



August: a bad month for Russian assets (Russian DRs conversion in focus)

SUMMARY

For the last 25 years August has been considered a bad month for Russian assets. This is also true for the US and European equity markets, whose turbulence normally drags on into September.

The key Russian assets, equities and the rouble, are set to come under pressure this month. Over the last 25 years, the rouble has weakened most against the dollar in August, by more than 3%.

We forecast that sales of Russian depositary receipts during August's conversion could range between \$5 bln and \$18 bln, including sales by foreign-controlled companies (CFC). It is also important to take into account the Bank of Russia's daily limit on the sale of securities after conversion at 5% of such securities received by the holder, compared with 0.2% previously.

Therefore we do not expect the market to slide sharply, MOEX may fall as much as 10-15% following such sales, to 1 880 p. We assume that residents will decide to sell 10-50% of their receipts after conversion.

In April, during the first phase of the DR conversion, MOEX dropped 23%, before recovering by 12% in May. The index stopped falling after the EU imposed sanctions on the National Settlement Depository (NSD) and the conversion window closed. Since then the Russian equity market has not recovered to its peak level of early April and is still 23% below that high.

Conversion was announced in advance and investors are expecting for the Russian index to decline especially after August 15, so they can partly offset the likely slump in equities, but the fragile market will not hold up amid massive sell-off due amid weak fundamentals and tougher sanctions.

The rouble decline is inevitable given a new budget rule that is expected to be set shortly. **The president has ordered to submit proposals to adjust the budget rule and currency buying rule after receipts conversion by July 25. In our view, the rouble could weaken against the dollar to ₴65.5/\$ and against the yuan to ¥9.8.**

RUSSIAN DRS CONVERSION: YET LIMITED

We estimate that holders won receipts worth ₴7,728 bln (\$124 bln), of which ₴5,410 bln (\$87 bln) are held by non-residents and ₴2,318 (\$37 bln) by residents. More than 80% of non-resident holders account for companies from "unfriendly" countries, in particular EU members and the US, represented by major investment funds

(Norwegian Sovereign Fund, Blackrock, Vanguard, etc.). **At the same time, among holders from "unfriendly" countries, there's a small number of holders with Russian roots who have formalised their ownership of securities in "unfriendly" jurisdictions, in particular in Cyprus, Luxembourg, etc. through CFCs (Controlled Financial Company).** Receipts sales by CFCs could top \$1 bln. They would also be allowed to convert RDs; they probably managed to buy back some of the receipts from non-resident international funds at 80-90% discount after the conflict in Ukraine broke out.

At the same time, non-residents from "unfriendly" countries, which accounted for most of the Russian securities, will still be banned from selling their shares on the Russian market and will have to use "Type C" accounts, as in the case of coupon payments made by Russian issuers under sanctions to meet their external debt obligations. Given the Central Bank's cautious approach to regulating the Russian financial market after February 2022, shares held by investors from "unfriendly" countries are not expected to be added to the core segment of the local market anytime soon. Since March, the regulator and the market have been discussing the possibility of non-residents from "unfriendly" countries trading in securities as part of a separate "order book".

We believe that at least 10% of these receipts will be offered for sale in August. The important thing is that the Bank of Russia has decided to increase the share of Russian receipts subject to conversion to 5% from 0.2% if they were purchased after March 1, 2022. **We estimate that sales of receipts by residents in August will amount to ₺229 bln (\$3.7 bln), or ₺11.8 bln (\$187 mln) a day, at least based on the daily sales quota set by the Central Bank and less sales by CFCs. The CFCs may put up \$1 bln worth of receipts for sale, bringing total sales in August to ₺291 bln (\$4.7 bln), or ₺14.7 bln (\$237 mln) a day, compared to the average daily trading volume on the Moscow exchange (₺25 bln), triggering a sharp jump in trading volume and liquidity to levels seen before the conflict in Ukraine. Based on the mentioned receipts amount, it would take about 25 working days (within a month) to sell them.**

Критерии	Оценка, ₺ млн	Оценка, \$ млн	Суммарные продажи, \$ млн	Дневные допустимые продажи, \$ млн	Комментарии
Рыночная капитализация Мосбиржи	31 386 802	506 239			
Акции в свободном обращении	11 733 177	189 245			
Доля резидентов	23 173 579	373 767			
Доля нерезидентов	8 213 224	132 471			
Держатели расписок	7 728 820	124 658			
Нерезиденты	5 410 174	87 261	8 726	436	Средства будут заморожены на счете С
Резиденты	2 318 646	37 398	3 740	187	Автоматическая расконвертация
Прочие международные фонды	4 928 780	79 496	7 950	397	Средства будут заморожены на счете С

Source: ITI Capital, Bloomberg

GREEN LIGHT FROM NSD AND EUROCLEAR

NSD waived its fee on conversion of depositary receipts into Russian equities until August 14 (16:00 local time), while Euroclear has also decided to continue executing orders for manual conversion of depositary receipts for Russian shares. **It cannot be ruled out that the conversion period could be extended in the future, as we assume that both the Bank of Russia and the NSD are interested in the return of free-float of Russian companies to the domestic market in the long run.** The exception is Russian shares registered abroad.

