



Analyst: Olga Belenkaya
 belenkayao@sovink.ru

Equity risk premium – historical and current levels

Almost a year has gone by since the start of the American credit crisis. Since the beginning of the year, all major global stock indices have fallen significantly – in developed markets, stocks have fallen 12-14% on average, and in some emerging markets they have suffered significantly higher losses. Until recently the Russian market, excluding the banking sector, had managed to avoid losses from the revaluation of global risks, however over the past few months the Russian markets also suffered significant losses as they lost their safe haven status in the eyes of institutional foreign investors. At the same time, our fundamental value estimates, based on extremely conservative forecasts, offer upside potential of 50-70% against current market levels – even for the banking sector, which faces the heaviest pressure. The business of Russia's largest banks – Sberbank and VTB – is developing quite satisfactorily. In spite of the slowdown in growth, income from core operations and interest margins keep increasing, liquidity remains at an acceptable level, and credit risk levels are buffered by significant reserves. However, the level and rate of the decline in Russian bank share prices are now comparable with those of Western banks, although the underlying factors are starkly different. This impacts not only bank shares – whenever the yield of US Treasuries falls, credit spreads widen (for instance, the EMBI+Rus spread climbed from 90-100 bps in June, 2007 to 160-170 bps). This is an indication of investors' lower risk tolerance and of their preference for risk-free assets. The growing gap between share prices and their fundamental evaluations, which is especially applicable to bank shares, makes it appear that the market is revising the system risk level. **In our opinion, the market expects a higher level of risk premium, which explains the significant decline in global stock indices.**

It is possible that the basic risk premium level with respect to share prices has also been revised – this primarily concerns the US risk premium level, the benchmark for evaluating global indices. The share price risk premium exerts a direct influence on the discount rate (required return for a particular risk level) – i.e. on the estimation of a company's fair value. **For the American market, the stagflation of the 70-80s, when the risk premium surged dramatically, offers one of the closest historical analogues – and investors can use it for comparison purposes.**

Therefore, regardless of companies' strong fundamentals, the market is valuing them on a significantly different basis than it had before the start of the US credit crisis.

Applying historic risk premiums, dating back to 1973-82 in order to evaluate the discount rate of, for instance, Russian banks' shares, implies a considerable reduction in their target prices.

Issuer, share	Former discount rate	New discount rate	Former target price, end 2008, \$	New target price, end 2008, \$	Current market value, 30.07.2008	Upside	Recommendation
Sberbank, common	11.46%	12.31%	4.97	4.08	2.97	37.5%	Buy
Sberbank, preferred	11.46%	12.31%	2.98	2.45	1.76	39.2%	Buy
VTB	11.45%	12.31%	0.0053	0.0045 (0.106 RUR, \$9.03 –GDR)	0.036	25.5%	Buy
Vozrozhdenie	12.54%	13.31%	74.9	66.7	48.0	39%	Buy
Bank Saint-Petersburg	12.83%	13.81%	7.76	6.61	5.79	10%	Hold

If our assumption is correct, it would explain why Russian market prices may not return to pre-crisis levels until global financial markets finally stabilize (even if economic and business conditions develop in line with conservative forecasts, without any system crisis).



Does the market have a memory?

Losses on global stock indices, which have recently affected the Russian stock market, are continuing amidst a significant deterioration of global economic forecasts. The scale of the financial crisis and its effect on the American economy is increasing, economic and sentiment indicators in Europe and the UK are deteriorating rapidly, and Chinese export and GDP growth is slowing. In July, oil prices fell sharply, which impacted the Russian market – at the moment, from the information available, it is not clear whether this is a correction or a reversal in trend.

According to the International Monetary Fund, there is no evidence indicating the abatement of the global credit crunch. In its updated report on global financial stability, the IMF stated that, for the time being, it can see no end to the decline in US house prices, while loan quality deteriorates and credit risks in the US are widening from subprime loans to other types of mortgages as well as all major loan categories – from car purchase loans to credit cards. The banks have already acknowledged these risks and written off almost \$500 bln in assets, however the new equity, which they raised, covers about two-thirds of these losses, and the fall in share prices has made it harder for them to attract more capital. Thus, it is highly probable that banks will have to further reduce credit financing, which adds to the threat of the deterioration in the economy continuing.

