
Monday, December 10, 2007

A Contrarian's Take on the World -- Part II

[Interview -- Part I](#)¹


And this, with the backdrop of inflation?

Easing monetary policy is going to reignite inflation. Every time we have a problem, the currency we choose to pay with is inflation instead of creating a temporary recession.

How do you think the emerging markets as a safe-haven theme will play out?

You are asking the wrong person because we have been very pragmatic. We have added some exposure to Southeast Asia, but we're not big advocates. There will be a delayed coupling as opposed to a decoupling. There will be a lot of spending in China ahead of the August '08 Olympics, and it may take awhile before the weakness in the U.S. trickles down to Asia. We have exposure to emerging markets more from a risk-management perspective as opposed to any conviction on the region. But our favorite market in the world for next year is Russia. With oil around \$90 a barrel, it doesn't make sense that Russia is one of the worst-performing emerging markets this year. The country has one of the most aggressive tax systems -- crude export duty is about 89 cents on the dollar for oil over \$25 a barrel.

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Isn't there concern about contract law?

Russia is not a big market for our multinational corporations compared with, say, China. U.S. multinationals are basically helping the Chinese government catch its dissidents. In Russia, where [President Vladimir] Putin has an 80% approval rating, we are pestering him. We are being hypocritical. There has been some backpedalling on reforms, but sometimes you have to take one step backward to take two steps forward. For me, the politics is a non-issue.

How are you investing in Russia? Oil plays?

Oil plays are relatively cheap. Though they are being punished by a very aggressive tax regime, ultimately there will be a different tax regime because the cost of exploration has gone up dramatically and these companies need compensation. That's why we don't see a lot of new development today in Russia. In order to see new fields and development there needs to be a better tax regime. That's a hidden catalyst in the future. The consumer and domestic-oriented sectors will be in the sweet spot for the next few years as the country is awash with money and foreign reserves. The government has announced it is going to spend about a trillion dollars in the next five years. I am interested in the broad Russian index. I don't have specific companies.

What else besides Russia?

We still like Central and Eastern Europe. There is no immediate gratification or catalyst but we would use weakness or a correction to add and build positions.

How about some companies?

FLSmidth [ticker: FLS.Denmark], a Danish company, is a play on commodities. It's a great way to bet on the increase in consumption of commodities and increased infrastructure spending. This is the world's largest supplier of cement plants. They have about a 29% market share and are a major provider of equipment and services to the minerals industry. Spending on new mines is growing. The CRB Index may be ahead of itself and see a correction, but the demand for commodities is going higher. This is one way to play it without worrying about commodities prices.

Company	Ticker	Recent Price
FLSmidth	FLS.Denmark	508 DKK
OTP Bank	OTP.Hungary	8550 HUF
Credito Emiliano	CE.Italy	€9.30
Siemens	SI	\$155.50

Source: Bloomberg

Is it reasonably valued?

Yes. The company's sales are 46% in the developed world and 54% in emerging markets, 49% in the cement sector and 45% in the mineral sector. The remaining 6% is in roofing, which I think they will sell. For the next two to three years there is a record backlog and strong order intake. Recently the company had a big breakthrough by winning its first Russian order. Russia, because of its oil plants and high infrastructure spending, will be a great new market for them. The company is integrating some of its

recent acquisitions in the mineral sector. It is a very fragmented sector and they will continue to make acquisitions.

Valuation?

On a 2008 basis the price/earnings multiple is roughly 13, and enterprise value [stock-market value plus net debt] is about 7.8 times Ebitda [earnings before interest, taxes, depreciation and amortization]. This is very high growth for very good value.

How about another name?

OTP Bank [OTP.Hungary], a Hungarian bank. I first mentioned it in *Barron's* years ago [[Feb. 14, 2000](#)²]. It has done well. This is a great time to bring it back. It is an excellent franchise, high growth potential and great management at a bargain valuation. OTP is a leading bank in Hungary with 32% market share in retail deposits. About 76% of their earnings come from Hungary. The bank is focused on regional expansion into Ukraine and Russia, Southeast Europe and the Balkans. They're targeting 50% of their income from those regions by 2010. While they have a dominant position in Hungary, Bulgaria and Montenegro, in other countries they are forming niche strategies. In Russia they are building a regional retail bank. In Croatia they are focusing on the lucrative coastal areas, and in Romania they are focusing on the wealthy Hungarian regions.

Let's look at the valuation.

The P/E is 8.7 times 2008 earnings estimates. Price to book value is about 1.9. The company is going through a digestive period because it did a lot of acquisitions outside of Hungary. In Romania its costs are going higher as it tries to gain economies of scale and market share. In Serbia it is integrating three acquisitions. Management's goal is to double earnings before taxes to €2 billion by 2010. If it succeeds, you're talking about a P/E of 5 by 2010. OTP is the last remaining independent bank in the region, but management believes it is too early to sell. They believe they can grow earnings by 30% a year at least for the next three to five years.

Next up?

Credito Emiliano [CE.Italy] is a bank with an old-fashioned business model, fully funded by depositors, unlike many banks that rely on the commercial-paper market for much of their lending. It's a solid franchise that pays attention to credit quality and redeploys excess capital for growth through new branch openings and acquisitions. It is the 13th largest bank in Italy, focusing on the Emilia-Romagna region and Lombardy. We expect annual profits to grow at least 10% in the next few years, driven by loan growth and a falling cost-to-income ratio. Credito Emiliano would also be a prized asset for both domestic and foreign banks. One of its greatest attractions is a high and growing dividend. You're buying a 5.3% dividend yield, a P/E of 9.5 times on 2008 estimates and a price-to-book of 1.6.

How about another pick?

Siemens [SI], in Germany, is a major restructuring story. Poor profitability and bribery scandals forced a genuine attempt to change. The portfolio is being repositioned; divestitures are being announced. They will reduce SG&A [selling, general and administrative] expenses by 10% to 20% and do a €10 billion share buyback. New investments will be made only in high-margin areas like energy, environment, automation and health care. The stock is trading at 15.4 times fiscal '08 earnings. As costs go down and margins increase, it will be a good performer.

Thank you, Riad.

E-mail comments to editors@barrons.com³

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