<u>Samuel Terry Absolute Return Fund</u> – July 2014 monthly report

The Fund's performance (net of fees), and those of the Australian All Ordinaries Accumulation Index and the MSCI World Equities Index, are as follow:

To 31 July 2014	STAR	All Ords	MSCI ($A)
1 month	0.42%	4.49%	-0.10%
3 months	4.41%	3.64%	2.34%
1 year	22.86%	16.56%	11.87%
3 years (%p.a.)	20.73%	12.59%	16.93%
5 years (%p.a.)	24.57%	10.33%	10.25%
Since inception on 1 Nov 2003 (%p.a.)	11.44%	9.62%	5.59%

Once again, our biggest loser was our position in a variety of call and put **options**. These cost us 1.9% of the Fund. As discussed previously, options across a variety of asset classes are trading at close to record low prices, implying that markets believe we are in a very safe world, both politically and economically.

At month end, we had a total of 4% of the Fund in 11 separate option positions Our option positions comprise:

- Call and put options on the S&P 500 Index
- Call options on the Australian ASX 200 Index
- Put options on CBA, Australia's largest bank
- Call and put options on the Australian dollar

I have structured it so that our monthly losses from options will probably be less than 1% of the Fund and are unlikely to exceed 2%.[1]

All of this may sound risky, but it does have important benefits for our unit holders. Most importantly, we are fully hedged against a major decline in world markets. We also have substantial leverage to rising markets. From the point of view of our US investors, nearly half the Fund's Australian dollar exposure is hedged.

Unlike many fund managers, we are willing to tolerate small losses to make our fund safer, provided we are comfortable that the odds are unusually favourable.

2.5% of the Fund was invested in **Sberbank**, Russia's largest bank. Sberbank is one of the world's most profitable banks, with average returns on equity of over 20% pa since the late 1990's. More importantly, its position in the Russian economy means that it is likely to continue earning high returns on equity for at least the next few years. Sberbank's enormous retail deposits and modest dependence on western capital markets mean it is unlikely to be seriously impacted by western sanctions. Indeed, its competitive advantages could be improved by sanctions.[2]

---

[1] The reason our options loss in July was so high is that one of our option positions expired at almost exactly the worst possible level – i.e. very close to the exercise price of our matching call and put options. Such a result is improbable, but does happen from time to time when one bets on volatility. This caused about half of our options' loss in July.

[2] This is because some of Sberbank's competitors are much more dependent for their funding on western bond markets than Sberbank. Those banks and some of their corporate customers might need Sberbank's help to fund themselves. Additionally, some depositors might decide to shift deposits to Sberbank because its deposits are guaranteed by the Russian government, unlike many competitors.

Like many Russian shares, Sberbank is very cheap. It trades at about 4-5x earnings, less than 90% of book value and pays a dividend yield of 4.2%. I think it probable that Sberbank will continue to grow its book value per share at a high rate, and that one day (don't ask me when!) its shares will again trade at well above book value.

Like all banks, Sberbank is highly leveraged and its accounts may not be reliable. Being Russian-based adds a whole lot more risk. Russia suffers from corruption at all levels of society, an unreliable legal system, opaqueness and a recession in 2014 is probable, even without tougher economic sanctions from the EU and USA. Finally, Sberbank is majority owned by the Russian state, meaning that we are, in effect, minority partners in a business controlled by Vladimir Putin. For these reasons, the Fund's investment in Sberbank is small, despite the large potential gain.

If you wish to learn more about Sberbank, the attached note by Kerrisdale Capital, a well-regarded hedge fund, gives a good description of the bank and the bullish case for its shares. It was written in 2013, when Sberbank shares were over 30% higher than they are now.

The Fund's net asset value per unit was $1.2968 at month end. This is after paying a distribution of $0.3564 per unit. The Fund owned securities issued by 24 companies. 6.9% of the Fund was in $A cash.

