

Russian Strategy

Back to a normal market environment?

Equity Strategy

Russia

A rollercoaster market YTD

Concerns about a deteriorating macroeconomic outlook and later tensions in Ukraine, sent Russian equities sharply lower this year. Nevertheless, the market's recent performance gives rise to optimism. In the last 4 weeks, MSCI Russia rose 8%, compared to MSCI EM's 2% gain. In fact, the RTS Index has now gone down just 4 times in the last 20 trading days. In our view, this signals that investors are likely becoming less concerned about risks stemming from the situation in Ukraine.

Falling volatility improves risk-adjusted return profile

Based on consensus estimates of MSCI indices' target prices, Russia has the second highest projected total return in the BRICS+CEE3+Tr space and one of the highest in GEM. With rolling 30 day volatility of the MSCI Russia Index now on a declining trend, the Russian market is also one of the most attractive on a risk-adjusted basis. Using the average volatility for 2013 as a proxy for 'normal' volatility improves the picture further.

The second-highest dividend yield in GEM

The dividend yield has become a key pillar of support for Russian equities – the MSCI Russia Index offers a 4.6% yield in 2014E. Furthermore, as payout ratios in Russia are still low compared to the peer group, there is scope for higher dividends in the future. With 20% projected DPS growth in 2014E-2015E, Russia is the second most attractive market in BRICS+CEE3+Tr on this measure. The stocks that offer exposure to the dividend theme include Lukoil, Rosneft, Bashneft, Surgutneftegaz pref, Bashneft pref, Tatneft pref, Norilsk Nickel, Acron and telecoms.

Domestic stocks' earnings momentum swings upward

Earnings of domestic stocks appear to have troughed and are now moving higher, even with a worsening GDP-growth outlook. We think this indicates there are still structural growth opportunities (i.e. rising internet penetration, switch to modern retail format, etc.). Thus, many of the domestic plays maintain attractive growth rates even in a challenging macroeconomic environment. We would specifically highlight the food retailers and Internet companies to capitalize on strengthening earnings momentum.

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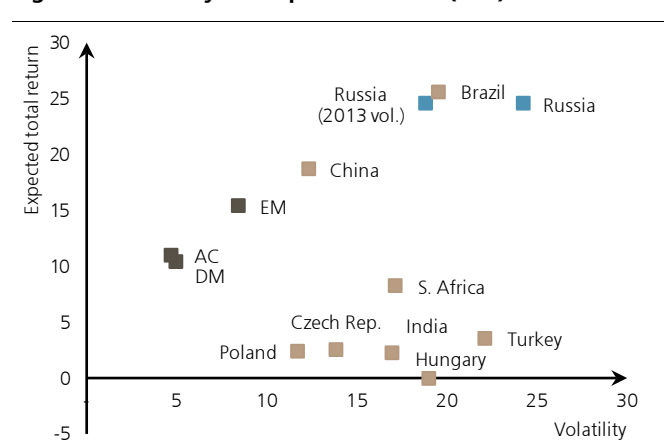
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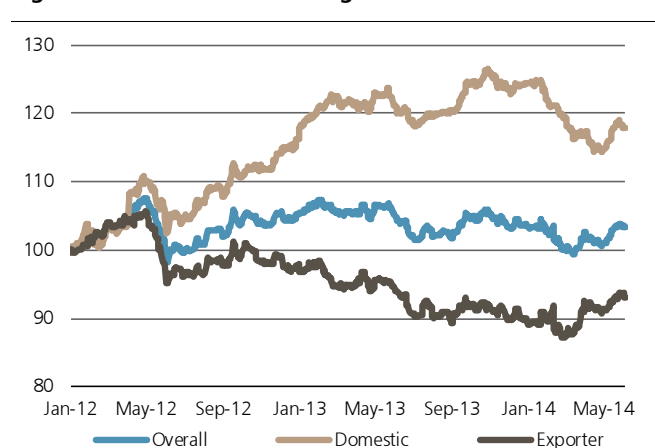
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Figure 1: Volatility vs. expected return (in \$)



Source: Bloomberg, UBS

Figure 2: 12M forward-looking EPS indices



Source: Bloomberg, UBS

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Executive summary

The performance of the Russian equity market has been highly volatile since the beginning of the year. Concerns about a deteriorating macroeconomic outlook and, later, tensions in Ukraine sent Russian equities sharply lower: at its lowest level this year, reached on 14 March, the MSCI Russia index was down 25% YTD.

Nevertheless, the market's most recent performance is cause for optimism. In the last weeks, MSCI Russia delivered a return of 8%, while MSCI EM was up 2% in the period. In fact, the RTS Index has fallen just 4 times in the last 20 trading days. In our view, this means that investors are becoming less concerned about risks stemming from the situation in Ukraine.

The presidential elections in Ukraine are an important step forward that gives the government a firmer mandate to deal with domestic issues. While we would not fully discard the risk of continued unrest, we still think that the probability of extreme outcomes, like involvement by the Russian military in eastern Ukraine and the introduction of economic sanctions, appears markedly lower. We also note that, importantly, Russian equities have become less sensitive to news flow from Ukraine, which we think indicates a decline in the level of uncertainty with respect to Russia's potential course of action.

The fall in market volatility supports this view. Volatility jumped in March in response to the unrest. Now, however, if we look at the rolling 30-day volatility of the MSCI Russia Index, we see that it is back on a declining trend. Compared with BRICS+CEE3+Tr, Russia still has the highest volatility of returns, but we note that it has almost closed the gap with Turkey, the second-most volatile market in our universe.

Despite the strong bounce in the last 6 weeks, we believe that the Russian equity market should remain on a positive trajectory in the short term. Based on Bloomberg consensus estimates for MSCI indices' target prices, Russia has the highest projected total return in EEMEA and one of the highest in GEM. While we acknowledge that these higher projected returns come with higher risk, as measured by the current level of 30-day volatility, the Russian market is still one of the most attractive on a risk-adjusted basis too. Using the average volatility for 2013 as a proxy for 'normal' volatility further improves the investment attractiveness of Russian equities on a risk-adjusted basis.

Trading on a 12-month forward PE of 4.67x, the Russian market continues to be one of the least expensive globally and the cheapest in the BRICS+CEE3+Tr universe. The low valuation, however, is not news and in itself is not a catalyst for the market to re-rate, though the cheap multiples also come with an attractive dividend yield.

Russia already boasts the second-highest dividend yield among BRICS+CEE3+Tr: 4.6% in 2014E. Furthermore, as payout ratios in Russia are still low compared with its peer group, there is scope for higher dividends in the future. In fact, in BRICS+CEE3+Tr, there are only three markets – Russia, Hungary and Czech Republic – where the dividend payout ratio is expected to increase in 2014E-15E. With 20% projected growth in DPS in 2015E, Russia ranks number two in this universe. We provide a list of key Russian stocks and their projected dividend yields for 2014E and 2015E on pages 12-13 of this report.

Domestic growth stories have been hit the hardest YTD by the market correction. Partially, this was because they were more vulnerable to the increase in equity risk premium. However, the underperformance is also a function of weakening fundamentals as a result of earnings forecast downgrades.

In this report, we demonstrate that the negative earnings momentum has reversed, as the earnings of domestic stocks troughed and, recently, returned to growth. We point out that the ongoing improvement in corporate profits in the domestic space is important, as it is happening against the background of continued downgrades to GDP growth forecasts. This indicates that a large number of listed domestic companies operate in structurally attractive industries (ie, Internet penetration growth, the switch to modern retail formats, etc.) and can maintain attractive growth rates even in an environment of slower real GDP improvement.

The consumer sector stands out as the area where the positive change in earnings momentum has been the most visible. After sliding in 1Q14, EPS growth recovered strongly, returning to the 2H13 trajectory. This has been primarily due to the Russian retailers, which delivered positive earnings surprises that in turn triggered forecast upgrades. Earnings momentum has not been as strong in the Internet space, but in this sector too, earnings appear to have troughed and returned to growth, albeit not as strong as previously.

