INSIGHTS FROM OUR MEETINGS WITH RUSSIAN ENERGY FIRMS GAZPROM AND NOVATEK

Christopher Gannatti – Global Head of Research
04/03/2014

Over the past few years, emerging market equities have delivered lackluster performance. As negative headlines come to the fore, the focus tends to be less on individual companies and their fundamentals and more on fears of a deteriorating macroeconomic environment. We believe that at precisely these times—when concerns over geopolitical events swamp considerations at the company-specific level—that potentially compelling entry points may emerge. On March 17–18, 2014, we participated in HSBC's CEEMEA[1] Investor Forum in New York and met with a variety of Russian companies. It was a great opportunity to hear directly from Russian managers what they thought of their operating environment, as well as their geopolitical picture. In this blog post, we will highlight our meetings with Gazprom[2] and Novatek[3]. Major focal points of those meetings include: **For Gazprom:** • Gazprom's outlook for natural gas demand and important weather-related concerns • Unique aspects of Gazprom's dividend policy • Potential risks to Gazprom from the Ukraine situation **For Novatek:** • Novatek's share buyback program • Unique aspects of Novatek's ownership structure and dividend policy • Potential risks to Novatek from the Ukraine situation **Europe and Asia Need Natural Gas, and Gazprom Is a Significant Supplier** According to Gazprom, the company currently supplies approximately 30% of Europe's natural gas. This means Russia's decision to annex Crimea creates a tricky political calculus for the European Union. If the EU responds with any sanctions, it could potentially cut off its own energy supplies. **Potential Deal Between China and Gazprom** Gazprom representatives believe there is potential of engaging China in a long-term resource partnership. President Vladimir Putin, as of the time of our meeting, was scheduled for a trip to China in May to discuss a potential treaty with China National Petroleum Corporation (CNPC). China has been using recent commodity price weaknesses to help secure its long-term goals of acquiring resources. China has also used the political disruption between Europe, the U.S. and Russia as an opportunity to step in and fill the void, given its own resource needs. **Weather: A factor that could impact European Political outcomes** As Europe's demand for natural gas increases, the political appeal of Russian sanctions will likely decrease. According to Gazprom, the current political turmoil could last until the end of summer—once fall hits and temperatures start going down again, the need for natural gas will rise. Gazprom does not see any easy way for Europe to replace its gas supplies in mere months. **A Potential Catalyst for Gazprom's Dividend Growth: Changing Accounting Standards** A potential switch to International Financial Reporting Standards (IFRS)[4] from Russian Accounting Standards could critically impact Gazprom's dividend levels. A switch to IFRS could mean almost doubling Gazprom's dividends if and when it happens, according to stock analysts we follow[5]. Gazprom has many subsidiaries in which it holds stakes ranging from less than 1% ownership to 100% ownership. At present, Gazprom reports its financials for purposes of its dividend payout using Russian Accounting Standards, which inhibit the consolidation of results from all of the different subsidiaries into the results of the parent company. Should the government approve this accounting change—and it is a government-level decision—the 25% mandated payout ratio for state-owned enterprises (such as Gazprom) could potentially be applied to the results of the entire set of businesses in which Gazprom owns a stake. Gazprom was unable to give specific guidance on the potential impact of this new set of accounting standards on future dividends, or exactly if and when the government would approve the change. **Gazprom's Current Dividend Picture** The latest results of Gazprom stock trading in Russia show an annual dividend of approximately 6 rubles per share, with an ex-date of May 14, 2013. With a price of 127.00 rubles per share on March 18, 2014, the approximate dividend yield equals 4.7%. If the dividend were to double as some expect with the changeover to IFRS accounting standards, at the same price that could mean an almost double-digit dividend yield. Thinking from a risk/return perspective, this higher income level could make Gazprom more attractive to income-oriented investors as the yield may compensate for the increased headline risk levels of Russian companies. **The Ukraine Risk Is Significant for Gazprom** Gazprom supplies much of its natural gas through Ukraine, including almost half the company's exports to Europe. This makes Gazprom vulnerable to economic sanctions against Russia for its annexation of Crimea. On a fundamental basis, the stock was already one of the most inexpensive stocks on a price-to-earnings (P/E) ratio basis before tensions between Russia and Ukraine began, trading at below three times earnings. As of our meeting, there were no forecasts for significant declines in earnings. Catalysts are always hard to see in advance, but these very depressed valuations make Gazprom an interesting opportunity for income strategies such as the WisdomTree Emerging Markets Equity Income Fund, DEM. The specific index DEM tracks caps its top holdings at 5% at each annual rebalance; as a result, Gazprom is unlikely to see its weight increase at the 2014 rebalance. That said, it could see its weight drift up between rebalances with positive performance turns compared to other holdings. **Meeting with Novatek: Starting with a Share Buyback Announcement** As of March 14, 2014 (the last business day before our meetings), Novatek's year-to-date share price was down approximately 25%, a significant drop before the end of the first quarter.[6] Generally speaking, the Russian energy sector[7] was down a similar amount over this same period and traded at below five times earnings.[8] If a company believes its share price is undervalued, one effective use of corporate cash is to initiate a share buyback program, such as the one Novatek announced on March 17, 2014. The company's buyback program began on June 7, 2012. Novatek tends to initiate share buybacks at varying amounts over 3- to 4-day intervals, according to a study on the company's investor relations website. At no single point between June 7, 2012, and March 11, 2014, did Novatek repurchase an amount greater than one million shares during one of these 3- to 4-day intervals . However, according to the March 17 announcement, from March 11 to March 14, Novatek bought back 2,476,250 shares.