TKB INVESTMENT PARTNERS

Russian equities outlook

February 2019

Russian equities: slow growth means higher yields

Egor Kiselev, PhD

Head of International Business & Investment Marketing

Gennady Sukhanov

Head of Research

The consensus view is that **Russia is not a growth story. We fully agree**. Over the next three years, we expect annual sustainable free cash flow growth to be close to zero[1]. When companies do not see many growth opportunities, they normally return cash to their shareholders or pay off debt.

The consensus view is that **Russian companies on average are expected to pay high dividends**. Bloomberg consensus forecasts show that Russia has the highest expected dividend yield in the world among large equity markets. **We fully agree with this as well.** For the funds under our advisory, we expect the dividend yield to be 9%-10% on average for the next three years.

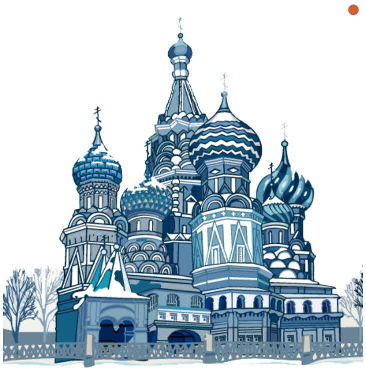
We see more in Russian equities than just a high dividend yield.

We expect Russian companies to generate much more cash than they are expected to distribute to shareholders. Consequently, there is **potential for dividend pay-out ratio increases and buybacks**. It is not in our base case scenario, but we view this as a **positive optionality**. We estimate that there is potential for up to 30%-70% growth in distributions to shareholders in the case that this optionality is realised.

What is in our **base case scenario is that stocks prices are likely to move close to their fair values**. For the market overall, we see 20% upside to the fair value level. For the funds under our advisory, it is 45%-55%. We expect this potential to be realised over the next three to five years.

We think that this picture of the Russian market is rather resilient:

- The government budget, consumers and the Russian currency market are **all living in a world with USD 40 a barrel oil prices already** due to the budget rule
- We believe there is a **low risk that oil prices will drop to below USD 40** per barrel and settle there for the long term
- Since 2017, **inflation has been low** and close to the US inflation rate
- **The risk of material sanctions against Russia is limited by the boomerang effect**
- **Non-material sanctions do not matter.**

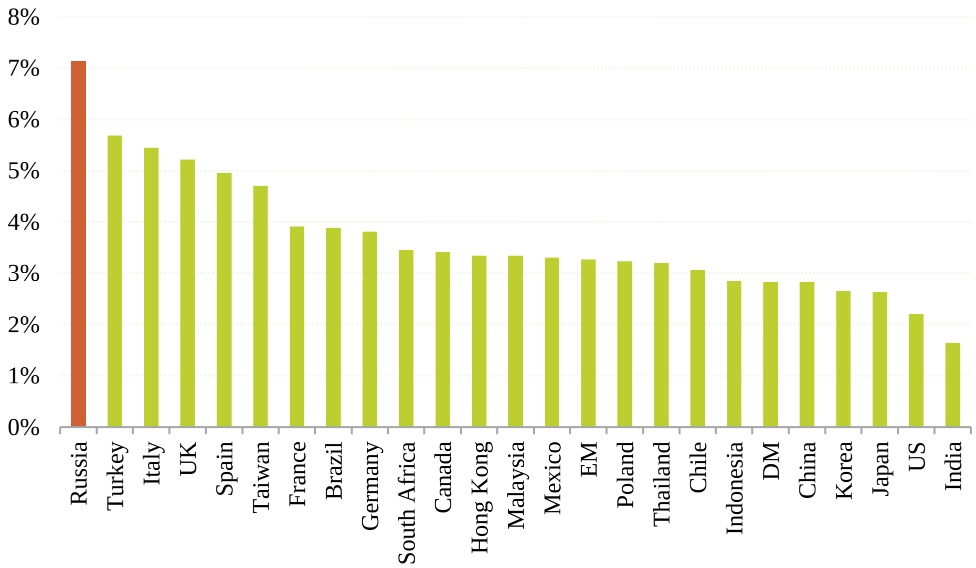


[1] On average for companies in the Parvest Equity Russia and Parvest Equity Russia Opportunities portfolios

7% dividend yield for the index, 10% for the funds

The Russian equity market has the highest expected dividend yield among large equity markets – 7% vs 3.2% for emerging markets (EM) and 2.8% for developed markets (DM). This is clear from the consensus expectations for dividends for MSCI indices from Bloomberg for the next three years.

