

From Russia... with gloves on

Shareholder activism in Russia has historically been a distinctly dangerous pastime, but for investors in The Hermitage Fund and its manager William Browder, it has produced returns of 990% since 1996.

BY DAVID WALKER

When your grandfather was educated at the heart of the USSR before returning to the US to head the Communist Party of America in the early 1930s, you can bet your family is used to putting up a good fight.

So standing up for what you believe – on the investment front among others – is nothing new to William Browder, who has retraced the steps of his grandfather, Earl Browder, to Moscow at least, where he is chief executive officer of the largest Russian equity hedge fund, Hermitage Capital Management.

Being willing to agitate for Western corporate reform in Russia's listed firms – Browder knows how, having been in court 47 times on such issues – often against the oligarchs who dominate Russia's post-Soviet landscape, has returned Browder and investors in the Hermitage Fund around 990% (as of 10 October, 2004) since the

portfolio's April 1996 launch.

The ride along the way, via Russia's debt default in 1998 and a booming market 75% focused on the oil and gas sectors – from which Russia earns about 60% of its tax revenue and 55% of its export revenue – has not always been smooth, Browder concedes. But a near 10-bagger, investors may consider, makes the fund's annualised volatility of 46.8% worth it.

As at 19 October, the Hermitage Fund was the fourth-best performing fund in year-to-date returns among 24 Russia-dedicated funds listed by Bloomberg with assets greater than \$50m. At \$1.3bn, it is the largest Russian equity hedge fund.

Browder was vice-president at Salomon Brothers, managing its proprietary Russian investments, profiting for the firm during Russia's 1990s privatisations, before establishing Hermitage with \$25m seeding from the late Edmond Safra, then chairman of Republic National Bank of New York, in 1996. Hermitage now sits within the HSBC Group.

Between 1996 and October 1997 investors received nine times their original outlay, but then gave almost all back during 1998. "If you're in Russia's stock market, you always have to be prepared for some serious trouble. The returns, however, can be very good if things work out," Browder says.

So how has Browder made the money since? Many equity hedge fund managers use post-tax or post-expense profits as a metric. In Russia, Browder says, it makes more sense for him and his team of 16, including forensic accountants, to analyse a company's 'post-stealing' profits. So Hermitage uses publicly available corporate data – surprisingly plentiful in bureaucratic Russia, Browder says – to work out what they think a company is stealing, embezzling, losing through poor management and paying in back-handers. Interviews with present and former employees, customers and suppliers – "most of it spurious, some of it true" – supplement this data. From this comes a 'profit-before-stealing' concept.

Because of the impaired state – often unrealised – of so many listed firms in Russia, Browder calls what Hermitage does "distressed equity or equity work-outs" rather than the traditional long/short.

Hermitage then buys up stock, perhaps agitating for a board seat or other position of influence, to clean up the company. (In his first years

in Moscow, he readily admits to having had armed protection although now arguments with management of listed firms end more often in court than in the streets.)

A prime example of this was Gazprom, the world's cheapest energy stock measured by share price per proven barrel of reserves. Gazprom, at \$0.49/barrel according to Hermitage as at October, sits directly below Russian competitors Yukos at \$0.54 (of which more later), Surgutneftgas (\$0.97) and Lukoil (\$1.29). By comparison BP is priced at \$13.56 and ExxonMobil at \$14.53. After analysing the pre- and post-stealing performance of Gazprom, Hermitage calculated it could be 31% more profitable, foregoing \$1.62bn in 2003 on top of its \$5.19bn reported net income due to poor leadership and graft (see bar chart).

Browder and his team of mainly US-educated native Russian researchers found Gazprom was paying a firm called EuralTransGas (ETG) to transport its gas to the Ukraine – despite the fact the transport was made through Gazprom's own (and the only) gas pipeline from Russia to the Ukraine. ETG was estimated to have received \$767m net proceeds from this unusual arrangement in 2003, also including transport to Germany, Poland and Slovakia. Hermitage discovered four individuals, three Romanians and one Israeli, were behind ETG in December 2002, and two Cypriot nominee accounts with no connection to Gazprom, by May 2004.

Hermitage narrowly missed out on gaining a board seat, but called for an investigation into Gazprom via international press and political pressure, from June 2004. This continued a long tradition of Hermitage activism at Gazprom, having sued PricewaterhouseCoopers over Gazprom's audit work, run for board membership for three years and held numerous meetings with politicians and press conferences.

