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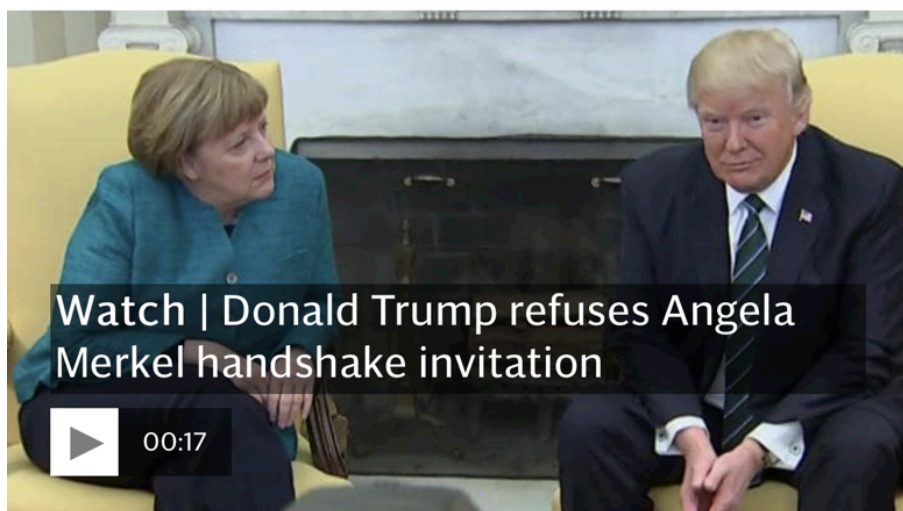
GAZPROM: FROM RUSSIA WITH LOVE

Remember the good ol' days when politicians who liked each other as much as tofu still managed to be polite and courteous, always smiling broadly for the cameras while behind closed doors they were no doubt doing the exact opposite?

A few short years from today we're going to be nostalgic for those times.

Last week Chairman Trump met with the leader of the EU death star, German Chancellor Angela Merkel. We can only guess as to how the discussions went but I think it's safe to say that the old rules are exactly that - old.

Take a look at [this hilarious video clip](#). You don't need to be a specialist in identifying body language here to know what message is being sent.



Pretty astonishing, really. So what does this have to do with our investing our hard earned capital?

Well, I'm glad you asked. The answer is **everything**.

One of the topics I've been hammering on about like an overzealous woodpecker is that of the rapidly shifting geopolitical environment.

A little while ago I wrote about how Trump was upsetting the rice bowls by turning his back on NATO. Deeply embedded in NATO is the not hidden agenda of checking Russian influence.

The two sides to the NATO coin (outside of the US) has been Germany and, of course, Russia.

Trump's made no bones about snubbing Germany with this simply being the last affront.

Now take a look at this, as reported by Reuters:

Exclusive: Tillerson plans to skip NATO meeting, visit Russia in April - sources

"U.S. Secretary of State Rex Tillerson plans to skip a meeting with NATO foreign ministers next month in order to stay home for a visit by China's president and will go to Russia later in April, U.S. officials said on Monday, disclosing an itinerary that allies may see as giving Moscow priority over them."

So here's where this matters. Russia is no longer looking like they're going to be the kicking dog they've been. This is likely true not only for US-Russian relationships but almost certainly true for European-Russian relationships. Why?

Well, that consolidated, joined at the hip, *"one for all and all for one"* European Union is going through a bit of a remake. As newly elected European leaders take over the tiller, they will increasingly be making choices based on what's directly seen to be good for them rather than what is seen to be good for the EU. And this looks to be decidedly positive for Russia.

In fact, Russian five-year credit-default swaps currently trade at levels that imply the country should shake off its junk rating. Last month, Moody's Investors Service, which along with S&P Global Ratings puts the country one level below investment grade, raised its outlook to stable from negative. Expect this shift to continue.

This brings me to Russian sanctions. The best way to think about sanctions is to think of them like a fence. A fence works only when it doesn't have any holes in it. Otherwise those you're trying to keep in or out simply go through the holes. Those holes become congestion points and where you have congestion you have profit.