Average expected dividend yield for the next three years*



* Bloomberg consensus; based on MSCI indices
DM – developed markets; EM – emerging markets
No assurance can be given that any forecast, target or opinion will materialise.
Sources: Bloomberg, TKB Investment Partners, January 2019

Actively managed portfolios can offer even higher dividend yields. According to our calculations, the Parvest Equity Russia and Parvest Equity Russia Opportunities funds will have a dividend yield of 9%-10% per annum over the next three years.

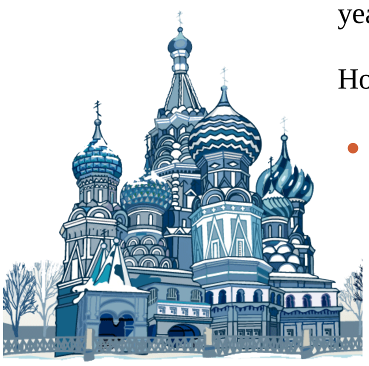
We see more in Russian equities than just a high dividend yield.

Potential for higher pay-outs

In 2018, Russian companies generated much higher cash flows than they paid out in dividends. They continued to earn good profits and cash flows, but saw little need to reinvest them to grow the business as economic growth is slow and the threat of sanctions limits their enthusiasm.

Over 2016-2017, Russian companies on average paid out 90% of their available free cash flow (FCF) in dividends. **Over 2018-2020, we expect Russian companies on average to earn much more cash than the expected dividends priced in by the market.** For the MSCI Russia 10/40 index, we estimate the average FCF yield for 2018-2020 to be 12% vs the 9% average expected dividend yield for the next three years.

How can companies use this FCF?:

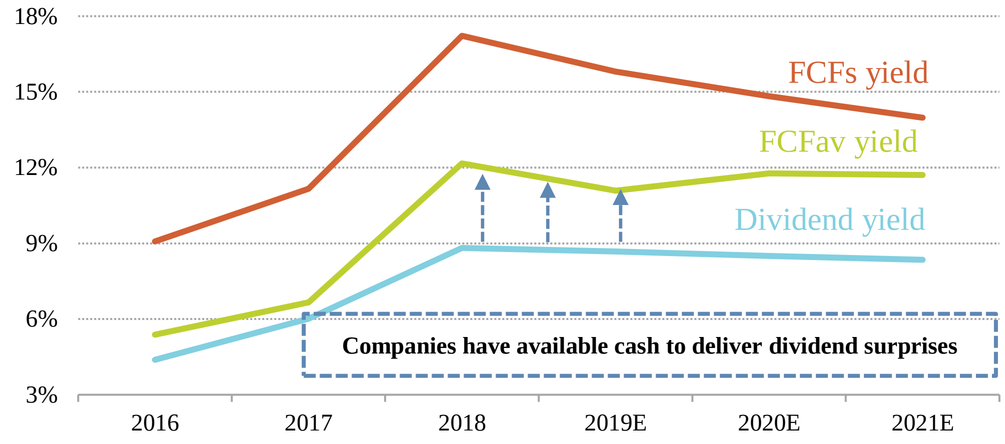


- **Pay off debt.** There is no need for this. Corporate debt is generally low. Many companies are actually debt free (Tatneft, Lukoil, steel companies, Alrosa). The average net debt to EBITDA ratio for Russia is 0.6 – far below 1.6 for EM and 2.0 for DM.

- **Increase dividend pay-outs.** In the past two years, companies paid out 90% of their available FCF as dividends. Over the next three years, this pay-out ratio is expected to fall to 60%-70%, paving the way for pay-out ratios to further increase. Some of the large state controlled companies managed to resist pressure for more distributions in the past. For example, Gazprom continues to keep its dividend pay-out ratio at 25%-26% of net income, which is far below the 50% level pushed by the government. On the other hand, some companies already started to distribute more to their shareholders: Lukoil, Tatneft and Magnit launched share buyback programmes last year; Tatneft increased its pay-out ratio from 30% to 75%.

