THE RUSSIAN STOCK MARKET

General characteristics of the market. In recent years, the Russian stock market has grown at extremely rapid rates. In 2003, stock exchange volumes for corporate securities grew by more than 2.2 times over to exceed USD 113 billion dollars (Graph 1). In addition, volumes of transactions outside of the stock market were evaluated at USD 200 billion.

Most trade volume is concentrated on three exchanges – The Moscow Interbank Currency Exchange (MICEX, with USD 80.4 billion in 2003), the Russian Trade System (RTS, USD 6.1 billion in 2003) and The St. Petersburg Stock Exchange (USD 8.3 billion in 2003). Specific characteristics are present in each exchange. On the largest exchange in Russia – the MICEX, where 2003 deals comprised more than 87% of stock exchange turnover (see Graph 2), trading mainly revolves around securities of the leading Russian petroleum, energy, and telecommunication companies. In RTS listings, not the blue chips, but companies in other sectors of the economy are more widely seen. Shares on The St. Petersburg Stock Exchange are those of the most important company in Russia – Gazprom, which are not dealt on the other domestic stock exchanges.

Shares are the prevailing form of securities traded on the Russian exchanges. Their percentage in 2003 was 83.1% of the total turnover of the stock exchange portion of the funds market. Active trading of companies from Russian and other subjects of the federation are conducted only on MICEX. In spite of the dynamic development of this market segment (in 2003, the turnover of bonds grew by 268%), their collective weight composed only 16.7% of the above total.

The high speculative demand on Russian company shares became a basic factor for increases in the stock market. For example, the volume of share transactions on the MICEX grew 2.1 times in 2001-2003, and more than quadrupled on the St. Petersburg stock exchange. The important stimulus for such increases in the share prices became the growing interest in these tools from foreign investors under conditions of the stagnation in both developed and developing markets (Graph 3).
Market instruments

In spite of rapid development in the domestic market, shares of highly-developed instruments for investment remain sufficiently narrow. After appearing at the end of the 1980s, the Russian fund market had not become a real market for capital until now. The classic RTS market includes shares of only 166 issuers, and only 36 companies are traded on the MICEX, with 34 of them also present on the RTS. In line with the weak development of the stock market, only 80 companies (20%) from the list of the most important (in terms of turnover) Russian companies in "Expert-400" are represented in the "Capitalization-200" list (both lists are compiled by the rating agency Expert RA). The greater part of the remaining 120 joint-stock companies from the "Capitalization-200" list are quite possibly offspring of the strong 80 represented companies. In other words, even large businesses are weakly represented on the stock market, and it is not necessary to even speak of smaller companies. The narrow market also leads anticipating increases in the shares of the few blue-chips that are traded on it. Their market value over the past year increased by more than a fourth, reaching a record level for the last decade of USD 237 billion, or almost RU7 trillion. Capitalization of the most important Russian companies has already exceeded its 1995 level by 9.6 times. Moreover, for the second year in a row, the market values of the most important Russian companies exceed the sales volumes by practically 20%. The number of successful IPOs has been minimal and carried out only recently (in the past year, there has only been three).

Given these conditions, investor interest is directed toward shares of mid-tier companies. The majority of such companies exist in forms of joint-stock companies; however, their shares, as a rule, are not traded on the exchange, or either they have not yet entered into the stock market. Most Russian companies are in this category, with turnover ranging from USD 30-100 million per year. In essence, these real-sector enterprises, and to a lesser degree, service enterprises, are scattered throughout the Russian territory and are thus little known to the market.

An increase in investor interest in shares of the "second tier" has already led to changes for the "Capitalization-200" list and strengthened the past year's tendency toward the deconcentration of capitalization for the list's companies. The percentage of the most important companies as well as the natural gas industries has declined for the third year in a row. On 1 September 2004, the twenty most important companies formed 83.7% of total market value, in comparison with 91.3% in 2000. The percentage of the natural gas industries was reduced by 6.4% in comparison with the previous year, declining to 60.2% (see Graph 4).

Certainly, a reduction in the percentage makeup of the natural gas industries was due to the great effect of events concerning YUKOS (the capitalization of which now comes to only a quarter of what it was last year). Investors were thereby forced to search for other investments. The metallurgical and telecommunication branches led the increases this year. We can also see confident growth in market values for the chemical, transport, and bank branches, while the capitalization of electric power and natural gas companies – the "blue-chips" – grew this year by 11.3% and 13.3% respectively. Decreases only occurred in the foods and machine building industries. The first is explained by negative news about the reduced market share for the most important public companies in the sector (Wimm-Bill-Dann, Produkty Pitanya, and Baltica); the second is explained by a decrease in the total number of shares for machine-building companies in the "Capitalization-200" list.