Looking at the evolution of the two-year expected EPS CAGR, we acknowledge that the growth outlook has deteriorated for both the consumer and Internet sectors. Still, we note that growth rates have recently stabilized and remain attractive in absolute terms – 20% for both.

The consumer and Internet sectors trade at above-market PE ratios. However, we note that they remain undervalued relative to their own history, meaning that slower growth appears priced in. Also, interestingly, while they offer virtually the same growth rates on a two-year horizon, the Internet sector trades at a noticeable premium to the consumer sector.

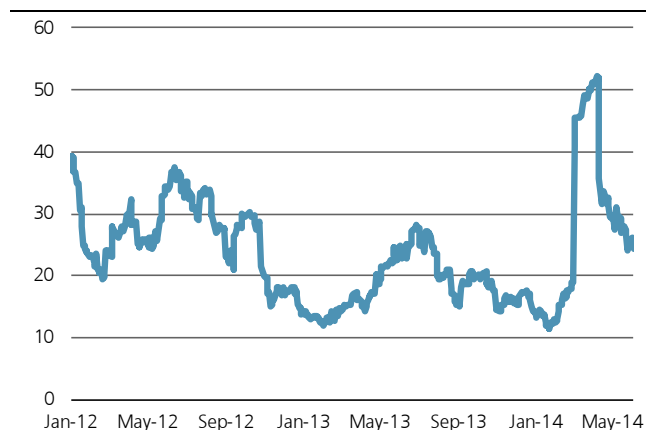
Of all domestic industries, the banking sector has de-rated the most, and at one point its PE dipped below 4x. However, earnings growth visibility in this sector is probably the lowest out of the domestic industry groups. Banks are highly vulnerable to the economic slowdown, which may lead to earnings pressure in the near term and subdued earnings growth in the medium term as a result of rising provisioning levels and slowing demand for loans. At this point, it is still not clear whether banks' earnings momentum is back on a positive trajectory, unlike what we see for the consumer and Internet segments.

Market volatility is on a downward trajectory

In our previous research notes, we highlighted that risk in the Russian equity market increased in response to the unrest in Ukraine. One way to measure risk is via the volatility of daily returns. This markedly increased in March and April. However, if we look at the rolling 30-day volatility of the MSCI Russia Index, we see that the trend reversed recently and is now declining.

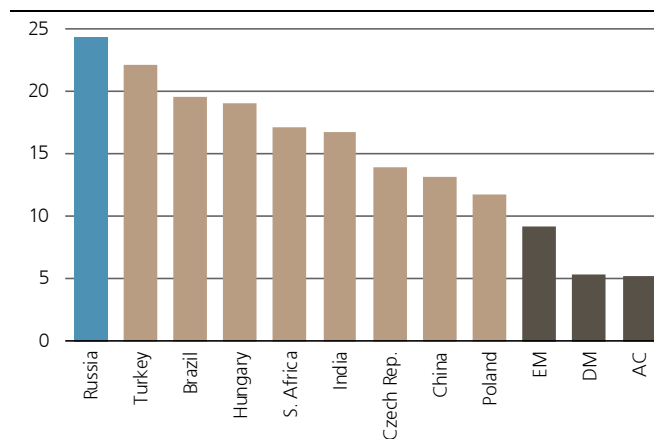
Compared with other markets in GEM (specifically, we look at Brazil, Russia, India, China, South Africa, Poland, Hungary, the Czech Republic and Turkey – hereafter referred to as 'BRICS+CEE3+Tr'), Russia still has the highest volatility of returns. However, we note that it has almost closed the gap with Turkey, the second-most volatile market in our universe.

Figure 3: 30-day rolling volatility of MSCI Russia Index



Source: Bloomberg, UBS

Figure 4: Current 30-day rolling volatility of MSCI indices



Source: Bloomberg, UBS

This means that investors are gradually taking a more constructive stance on the risks involved in investing in Russian equities. We believe that they are becoming less concerned about the implications for Russia of developments in Ukraine. This includes the prospect of a third round of sanctions, which could be economic rather than targeted at individuals, as the previous two rounds were.

Moreover, we take the fall in volatility as an indication that investors are now assigning much lower probability to extreme outcomes, such as direct involvement by the Russian military in eastern Ukraine.

Distribution of returns has widened since the crisis in Ukraine...

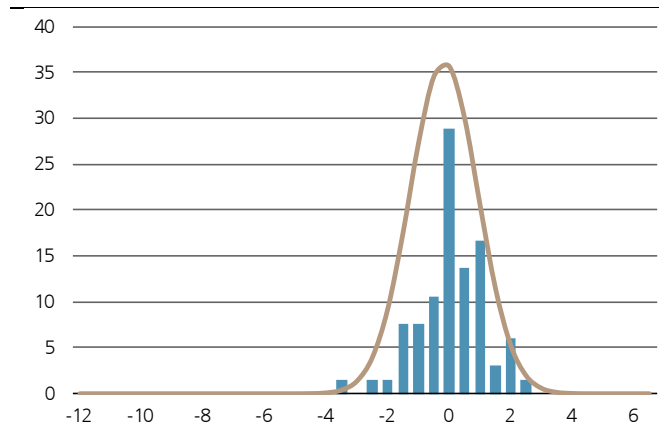
We investigated the performance of the Russian market before and after the beginning of the crisis in Ukraine (we take 3 March as the cut-off point), looking at the distribution of daily returns of the RTS Index. The charts below demonstrate that 66 days before the crisis, the range of daily returns was much narrower: the sharpest daily decline was 3.8%, and the highest index increase was 2.1%. The second observation is that, prior to the crisis, the returns tended to be much more concentrated: the number of returns between -0.5% and +0.5% was 35 during the period before the crisis.

For comparison, during the 66 days after 3 March inclusive, the daily returns showed much greater fluctuations – from -12% (the fourth-largest index decline

since 2000) to +6%. The returns also appear to have been much less concentrated within this range.

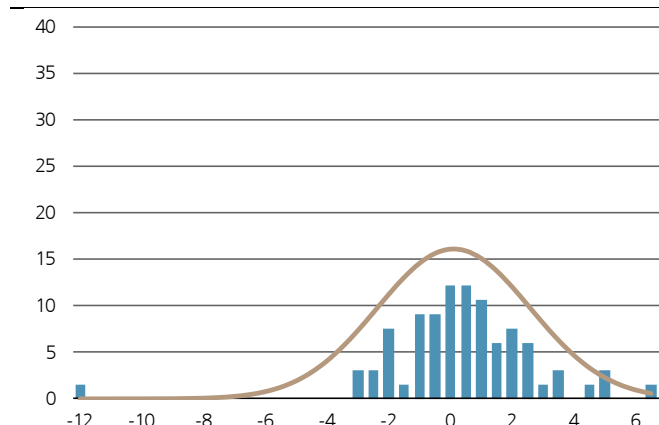
The charts below illustrate the big difference in distribution of returns between the two periods. The standard deviation increased more than twofold after 3 March, which significantly increased the risk of 'outlier' outcomes (e.g., a 12% drop on 3 March and 6% jump on 4 March).

