is past his political peak – still looks like a reasonable investment strategy in Russian equities.

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