The change in the structure of "Capitalization-200" provoked a gradual levelling off in the market,
which finds reflection in the change in stock exchange turnovers for the shares of Russian companies and average values of quality indicators (see Graph 5). Despite the tendency toward deconcentration in the Russian stock markets witnessed in recent years, it is hardly possible to expect major changes in the following years. The quality of most Russian issuers continues to remain low, and the level of free-float for the majority rarely exceeds 10%. Achieving a serious level of liquidity requires a free-float of not less than 20-25% of company shares. In this case, increased share capitalization in the very near future can be exhausted by the limited number of those accessible to investors interested in the second tier. However, real development of an IPO market in Russia is not expected earlier than the end of 2006. This should happen when the quantity of companies that are actually ready for this procedure can reach the critical stages.

The Antanta Capital investment company

At present, the number of companies dealing with the stock exchange sector of the Russian funds market exceeds 1000. However, almost 90% of stock-exchange transactions fall to fifty of the most important investment companies and banks. In the first nine months of 2004, their stock exchange turnover on the MICEX and RTS came to USD 117.2 billion. Among them was the leading IR Aton (with USD 13.618 million – USD 13.471 million on the MICEX and USD 146 million on the RTS), the company Broker Kredit Servis (USD 12.647 million – USD 12.636 million on the MICEX and USD 11 million on the RTS), and finally the broker house Discovery (USD 11.736 million – USD 11.709 million on the MICEX and USD 26 million on the RTS). The Antanta Capital group was formed by private investors of Russia, France, Israel, and other countries for the purposes of realizing highly remunerative investments out of the underestimat-ed working industrial enterprises of the Russian Federation. Antanta Capital was formed in the summer of 2003, and within a short period, it entered into the ten most important companies by volume of operations on the RTS, actively working by its own means and monies from important Russian and foreign investors on the entire spectrump of the securities market.

Antanta Capital is the main Russian stock market company that specializes in working with the most promising mid-tier companies. The company won the NAUFOR national competition (equivalent to
the British FSA) “Elite Fund Market 2003” in the category “Company Discovery of the Year”. The company’s main activities are the trade of securities and confidence control.

As of September 2004, Antanta Capital occupied 5th place among companies dealing with the classic market sector of the RTS. The total volumes under its management’s control came to USD100 million, where consolidated profits for the first half of the year was USD 1.5 million in 2004. Next year, the company proposes the goal of entering the top five largest investment companies on the Russian stock market. Company clients number more than 200 large Russian and Western funds, enterprises, and private individuals.

Excerpts from an interview with General Director of Antanta Capital Andrey Babenko

**What exactly is meant by the terms "mid caps" and second-tier companies? And why should investors take an interest in them?**

We’re talking here about a very broad spectrum of companies in Russia. Most of them are not publicly traded. Even though they are technically classifiable as joint stock companies, their legal status can be somewhat misleading. The point is that they’re closed entities from the standpoint of minority shareholders’ ability to participate in the management of a company as well as information transparency. They are mostly companies that operate in the real sector of the economy with turnovers ranging from USD 30-100 mn per year, which are spread out all over Russia and are unknown entities to the market. Nonetheless, more than 200 or so of these companies have RTS listings and RTS acts as the market maker for most of them. On the downside, they are low-liquid shares, which is the case for two main reasons: first of all, there is a lack of standard analytical information on such companies so as to make investors aware of their existence, and secondly, they all have small free floats.

**How do these companies end up on the market?**

The only place these companies can go is the so-called RTS-board, which is a simplified listing system. To achieve this status, the required application kit should be completed and submitted to RTS. Even the issuer does not need to be aware that its shares are listed on the RTS. In order for this to be accomplished all the stock exchange requires is the minimum amount of public infor-
mation (balance sheet, charter documents, etc.). Meanwhile, these shares might not actually be tradable entities. The main thing is for them to have received a listing so they can enter into circulation on the exchange.

**How are they quoted?**

After a share has obtained a listing, we can say that a new road is being built. A broker who brings in a new share entity to the trading system is obviously aware that his ultimate goal is to get the share traded. Let’s suppose the research department has found information on some plant and it turns out that according to the analyst’s valuation the plant should be worth more than it currently is. This still doesn’t mean that some investment company would buy a large block of its shares or attempt a sale on the open market. Such shares might also be launched on the marketplace for subsequent sales at the request of the client. But what sets Antanta Capital apart is that we take an arms-length approach to second-tiers and treat them as public companies. Our starting point is the market and we are prepared to have most shares quoted without necessarily pursuing the aim of acquiring any specific block of shares. The bottom line is that we basically create our own new instruments.