Ultimately, in August 2004, Gazprom announced that, from 2005 it would give up intermediary services at ETG. Gazprom's share price has risen from around 40.5 roubles at 1 January 2004 to 73.65 roubles at 18 October.

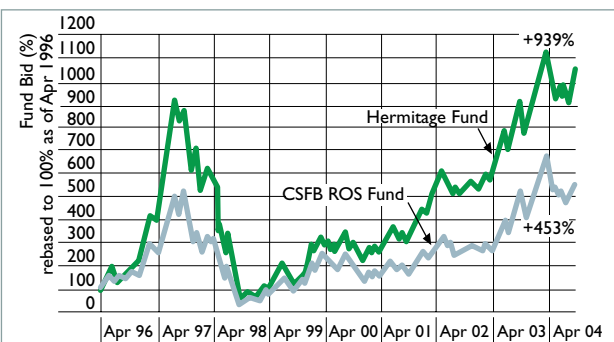
In the first nine months of 2004, Hermitage had returned investors 22.8%, behind only Brunswick Russian Growth's 23.4% and Charlemagne Capital Russian Fund's 25.7%, according to figures from Bloomberg.

Browder says Hermitage will seek cheaply valued companies, qualifying this as "cheap in the Russian context." Russia's equity market as a whole had a price earnings ratio of 7.4 times on 2004 estimates, against 6.4 of the Hermitage fund's holdings.

Finding undervalued firms may not be difficult in Russia, the world's second-cheapest emerging market after South Korea on a 2004 price earnings estimate (7.4 times), and third-lowest on a price/book value (1.31 times). The low valuations come despite an oil price breaching new records almost weekly, Browder says, as the market has priced in all the bad news from Yukos, which represents about 4.23% of the benchmark RTS Index (at 19 October), according to Bloomberg, and traded at a price earnings of 1.4 times 2004 estimates. While the biggest names are oil and gas, Browder notes there are 50 names liquid enough for investment but only 10 of these comprise 90% of Hermitage's portfolio.

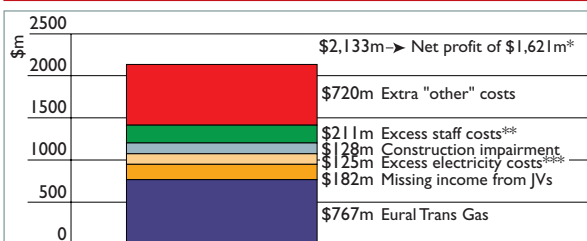
Finding companies important to the country is also essential, Browder says, as politicians may then be more willing to act around issues of poor governance that plague those firms rather than hoping investors can seek redress in the courts.

HERMITAGE FUND vs CSFB ROS INDEX



Source: Bloomberg, Hermitage. Total returns for each period calculated using values of fund's bid and CSFB ROS Index at 24 September 2004. Hermitage fund launched 27 April 1996.

GAZPROM'S COSTS AND INCOME (2003)



Total estimated financial impact on Gazprom - pre-tax profit (2003, \$m). Estimated costs shown for Eural Trans Gas are for the full year 2003. Other estimated costs shown are for the first nine months of 2003. The total estimated annual cost to Gazprom, therefore, may be higher than shown. *After a statutory tax rate of 24%. **Staff costs shown are those incurred above average salary increase in Russia. ***Electricity costs shown are those incurred in excess of tariff increase. Source: Hermitage Capital Management

THE YUKOS AFFAIR

Mention Mikhail Khodorkovsky to most Russian investors and they will probably look away in disgust.

As oligarch and former CEO of oil giant Yukos, now behind bars on tax-evasion charges, Khodorovsky is in a pitched battle with President Vladimir Putin, one that began in 2000.

Four years ago, Putin met Russia's 23 oligarchs, made rich by various means including profits from Russia privatising previously state-held monopolies, and cut a deal, according to Browder. Behave yourself and you can keep what you have, was Putin's offer.

Two attendees who rejected Putin's offer – Boris Berezovsky and Vladimir Gusinsky – were shortly afterwards forced to leave Russia, and their colleagues who stayed were arrested. Khodorovsky, then 35, toed Putin's line, brought Western accountants into Yukos, stopped dubious transfer pricing, and shares rose from \$0.08 in 1999 to around \$16.

