# Equity Research; Russia/ Ukraine- Part 2

COLLINS SARRI STATHAM
INVESTMENTS

Research Report

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Key Risks to Price Target

Not applicable

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Russian President Vladimir Putin launched a military invasion of Ukraine in the early hours of the 24th February 2022 – a move contradicting Russian government statements during the military build-up.

Remarks that Putin had gone 'full tonto', that he suffered 'cabin fever' during C-19 becoming isolated and irrational, underline the widespread dismay and loss of confidence in the man. His statements about nuclear preparedness and Mussolini-esque rantings have exposed incoherence, unpredictability, and the lack of any internal checks and balances. Russia is experiencing pure form "Caesarism" which in historical terms has never ended well.

For two decades, Germany gave Vladimir Putin the benefit of the doubt, focusing on economic opportunities to the exclusion of all else. Now under the new leadership of Olaf Sholtz, that approach has ended. Germany is now rapidly re-arming, reversing an 80 year pacifist stance and rapidly strengthening NATO.

The C-19 pandemic reminded governments that major action can be taken quickly and will usually obtain public support, if trailed in advance on social media. The admirable concerted actions taken so far have incredible reach. For example the move to destabilize the Central Bank of Russia, limiting its reserve access, ending dealings with Russian bank counterparties, SWIFT exclusion, undermining confidence in the Russian rouble to the extent that the currency requires 20% interest rates, weakening Russia's ability to make payments abroad is quite brilliant. This will hurt the Russian banking system's credit provision, and damage the government's ability to manage the economy, and it will hurt the working man and the previously untouchable oligarchs.

Furthermore, and as important, are private sector sanctions, Apple withdrawing iPhones, Hollywood removing film distribution, the reduction of bulk shipping and logistics access, the lack of flights abroad and airspace closures, divestments by major western companies, sporting/ events exclusions, going after oligarch's private assets, are also beginning in earnest. This approach demonstrates that nobody will be unaffected. Companies have ethical and moral issues and hence their reputations to consider, but what is also being realized is this is fundamental change. An iron curtain has descended, and companies cannot play both sides of the fence.

The rest of the world is united in the objective of bringing about Russian withdrawal from Ukraine using sanctions and economic pain. There is further escalation in the works. So far only Canada has sanctioned Russian oil and gas. As President Biden alluded to in the State of the Union, the next step is likely to be western sanctions on Russian energy. This is the jugular of the Russian system. It would lead to a 'supply shock' due to Western Europe's reliance on Russian gas and have an impact on OPEC + where Russia oil sales are c. 10% of the quota.

The US and EU could also go after Putin's money more directly, confiscating assets he holds in their jurisdictions.

So far the Russian government has retaliated with flight bans and 30% commissions on purchases of foreign currency purchases, closing down foreign media in Russia, all mild stuff. Whilst more countermeasures are expected, is it surprising there has been such limited response to date. It is hard to envisage short of a nuclear war, what precisely Russia could do that would economically hurt the rest of the world.

Perhaps the main problem is Russia's tilt towards China and reinforcing the recent alliance that appeared to encourage Putin's initial move against the Ukraine.

How will the Russia / Ukraine issue transmit to Western Europe and beyond?