**Among this vast array of mid-caps, how many of them are getting ready to go public?**

Just to give you a ballpark figure, I’d say about 25%. In the listing process, we interact both with management and accounting and request all documents which are needed. Top managers of these companies do not always have a clear understanding of why all of this is necessary and even when they do they’re still not always interested. But if they have, say, some options in the company then it’s usually clear sailing. Then again, many managers are neither upbeat nor downbeat about the company going public. They’re more concerned about raising sales and whatever happens to shares is a matter relegated to the shareholders themselves. But as soon as they start getting together with stock market specialists, is usually not that hard to create an incentive. There might be a management shakeup and then people start to get the hint that this is a necessary step, even the old-style “red-guard” CEOs. The overwhelming majority of top managers in Moscow are now aware of the need to go public, while roughly 20% of regional directors realize that this is the right way to go, although very few are willing to actually set the wheels in motion. All the people in this 20% may have their own reasons why they have not started the ball rolling yet, but these are usually immaterial. There are hundreds of companies out there like this. It will likely take somewhere from 2 to 5 years for these hundreds to turn into thousands.

**What kind of “transparency premium” applies to these companies?**

Over a 12-month horizon, market cap can rise as much as 2-5 fold. This is a natural process and these shares are not artificially inflated since it’s actually quite easy to convey the appropriate information to the market. Conversely, the lack of information in and of itself is usually grounds for assigning a 100%, or even heftier, discount.

**Do you think the market is ready to pick up the slack and list such a large amount of new shares?**

Russia’s core trading venues, MICEX and RTS, are geared to handle not 200-300 shares, which is now the case, but 2,000-3,000 companies. As for the communications infrastructure, it’s rather underdeveloped and there is a great dearth of information.

**Are there many companies in Russia now with a focus on second-tiers?**

Second-tiers are not a priority for large Russian investment companies, which deal mostly in blue chips. They may have people who are knowledgeable in this area, but most research departments write almost entirely about Gazprom and other topline blue chips. This means that they can offer their clients only a limited range of investment options and are not in the habit of offering their clients small plants. This kind of work is just a side-light for them, something they are forced to do because theoretically their clients might come up with such interests. On the other hand, there are companies like Antanta Capital, which specialized in second-tiers. There may be five or so such companies in Russia.
Why has this market niche not been filled and why is there not the same kind of fierce competition here that you encounter on the blue-chips market?

First and foremost, because Russia is such a huge country. The second reason is because the shares of the Russian Mid Cap companies are a certain option that Russia has not yet exercised. In the event of a meltdown or a downturn, blue chips will still retain their liquidity. But if you buy into second-tiers, demand will disappear for them overnight and all their value will evaporate in the event that the market crashes. I dub second-tiers "options" because if you have a reckless management, a change in ownership or a shift in plans, this paper would become significantly lower. By the same token, it might also post exponential growth. Therefore, whatever second-tier you're talking about, it will always end up being undervalued vis-à-vis blue chips. The point is that company valuations are performed not only on the basis of financial indicators, which analysts are used to assessing, but also other factors which cannot be readily quantified. For example, having a reasonable management in place is definitely a huge asset, although it can't be gauged and from the standpoint of investors can and should be factored in.

Getting back to those five or so investment companies you said are focused on second-tiers, would you say they have the expertise needed to properly assess the risks and gain a competitive advantage?

Not all of these companies are trying to promote themselves on the market and some of them operate merely as a service to their shareholders or for specific clients. Then there are higher-profile "public" companies like Antanta Capital. I say this because we offer a whole range of up and coming investment options to the public at large. Antanta features a powerful team of traders that zero in on second-tiers. When the company recommends one or another paper, it strives on the one hand to give the market the right amount of information, while on the other hand, performing a market-making function for all of these shares. But at the end of the day, the only real way to show a client that our company recommendation is credible and well-substantiated is to look at our business reputation, which is a success story.

Let's imagine that you're interested in a certain company. Who decides and how whether this company should apply for a listing?

The research department, or more often the management or the head of the second-tier trading department takes an interest in a certain plant or market segment. Then the research department is assigned the task of gathering all information available on the company. After this there is an exchange of opinions and a decision is reached on the basis of all available data, which of course is a subjective decision. We only contact the management if and when an affirmative decision is reached to go public, that is, unless we've had prior relations with these companies. Once we've decided that the company looks interesting, a meeting is held with the top managers. We try to get a feeling about whether they would be ready to live in a new world and if the outcome is positive then professionals from our Investment Banking Department take over. These consultants go to the company to conduct an internal audit, scrutinize information and numerous other facets of the company's business. In the process they might tell us at some point that all of this is of little interest and that they have their own business targets. Or they could prove to be indifferent and tell us that if we'd like we can go ahead with the listing procedure or drop it, as we wish.

Are there quite a few potential public companies that fall into this category?

I'd say that most of them are like this in Russia, even among the ones that have achieved listing status. This is nothing out of the ordinary and most companies go through this phase. But sooner or later it dawns on either the management or the shareholders that something needs to be done with the company's property. At this point they start to put together an exit strategy and by this time the owners themselves are ready to deal with investment companies. So when all is said and done, the big difference between our company and others involved in the second-tier market is that we can do everything from A-Z, including consulting and investment banking.