However, the billionaire 15 times over started plying politicians for political influence, Browder said. "Khodorkovsky, an unelected billionaire, was actively seeking to establish power over policy-making in the Duma. To Putin, this situation was intolerable and unsustainable." The Russian president responded by arresting Yukos's second largest shareholder, Platon Lebedev, in July 2003 and then Khodorovsky six weeks before the December 2003 parliamentary elections.

A public relations battle ensued on both sides, with Khodorovsky on remand and Putin on attack, also issuing a warrant for the arrest of Leonid Nevzlin, a Yukos manager, not only for fraud, but also murder.

For Browder, Putin's tactic for Khodorovsky is clear – a personal warning that worse could be to come.

And for Yukos, through imposing tax bills but prohibiting it from selling non-core assets, to decrease Khodorovsky's stake to such a degree he relinquishes it.

Browder sees Khodorovsky's divestiture as a precondition to the resolution of the Yukos affair. "Even if Yugansk is sold at a fair price – and Dresdner Kleinwort Wasserstein has estimated it at between \$15.7bn and \$18.3bn – it's still not an optimal outcome for Putin because it leaves Khodorovsky a rich

man with his 30% stake of Yukos."

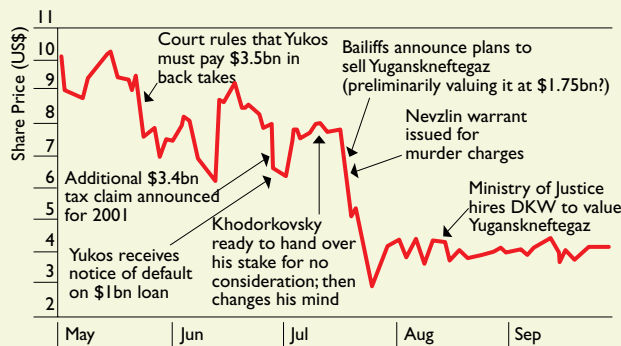
So has the affair of Yukos, producer of 2% of the world's oil, ruined Russia as a country for doing business? With oil firms still profitable even after a special tax equivalent to \$0.90 for every dollar over \$27 per barrel of Brent, it would seem not.

"The Yukos affair has certainly raised the risk profile of doing business in Russia, but the market has proven buoyant as the nervous money has already fled the market and most investors have managed to isolate the Yukos risk," Browder says. "We have recently witnessed a decoupling of Yukos from the rest of the market as other companies are beginning to trade on their own fundamentals."

He says on the macro side, the rainy-day fund Russia's government has established for when Brent Crude falls – due to have around \$19bn by 2005 – has left Russia with a fiscal balance worth 5.7% of its surplus for the second quarter of 2004.

"Russia now has \$98.3 bn in the Central Bank, about as much as they owe foreign creditors," he notes and, with a 92.3% correlation between money supply and the RTS Index, a healthy outlook for its undervalued market. Its 7.4% predicted GDP growth in 2004 is also the healthiest among emerging markets.

THE DECLINE AND FALL OF THE YUKOS EMPIRE



6 May - 18 September 2004. Source: Bloomberg UBS, Hermitage Estimate

"The Russian court system is inherently corrupt, so I stick to large companies because if an investor can't rely on the court system, there has to be another arbiter. If the firm is important enough to the country, then politicians and the government are often embarrassed into acting."

Browder says, perhaps surprisingly, he also favours companies under-owned by foreigners, whom he dubs "the most superficial investors in Russia, reacting to sensational headlines in the

West as opposed to real information in Russia."

Russia's stock market in 1998, being 90% foreign owned and 10% held domestically, has since reversed, providing "much larger levels of domestic liquidity and support," in Browder's view. For this reason, the manager adds, a repeat of 1998's near-total market collapse is unlikely.

Obviously, finding firms where shareholder activism can add value is also crucial. Browder, who may use proxy votes given to Hermitage by other Russian funds as well as his own in shareholder votes, says it is "eye-opening" to see how many mutual fund investors pay lip-service to encouraging better corporate governance, but then neither give up their proxies to Hermitage nor vote themselves.

