

2008



Russian Capital Market



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Russian stock market at glance

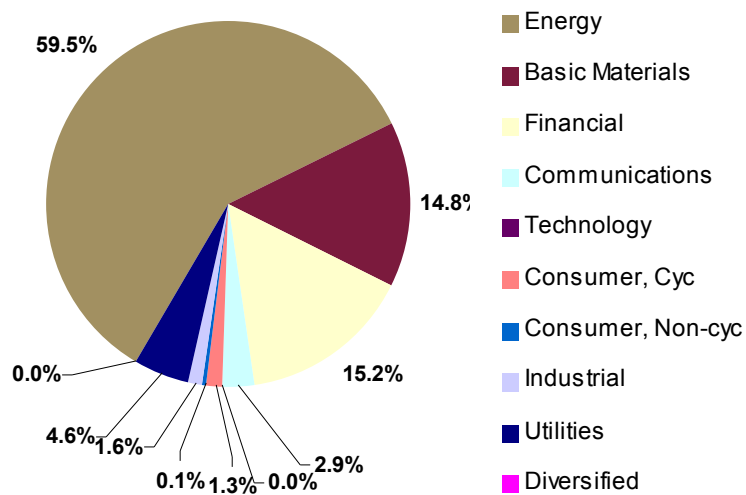
Market Capitalization: \$300 bn

Free-float: \$100 bn

Foreign investors in free-float: \$60 bn

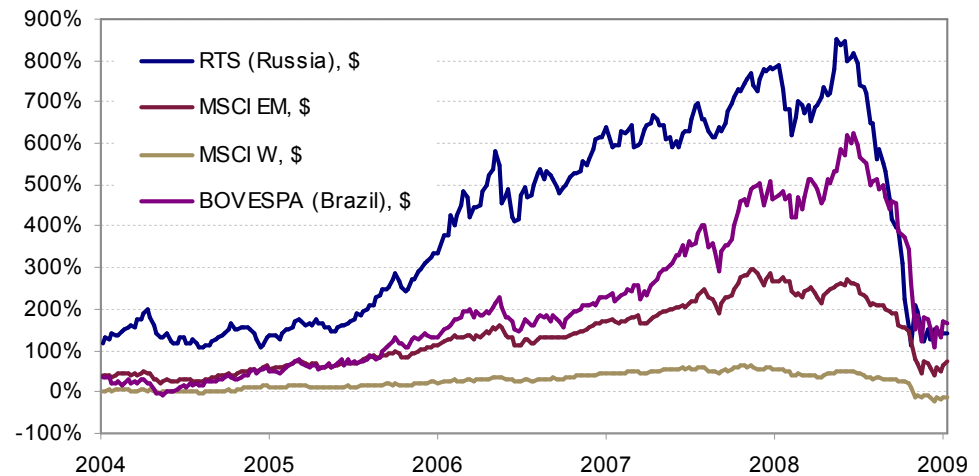
Local investors in free-float: \$40 bn

RTS Index composition



Source: Bloomberg, Arbat Capital

Stock markets cumulative return



Source: Bloomberg, Arbat Capital

Russian stock market is currently

Consisting of three super fields: commodities, domestics and utilities

Dominated by commodities: ~70% exposure.

Highly concentrated: 80% of market capitalization in top 15 stocks.

Driven by both global growth (commodities) and domestic growth (domestics and utilities).