Think of it like this. Say one country opting out of the EU chooses unilaterally to begin trading with Russia under some new trade agreements, thus either ignoring sanctions or by formally lifting them. This then becomes a gap in the fence. Consider this as an example. You and I trade machine parts in Europe and our business is based in Austria.

Now, let's say that Le Pen wins in the French elections and then turns around and lifts sanctions with Russia (something she's already hinted at doing). Well, if we want to get our machine parts into Russia we'd simply setup a distribution hub inside France... or we'd partner with a French firm and get our products into Russia. It'd be 100% legal as we'd be trading directly with France and so unless there are sanctions against France imposed by Austria we'd be doing nothing wrong. More volume and often higher profit margins. What's not to like?

As you can see the entire sanction system rapidly crumbles unless ALL parties agree to the sanctions.

I think the days of all countries in Europe agreeing to continue being dictated to by Brussels are coming to an end. Perhaps a very abrupt one.

We need to rethink the entire macro framework for how the world's been structured post bretton Woods. All the rules written are going to be redrawn and they'll be redrawn according to individual interests rather than collective interests. New alliances are already being made and we need to be very aware of this. Russia stands to benefit from things going from bad to less worse in this respect.

Since we're looking at an oil and gas producer I'll spend a short bit of time on oil.

Oil Price What?

For a host of reasons I'm not particularly bullish on the price of oil. Global inventories remain near record highs, we have Iranian supply coming onstream - slowly, but it's coming. Sanction against Iran have largely been lifted and while this hasn't translated into any significant FDI what it does mean is that Iran is free to sell to the rest of the world. They've made it dead clear that they want no part in OPEC. And why should they?

Then we have Iraq who just announced (on the 13th March) they will hit 5 million barrels per day up from 4.57 million. Clearly, they're not paying attention to that dying cartel called OPEC of which they're currently a member. The cartel only works when all players abide by the rules and increasingly OPEC members are choosing to do what's best for them individually.

And then we have Russia who are not a member of OPEC and who currently pump about 11 million barrels per day because quite frankly they need the money. To top it all off we have the US shale industry which thanks to technological advances in shale drilling have seen US production ramp from around 5 million barrels in 2009 to around 9 million today. All of this is to say that OPEC is not what it used to be and I don't see any reason to be massively bullish on the price of oil.

Thankfully we don't need to.

Trade: Gazprom PAO - the London listed ADR or US-listed Pink Sheet (OZGPY)

Investment Thesis: Due to a number of geopolitical and economic factors Gazprom is essentially priced for bankruptcy or nationalization. I don't think reality will be remotely close to what the market is currently pricing, and over the coming months Gazprom's stock price is likely to surprise everyone on the upside.

Discussion: Every now and then you come across a stock that is ridiculously cheap, so much so that you think - I would have to be absolutely insane not to be invested in this stock! Or **"you wouldn't catch me in a million years being short this stock."** Well, by default if you would never short it you should always consider being a buyer no matter how unpopular the trade may be at first blush. That stock is Gazprom.

Mention this at the next cocktail party you attend and watch people scuttle from you like they've just found out you've contracted Ebola. Here's the thing though, if you peer through the well documented geopolitical and macro issues, Gazprom appears to be a very solid company with material upside on offer in its stock price over the coming months/years.

Here are some interesting facts about Gazprom. The company holds the world's largest natural gas reserves, which account for approximately 18 percent of global reserves. In an increasingly turbulent geopolitical world that's pretty damn significant. In addition it accounts for 14 percent of global gas output and 74 percent of Russian gas output. It owns the world's largest gas transmission network which supplies about 30% of Western Europe's Gas demand.

Gazprom's share price has been a disaster to put it bluntly - it still trades below the very worst of the GFC lows



Gazprom ADR on the LSE (in USDs)

Fundamentally, Gazprom is extremely cheap. For me, the huge attraction is the fundamental valuations that would have any deep value investor salivating. Let's compare a few fundamental metrics of Gazprom to Exxon (I'm using Exxon merely as a reference point because everyone can relate to the valuation of Exxon).