The fund generally avoids what Browder terms 'oligarch stocks', with 2.8% of its portfolio in the firms owned by the 23 main powerbrokers, versus 19.5% of the RTS Index in September. Although Browder does not foresee another Khodorovsky affair, he predicts "continuing subtle and unpleasant attacks on oligarchs," stating that "There is no reason why I, as a foreigner, should carry the liabilities of the oligarchs."

As with many managers, Browder also avoids stocks whose products he wouldn't buy – so while Russia's boom makes finding British Airways seats into Moscow increasingly difficult, his aversion to Aeroflot bars it from Hermitage's portfolio. Hermitage has also avoided stocks such as juice and milk firm Wimm-Bill-Dann, pushed to IPO as brokers among others felt investors wanted consumer stories, rather than

FUNDAMENTALS

Name of manager:	HSBC Management Group (Guernsey)
Full name of fund:	The Hermitage Fund
Address of manager:	HSBC Republic Building, Rue du Pre, St Peter Port, Guernsey GY1 1LU, Channel Islands
Phone contact for further information:	+44 (0) 1481 710901
Launch date of fund:	April, 1996
Present size of portfolio:	\$1.3bn.
Is the fund open or closed to new investors:	Open
Target annualised return:	n/a
Average annualised return (net):	32.65% (as at 10 October)
Target annualised volatility:	N/A
Avge annualised volatility:	46.8%
Geographic focus (if applicable):	Russia
Administrator:	Investor Fund Services (Ireland)
Prime broker:	none
Auditor:	KPMG Guernsey
Initial fee:	None
Annual fee:	management fee of 2%, administrative fee of 1%
Performance fee:	20%
Is there a high watermark for the performance fee?	Yes
Is the fund listed:	No
Domicile:	Guernsey
Share classes/currencies:	\$
Minimum investment:	US\$100,000 (non-US residents), \$250,000 (US residents)
Minimum additional investments:	\$100,000
Lock-in period:	None
Redemption period:	Quarterly basis with eight-week notice period
Envisioned capacity before soft and/or hard close:	N/A
Can the investment be accessed through segregated account as well as existing portfolio?	No

because of anything inherently worthy about the business.

Hermitage's avoidance of replicating the index has allowed its 32.65% stated annualised returns (inception on 27 April, 1996 to 10 October, 2004) to outperform comfortably the index's 24.93%.

Browder adds once the fund is in a stock – of which only 50 offer sufficient liquidity for the portfolio to invest in – it generally doesn't actively trade in and out. Looking at the Russian market's annualised return of 25.2% between 1996 and August's end 2004 may vindicate this view. It is strengthened, however, by seeing that missing the 10 best of 3,101 days in that period reduces annualised returns to 7.2%, and missing the top 15 produces only 1.3%. Miss the top 20 and you lose 3.9%, annualised, in the same period. While the 75% of Russia's market that is oil and gas may grab the headlines, Browder notes foreign investment in Russia has gone far beyond Russia's oil and gas juggernauts.

In 2004 alone BNP Paribas has bought Bank Russia Standard, GE Consumer Finance acquired DeltaBank, Siemens swallowed Power Machines and Spain's Altadis bought Balkan Star/Tobacco. Interbrew has also bought a stake in brewery from SUN Group, UBS acquired Brunswick UBS and HypoVereinBank acquired International Moscow Bank.

BIOGRAPHY: WILLIAM BROWDER, CHIEF EXECUTIVE OFFICER, HERMITAGE CAPITAL MANAGEMENT



William Browder is founder and CEO of Hermitage Capital Management. The firm's clients include high-net-worth individuals and major financial institutions. Browder's position on corporate governance practices in Russia has made him a leading shareholder-rights activist and outspoken fighter for better corporate governance. He has been credited for a number of breakthroughs in improving corporate standards at major Russian companies, including Unified Energy Systems and Gazprom. He also spearheaded radical changes in the Russian corporate law, which resulted in pre-emptive rights being granted to minority shareholders in all Russian companies. He is chairman of the Russia Task Force for the Institute of International Finance, a member of the OECD/World Bank roundtable on Corporate Governance in Russia and a Member of the International Corporate Governance Network. Before starting Hermitage, Browder was vice-president at Salomon Brothers managing the firm's proprietary investments in Russia and before that, management consultant with the East European practice of the Boston Consulting Group in London.