- **Share buybacks are another way to return cash to investors.** Lukoil, Tatneft and Magnit have launched buybacks. Given the low valuations of Russian equities, other companies may choose to launch buybacks to distribute their excess cash and prop up their share prices.

Free cash flow vs dividend yield

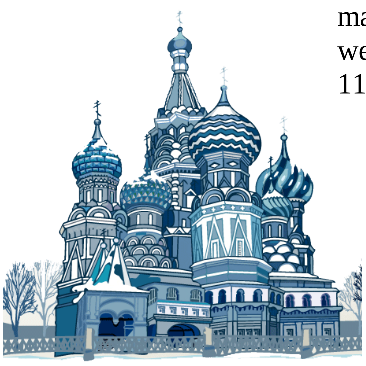


E - expected
Yields are demonstrated for MSCI 10/40 Net return index
FCFs yield– free cash flow sustainable on the base of Stay-in-business CAPEX divided by market capitalization
FCFav yield – (free cash flow sustainable – expansion capex) divided by market capitalization
No assurance can be given that any forecast, target or opinion will materialise.
Sources: Bloomberg, TKB Investment Partners, January 2019

- **For actively managed funds, the potential rise of distributions to investors could be even higher.** For Parvest Equity Russia fund, we estimate the average free cash flow available yield for 2018-2020 at a level of 17% vs 10% average expected dividend yield for this period.

Upside to a fair value level

We think there is 20% upside to the estimated fair value level of the MSCI Russia 10/40 index. We calculate the fair value for individual stocks as the price that would match the expected sustainable FCF yield and the cost of equity. On our estimates, the weighted average FCF yield for the index is 14% compared with a cost of equity of 11%. We assume that over three to five years, stock prices will reach their fair levels.



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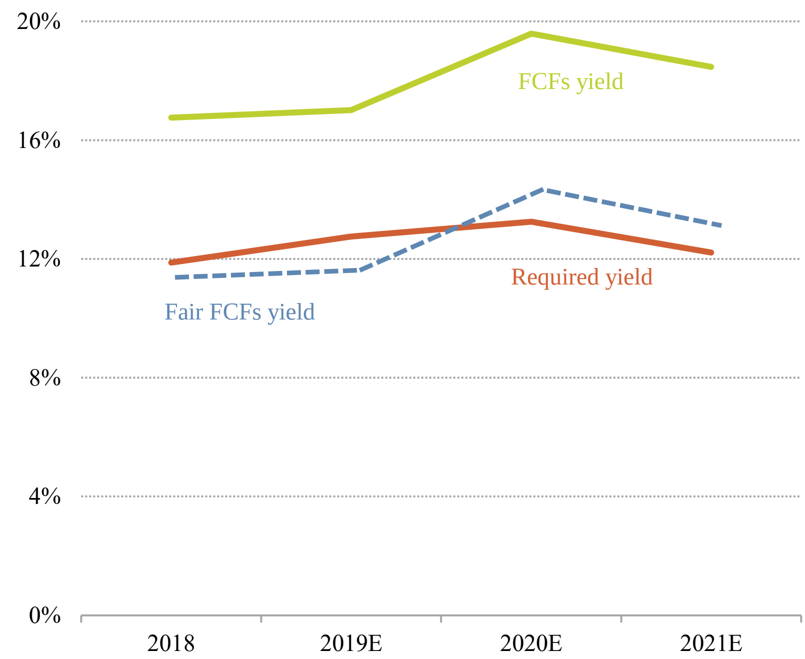
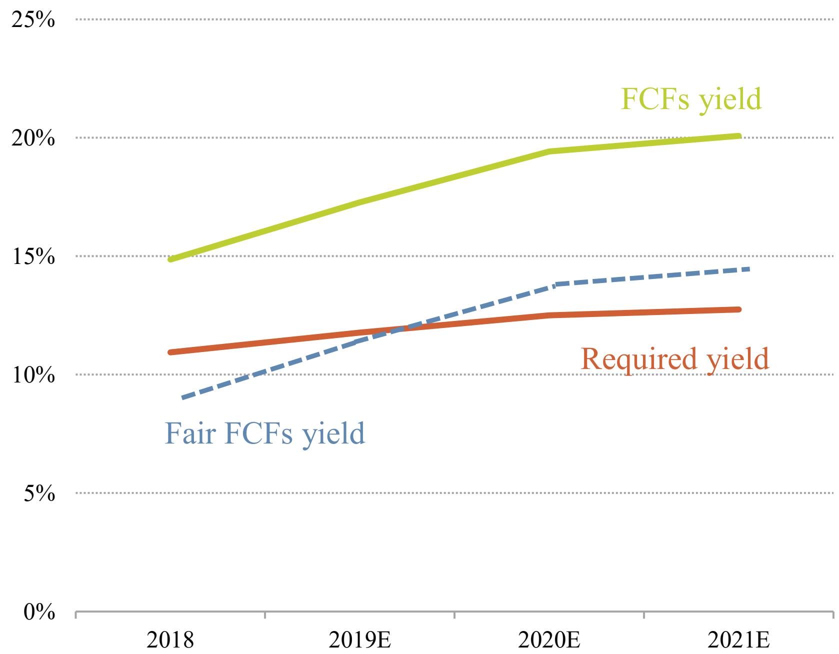
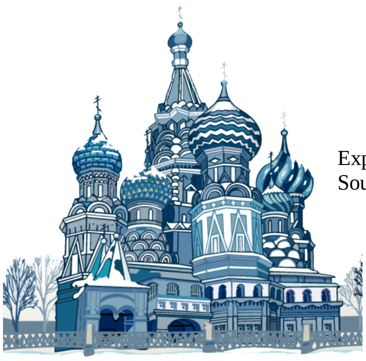
Funds under our advisory can provide greater upside: 45% for Parvest Equity Russia and **55%** for Parvest Equity Russia Opportunities. This is **the highest upside we have seen for our portfolios for many years.**

