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EMERGING MARKETS

Betting on Gazprom, Petrobras

Brandes Emerging Markets fund manager Louis Lau thinks the two out-of-favor energy giants have room to rise.

(The following has been excerpted.)

By SHULI REN

Equity strategists have been wondering aloud about the Big Rotation into value ever since early March, when growth stocks fell out of favor. So where are the deep pockets of value that deserve better earnings multiples?

Try Russia and Brazil, suggests San Diego-based Brandes Investment Partners, whose approach is value-oriented and sharply contrarian, with its top holdings regularly including names that have been beaten up in the media. Its $820 million Brandes Emerging Markets fund (ticker: BEMIX) in March received an initial four-star rating from Morningstar.

While large U.S. banks from JPMorgan to Bank of America Merrill Lynch have been sharply reducing their holdings in Russia, Brandes has been piling in. Its No. 1 holding there is Gazprom (GAZP.Russia), which was rumored—falsely, as it turned out—to be on the list of the latest round of U.S. sanctions.

Gazprom's value proposition is undeniable. Russia's conflict with Ukraine has sent its share price down to just 2.5 times forward earnings, well below the three-year average of 3.3 times, even though on paper Gazprom's fundamentals are stable. In 2013, total sales rose 10%, driven by a 16% increase in the export volume to the European Union. Gazprom's margin of earnings before interest, taxes, depreciation, and amortization was a handsome 38%.

Brandes is betting that Western sanctions won't affect Gazprom, which Western Europeans rely on for a quarter of their natural-gas supply, and that Russia can always sell to China, which has been conspicuously silent on the crisis in Ukraine. President Vladimir Putin is expected to sign a gas-supply deal with China when he travels there later this month. "Since many investors have left Russia, any positive news will move prices," notes Louis Lau, director of investments for the Brandes fund.

BRAZIL'S ENERGY GIANT Petrobras (PBR) is troubled, though for different sorts of government issues. Controlled by a populist government keen to contain consumer inflation (without much success to date), Petrobras must sell its retail petroleum products at a loss. In 2013, its refining-and-marketing segment ran up almost $10 billion in red ink, dragging down the entire company's operating profit by about 25%. Petrobras trades at 7.9 times forward earnings, a 35% discount to its 15-year average, and less than 0.8 times book, according to estimates provided by Morgan Stanley.

But that may change. Hurt by stagflation, Brazilians have expressed frustration with President Dilma Rousseff's economic policies in opinion polls. The most recent one showed that Rousseff may need a runoff to be re-elected in October, a sharp turn of sentiment from just two months ago. Petrobras has rallied almost 50% since then. "Investor interest has re-emerged, fueled by the perception of a tighter election campaign and a strong real [Brazil's currency], which lowers refining losses," notes Morgan Stanley's Latin America equity-research team, which ranks Petrobras among its top 10 regional picks, agreeing with Lau.

Brazilian airplane maker Embraer (ERJ) is another stock Brandes likes and is also a top Morgan Stanley Latin American pick. Embraer enjoys a Brazilian duopoly with Bombardier (BBD/B.Canada) in regional-jet sales. Embraer also has a handsome 20% global market share in the business-jet market and sells military airplanes to Brazil. It sees strong government demand for a new military-cargo aircraft, the KC-390; government-policy support for heavier traffic to smaller airports; and a gradual pickup in the business-jet market from a five-year slump as global economies recover.