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**PRICE POINT**
September 2018

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# Quantifying "Oligarch Risk"
## TACKLING THE SANCTIONS FACTOR IN EM CORPORATE BOND INVESTING


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**KEY POINTS**

- Governance risk has always been central to emerging market (EM) credit analysis but, given recent sanctions developments, Russia's corporate landscape currently presents its own set of challenges.
- For bond investors, putting a price tag on "oligarch risk" calls for assessments of both the business risk and the sanctions risk associated with these billionaire businessmen.
- Building sanctions risk into fair value for Russian bonds helps compare local issuers, but it can also help evaluate Russian issuers against opportunities elsewhere in the world.

In April this year, aluminium producer Rusal's bonds plunged more than 60% after the US Treasury announced sanctions against seven high-profile Russian businessmen and 12 of their companies. Emerging market (EM) corporate bond investors are no strangers to governance risk, but Russia's corporate landscape brings a set of challenges all its own. How should analysts think about building "oligarch risk" into their models?

Oligarchies and corporate governance issues are by no means unique to Russia, but recent developments in Specially Designated Nationals (SDN) sanctions by the US Treasury have brought Russian governance into sharper focus. Analysis of sanctions risk is increasingly relevant today as the US has become more proactive in imposing sanctions, notably also on Turkey and Venezuela.

The objective of this analysis is not just to avoid tail risk, but also to try and put a price tag on risk and make relative valuation judgments—both among Russian companies and between opportunities in Russia and other regions. We recently did an exercise that combined both qualitative and quantitative information in a systematic framework, seeking to arrive at a risk-adjusted fair value for nine Russian companies.

### STEP 1: PROFILING THE OLIGARCHS

Russian president Vladimir Putin has effectively put 25 oligarchs in control of 80%-85%[1] of corporate Russia. For investors, it's important to understand who these influencers are, and to what extent their interests are aligned with those of bondholders. We scored each oligarch on several criteria:

1. **Political connections**. Business benefits tend to accrue to members of Mr. Putin's inner circle. How close is his connection to Mr. Putin? Is it family, business, political? Or, like Gennady Timchenko[2], is he a judo sparring partner?

2. **Historical behaviour**. Information about how oligarchs climbed the ladder and dealt with competitors—notably the winners of the Siberian Aluminium Wars of the lawless 1990s—can tell us something about how emotionally invested they are in their companies' survival.

3. **Capital allocation**. Are investors all treated fairly, or is there an imbalance? Is the sponsor using the business as a cash cow to fund his own needs? In 2015 the Kerimov family, which had a 40% stake in Polyus Gold, took the company private[3]. The loan financing made them dependent on dividends from the company to service their debt, which left little scope for improvement in the company's credit metrics.

4. **Net worth and asset diversification**. The larger and more diversified the oligarch's asset base, the more able he will be to extract funds from other businesses if the company needs a cash injection. Two who score well on this are Severstal's Alexei Mordashov and USM's Alisher Usmanov.

5. **Other information**. This includes qualitative measures such as: how extravagant is the oligarch's lifestyle and how erratic or risky is his behaviour? For example, Mikhail Prokhorov's flamboyant lifestyle has been perceived as one of the contributing factors to the divestment of his stake in Norilsk Nickel.[4]

### STEP 2: ASSESSING SANCTIONS EXPOSURE

While our first assessment focuses on business risk – essentially how bondholder-friendly the individual is – Russia's unique environment calls for a second filter based on sanctions-specific factors. For example, being close to Mr. Putin may historically have been good from a business perspective, but in today's environment it carries a higher sanctions risk. We ranked oligarchs based on factors that tend to come up on the US Treasury's radar or have previously been a trigger for sanctions.

1. **Political connections**. Mr. Putin's inner circle includes names such as Chelsea football club's Roman Abramovich, who is seen as an influencer and dealmaker among the oligarchs and close adviser to Mr. Putin. Those with lower profiles include NLMK's Vladimir Lisin.

2. **Ownership**. Does the oligarch fall foul of the Treasury's Office of Foreign Assets Control (OFAC) 50% rule? Alexei Mordashov scored highest on our scale of bondholder-friendliness, but his 77% stake in Severstal makes him a potential sanctions target. Vladimir Lisin is also at risk, with an 85% stake in NLMK.

[1] This is based on an assessment of their wealth relative to the total Forbes list of the world's billionaires.
[2] https://edition.cnn.com/2014/03/21/business/russia-sanctions-targets/index.html
[3] https://www.ft.com/content/201894b6-678d-11e5-97d0-1456a776a4f5
[4] https://www.nytimes.com/2007/07/08/business/yourmoney/08nickel.html

3. **Fraudulent activities.** In April, one of the US Treasury's seven designated oligarchs was Polyus Gold's Suleyman Kerimov[5]. OFAC cited his detention in France for allegedly failing to pay taxes and laundering funds through the purchase of villas (France has since dropped the charges.)

4. **Cost of sanctions to the US.** As we'll discuss shortly, sanctions on some companies would increase commodity costs for US businesses, while others would have less impact.

5. **Facilitating Cronyism.** For example, Severstal's Alexei Mordashov controls 6% of Bank Rossiya, which was one of the firms sanctioned in April and is sometimes referred to as "Putin's bank"[6]. Bank Rossiya has been associated with the illegal transfer of funds from the Russian state for the benefit of senior officials.