Parvest Equity Russia
+45% upside to the estimated fair level



Parvest Equity Russia Opportunities
+54% upside to the estimated fair level





Expected figures can be considered as being in USD terms given the expected flat rouble exchange rate vs USD
Sources: Bloomberg, TKB Investment Partners, January 2019

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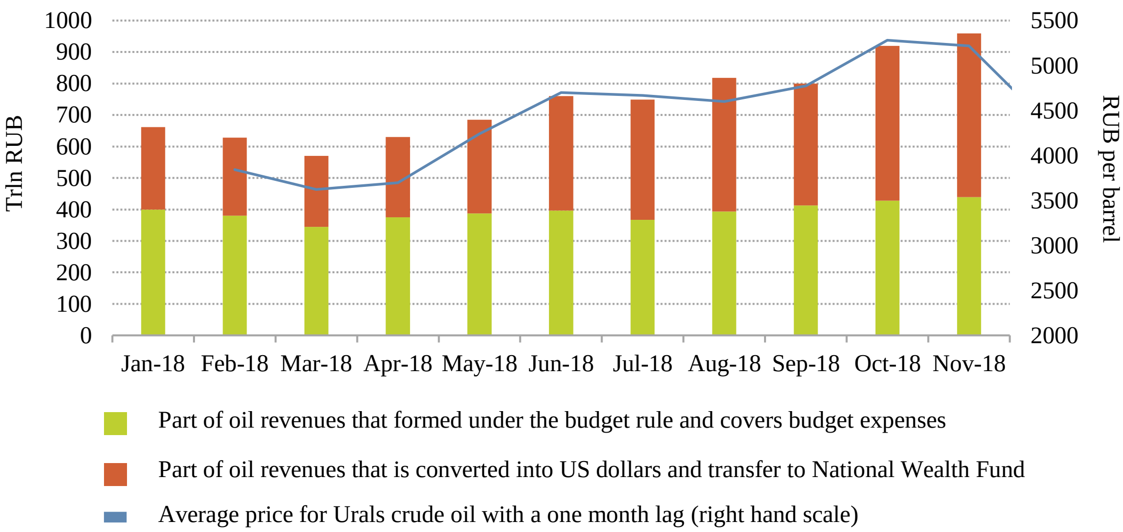
Strong macro factors mitigate currency risk