Figure 5: Density of daily returns (22 Nov-28 Feb)



Source: Bloomberg, UBS

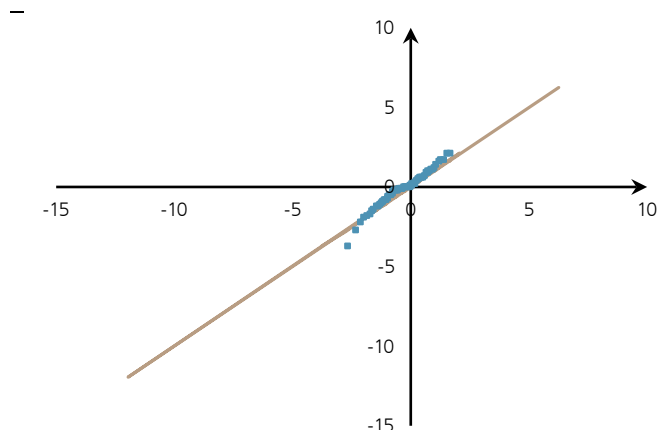
Figure 6: Density of daily returns (3 Mar-5 Jun)



Source: Bloomberg, UBS

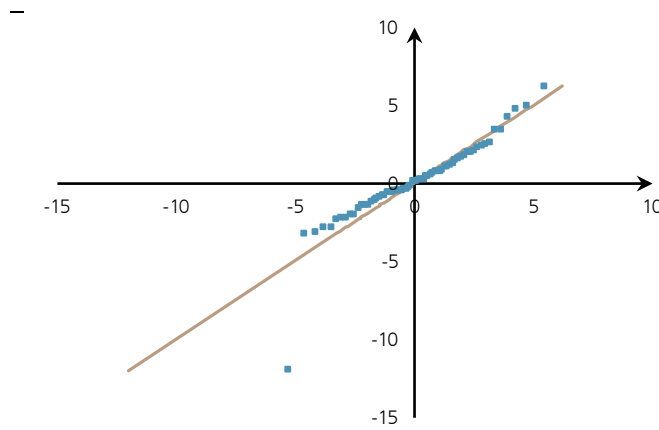
Another way to illustrate the same point is by constructing Q-Q plots, which compare the quantiles of the empirical distribution with the quantiles of the theoretical normal distribution illustrated in the charts above. If the distributions compared were identical, then all points would lie on a 45 degree line from the origin. It can be clearly seen that this is not the case for the period after 3 March. Conversely, Q-Q plot analysis shows that the distribution of returns during the pre-crisis period under review closely matches the theoretical normal distribution.

Figure 7: Q-Q plot (22 Nov-28 Feb)



Source: Bloomberg, UBS

Figure 8: Q-Q plot (3 Mar-5 Jun)



Source: Bloomberg, UBS

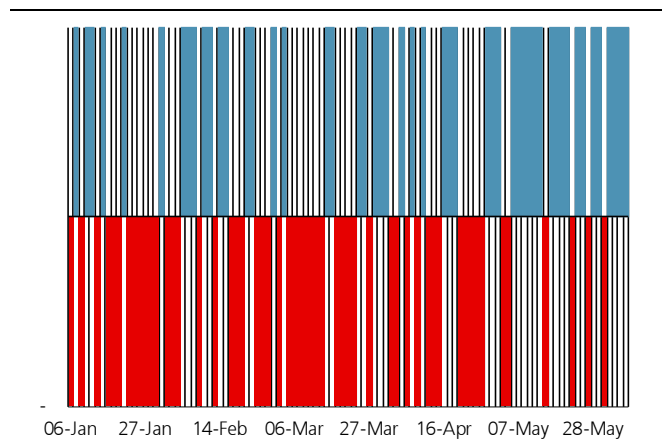
...but positive returns have been dominant in the last four weeks

Importantly, several last weeks have seen predominantly positive index returns, again supporting over view that investors are becoming less concerned about risks stemming from the Ukrainian situation. In fact, the RTS Index has fallen just 4

times in the last 20 trading days. The fact that positive market returns have been dominant recently is illustrated in the charts below.

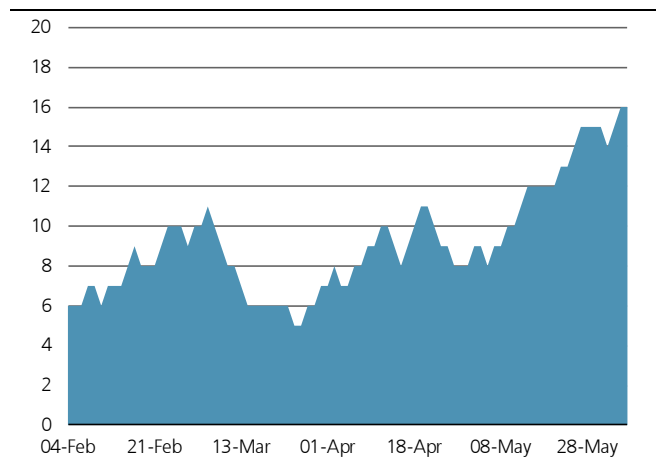
The chart on the left shows positive and negative daily RTS Index returns. The blue (positive) bars are concentrated on the right-hand side of the chart. An alternative way to illustrate the market movements is to look at the change in the number of positive market returns over the last 20 trading days, shown in the figure on the right. The uptrend is clearly visible in this chart too.

Figure 9: Sign of RTS Index daily returns YTD



Source: Bloomberg, UBS

Figure 10: Number of +ve returns over trailing 20 days

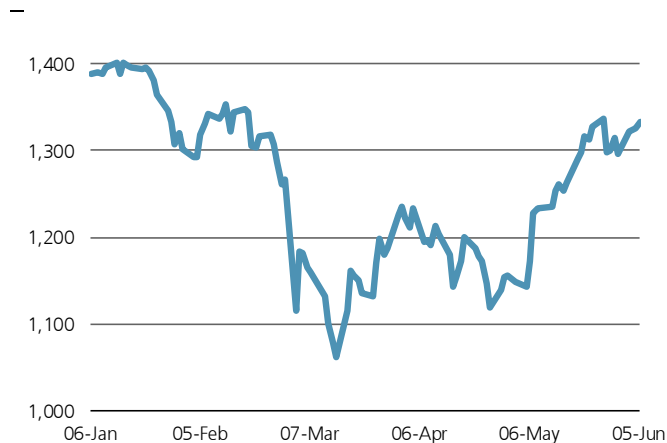


Source: Bloomberg, UBS

One final observation is that the RTS Index is currently 5.5% higher than on its 28 February close (i.e., just before the crisis).

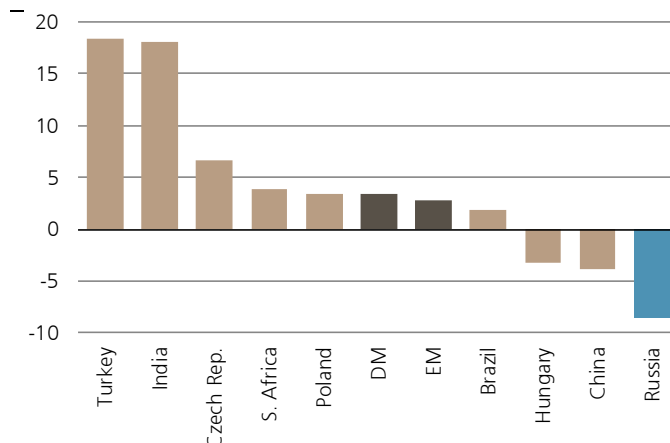
Russia remains the worst performer in the BRICS+CEE3+Tr space, having dropped 8.5% YTD as measured by MSCI Russia Index. Nevertheless, the most recent performance is cause for optimism. In the last 4 weeks, MSCI Russia delivered a return of 8%, while MSCI EM was up 2%.

Figure 11: RTS Index YTD



Source: Bloomberg

Figure 12: Returns of MSCI Indices



Source: Bloomberg, UBS

Ruble tells the same story

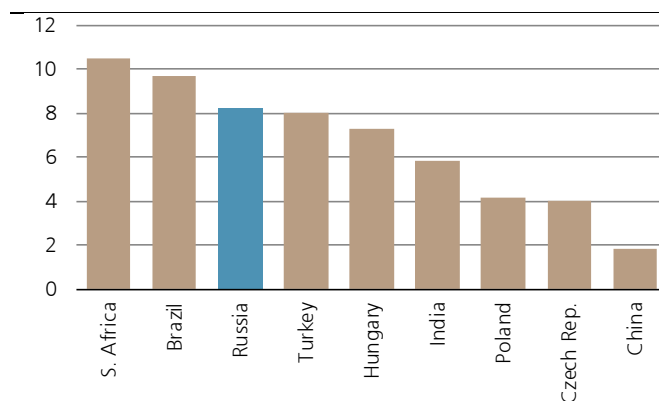
We again use 30-day rolling volatility to demonstrate that although Russian currency remains one of riskiest market in the BRICS+CEE3+Tr space, the gap is gradually closing.