[9] The share buyback program and especially its relative size reflect the confidence of Novatek's board of directors in the fundamental value of the firm. **Surprise! Novatek Has No Direct Government Ownership** Many Russian firms have large, direct state ownership stakes, but Novatek actually has no Russian government ownership[10]—a big contrast to Gazprom, which is majority-owned by the Russian government. Novatek's dividend policy is a function of the company's own judgment and not determined by a majority government shareholder. **Novatek's Dividend History** Looking at Novatek's dividend history, the cash dividend, measured in rubles, has increased over the course of each calendar year since 2009. During our meeting, the company representative expressed his view that the dividend is important—it has been growing, and he didn't see a reason at this time why that trend couldn't continue. **Conclusion: Any Risk to Novatek's Ongoing Operations?** The development of new fields as sources of oil and natural gas and the construction of facilities to improve the efficiency of the firm's existing fields generated the greatest excitement during the meeting with Novatek. Each aspect of the presentation was designed to emphasize that natural gas sells for approximately $4.50 per 10,000 British thermal units (BTUs),[11] whereas oil sells for approximately $106 per barrel.[12] The more that can be done with the liquid elements that are, in essence, somewhere between gas and oil, the higher the profit margin that Novatek is able to earn and the more cash the company is able to generate. The big point was that Novatek's expansion plans are much more focused on liquids than on gas. A critical question, today, is what the company views as the main risks relating to its ongoing business. Share buybacks and dividends are all well and good, but keeping the firm running is first and foremost. The Novatek representative emphasized that he'd been living in Russia for 20 years, and his view was that things like this current disruption tend to happen, but that in the past, they've tended to represent significant buying opportunities where share prices of otherwise strong businesses are depressed. A factor that was cited as a potential risk was the fact that European banks were definitely involved in the financing of Novatek's new projects, so, depending on the nature of any EU sanctions, these financing channels could potentially face delays. However, he did mention the potential for China to step in and offer funding, should this occur. All in all, Novatek was confident as of March 17, 2014, that business would be able to continue. **A Great Time to Meet with Individual Russian Firms** We appreciate HSBC's allowing us to attend their CEEMEA Investor Forum in New York. We learned a lot and look forward to participating in similar future events that can help us better understand some of the constituents of our Indexes. Unless otherwise noted, source is Bloomberg, as of 3/19/2014. [1]Central & Eastern Europe, Middle East & Africa. [2]Gazprom's weight equaled 5.25% of the WisdomTree Emerging Markets Equity Income Fund (DEM) as of 3/19/2014. [3]Novatek's weight equaled 1.40% of the WisdomTree Emerging Markets Dividend Growth Fund (DGRE) as of 3/19/2014. [4]International Financial Reporting Standards (IFRS): A set of accounting standards, developed by the International Accounting Standards Board (IASB), that are becoming the global standard for the preparation of public company financial statements. [5]Source: Moshkov, Maxim & Constantine Cherapanov, CFA. "Gazprom: Conservative DPS Outlook Despite Record Earnings," UBS Global Research, 3/4/14. [6]Source: Bloomberg, from 12/31/2013 to 3/14/2014. [7]Refers to the MSCI Russia Energy Index. [8]Refers to the P/E ratio of the MSCI Russia Energy Index as of 3/19/2014. [9]Source: "Novatek Resumes Share Buyback Program" news release, dated 3/17/2014, and Share Repurchase Program history available on company's investor relations website. [10]Source: 3/17/2014 meeting, confirmed by Bloomberg as of 3/19/2014. [11]Refers to the price of a futures contract, which is an agreement where parties agree to deliver or purchase a set amount of natural gas at a date specified in the future. [12]Refers to the price of a futures contract on specifically Brent crude, where parties agree to deliver or purchase a set amount of natural gas at a date specified in the future.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Funds focusing on a single sector generally experience greater price volatility. Investments are focused in Russia, Ukraine, Crimea and China, thereby increasing the impact of events and developments associated with those regions, which can adversely affect performance. Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation, intervention and political developments. Due to the investment strategy of the Funds, they may make higher capital gain distributions than other ETFs. Please read each Fund's prospectus for specific details regarding each Fund's risk profile. Dividends are not guaranteed, and a company's future ability to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time. ALPS Distributors, Inc., is not affiliated with HSBC, Gazprom, Novatek or CNPC.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

Dividend : A portion of corporate profits paid out to shareholders.

Payout ratio : The percentage of earnings paid to shareholders in dividends. Calculated as yearly dividends per share over earnings per share.

Ex-date : The date after which shareholders in a particular stock may sell their shares but still be entitled to an upcoming dividend payment that has been previously announced but not yet paid.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Trailing 12-month dividend yield : Dividends over the prior 12-months are added together and divided by the current share price. Higher values indicate more dividends are being generated per unit of share price.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Rebalance : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

Fundamental value : The value of a firm that is related to a company's actual operations and production as opposed to changes in share price.

Profit margins : Net income divided by total sales. Higher values indicate a greater fraction of each dollar of sales being left to the firm and its owners after expenses are accounted for.

MSCI Russia Energy Index : Designed to measure the market performance of the Energy sector within the Russian equity market.