These are the key macroeconomic factors to help you understand currency risk for Russia:

Oil price. Historically, there has been a strong link between the rouble and the oil price. This is not the case anymore. With the introduction of the Budget Rule, the rouble disconnected from the oil price. The rule calls for the federal budget to be balanced at an oil price of USD 40 per barrel. All extra oil tax revenues are used to buy currency on the open market, to be set aside for a rainy day in the National Wealth Fund. At the current price of USD 60-65, the amount of currency purchases is USD 40 billion, which amounts to 60%-70% of the current account surplus. These purchases are pushing the rouble exchange rate down, effectively making the **budget, consumers and the rest of the economy live in a world with a USD 40 oil price.**

We believe this is good since **it protects a substantial part of the Russian economy when the oil price drops** from current levels to USD 40. Moreover, the pressure to abandon this budget rule is low. The Russian government is keeping its expenses under tight control. They have been declining in real terms for the last six years.

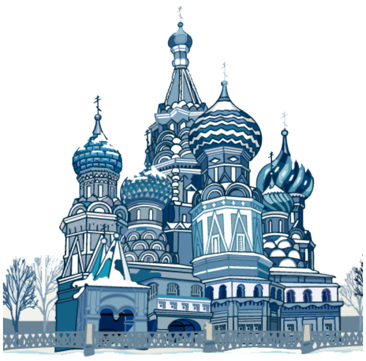
Budget oil revenues split: base revenues vs additional revenues



No assurance can be given that any forecast, target or opinion will materialise
Sources: Minfin, Bloomberg, TKB Investment Partners, January 2019

For the **Russian economy to be "shocked" by falling oil prices, they need to drop below USD 40** and settle there for many years. We believe **this is an unlikely scenario** since:

- **USD 50 per barrel is breakeven for new wells for most of the US shale oil fields**. This is what we understand from various sources. Should the oil price fall to below USD 40, US shale oil production will reverse and start declining, thus helping to rebalance the oil market
- Meanwhile, **Russia and OPEC will come up with meaningful efforts to balance the market**. In December 2018, they agreed to cut output by an additional 1.2 million barrels per day starting January 2019.



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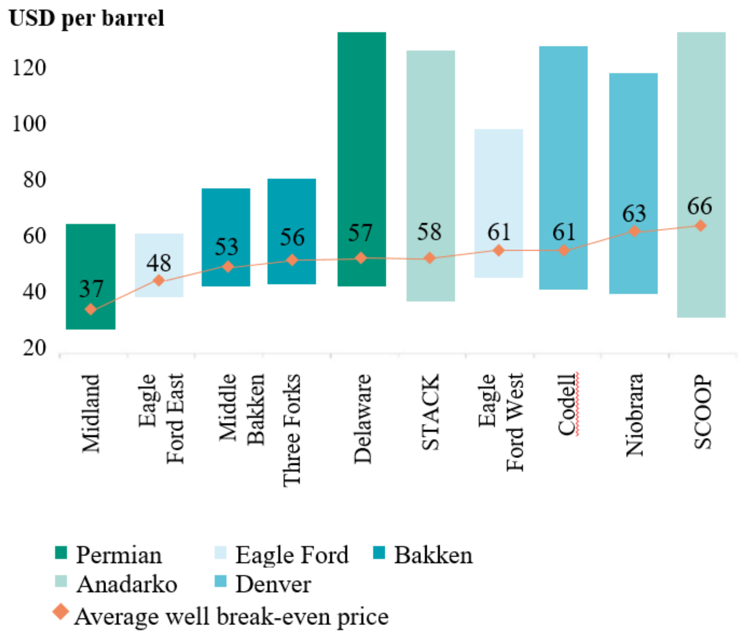
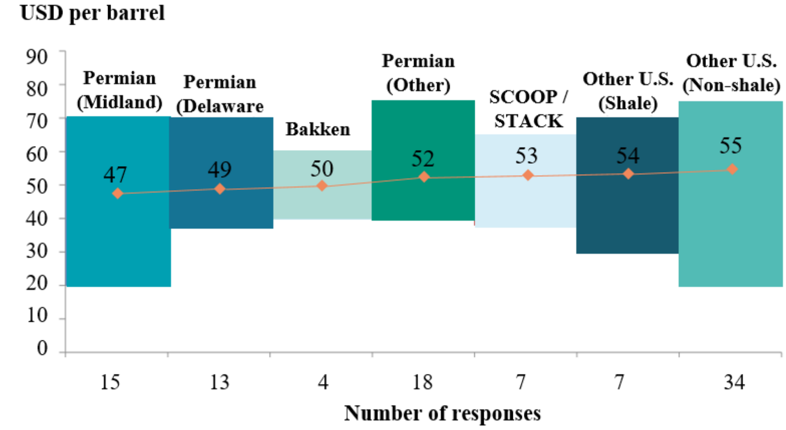
Lower 48 oil break-even costs curve