The problems facing the US financial sector have increased. The draft law on saving the largest GSEs (Fannie Mae and Freddie Mac) has been adopted, and its implementation (according to the extremely low estimates of the budget committee) may cost \$25 bln (with some estimates being as high as \$100 bln). However, the actual costs will most likely be much higher. A \$300 bln aid package for house owners is supposed to help 400,000 families re-finance their mortgages and avoid selling their houses in already dead market. The bankruptcy of IndyMac (the third largest bankruptcy in the US) and the subsequent collapse of two much smaller regional banks is indicative of the growing scale of problems facing the US economy – and of the strikingly low small FDIC insurance available (\$53 bln). Probably, here, too, in case of mass bankruptcies of regional banks, the state will need to significantly recapitalize the FDIC.

The latest revised US GDP data shows that there was negative growth in the American economy in 4Q07. It is quite possible that the economy is already in recession, which also appears to be implied by other indicators (employment, production), and will be formally registered at a later date. The Federal Reserve is concerned over higher risks regarding economic growth and price stability (especially rising inflationary expectations). Inflation has increasingly undermined customer demand not only in the US, but also globally. Consumer confidence indexes are at their lowest level in about 16 years. Until now, consumers have continued to spend due to the package of tax incentives; the July correction of record oil prices must also be of some help – however, at the moment, there is not enough evidence to believe that the trend of higher oil prices has been reversed. Even the stabilization of oil prices at current levels (\$120-130 per barrel) may be too heavy a burden for consumer demand to bear.

Estimates of the total probable losses that will be caused by the loan crisis and security revaluations range from \$1-2 tln. Current US economic conditions are increasingly compared with the stagflation of the 70-80s, and some researchers (such as Nouriel Roubini, professor, NYU Stern School of Business) believe that the crisis in the financial sector is the worst since the Great Depression (though not comparable to in terms of its consequences).

The pressure on globalization mechanisms is increasing (the consumer boom in the US - the trade deficit - the export incomes of developing countries with strong state support - the understated exchange rates of local currencies - the accumulation of excessive sovereign savings in developing countries - investments in American assets and financing its trade deficit and the credit levels of US consumers - the consumer boom in the US). Over a long period of time this mechanism maintained excess liquidity, high global growth rates, low inflation and low interest rates, which could not but benefit all participants in the chain. Now that global growth rates are slowing, and inflation, imported due to the falling dollar, increases, it becomes increasingly hard to maintain this mechanism.

Currently, it is extremely difficult to predict how the crisis will develop (recession/ long-term weak growth, stagflation/ deflation), as well as the degree of the impact of US problems on the global (and Russian) economy. Nevertheless, if in the near future, the Federal Reserve restrains from aggressively tightening US monetary policy and the correction in commodities prices does not end in a sharp fall in energy and food prices, inflation will most likely remain high. In addition, the continuing crisis in the housing market and the financial sector may significantly delay the recovery of normal economic growth rates. This leads us to use **the stagflation scenario of the 70-80s for**



defining the new financial conditions prevalent today, and particularly, the risk premium for investments in stocks, which directly impacts the discount rate.

Impact of the risk premium on the discount rate

Our method of defining the discount rate is based on the following:

Risk-free rate, Russia	5.77%	YTM, Russia -30
US equity risk premium	4.36%	Damodaran, 1929-2005 (web-site)
Sovereign default spread, Russia	1.10%	For countries with Baa1 / BBB+ rating
Excess stock market volatility compared to the volatility of Eurobonds	1.5	Average for emerging markets (Damodaran)
Russia – country risk premium	1.65%	
Russian equity risk premium	6.01%	
Cost of equity capital	11.78%	

However, the historical average of the US equity risk premium in 1929-2005, is, not entirely relevant for the current period of excess financial market volatility and falling investor risk appetite. In our opinion, the market expects a higher level of risk premium, which explains the significant declines in global stock indices.

Studying similar historical situations (<http://pages.stern.nyu.edu/~adamodar/>), we see that there have already been precedents of sharp rises in US equity premiums. This occurred in the 70ies and early 80ies – in a period of stagflation and oil shocks. At that time risk premiums grew to 5-6%, with an average in 1973-82 of 5.23% per annum.



Implied Premium - US Equity Markets



Source - <http://pages.stern.nyu.edu/~adamodar/>

We believe that, based on a conservative approach and taking the risk of stagflation in the US as one of the core scenarios, it makes sense to assume a higher risk premium, characteristic of periods of increased business risks (even though there are differences between current conditions and past crises, as, today, the risks mostly cover the global economy, as well as financial and commodity markets).