Figure 13: 30-day rolling volatility of RUB/USD



Source: Bloomberg, UBS

Figure 14: Current 30 day volatility of currencies



Source: Bloomberg, UBS

How adequately priced is risk in Russian equities?

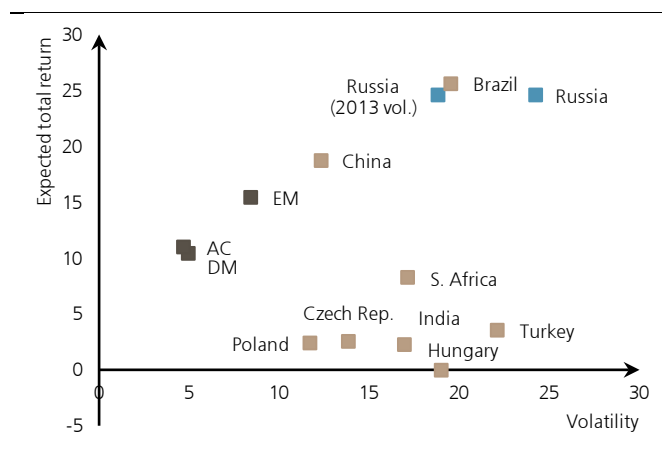
We now proceed with a discussion of how adequately the market is pricing the risk in Russia. We start our analysis by estimating the projected returns, putting them into the context of the BRICS+CEE3+Tr universe. To calculate the returns for these markets, we have relied on Bloomberg consensus estimates of MSCI indices' target prices adjusted for expected currency movements. We also added Bloomberg consensus current fiscal year dividend yield to calculate the total return for the indices.

As a big underperformer since the beginning of the year, Russia, quite unsurprisingly, stands out as the market with the highest projected total return in EEMEA and one of the highest in GEM.

Arguably, however, this projected return should be viewed in the context of investment risks to understand whether the Russian market is really attractive. For the purposes of our analysis, we have used the 30-day volatility of daily returns as the measure of risk. The results of this analysis are presented in the chart below. Our conclusion is that the Russian market stands out as one of the most attractive on a risk-adjusted return profile basis, although it is inferior to China and Brazil, which offer similar returns but lower risk.

However, we note that the volatility of the Russian market remains at elevated levels, so 30-day historical volatility may not be a good proxy for risk in the context of the next 12 months of returns. We therefore do the same analysis using 2013 year-end 260 day volatility. This analysis makes Russia look more attractive on a risk-adjusted basis.

Figure 15: Volatility vs. expected return (in \$)

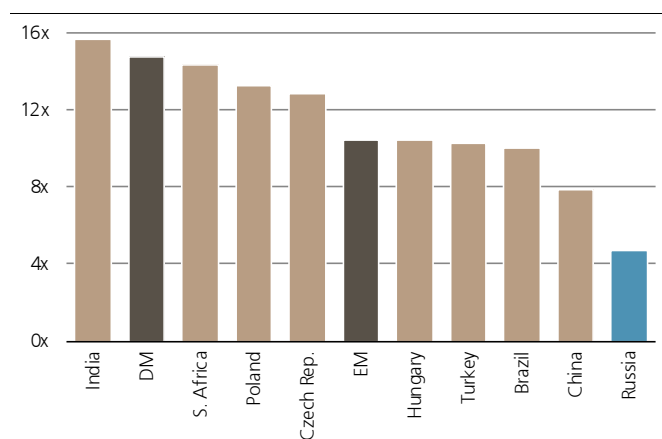


Source: Bloomberg, UBS

Low valuation...

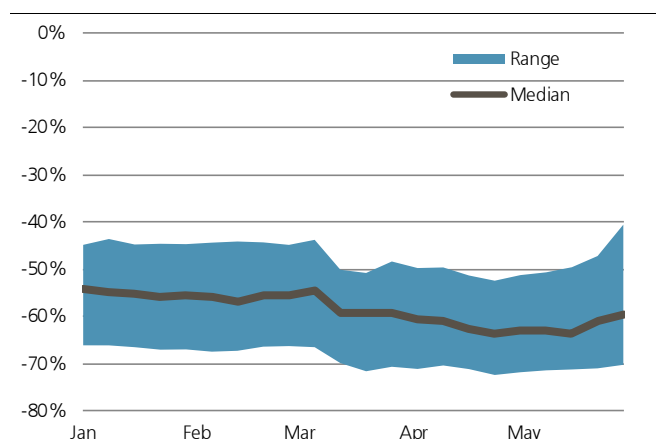
Trading on a 12-month forward-looking PE of 4.67x, the Russian market continues to be one of the least expensive globally and the cheapest in the BRICS+CEE3+Tr universe. In itself, however, this does not have any specific investment implications, as: 1) low valuations *per se* are not a trigger for re-rating; and 2) the times when Russia traded on double-digit PE multiples are long gone, and valuations have been low since the 2008 crisis.

Figure 16: 12-month forward looking PE multiples



Source: Reuters, UBS

Figure 17: PE discount evolution



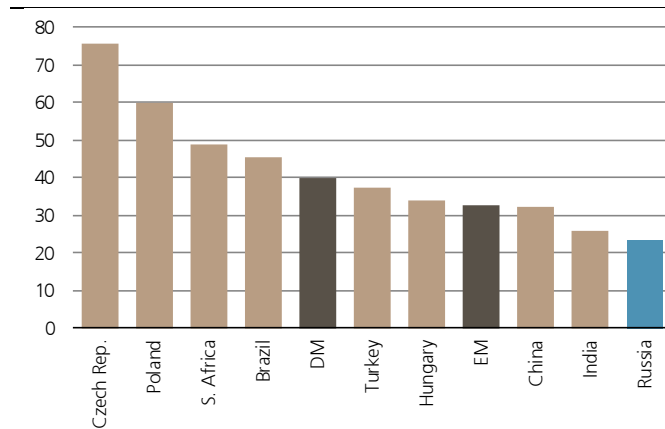
Source: Reuters, UBS

...that now comes with high dividends

The low valuation is not news. However, the cheap multiples now come with an attractive dividend yield. Payout ratios in Russia have been rising since the 2008 crisis. This has been driven by both higher pressure from the government on state-owned enterprises (SOEs) to increase cash flow allocation to dividend payments, as well as private companies' increasing dividend payout ratios. Specifically, the Ministry of Finance plans to set the minimum dividend payout ratio for SOEs at 25% of IFRS consolidated net profit. Although full compliance with the new requirement has never been reached, SOEs have still been increasing dividend payments.

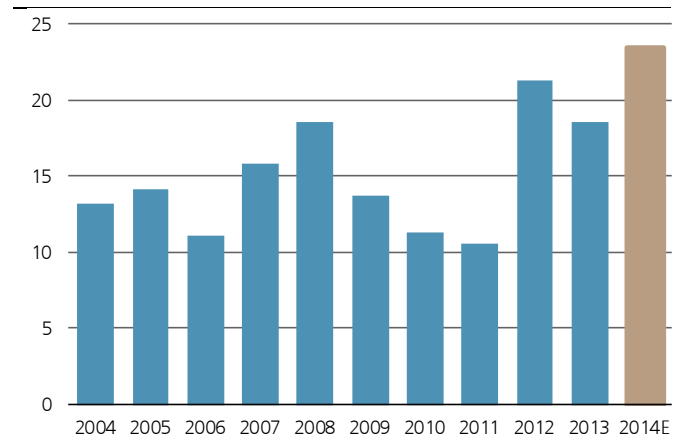
The chart below shows the evolution of the dividend payout ratio for MSCI Russia. While in 2007 it was only 16%, it is rising to 23.5% as of now. Although this is a significant increase, this payout ratio is still low in the EM context, where the dividend payout ratio is 32.5% for MSCI EM Index. The markets that we use for comparison purposes also have dividend yields higher than Russia. In Brazil, companies allocate 46% to dividend payments and China the share is approximately than one-third. The other two big markets – South Africa and Turkey – also offer higher dividend payout ratios.