Fred Woollard
11 August 2014

My Take on Sberbank (http://www.beyondproxy.com/sberbank/)

by Sahm Adrangi (http://www.beyondproxy.com/author/sahm-adrangi/) on October 25, 2013 (http://www.beyondproxy.com/sberbank/)

The following commentary is taken from the Kerrisdale Capital (http://kerrisdalecap.com/) letter for Q3 2013.

We own shares in Sberbank (SBER), Russia's largest bank. Sberbank dominates the Russian banking sector, controlling 29% of the country's assets, 34% of corporate lending, 33% of retail lending, and 46% of retail deposits. Its retail branch network is over 10x the size of its nearest competitor. Due to its unique history and starting deposit base, Sberbank enjoys an enormous funding cost advantage relative to its competitors.

This dominance has led to some of the highest NIMs (6.1% in 2012), ROE's (24.2% in 2012) and ROA's (2.7%) in the global banking coverage universe. In addition, Russia remains a significantly underbanked market, providing Sberbank substantial runway for future growth. Yet despite its competitive position and enormous growth potential, Sberbank trades at only 6.5x LTM P/E and 1.3x TBV. We think Sberbank's dominance warrants an 18x P/E and 3.0x TBV and that the company is therefore fundamentally worth 200% more than its current price.

Russia Remains Substantially Underbanked

On numerous metrics, Russia has substantial capacity for additional corporate and household debt, and remains underbanked and generally underlevered as a country. Here are relevant statistics:

- 2012 Household Debt to GDP for Russia was 13%, compared to 31% for China, 67% for France, 78% for the United States, and 98% for the UK (reference (http://sberbank.ru/common/_en/img/uploaded/files/info/en/Investor_presentation_September_2013.pdf))
- 2012 Domestic loans to private sector as a percentage of GDP was 48%, compared to 57% for China, 68% for Brazil, 102% for Germany, 179% for UK and 194% for US (reference (http://sberbank.ru/common/_en/img/uploaded/files/info/en/Investor_presentation_September_2013.pdf))
- Non-financial corporate debt to GDP is 40% in Russia, compared to nearly 80% in US, more than 100% in China, 110% in UK and more than 120% in Spain (reference (http://www.economist.com/blogs/graphicdetail/2012/09/global-debt-guide))
- Financial Debt as % of GDP is less than 30% of GDP in Russia, compared to 40% in US, 90% in Germany, etc. (reference (http://www.economist.com/blogs/graphicdetail/2012/09/global-debt-guide))
- Total banking assets as a % of GDP is a small fraction of other countries: (reference (http://www.zerohedge.com/news/2013-05-18/spot-odd-continent-out-total-bank-assets-gdp))
- Bank deposits to GDP are also much lower than other countries: (reference (http://datamarket.com/data/set/28m2/bank-deposits-to-gdp%23!display=bar&ds=28m2!2rr3&s=bjz#!))

Viewed in a global context, Russia is underlevered and underbanked. The implication is that the Russian banking system has a lengthy runway to experience future growth as it catches up to the penetration levels of other countries. Deposits and loans are almost certain to grow rapidly year after year, for the next 10 to 20 years. The 2011 to 2015 OECD CAGR forecast for bank loans for Russia is 17%, compared to 4% for the USA and 3% for the UK. For Sberbank, deposits grew 10% in 2012, 28% in 2011 and 19% in 2010.

The drivers of non-interest income are also growing rapidly. Fees and commissions income grew 28% in the most recent quarter. Card fees grew 48% in 2012. Insurance sales agency fees grew 21% in 2012. The number of credit cards issued grew 97% in 2012. We expect this rapid growth to continue for many years to come. Over the next decade, more and more Russians will deposit their earnings in banks and lever themselves up in the rapid global leveraging that is the hallmark of modern capitalism.

Sberbank's Competitive Position

Sberbank's history traces back to 1841. It is the largest bank in Russia and Eastern Europe, and the 3rd largest bank in all of Europe. Its operating profits and regional market share are superior to any other major European bank.