	Gazprom	Exxon
Forward P/E	4x	19x
Dividend Yield	5.41	3.64
EV/EBITDA	3.72	7.82
P/Book	0.27	2.0
Debt/Equity	0.30	0.26
ROE	7.75	4
ROA	5.16	2.51

Am I missing something here? Sure you can probably justify paying a premium on Exxon relative to Gazprom but 6x on a P/Book basis and 4x on a P/E basis? This is absolutely nuts! And look at the Debt/Equity ratio and ROE!

Why Is It So Cheap?

The main reason why the stock tanked in USD terms from 2014 - 2016 was the perfect storm of a collapse in the Ruble and crashing natural gas and crude oil prices. In January

2016, the USDRUB peaked at about 80 and Gazprom (in USD terms) hit a low of approximately \$3.

Now, when that happened CNBC, Bloomberg, and a host of other news outlets were all running pieces and bringing out experts to opine on the topic. It was a veritable bandwagon of negativity. This was NOT negative. It was bloody positive. Why? Because what was happening was that the imbalances were being corrected. That is fundamentally good.

Russia basically took the pain in their currency letting the market reprice it without attempting to intervene. Today they stand much much stronger for having done so.



Gazprom (ADR on LSE in USDs) and USDRUB

You can see this in the stock which has been essentially flat in Ruble terms. It was only the exchange rate fluctuations that saw Gazprom fall some 50% since early 2014.



Gazprom on the Moscow Stock Exchange (in rubles)

The other main driver in the valuation of the stock has been the political situation between Russia and the west and a long term (2-year) spat with European antitrust regulators. I'm not going into a huge political analysis, because there can be many twists and turns which are impossible to anticipate.

Amongst investors there is a reasonable fear of a nationalization of Gazprom either through law or taxation. While I see this as the biggest long term threat I think the probability in this case is considerably lower the crowd is pricing into the stock price of Gazprom - although the nationalization of Yukos is still foremost in my mind! I won't forget that one!

But that was some 15 years ago, and while it's always a risk I don't think it's one that is currently priced correctly. If Russia nationalized Gazprom today, they'd undo a lot of the work they've done in terms of slowly attracting foreign capital back into their markets.

It doesn't mean it can't happen but investing is more about pricing probabilities and this probability is currently priced as a near certainty which I don't think it is.

Either which way one can theorize about nationalization or Gazprom going bust (essentially the same outcome for stockholders), the reality is that Gazprom is essentially priced for a nationalization/bankruptcy.

What would happen to the stock price over the coming months if this didn't happen? I think the answer is obvious.

The Macro Picture

Let me cut to the essence of the macro setup for Gazprom. **Western Europe is running out of natural gas reserves and quickly.**

Europe's biggest producer, the Netherlands, is cutting back due to having chugged through some 80% of its reserves, and even if it hadn't used up so much they have to contend with earthquakes.