Figure 18: 2014E dividend payout ratio



Source: Bloomberg, UBS

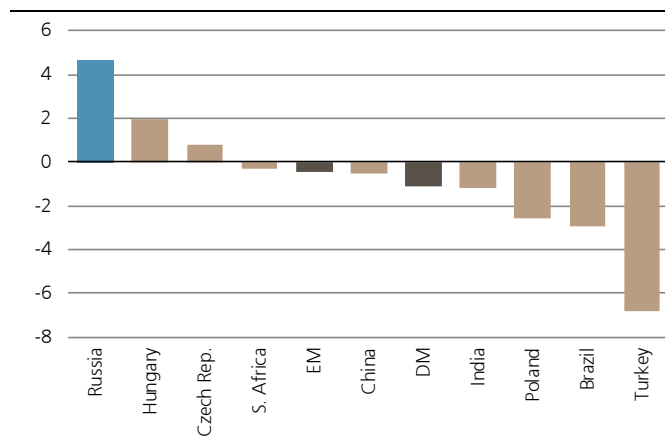
Figure 19: MSCI Russia dividend payout ratio



Source: Bloomberg, UBS

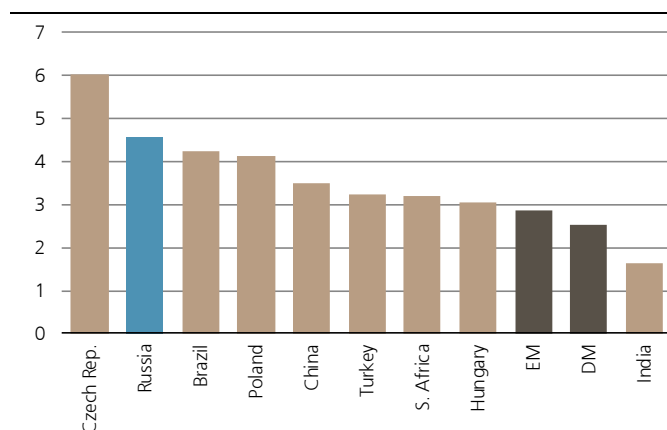
Nevertheless, despite the still low payout ratio, Russia already boasts the second-highest dividend yield among BRICS+CEE3+Tr. This is unsurprising given the large valuation discount that the Russian market offers. Furthermore, of the markets offering high dividend yields, Russia stands out as the one where DPS growth can easily be achieved via rising payout ratios rather than earnings growth. In fact, in BRICS+CEE3+Tr there are only three markets – Russia, Hungary and Czech Republic – where the dividend payout ratio is expected to increase in 2014E-15E. In all other markets the ratio is expected to contract.

Figure 20: Expected change in div. payout 2014E-15E, ppt



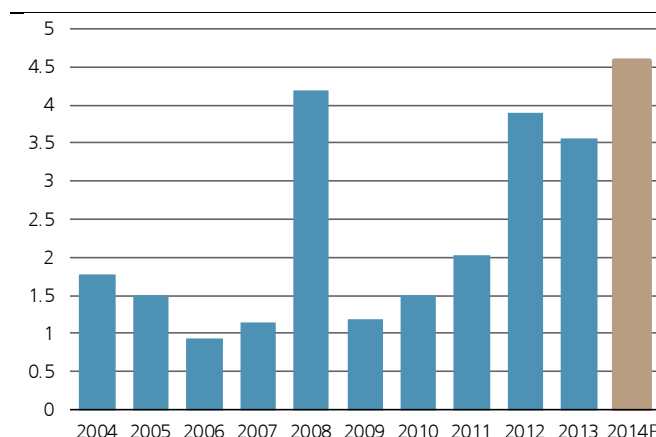
Source: Bloomberg, UBS

Figure 21: 2014E dividend yields



Source: Bloomberg, UBS

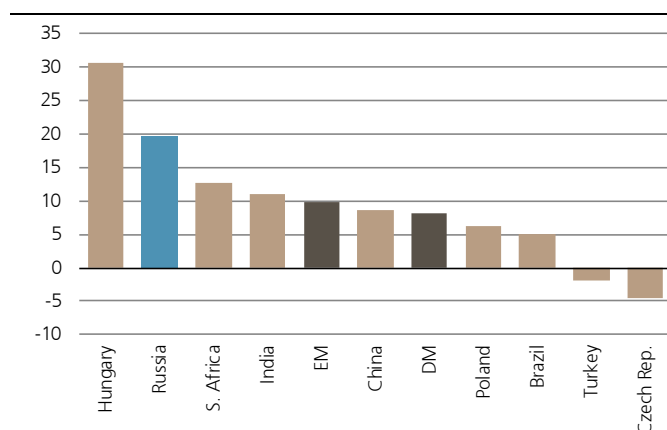
Figure 22: MSCI Russia dividend yields



Source: Bloomberg, UBS

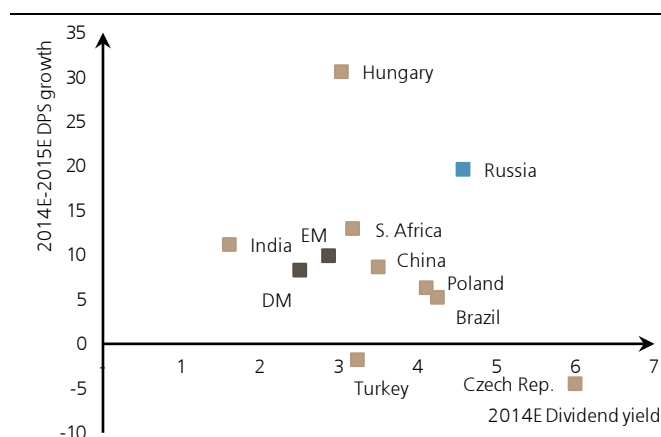
Based on Bloomberg consensus estimates, the Russian market is also attractive in terms of expected dividend growth. Consensus estimates imply that DPS growth for the MSCI Russia Index will be almost 20%. This makes Russia the second-most attractive (after Hungary) market by this measure among BRICS+CEE3+Tr.

Figure 23: 2014E-15E DPS growth



Source: Bloomberg, UBS

Figure 24: Dividend growth versus dividend yield



Source: Bloomberg, UBS

In the table below, we provide a list of specific Russian stocks with their dividend yields, calculated based on 2013 and 2014E fiscal year dividends. As can be seen from the table, the most attractive stocks from a dividend yield perspective are mainly concentrated in exporters, specifically in the oil and gas sector. Preferred shares typically offer a higher dividend yield than common shares, as the former normally trade at a discount to the latter and enjoy higher DPS. In the domestic space, telecoms and real estate developers stand out as offering above-average dividend yields.