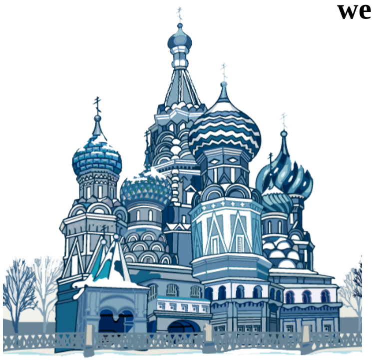
Sources: Bloomberg New Energy Finance

Dallas Fed Energy Survey – In the top two areas in which your firm is active: What WTI oil price does your firm need to profitably drill a new well?



Notes: Line shows the mean, and bars show the range of responses
65 E&P firms answered this question from March 14-22, 2018
Sources: Federal Reserve Bank of Dallas

Inflation. The Russian central bank's new inflation targeting policy has been successful in bringing inflation rates down from 17% in the spring of 2015 to below 4% in 2017. To do this, the CBR has had to maintain rather high real interest rates and raise them in the second half of 2018 to tame inflation expectations ahead of the increase in the value added tax from 18% to 20% in January 2019. This VAT increase will be a one-off and **we expect CPI to fall back to the 4% long-term target of the central bank.**

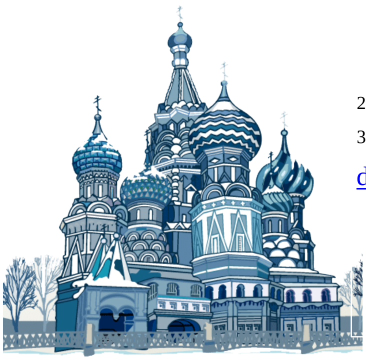


Material sanctions risk is not material

Any material sanctions against Russia will likely have a boomerang effect. The Russian economy is deeply integrated into the global economy: it has a 20% share of global gas exports and 11% of the global oil market. Any sanction that would limit Russia's ability to export oil and gas and other key commodities will likely have a devastating effect on the commodity markets and the world economy.

Consider the case of Rusal, Russia's largest aluminium producer accounting for 6% of global aluminium production. Sanctions against Rusal and its owner, Mr. Deripaska, were announced in April 2018.[2] The US Treasury required US citizens to cancel all business with Rusal by June. This sent aluminium prices flying up by 30%. The US authorities had to shift the deadline eight times. The sanctions never came into force and were cancelled in January 2019.[3]

Non-material sanctions do not matter. Russia saw eight new sanctions being levelled against it in 2018 and yet they did not prevent it from becoming the best performing equity market among the top-20 largest countries.



[2] Three public companies on US blacklist: opening Pandora's Box or a one-off event

[3] First lifting of sanctions: Rusal, En+ and EuroSibEnergo are no longer in the US special designated nationals list

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Contacts

For more information contact:

Egor Kiselev, PhD
Head of International Business & Investment Marketing
e.kiselev@tkbip.ru

Maria Rybina
Investment Specialist
m.rybina@tkbip.ru

TKB Investment Partners (JSC)
69/71, lit. A, Marata Street
St. Petersburg, Russian Federation

Tel: +7 812 332 73 32
Fax: +7 812 324 65 57
info@tkbip.ru
www.tkbip.com

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