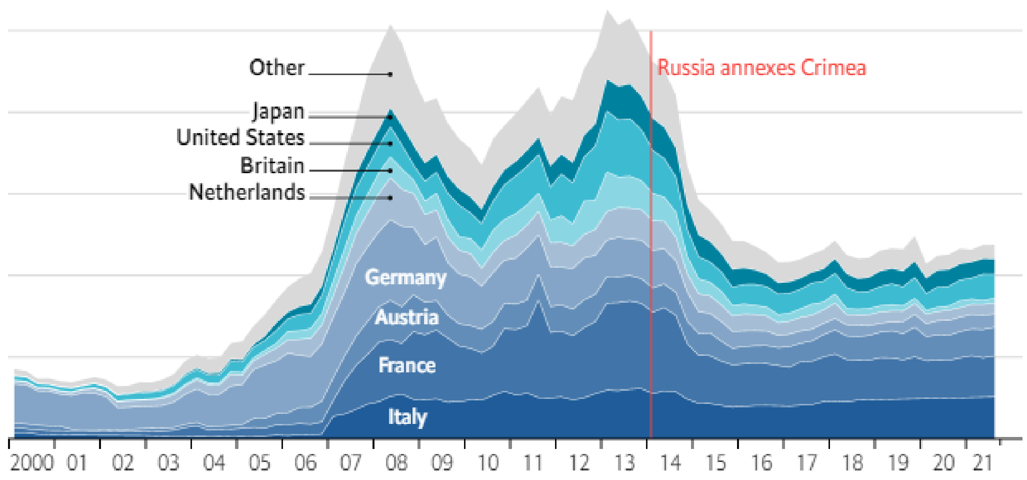
i) Higher commodity prices- major impact has occurred in a) crude oil, LNG, imported gas b) Soft commodities; wheat, corn, sunflower oils, honey c) iron ore pellets, steel. Supply shortages in these commodities are expected over H1 2022.

ii) Direct impact of sanctions/ EU economic slowdown – recent events and media coverage, the arbitrary invasion of a peaceful country, is disconcerting, and its timing, arriving precisely when Europe was exiting C-19 will dampen 'animal spirits' and GDP expectations over H1 2022. Recent bond market moves suggest the crisis will delay significant monetary policy changes.

iii) Loss of investment interest- the collapse in value of London quoted Russia based companies has been quick. Prior to their suspension yesterday, around 98% of the value, c. £480bn has been wiped off the market capitalization of Rosneft, Sberbank, Gazprom in the last ten days. Both ETF and sovereign wealth funds have sold down or totally exited their Russian holdings. The Moscow exchange, assuming it re-opens on Monday 7$^{th}$ will experience possibly its largest ever one day loss. Without western capital markets or consumer market access and with Putin's government grabbing their foreign exchange, the future for Moscow's listed companies is bleak.

iv) Implications of Russian economic collapse – no banks have disclosed their individual Russian loan exposure recently – what has been disclosed by the B.I.S. end September 2021 is $91bn of Russian loan exposure (of which $41bn was local loans via Russian subsidiaries to Russian borrowers), and $9bn of Ukraine exposure. As the data shows total exposure is c.40% of the levels of 2013.

Bank exposure to Russian borrowers
Amounts outstanding by country, $bn




Source: Bank for International Settlements

Italian and French banks have the largest loan exposures at $15bn and $10bn respectively with the rest of Western Europe including the UK at $17bn. SocGen and Unicredit have the largest individual Russian risk exposure but in both cases the exposure is sub 2% of the loan book and would cost c. 40 basis points of CET1 ratio is fully written off.

V) Impact on the USA / Canada

The Russia/ Ukraine crisis has impacted petrol, gas and transport costs and will impact US foreign subsidiaries for example, ExxonMobil and McDonalds Russian subsidiaries (in 2014 the Russian regulators started mass inspections of the restaurant chain in response to Washington’s sanctions following the annexation of Crimea). However this factor is relatively limited in US terms.

## Conclusion; “some are kicked out, some are carried out”

A quick solution/ end to the Ukraine invasion can only be provided by Vladimir Putin. Whether or not he can be made to change his mind, is unknown at this point. A great deal will depend on how long the brave Ukrainian resistance can hold out. So far, its efforts have greatly surpassed previous expectations. I suspect however that there needs to be far greater Russian public unrest than there has been so far to sway Putin. How long can he survive in office given the scale of the economic crisis heading Russia’s way? On this point, some dictators have survived sanctions for years, Fidel Castro, Saddam Hussein however both had very closed economies.

In terms of UK assets, I would caution against panic and making significant portfolio changes at this point, given the surrounding volatility.

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