Figure 25: Dividends

Industry	Name	Ticker	Currency	Price	Last DPS	2014 Dividend yield	2014 Record date	2015 DPS median forecast	2015E Dividend yield	2015E Ex-date
Oil & Gas	Bashneft	BANE RX	RUB	2310	211	9.13	23/06/2014	185.005	8.01	n/a
	Bashneft pref	BANEP RX	RUB	1815	199	10.96	05/11/2013	190.121	10.47	n/a
	Eurasia Drilling	EDCL LI	USD	31.55	0.92	2.92	31/12/2013	0.83	2.63	n/a
	Gazprom	GAZP RX	RUB	142.75	7.2	5.04	17/07/2014	7.26	5.09	08/07/2015
	Gazprom Neft	SIBN RX	RUB	148.39	5.29	3.56	23/06/2014	9.815	6.61	17/06/2015
	Lukoil	LKOH RX	RUB	2035	118*	5.80	15/07/2014	122.338	6.01	n/a
	Novatek	NVTK RX	RUB	392.56	4.49	1.14	29/04/2014	10.242	2.61	n/a
	Rosneft	ROSN RX	RUB	229.5	12.85	5.60	08/07/2014	10.015	4.36	08/07/2015
	Surgutneftegaz	SNGS RX	RUB	26.999	0.6	2.22	16/07/2014	0.71	2.63	15/07/2015
	Surgutneftegaz pref	SNGSP RX	RUB	27.263	2.36	8.66	16/07/2014	2.075	7.61	15/07/2015
	Tatneft	TATN RX	RUB	208.79	8.23	3.94	16/07/2014	9.325	4.47	08/07/2015
	Tatneft pref	TATNP RX	RUB	124.4	8.23	6.62	16/07/2014	8.79	7.07	08/07/2015
Metals & Mining	Transneft	TRNFP RX	RUB	76500	724.21	0.95	n/a	767.44	1.00	n/a
	CTC Media	CTCM US	USD	10.57	0.175	1.66	16/06/2014	0.7	6.62	n/a
	TMK	TRMK RX	RUB	81.4	0.78	0.96	07/07/2014	2.137	2.63	n/a
	Nordgold	NORD LI	USD	1.71	0.018	1.05	12/06/2014	0.02	1.17	n/a
	Alrosa	ALRS RX	RUB	44.35	1.47	3.31	18/07/2014	1.97	4.44	n/a
	Norilsk Nickel	GMKN RX	RUB	6882	469.2*	6.82	17/06/2014	539.151	7.83	17/06/2015
	Novolipetsk Steel	NLMK RX	RUB	47.87	0.67	1.40	17/06/2014	0.733	1.53	18/06/2015
	Severstal	CHMF RX	RUB	286.4	2.43	0.85	23/06/2014	8.026	2.80	n/a
	Polymetal	POLY LN	GBp	526.5	0.08	0.02	02/05/2014	8.312	1.58	n/a
Financials	Polyus Gold	PGIL LN	GBp	185	n/a	n/a	n/a	1.189	0.64	21/05/2015
	Moscow Exchange	MOEX RX	RUB	65.3	2.38	3.64	11/07/2014	2.77	4.24	n/a
	Sberbank	SBER RX	RUB	87.43	3.2	3.66	17/06/2014	3.25	3.72	09/06/2015
	Sberbank pref	SBER RX	RUB	87.43	3.2	3.66	17/06/2014	3.25	3.72	09/06/2015
	VTB	VTBR RX	RUB	0.04844	0.00116	2.39	01/07/2014	0.001	2.06	25/06/2015
	Vozrozhdenie	VZRZ RX	RUB	387.8	0.5	0.13	08/07/2014	0.5	0.13	n/a
	AFK Sistema	AFKS RX	RUB	43.75	2.06	4.71	17/07/2014	1.91	4.37	15/07/2015

Source: Bloomberg consensus estimates, UBS; Note: * – includes final and expected interim dividend

Figure 26: Dividends (continued)

Industry	Name	Ticker	Currency	Price	Last DPS	2014 Dividend yield	2014 Record date	2015 DPS median forecast	2015E Dividend yield	2015E Ex-date
Retail	Dixy	DIXY RX	RUB	371.01	n/a	n/a	n/a	0	0.00	n/a
	Magnit	MGNT RX	RUB	8928.8	89.15	1.00	13/06/2014	169.065	1.89	n/a
	O'Key	OKEY LI	USD	9	0.2267	2.52	18/02/2014	0.2	2.22	n/a
	X5 Retail	FIVE LI	USD	19.91	n/a	n/a	n/a	0	0.00	n/a
Telecoms	MTS	MTSS RX	RUB	297	24.65*	8.30	07/07/2014	25.15**	8.47	n/a
	Megafon	MFON RX	RUB	1045.5	64.51	6.17	11/07/2014	72.575	6.94	n/a
	Rostelecom	RTKM RX	RUB	84.71	3.12	3.68	14/07/2014	2.795	3.30	29/04/2015
	Rostelecom pref	RTKMP RX	RUB	56.91	4.85	8.52	14/07/2014	4.67	8.21	29/04/2015
	VimpelCom	VIP US	USD	8.81	0.45	5.11	18/11/2013	0.035	0.40	n/a
Internet	Mail.Ru	MAIL LI	USD	34.65	4.3	12.41	20/03/2013	0.94	2.71	n/a
	Yandex	YNDX US	USD	33.08	n/a	n/a	n/a	0	0.00	n/a
Media	Qiwi	QIWI US	USD	44.01	0.32	0.73	13/06/2014	1.379	3.13	n/a
Fertilizers	Acron	AKRN RX	RUB	1368.3	152	11.11	09/06/2014	79.3	5.80	n/a
	PhosAgro	PHOR RX	RUB	1189.2	19.3	1.62	24/06/2014	51.035	4.29	n/a
	Uralkali	URKA RX	RUB	154.5	1.63	1.06	20/06/2014	4.843	3.13	n/a
Real Estate	Etalon	ETLN LI	USD	4.43	0.075	1.69	13/06/2014	0.1	2.26	n/a
	LSR	LSRG RX	RUB	615.1	40	6.50	01/07/2014	28.79	4.68	n/a
	PIK	PIKK RX	RUB	91.29	n/a	n/a	n/a	1.215	1.33	n/a
Transport	Aeroflot	AFLT RX	RUB	57.57	2.4984	4.34	08/07/2014	2.101	3.65	05/07/2015
	Globaltrans	GLTR LI	USD	10.97	0.62	5.65	28/04/2014	0.58	5.29	n/a
	NCSP	NMTP RX	RUB	2.1998	0.023364	1.06	09/07/2014	0.023	1.05	n/a
Utilities	Inter Rao	IRAO RX	RUB	0.009302	n/a	n/a	n/a	0	0.00	n/a

Source: Bloomberg consensus estimates, UBS; Note: * – includes final and expected interim dividend, ** – UBS estimate

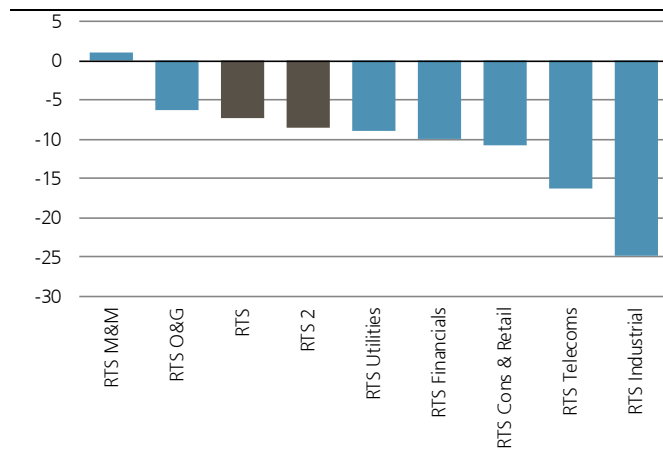
Assessing growth outlook

Growth is the key value driver in EM. In this respect, Russia is an atypical emerging market. This is because the composition of its stock universe is heavily dominated by commodity exporters, whose revenue generation is not really dependent on the domestic economy. Instead, their financial performance is linked to the global business cycle. Commodity prices, after the rebound from 2009 lows, were largely stable over the last three years. Specifically, the oil price, after doubling between early 2009 and late 2010, fluctuated in the range of \$90-125/bbl (Brent) without showing any trend. It is currently \$108/bbl. As Russian oil production volumes have barely grown, it is unsurprising that oil companies' earnings remain largely stable.

That said, stocks with exposure to domestic demand have clearly been valued on earnings growth potential. Those companies that operate in structurally attractive industries (ie, Internet penetration growth, the switch to modern retail formats, etc.) and demonstrate a consistent ability to meet or beat earnings growth expectations have significantly outperformed the market and traded at earnings multiples considerably higher than the market average.

However, as we highlighted in our previous research notes, the earnings growth outlook for consumer-oriented stocks deteriorated in 2014 as a result of currency weakening and slowing economic growth. Furthermore, they appeared to be more vulnerable to deteriorating investor sentiment as a result of the crisis in Ukraine – which is perfectly natural given that they exhibit a higher sensitivity to changes in discount rate.