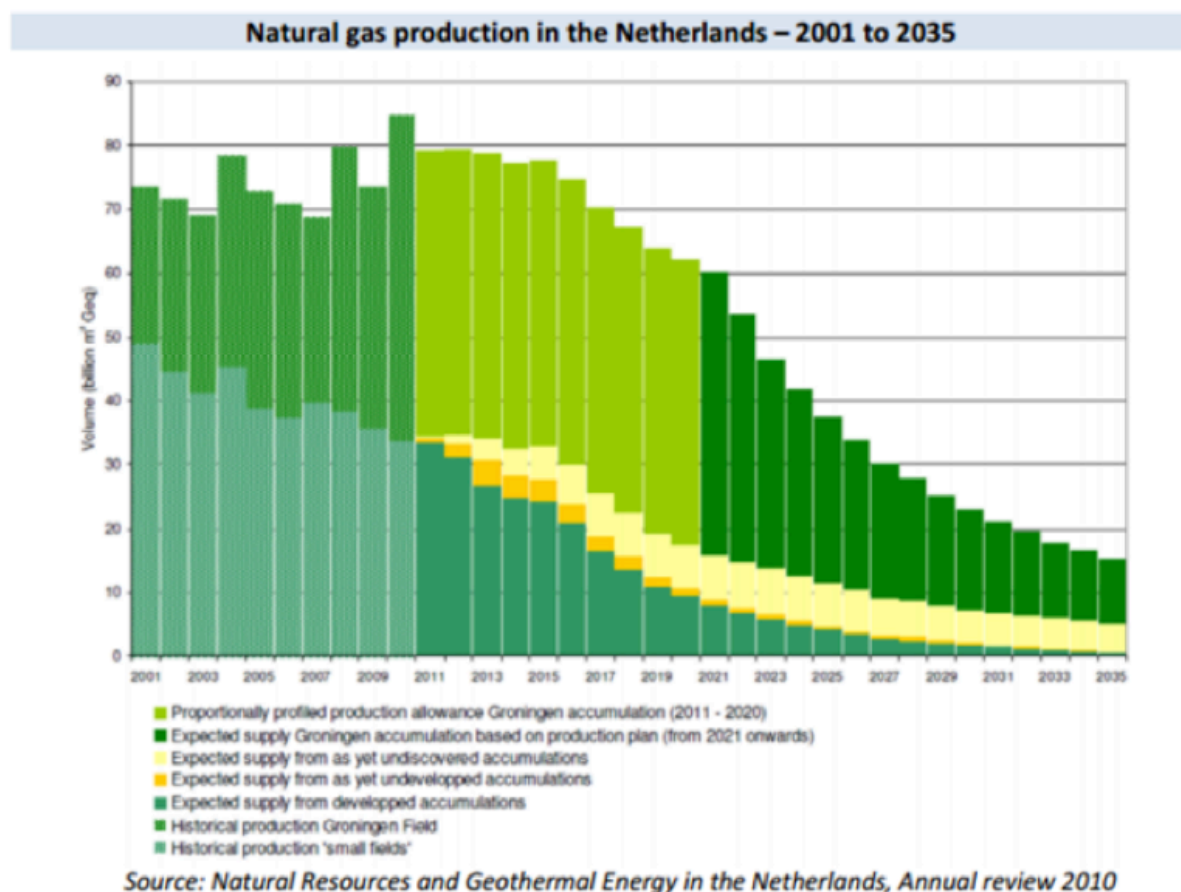
Shell and Exxon's €5bn problem: gas drilling that sets off earthquakes and wrecks homes

Groningen has been one of Europe's richest gas fields for 30 years, and thousands of people say their homes have been damaged by the tremors that drilling sets off. Now a class action may finally bring them compensation - and force a rethink of European energy security



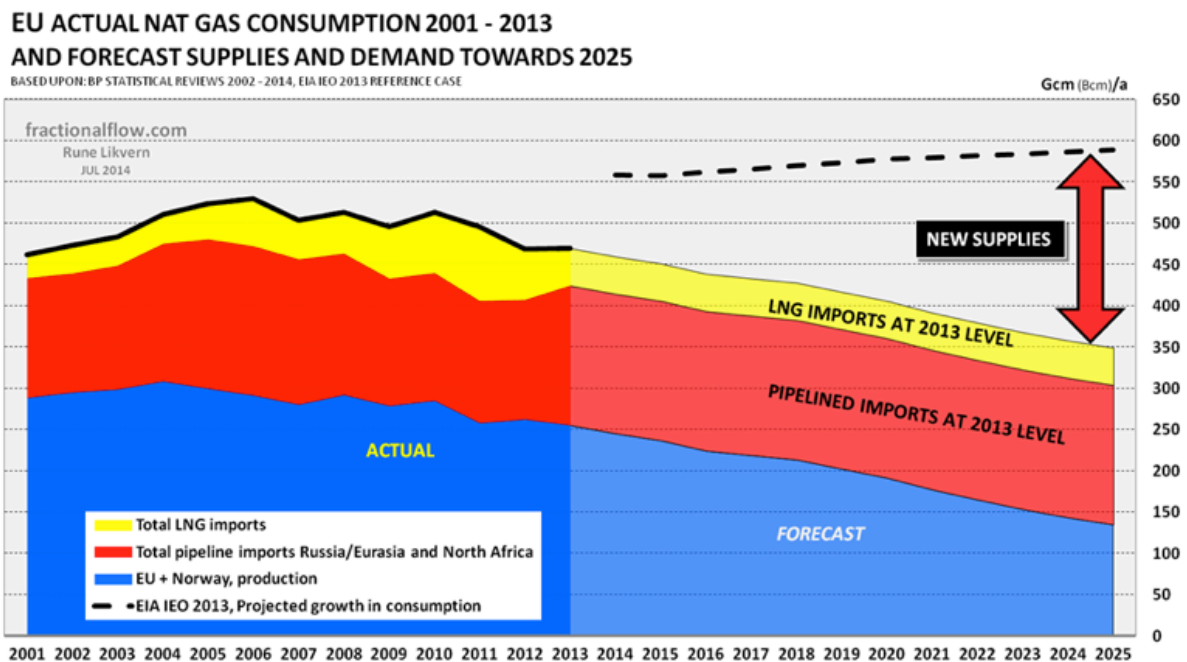
❗ 'Nobody is taking this seriously, not the school or the mayor, no one' ... Annemarie Heite, whose home in Groningen has been scheduled for demolition after earthquakes caused by oil drilling. Photograph: Hans Knikman/Demotix