It is also important to note that the Federation Council is now considering a draft law on the receipts conversion through Euroclear, which is to be signed by the president. Once the law enters into force, the receipts must be converted within 90 days. The law does not apply to Russian companies registered abroad (CIAN - Cian; EM44 - United Medical Group (EMC); ETLN - Etalon Group; FIVE - X5 Retail Group; FIXP - Fix Price; GEMC - United Medical Group (EMC); GLTR - Globaltrans; HHRU - Headhunter; HMSG - HMS Hydraulic Machines & Systems Group; MDMG - MD Medical Group (Mother and Child); OKEY - O'KEY; OZON - OZON; QIWI - QIWI; SFTL - Softline; TCSG - Tinkoff; VKCO - VK Company Limited).

On July 22, during its board meeting the Bank of Russia set the date for automatic conversion of Russian companies' receipts, including of those issuers that kept the depositary receipts programme, on August 15. Conversion applies to receipts owned by local holders directly through NSD.

Therefore, since August a stock overhang is set to grow due to a combination of technical factors:

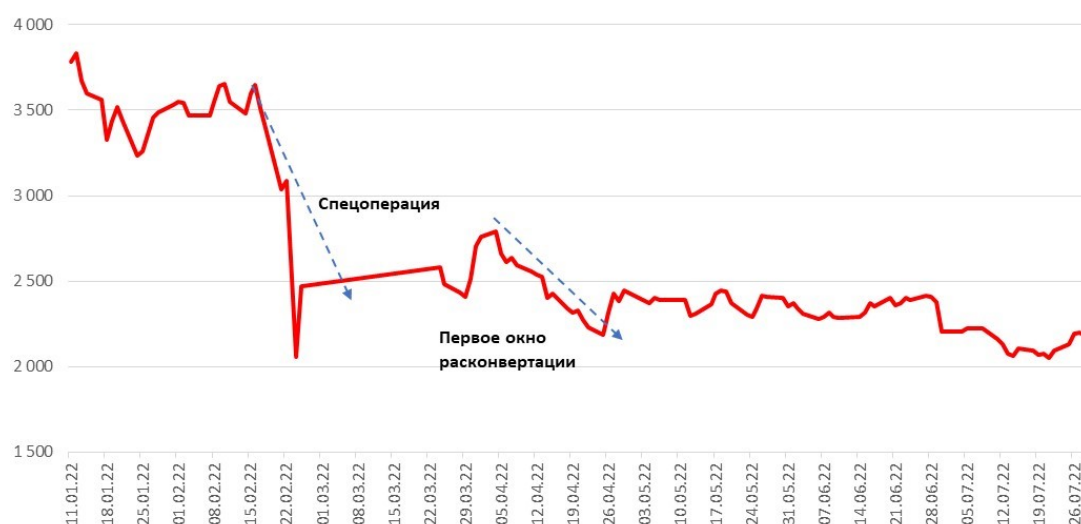
- 1) Conversion of shares amid temporary operation of the Euroclear/Clearstream-NSD bridge until at least August 14
- 2) The Russian regulator has allowed non-residents from "friendly" countries and foreign companies controlled by Russian residents (CFCs) to sell shares since August 8
- 3) Automatic conversion of receipts held with the Russian depository will start on August 15, after the relevant law takes effect

THE RUSSIAN STOCK MARKET: SUPPORT FACTORS

As a result of the three processes outlined above there will be less room for arbitrage between external and internal market segments in August. The Moscow Exchange may benefit from the conversion since the exchange has a monopoly on trading in Russian equities. **Depositary receipts will cease to exist in the Russian equity market. All other things being equal, this will also create conditions for Russian issuers, who have suspended paying dividends to investors and major beneficiaries due to blocked settlement channels, to return to dividends pay-outs.** This factor may drive up the price of beaten-down Russian equities, all other things being equal.

Purchases by US funds? The US Treasury said on 25 July that US residents can convert depositary receipts into Russian shares. Conversion (Cancellation) of depositary receipts into shares of non-designated Russian companies will not be considered a “new investment” for US entities and individuals and hence conversion is allowed. US residents will also be able to buy stakes of funds that include securities issued by Russian issuers. The stakes may contain debt or equity securities issued by Russian issuers which will not be considered a new investment unless Russian assets dominate the US fund structure. Therefore, US residents will be able to continue investing in such funds with Russian assets.

MOEX, BPS



Source: ITI Capital, Bloomberg

FX-TRADING: DEDOLLARIZATION IS INEVITABLE

Trading volume in the CNY/RUB pair on the Moscow Exchange rose steadily last week and has already reached the weekly average of ₴66 bln, up from ₴35-40 bln a week earlier. The rise in trading volume and the strengthening of the CNY against the rouble since the start of the major tax and dividend pay-outs indicate a strong demand for the CNY primarily from financial institutions. This trend will continue in anticipation of the new budget rule that is set to take effect in 2023.

USD assets are also likely to be removed from the list of collateral means for interbank settlements and the US currency will switch to over-the-counter trading, as happened with the Euro after the EU imposed sanctions against the NSD. Market participants should be prepared for such measures in the run-up to EU's formal sanctions against the National Clearing Centre (NCC) and US sanctions against the NSD. All these factors set the stage for increased demand for CNY and currencies of other "friendly" countries.

The Bank of Russia is said to discuss with FX-market players a mechanism to remove USD assets as part of dedollarisation and other measures to ease bank liabilities in FX and to replace them with friendly currencies such as CNY in the wake of sanctions against the National Clearing Centre (NCC). Under such restrictions, currency trading would be limited and the mechanism that the Central Bank has had in place since 2014 to hedge against currency circulation limitations would be useless. An alternative that the Bank of Russia is considering is a Russian equivalent of Bloomberg (OTC trading), a platform where currency quotations of major banks are published.

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