Based on a risk premium of 5.23%, we obtain:

Risk-free rate, Russia	5.77%	YTM, Russia -30
US equity risk premium, USA	5.23%	Darmodan, 1973-87 (web site)
Sovereign default spread, Russia	1.10%	For countries with Baa1 / BBB+ rating
Russia – country risk premium	1.5	Average for emerging markets (Damodaran)
Russian equity risk premium	1.65%	
Risk premium for investments in Russian stocks	6.88%	
Cost of equity capital	12.65%	



How does this influence the estimation of fair value?

Applying this rate for the **evaluation of Russian banks** which we analyze, we obtain the following:

Issuer, share	Former discount rate	New discount rate	Former target price, late 2008, \$	New target price, end 2008, \$	Current market value	Upside	Recommendation
Sberbank, common	11.46%	12.31%	4.97	4.08	2.97	37.5%	Buy
Sberbank, preferred	11.46%	12.31%	2.98	2.45	1.76	39.2%	Buy
VTB	11.45%	12.31%	0.0053	0.0045 (0.106 Rub, \$9.03 – GDR)	0.036	25.5%	Buy
Vozrozhdenie	12.54%	13.31%	74.9	66.7	48.0	39%	Buy
Bank Saint-Petersburg	12.83%	13.81%	7.76	6.61	5.79	10%	Hold

Therefore, if our assumption is correct, it could explain why Russian market prices might not recover their pre-crisis levels until global financial markets finally stabilize (even if economic and business conditions develop in line with conservative forecasts, without a systematic crisis). Nonetheless, most Russian banks at current price levels remain highly attractive and deserve a **BUY** recommendation.



STOCK RATING POLICY

STRONG BUY:	Upside over 25%, confidence level – high/ upside over 100%, confidence level – low
BUY:	Upside between 15 and 25%, confidence level – high / upside between 25 and 100%, confidence level – low
HOLD:	Upside of less than 15%, confidence level – high», upside of less than 25%, confidence level – low
SELL:	Target price at or below current price levels

SOVLINK LLC

Tel.: +7 495 967 1300

Fax: +7 495 967 1311

Kremlin embankment 1, bld. 2,

Moscow, 119019, Russia

www.sovlink.ru

research@sovlink.ru

©2008 Sovlink LLC. The information in the enclosed Report (the "Information") is not an advertisement for any security or particular issuer and should not be interpreted as such. The Information is intended solely for the personal use of Sovlink LLC's clients or other parties pre-agreed to with Sovlink LLC. The Information is not intended for use by citizens of the USA or legal entities registered in the USA. Nothing contained in the Information is, or should be interpreted as being information intended for an undetermined audience.

The Information is exclusively of an informational/analytical nature, and should not be interpreted as a recommendation to take any particular investment action. The Information should not be relied upon as a justification for the execution of any transactions, and should not be referred to as such. Sovlink LLC takes no responsibility for any actions taken on the basis of the Information. The enclosed Report does not contain an offer or an invitation to make an offer to buy or sell any securities or any options, futures or other derivatives related to such securities.

This Report does not have regard to any specific investment objectives, financial situation and the particular needs of any specific person who may receive this Information. Investors should seek financial advice regarding the appropriateness of investing in any securities mentioned and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities, if any, may fluctuate and that each security's price or value may rise or fall. Accordingly, investors may earn less than originally invested. Past performance is not necessarily a guide for future performance. Foreign currency exchange rates may adversely affect the value, price or income of any security mentioned in the Report. Please bear in mind that investment activity in emerging markets is very risky, and investors should conduct their own due-diligence prior to making an investment decision.

The individual(s) responsible for the preparation of this Report (the Author(s)), or Sovlink LLC may hold short- and long-term positions in any of the securities mentioned in the Report, and may take part in investment activities with companies mentioned in the Report.

In preparing this Report, the Author(s) assumed that the issuers mentioned in the Report disclose information in the amount and under the procedure stipulated by the securities legislation of the Russian Federation for issuers who publicly place securities.

This Report and the Information is based exclusively on publicly-available information, which is deemed to be reliable, however Sovlink LLC makes no representation that this Information is accurate or comprehensive, and it should not be relied upon as such. Sovlink LLC makes no representation that this Report has been released to all readers simultaneously, nor that Sovlink LLC will update this material on a regular basis, or that it will correct inaccuracies contained in this Report.