Take a look at the chart below showing natural gas production rates for the Netherlands.



Less than half a decade ago, Dutch natural gas production accounted for about half of all EU domestic supply. This has been in freefall and within the next decade our cheese making friends look set to be a net importer of natural gas.

Europe's other big producer, Norway, reached peak production and has been in decline for the last 13 years.



So where is the shortfall between consumption and production going to come from? Essentially, LNG imports (not so cheap) and Russian pipelines (cheap).

To cut a long story short, like it or not, Europe is going to become more dependent on Russian gas imports (aka Gazprom).

Couple that with a fragmenting political union in Europe and I wouldn't be at all surprised to see Russian sanctions being scaled back or lifted altogether.

You don't need me to tell you what institutional money managers will do when or if that takes place. They'll re-allocate a percentage of their emerging market allocations accordingly and it won't take much of a shift of institutional money to move the market. Institutional money will buy the index and the "blue chips". Gazprom stands to benefit from both.

Conclusion

Gazprom has had its issues over the last three years due to geopolitical and macroeconomic factors.

However, on a long-term basis, the company should do well because of the importance of natural gas in Europe and Western Europe's dwindling supplies.

From a valuation perspective, **Gazprom is priced as if equity holders will be wiped out within a few years** (via nationalization or bankruptcy). We don't think this is realistic and patient investors will be well rewarded over the coming months.

Now, I know equities are a "helluva" lot more volatile than fixed income but when I look at the yields on sovereign debt and the fact that I can buy Gazprom paying a 5.51% dividend yield.

Gazprom Dividend Yield (TTM): 5.51% for March 21, 2017

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Gazprom Dividend Yield (TTM) Chart

[View Full Chart](#)

1d 5d 1m 3m 6m YTD 1y 5y 10y Max



How to trade Gazprom: If you can trade stocks on the London Stock Exchange, it is as easy to trade Gazprom as it is BP or Barclays! For trivia, you can also trade it in Frankfurt. It can also be traded in the US via the OTC market code: OZGPY.

OGZPY PJSC Gazprom		OTCPink		
Sponsored ADR (1 ADS : 2 Ordinary) International Reporting		Pink Current Information		
4.385 ↑ 0.075 (1.74%)		Previous Close	Daily Range	Volume
Real-Time Best Bid & Ask 4.37 / 4.40 (1 x 1) Why is size 1?		4.31	4.33 - 4.40	719,582
Open		52wk Range	Dividend	Average Vol (30d)
4.35		3.925 - 5.33	0.1855	799,408
			Net Dividend Yield	
			4.23	

Trade Data Delayed 15 minutes. Trade Time 6:59:45 ET / Last Best Bid & Ask Update Mar 13, 2017 8:00 AM ET

An indirect way of trading Gazprom is via the ETF RSX (Gazprom is some 7% of this ETF).

Weighting: I wouldn't hesitate to have a 2% weighting to GAZPROM in one's portfolio.

When to take profit: I don't have any specific profit targets in mind.

However, I do know the signs to watch out for to close out the trade, namely optimism towards Russia. We are light years away from that.

Disclosure: The AOF is long Gazprom at \$4.50.

Sincerely,

Chris MacIntosh

Founder & Editor In Chief, Capitalist Exploits Independent Investment Research
Founder & Managing Partner, Asymmetric Opportunities Fund

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