Sberbank was created as part of the Russian banking overhaul under Mikhail Gorbachev in the 1980s. Separate state-owned banking enterprises were established to service different sectors of the Russian economy; Sberbank was established in 1988 to focus on retail deposits. In the 1990s, Sberbank was organized as a joint stock company.

Sberbank faced significant competition during the 1990s from thousands of independent banks but various financial crises, culminating in the Russian Ruble crisis in 1998, cemented Sberbank's dominant deposit base. Amid the 1998 currency collapse, Russian depositors were given the opportunity to transfer their deposits to Sberbank with an explicit government-backed deposit guarantee. Sberbank's market share and reputation as a safe bank, effectively backstopped by the Russian government, has given Sberbank a significant funding advantage for retail deposits relative to most of its competitors. The Russian government has been gradually selling down its stake in the bank, recently selling 8% in 2012, bringing its stake down to 50.1%.

Today, Sberbank dominates Russian banking. It controls an incredible 46% of Russia's retail deposits and 32% of its loans. It controls 29% of Russian banking assets, 28% of banking capital, 34% of corporate loans, 34% of retail loans and 43% of debit and credit cards. Its 18,625 branches compare to 1,583 branches for its next largest competitor, Russian Agricultural Bank, and 1,257 for VTB. As can be seen from this link (http://www.banksdaily.com/topbanks/Russia/2012.html), although other banks have significant assets relative to Sberbank, SBER has the far larger retail footprint.

This massive market dominance has led to among the highest NIMs, ROEs and ROAAs among global banks. Its 2.4% ROAA is industry-leading. Its NIM has exceeded 6% for the past few years, and should remain well above 5% for the foreseeable future. ROAE was 21% in 2010, 28% in 2011 and 24% in 2012. More than half of its deposits are retail, which should continue to fuel lofty NIMs.

Credit Quality and Capitalization

Credit quality and capitalization have both been reasonable. The percentage of non-performing loans within its loan portfolio is 3.2% and Sberbank's NPL coverage ratio (ratio of provision for loan impairment to NPLs) is 1.6x. Sberbank's ratio of equity to assets is 11%, higher than the 10% average in the United States, 7% in Brazil and 6% in China.

Loans are well diversified, with 25% to retail, 21% to corporates, 33% commercial, 14% to SMEs, and 6% to the agricultural sector. Its corporate loan portfolio is also well diversified amongst different industries, with no alarming exposures to high-risk sectors. Construction loans stand at 6%, energy at 6%, metallurgy at 5% and oil/gas at 2%.

Russian Macro Statistics

The central risk to the Russian economy is its overall dependence on the oil and gas sector. If oil and gas prices decline, the Russian economy and government will face numerous disruptions. This Economist article (http://www.economist.com/news/business/21580131-shale-gas-revolution-unnerves-russian-state-capitalism-spooked-shale) discusses some of the risks that Russia faces as the U.S. shale revolution begins to encroach on the country's oil and gas revenue.

Beyond this oil and gas risk, however, Russia's long-term future appears relatively healthy. Russia's government debt to GDP is quite low, at less than 8% of GDP. China's ratio is 32%, Brazil's is 59%, and America's is 73% (reference (https://www.cia.gov/library/publications/the-world-factbook/rankorder/2186rank.html)). Russia has a healthy trade surplus, with a 2012 surplus at 3.7% of GDP, providing a cushion should oil and gas prices weaken. Finally, Russia has large international currency reserves. International reserves comprise 30% of GDP. That compares to 46% for China and 23% for Japan. Foreign reserves at 30% of GDP are one of the highest in the world.

It's unclear exactly how badly Russia's economy would suffer if oil prices declined to $70. But the country's fortress balance of reserves and low government debt should provide protection as the government readjusts expenditures to a new revenue environment if energy prices were to decline. The Russian economy doesn't appear to be in serious danger anytime in the near to intermediate future.