### STEP 3: SCENARIO ANALYSIS

Can anecdotal and qualitative information be incorporated into bond valuations in a meaningful way? For nine companies, based on our analysis of their sponsors so far, we did an exercise in which we assigned a probability to a Rusal-type scenario where sanctions escalate. The table in **Figure 1** shows an edited extract from the study.

In the first example, we believed Company A, a large and growing commodity producer, faced relatively low sanctions risk, largely because of the potential impact on the price of that commodity. In our assessment, the bonds were slightly cheap at the time of the study (June 2018).

By contrast, we concluded that the bonds of Companies B and C were not correctly pricing in sanctions risk. Both are more than 50% owned by their sponsors. If OFAC decides to classify the sponsors as Specially Designated Nationals (SDNs), all holdings in which they own more than 50% will automatically be classified as SDN[7].

For Company C, its sponsor's connection with another firm that has been sanctioned adds an additional layer of risk by being a potential target for OFAC sanctions. When the higher probability of being sanctioned was incorporated into the analysis, we didn't believe investors were compensated for the risks involved. At the time of the study we thought Company C was trading about 13.5% higher than it should have been.

**Figure 1. Scenario Analysis of Oligarch-Sponsored Companies**

| | Probability of Sanctions | Current Price | Risk-Adjusted Fair Value Price | Upside/ (Downside) |
|---|---|---|---|---|
| Company A | 5% | 97.65 | 97.98 | 0.33 |
| Company B | 25% | 97.07 | 88.25 | (8.82) |
| Company C | 30% | 103.76 | 90.25 | (13.51) |

As of June 2018
Source: T. Rowe Price. For illustrative purposes only

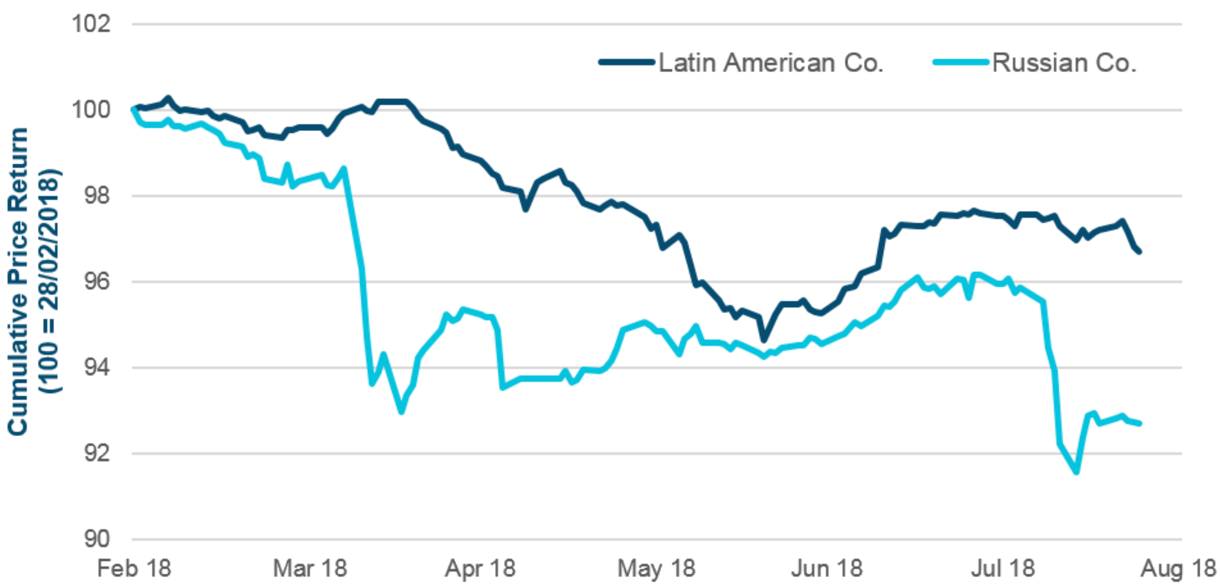
5 https://home.treasury.gov/news/press-releases/sm0338
6 https://www.ft.com/content/ac0bee28-b05a-11e3-8058-00144feab7de
7 SDNs' assets are blocked and US persons are generally prohibited from dealing with them.

THE GLOBAL CONTEXT

Building governance factors into relative valuations helps assess opportunities within Russia, but it also helps give regional perspective. We concluded that a number of the Russian companies in our study were not fully pricing in the governance risks. Comparing these companies with peers in other regions (Latin America or Asia) at the time, we found a number of firms with similar credit ratings and balance sheet fundamentals, offering similar yields, but without the corporate governance concerns.

For example, the chart in **Figure 2** compares the price returns of the bonds of a Russian metals company with those of a comparable Latin American peer since March this year. Both bonds are rated BBB- and both mature in 2023. Since March, The Russian company has been far more volatile, suffering two bouts of sanctions-risk jitters and underperforming the Latin American company by about 4 percentage points.

Figure 2. **A Tale of Two Metals Companies**




**Past performance is not a reliable indicator of future returns.**
As of August 22, 2018
Source: Bloomberg - Bloomberg Finance L.P. Used with permission.

Today, despite the recent volatility and negative news flow, we still believe that Russian corporate bond valuations are underpricing sanctions risk. This is largely due to technical support: limited new issuance means that supply has been shrinking, with the result that tail risk is not being fully priced in. Against this backdrop, we are maintaining minimal exposure to corporate Russia.

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201808-590318