Figure 27: RTS indices performance YTD



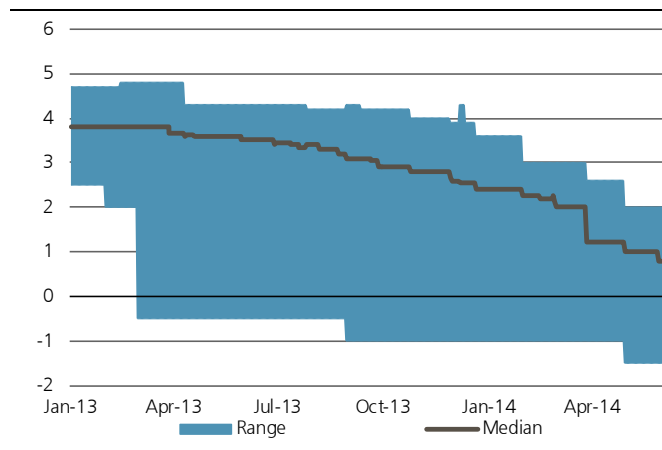
Source: Bloomberg, UBS

To track the changes in earnings momentum, we have constructed free float-adjusted market capitalisation-weighted next 12M median forecast EPS indices for the key sectors in the Russian market using the end of 2011 as the base period (100). We disclose the methodology for the construction of EPS indices in the Appendix.

We start our analysis by looking at the performance of the aggregate indices: the overall market index, as well as domestic and exporters' indices. The conclusion is that all three EPS indices recently started showing an upward earnings trend. For exporters, the pickup in earnings growth momentum is mainly a function of a weaker rouble. The same trend had an initial negative impact on the earnings growth of domestic stocks, though even in this segment, earnings appear to have

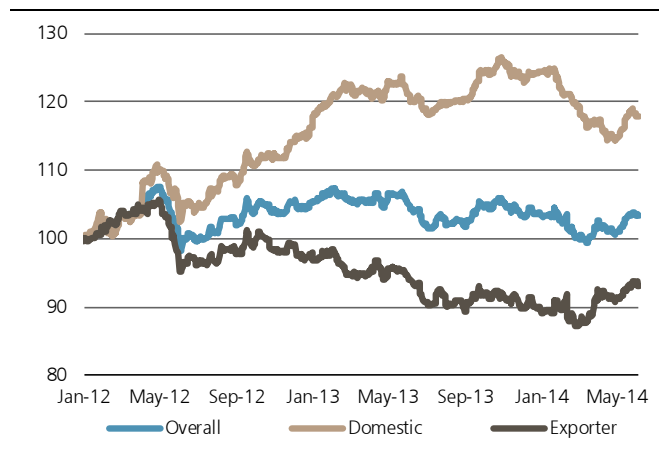
troughed and, more recently, returned to growth. We point out that the improvement in corporate profits in the domestic space is important, as it is happening against the background of continued downgrades to GDP growth forecasts.

Figure 28: 2014 GDP growth forecast evolution



Source: Bloomberg, UBS

Figure 29: 12M forward-looking EPS indices

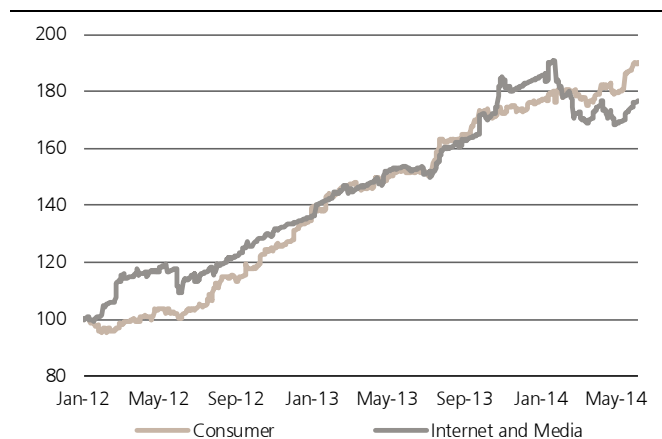


Source: Bloomberg, UBS

Moving to a sector level, the EPS analysis reveals that the consumer sector stands out as the area where the positive change in earnings momentum has been the most visible. After sliding in 1Q14, EPS growth recovered strongly, returning to the 2H13 trajectory. This has been primarily due to Russian retailers, which delivered positive earnings surprises that in turn triggered forecast upgrades. Earnings momentum has not been as strong in the Internet space, but in this sector too, earnings appear to have troughed and returned to growth, albeit not as strong as previously.

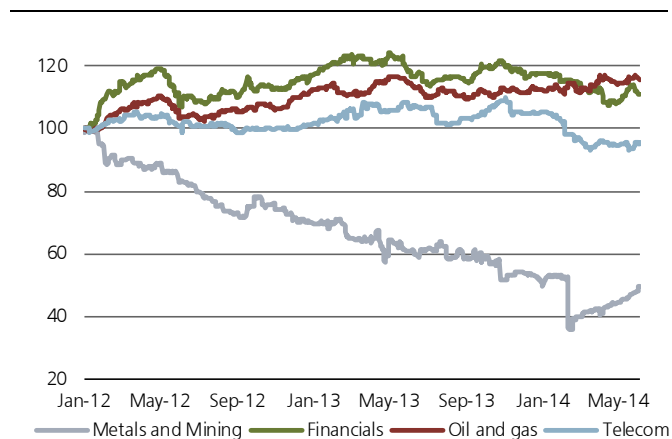
It is also worth highlighting the metals and mining sector, where the long-term trend of falling earnings reversed and next12M started rising. This is mainly due to earnings upgrades for Norilsk Nickel, which reflect the strength in nickel and palladium prices. The earnings growth outlook also improved for financials.

Figure 30: 12M forward-looking EPS indices



Source: Bloomberg, UBS

Figure 31: 12M forward-looking EPS indices

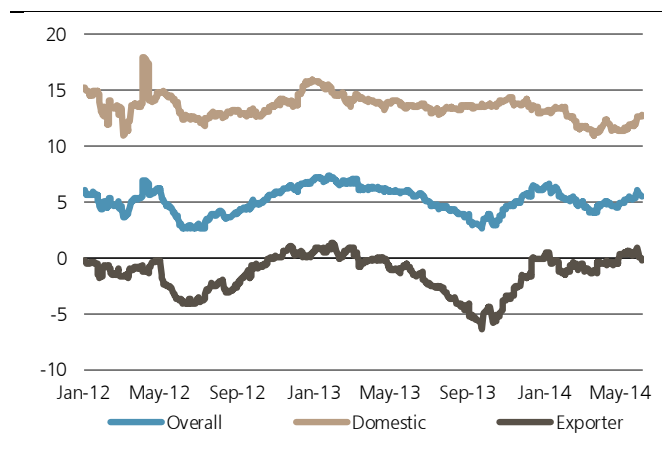


Source: Bloomberg, UBS

Another way to assess the earnings growth outlook is by looking at the evolution of two-year expected EPS CAGR (free float-adjusted market capitalisation-weighted).¹

The conclusions from this analysis are somewhat different than the ones above. The market-wide EPS CAGR increased; however, this was mainly driven by exporters, which currently show marginally positive earnings growth as opposed to the decline that prevailed in 2H13. In the domestic space, EPS CAGR slowed at the beginning of the year and more recently stabilised around 12%.

Figure 32: Two-year expected EPS CAGR



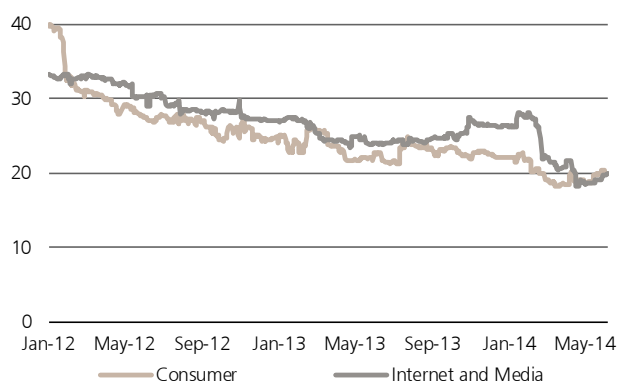
Source: Bloomberg, UBS

Looking at specific sectors, we note a significant contraction in earnings growth expectations for the two fastest growing segments: consumer and Internet. For example, two-year expected EPS CAGR averaged 25% for the Internet sector and 24% for the consumer sector. These have fallen to 20% for the two sectors as of now. Still, we note that growth rates have recently stabilized and appear attractive, especially if considered in the context of the underperformance of the consumer and Internet sectors YTD.