Valuation

Given Sberbank's promising runway, the current valuation is very cheap. The company trades at 100 rubles per share, and we think it's worth 300. A fast-growing bank with a 6% NIM, 20% ROAE and 2%+ ROA should trade between 2x to 3x TBV. Some emerging market banks with Sberbank's range of operating statistics trade north of 3x.

The typical explanation for Sberbank's heavily discounted valuation is that it's a Russian bank, and therefore plagued with corruption. We're not sure this stigma is justified. Sberbank mostly makes money from a large spread between the diversified collection of retail deposits it holds and the diversified array of loans it makes. Short of a collapse of the ruble, we're not sure Sberbank's future is in much jeopardy, and we have difficulty understanding why Sberbank would be any more corrupt than the largest banks of many other emerging markets. Furthermore, we haven't seen any evidence that Russian corporates or individuals are heavily insolvent. On the contrary, Russia as a whole appears to have more capacity for additional leverage than any other major country in the world.

Governance and Minority Shareholder-Friendly Culture

Though Sberbank is 50.1% owned by the Russian government, it has uniquely friendly policies catered to minority shareholders.

First, Sberbank has a committee (http://2011.report-sberbank.ru/reports/sberbank/annual/2011/gb/English/10607040/shareholder-and-investor-engagement.html) appointed to represent minority interests and has implemented a number of the committee's corporate governance recommendations. The Minority Shareholders Committee includes a Deloitte partner, a director at a non-profit whose mission is to protect shareholder interests, a lawyer / public activist, etc. This link (http://2011.report-sberbank.ru/reports/sberbank/annual/2011/gb/English/106070/improving-corporate-governance.html)discusses Sberbank's corporate governance efforts more broadly.

Second, part of Sberbank's cash flow is being paid out to investors. The bank pays a healthy dividend of 2.6%. Sberbank's dividend could double if the government enacts a directive requiring state-owned entities to increase their dividend payout ratios to 35%. Ultimately, Sberbank will grow faster if it can reinvest profits to grow its business, but the existence of a reasonable dividend demonstrates a willingness to return capital to shareholders, which is comforting to see in an emerging market company.

Third, one cannot understate the importance of Sberbank to Russia's reputation. As a large, liquid, publicly traded state-controlled institution, the treatment of minority shareholders in Sberbank will have enormous repercussions for Russia's future FDI. Thus far, Sberbank's governance, shareholder orientation and culture appear to be superb.

The bank's management team seems quite competent. Herman Gref was appointed CEO in 2007 and has transformed Sberbank from a bumbling state bank to a modern, innovative powerhouse. The bank's operating metrics and statistics are best-in-class globally, and Gref exudes a welcoming level of competence. The company's disclosures to investors are excellent, and Sberbank is working hard to communicate its story to the investment community, as can be seen by their informative investor relations site, regular equity research conference appearances, frequent posts of translated speeches on YouTube, and other outreach efforts.

Sberbank has won awards for "Best Interactive Annual Report" and other graphic design-oriented awards for its investor presentations. While a graphic design may sound trivial, let's keep in mind that Sberbank trades at a discount to some degree because investors don't trust Russia, or trust it even less than other emerging markets like Turkey, Poland, Mexico, Brazil, Indonesia and other countries where banks boasting metrics like Sberbank's trade at 3x TBV. We don't see enough evidence to believe that Russia is any more corrupt than the countries mentioned above, and proactive investor communications may help drive that point home. At some point, management's investor advocacy should stop falling on deaf ears.

A video of the company's annual meeting is available here (http://www.youtube.com/watch?v=GgQaLEpXGxU). The promotional video at minute 12:30 rivals the KPMG corporate anthem (http://www.youtube.com/watch?v=yXUhQnOYR54) in terms of corporate motivational multimedia.

Finally, Russia is trying to change its image abroad with respect to corporate governance. Recently, the Russian government 'encouraged' Rosneft to buy out minority shareholders in a situation where it was being criticized for being unfriendly to minority holders. Having watched its stock market trade down to one of the lowest valuations in the world (Russia's P/E ratio is approximately 5x), the government has finally recognized that it needs to be proactive in boosting its country's investor image abroad.

