# Baltics 2013

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This summer, we completed a Baltic region investment research trip, attending an economic conference in Russia, and visiting with analysts and companies in Finland. We would categorize the investment opportunities as sporadic, given the geographic size of the region, but expanding. Finland, with a population around 5 million, is well off most investors' grids. However, it does offer Western efficiencies and accessibility to both Western and Eastern European markets. Russia, with nine time zones and a land mass almost twice the size of the U.S., is much more visible, politically and economically. Yet, regardless of its size, Russia is only marginally represented in the global capital markets. Recently, Russia has ventured to expand its business visibility, attempting to downplay its historical militarism, while working to build a reputation as a viable place to conduct business. Western investors tend to have difficulty envisioning Russia outside of its historical role as a political nemesis and counterbalance to the U.S., which is understandable. However, the country is taking small, but meaningfully positive, economic strides. As examples, Russia has introduced a well-received flat income tax rate system, has enacted more stringent DUI laws, and has managed internal infrastructure growth while avoiding a build-up of government debt that would threaten its currency's stability. There is a recognizable push to redistribute the extreme pockets of wealth (think: oligarch billionaires) to the middle class, and to lessen the stifling impact of bureaucracy. Progress on these fronts is slow, more of words over deeds; but there is transparency with those issues, and with the issue of corruption, that simply did not exist ten years ago. Conversely, Russia is facing the formidable challenge of a declining population that is culturally tied to their lifestyles. This transformation is a painstakingly slow process, but one that is showing improvement. Finland, similar to Russia and the entire Baltic region, is also not a population-driven consumption story, yet it has an attractive group of excellent, publicly-traded companies that have been seemingly overlooked.

Our portfolios have historically held very few direct Russian exposures. Along with many Western investors, we have been hesitant to invest with any significance for a number of obvious reasons: a lack of capitalistic history; weak accounting standards; a lack of consistency in the application of contract law; little public trust in the courts. Yet, as easy as it might be for American investors to just say "nyet" to Russia, the economic conference highlighted that Russia has been busy developing commercial relations with many of our allies and is opening itself up to business. Canadian, German, Swedish, British, and French corporate interests, to list a few, were well represented, with cards in hand, already years into their business dealings in Russia. We took particular note of both Chinese and Japanese corporations embedding themselves with the typical "joint venture." This strategy, ubiquitous in the developing markets, is a way of sharing risk and smoothing over the bumps by working directly with a local vested interest. *Renault*, the French/Japanese car manufacturer, led by Carlos Ghosn, was a memorable delegate at the conference. It made note of its ownership of 30% of *AvtoVAZ*, the manufacturer of Russia's infamous *Lada* automobile brand, a car most recognizable for its dull paint, boxy exterior, and a take it or leave it marketing attitude. *Renault's* stated goal for this partnership is to build *Lada* into a world class global Russian brand, something that is very politically appealing to a country lacking in business cache. Despite having a steep hill to climb in the highly competitive automotive sector, Carlos Ghosn and a host of his executive peers are not waiting for pristine conditions, or a perfect Western-style political situation, before getting their toes wet in the region. For that matter, *Pepsi*, an iconic American brand, is still going strong in Russia, having started out there in 1972 with a now-famous photograph of Premier Nikita Kruschchev and President Richard Nixon toasting with Pepsi-Cola. *Daimler,* the manufacturer of *Mercedes* vehicles, was also highly visible with its luxury sedans and *Smart* cars, U.S. accounting and energy firms, Korean technology firms, and a full roster of recognizable, non-Russian franchises all lined up to sell to a well informed and educated middle class. The middle class represents the vast majority of the population, despite the well-publicized list of billionaire oligarchs who always seem to catch the headlines for buying and selling sports teams. At the heart of their economy, and the core of future investment opportunity, is the middle class with a per capita GDP of $12,993, which stands in stark contrast to India, with a per capita GDP of only $1,388, or China with a per capita GDP of $5,413, according to the International Monetary Fund.

Russia utilized the visibility of the economic conference to announce an enormous $270 billion 25-year oil deal between *Rosneft OAO (*a large Russian Oil company*)* and *China National Petroleum Corporation* (a large Chinese Oil company). China and Russia appear to be quite intertwined, from an economic perspective; Russia craves China's capital, and China covets Russia's energy resources. The *China Petro* transaction underscores the investing complexity for the region. While direct investment via the *Gazproms* and *Rosnefts* is available for U.S. investors, it can come with a brazen "Soviet-style" attitude, which often places shareholders' interests well below that of the government or the local management team. If direct exposures are too formidable or risky, an alternative strategy is through owning the successful multinationals with an existing footprint. Investing in *McDonalds*, *Pepsi,* or *Daimler*, as examples, provides meaningful Russian consumer exposures but with greater diversification. The busiest *McDonald's* restaurant in the world is in Moscow, serving over 40,000 customers a day from Pushkin Square, something Ray Kroc probably could have never imagined when he was getting started with *McDonalds* in 1954. Alternatively, we identified a Finnish industrial firm that enjoys strong and growing earnings, a low valuation relative to its global peers, higher profit margins than those peers, and with Russian consumers as the company's largest target market. The firm relies on European quality and accounting standards, while providing an almost direct play on the expanding wealth of the Russian middle class.

Unfortunately, many U.S.-based investors ignore the Baltic region because of its demographic challenges, and in the case of Russia, its historic anti-capitalist bent. However imperfect the region may be, spigots of profit are opening in the most unexpected places, like Russia and Belarus, and we expect that flow to continue. While we do not envision having a significant exposure to the area, we feel it advisable to set aside historical biases and analyze those firms when they are trading at 30%-40% discounts to their peer group. The coming winter Olympics in Sochi, Russia will be a litmus test for our thesis. Along with the rest of the world, we will closely watch the event's successes and shortcomings. The outcome could reflect just how far Russia has come, or still must travel, to earn international trust and investment.