The analysis also reveals that, somewhat counterintuitively, the metals and mining sector stands out as offering the highest two-year EPS CAGR in the Russian market. Even after the contraction, it is currently at 19%, ie, very close to that of retail and Internet. To a large extent, this is a result of a low base effect and very high operational leverage.

¹ We divide last 12M EPS by the expected EPS for 12M after the next 12M, take the square root of the result and subtract one. We use weighted averages of yearly EPS forecasts.

Figure 33: Two-year expected EPS CAGR



Source: Bloomberg, UBS

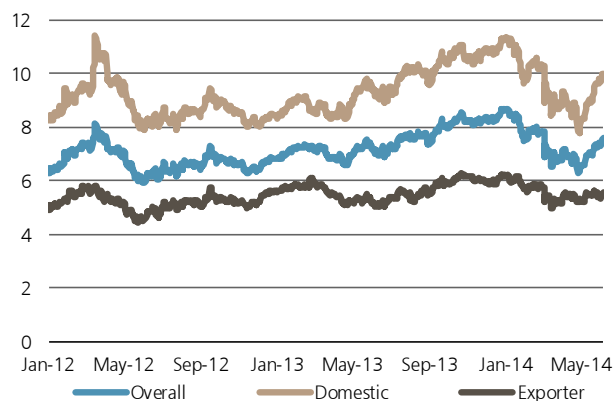
Figure 34: Two-year expected EPS CAGR



Source: Bloomberg, UBS

We conclude our sector discussion by looking at the evolution of next 12M PE ratios before moving to the stock-specific analysis. Despite the outperformance of exporters, their PE ratio has been approximately 2.5 times less volatile since the beginning of 2012 compared with the universe of domestic stocks. Domestic names recorded their lowest PE since the beginning of 2012, 7.8x, at the end of April this year. Since that time, the ratio has been rising steadily and is currently 10x. This is still 12% below the 2013 peak.

Figure 35: 12M forward-looking PE ratio

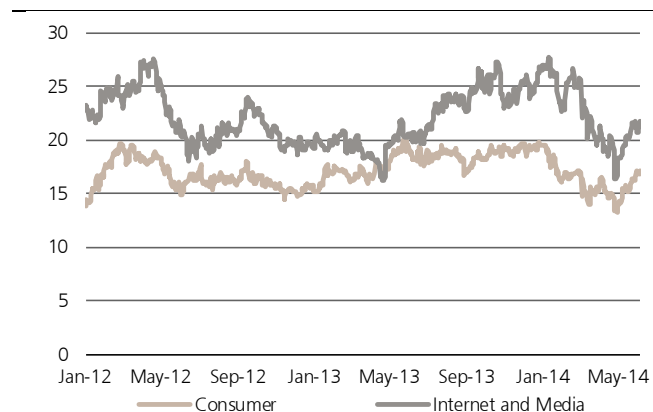


Source: Bloomberg, UBS

In the discussion above, we highlighted the consumer and Internet sectors as the most attractive from a growth perspective. However, they are also the most expensive in terms of PE ratios. Both sectors have de-rated from 2013 levels and recently recovered. Nonetheless, we note that while they offer virtually the same growth rates on a two-year horizon, the Internet sector trades at a noticeable premium to the consumer sector. Both are currently undervalued relative to their own history.

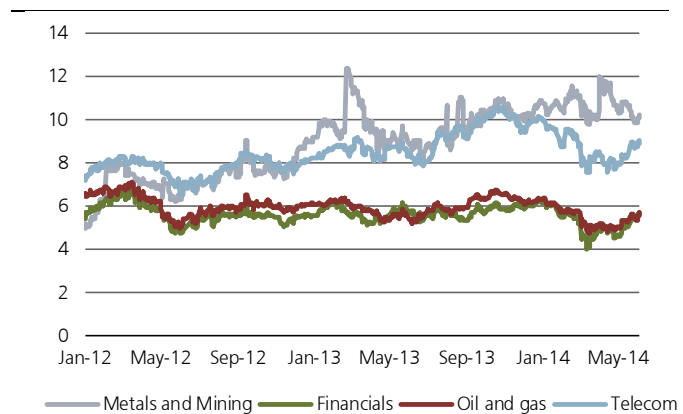
The banking sector has de-rated the most, recording PE of below 4x at one point. More recently, however, the ratio has been on a steady upward trend. Together with the oil and gas sector, financials stand out as the cheapest sector in Russia. Despite the turnaround in earnings momentum, the metals and mining sector does not appear to be particularly undervalued relative to own history.

Figure 36: 12M forward-looking PE ratio



Source: Bloomberg, UBS

Figure 37: 12M forward-looking PE ratio



Source: Bloomberg, UBS

Appendix

Index construction methodology

For the purposes of index construction, we use the following stock universe:

- Stocks currently included in the RTS Index;
- The most liquid stocks listed on foreign exchanges (Yandex, Mail.ru, Qiwi, Eurasia Drilling Company, TCS, VimpelCom, X5 Retail Group, CTC Media, Globaltrans);
- RTS Index members excluded from the RTS Index at the last index review (Kamaz and Mechel pref).
- We also add Acron (not included in the current and previous RTS Index constituents list).

We use our estimates of number of shares outstanding and free float coefficients.

Stock weights in each index are assigned proportionately to free float-adjusted market capitalisation.

At each date we include stocks with positive EPS only.

Statement of Risk

The main risks we see in investing in Russian stocks are as follows: The global economy may fail to deliver the continuation of growth we expect, so leading to a fall in commodity prices, including oil. Global interest rates may also tick up more than expected due to global economic strength, thus upsetting (eventually) asset valuations. Key Russian-specific risks that investors in Russian equities face include: a deterioration in the political climate (sources of unrest include the Northern Caucasus), more state purchases of assets, and poor corporate governance in private Russian firms.

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UBS 12-Month Rating	Definition	Coverage ¹	IB Services ²
Buy	FSR is > 6% above the MRA.	47%	33%
Neutral	FSR is between -6% and 6% of the MRA.	42%	34%
Sell	FSR is > 6% below the MRA.	11%	23%
UBS Short-Term Rating	Definition	Coverage ³	IB Services ⁴
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 31 March 2014.

1: Percentage of companies under coverage globally within the 12-month rating category. 2: Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

3: Percentage of companies under coverage globally within the Short-Term rating category. 4: Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

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Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
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Bashneft ⁵	BANE.MM	Buy	N/A	RBL2,310.00	05 Jun 2014
Lukoil ^{4, 5, 22}	LKOHq.L	Buy	N/A	US\$58.60	05 Jun 2014
Megafon	MFONq.L	Buy	N/A	US\$31.00	05 Jun 2014
MTS ¹⁶	MBT.N	Neutral	N/A	US\$19.05	05 Jun 2014
Norilsk Nickel ^{5, 22}	NKELYq.L	Neutral	N/A	US\$19.84	05 Jun 2014
Rosneft ⁵	ROSNq.L	Buy	N/A	US\$6.56	05 Jun 2014
Rostelecom ⁵	RTKM.MM	Neutral	N/A	RBL84.71	05 Jun 2014
Rostelecom (pref shares) ⁵	RTKM_p.MM	Neutral	N/A	RBL56.91	05 Jun 2014
Surgutneftegaz	SGNSyq.L	Buy	N/A	US\$7.70	05 Jun 2014
Tatneft	TATNxq.L	Buy	N/A	US\$36.25	05 Jun 2014
VimpelCom ^{3, 4, 5, 6, 16}	VIP.O	Neutral	N/A	US\$8.79	05 Jun 2014

Source: UBS. All prices as of local market close.

Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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