Summary

Sberbank has phenomenal metrics, among the best in the world among global banks. Russia's financial system is underdeveloped relative to other emerging markets, and Russia's banks have many years of growth ahead. Despite this, Sberbank trades at 1.3x TBV and 6x P/E. We think this is due to the fact that it is Russian, and investors don't trust Russia. We believe this concern is overblown, and don't understand why Russia is deemed to be any more corrupt than Indonesia, Mexico, Brazil, Colombia, etc., where banks with Sberbank's metrics would be trading at 2x to 3x TBV. Outside of a meltdown in global energy prices, Russia should continue to grow nicely macroeconomically, and Sberbank should have a bright future.

Risks

Government Ownership

Sberbank is 50.1% owned by the Russian government. Government ownership of banks poses risks. In certain countries, government-owned banks become increasingly less competitive than privately-owned banks and thus lose market share to privately-owned banks. India is a good example of this, where privately-owned banks have grown faster, generate higher returns on capital and therefore trade at materially higher multiples than state-owned banks. Privately-owned banks can attract more talented employees given their ability to pay higher wages, tend to be more innovative, tend to be more profit- and ROIC-focused, and feature less bribery and corruption, etc.

Additionally, in a time of economic distress, the government may pressure Sberbank to make an uneconomical decision in order to support the overall Russian economy.

In Russia, many of the largest banks are currently publicly owned, so the risks to Sberbank are not on the near-term horizon. Secondly, the management team led by Herman Gref that took over in 2008 appears particularly good, and seems keenly focused on running Sberbank as if it were privately owned. Gref has openly advocated the Russian government to further privatize the bank.

Sberbank is Dependent on the Health of the Russian Economy

The Russian economy is fueled by oil and gas exports, and therefore is overly reliant on oil and gas prices. To the extent energy prices decline, Russia may see GDP declines and will be forced to cut government spending. The severity of the recession would test the credit quality of Sberbank's loan book, and the stock would probably trade down until it becomes more clear the level at which NPLs would stabilize. While Sberbank is well capitalized, especially when compared with Western banks, it does not have the same large capital buffers seen at banks in other emerging markets like Turkey or Brazil.

Sberbank's Operating Metrics are at Peak Levels and Will Decline to More Normalized Levels Over Time

Currently, Sberbank benefits from a relatively consolidated banking landscape with far less competition than a country such as the United States. Over time, smaller and more nimble competitors should gain market share from Sberbank, and this increased competition should reduce Sberbank's NIMs, ROAE and ROAA. However, the company's valuation multiple is sufficiently low, and this competitive pressure sufficiently gradual, that the stock still seems attractive even as NIMs, ROAE and ROAA will ultimately begin approaching the levels we see from other emerging market banks.

PREVIOUS ARTICLE
Chico's FAS: A Growth Business Trading Like a Value Trap (http://www.beyondproxy.com/chicos/)

NEXT ARTICLE
Tired Asian Businessmen, Assessing Management Quality and the $15 Billion Oshin Retail Stock in China (http://www.beyondproxy.com/tired-asian-businessmen/)

AUTHOR

Sahm Adrangi (http://www.beyondproxy.com/author/sahm-adrangi/)
Sahm Adrangi is the portfolio manager of Kerrisdale Capital Management, a private investment manager that focuses on value and special situations investments. Sahm is a leading expert on Chinese reverse merger frauds. Prior to founding Kerrisdale Capital Management, Sahm was an investment analyst at Longacre Fund Management, a distressed debt credit fund. Prior to Longacre, Sahm worked in the bankruptcy restructuring group at Chanin Capital Partners and the leveraged finance group of Deutsche Bank Securities. Sahm holds a Bachelor of Arts in Economics from Yale University.
More articles from this author (http://www.beyondproxy.com/author/sahm-adrangi/)