Russian stock market – cheap valuations



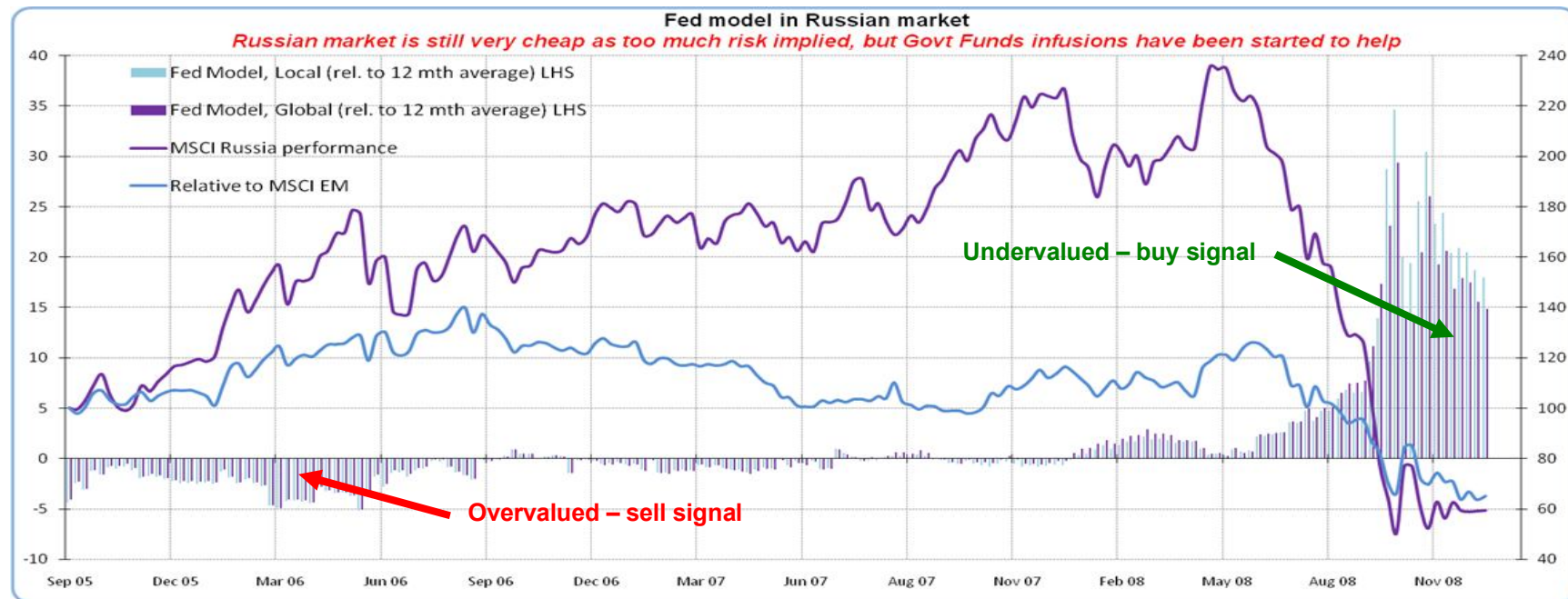
	Market Cap, \$ m In.	P/E		EV/EBITDA		EV/Sales		P/Book		Div yield	EBITDA margin
		2008	2009	2008	2009	2008	2009	2008	2009		
AMERICA		10.77	7.56	7.09	6.33	1.78	1.65	2.00	1.79	4.0%	25.4%
Argentina	92 930	5.98	2.67	7.89	6.73	1.92	2.04	1.10	1.47	3.6%	24.4%
Brazil	425 232	9.77	6.34	6.14	5.30	1.66	1.50	2.89	1.43	4.8%	27.0%
Chile	101 482	12.72	10.27	9.74	9.09	2.04	1.94	2.54	2.87	3.2%	20.9%
Mexico	169 469	10.68	9.78	6.50	6.19	1.58	1.51	N/A	1.92	2.4%	24.2%
Colombia	71 943	20.41	12.09	9.34	8.32	2.47	2.00	1.78	2.57	4.6%	26.4%
EUROPE		5.91	6.43	9.78	9.58	1.77	1.65	0.97	0.92	5.6%	17.4%
Czech Republic	54 305	6.84	7.20	16.82	16.23	3.92	3.71	1.10	1.02	6.9%	23.3%
Hungary	16 034	4.58	6.35	9.49	9.20	1.89	1.80	0.91	0.85	5.9%	19.9%
Poland	81 584	6.69	8.01	9.56	9.37	1.13	1.01	1.07	1.00	5.1%	11.9%
Romania	6 617	2.71	3.31	9.87	8.50	4.52	4.15	0.75	0.69	5.1%	45.8%
Slovenia	8 161	9.81	10.97	14.85	13.62	1.41	1.32	1.18	1.11	2.9%	9.5%
Turkey	96 896	5.20	4.91	5.49	5.91	0.97	0.92	0.82	0.75	5.5%	17.6%
Ukrain	5 945	H/Д	H/Д	12.10	7.94	1.09	0.91	1.09	2.01	3.5%	9.0%
ASIA		15.54	14.34	14.44	12.57	2.27	2.07	2.30	2.10	5.2%	23.4%
China	1 477 538	14.73	11.58	12.39	10.40	1.39	1.24	2.13	1.88	2.4%	11.9%
India	291 149	9.13	9.41	11.86	10.70	2.54	2.34	1.75	1.53	2.2%	21.9%
Indonesia	97 234	8.57	H/Д	6.43	5.89	1.79	1.65	1.63	1.50	9.8%	28.1%
Malaysia	138 990	10.60	10.91	8.01	7.43	1.67	1.62	1.34	1.30	4.7%	21.7%
Philippines	36 905	10.12	8.83	6.79	6.37	1.88	1.77	1.22	1.14	5.5%	27.8%
Taiwan	340 347	8.42	14.27	9.49	8.69	1.01	0.98	1.25	1.39	5.4%	11.2%
Thailand	101 479	7.36	7.41	6.93	6.43	0.98	0.93	1.01	0.97	5.8%	14.5%
Hong Kong	920 603	8.56	9.03	8.89	7.90	2.10	1.90	1.24	1.15	5.0%	24.1%
MSCI EM	3 612 574	8.43	7.84	8.17	7.43	1.67	1.53	4.46	2.20	4.0%	20.5%
MCAP WEIGHTED		10.44	9.34	9.61	8.56	1.68	1.56	1.63	1.49	4.1%	19.1%
MEDIAN		8.56	8.83	9.34	7.94	1.67	1.65	1.20	1.30	5.0%	21.9%
RUSSIA	295 891	3.28	4.32	6.14	7.12	1.60	1.86	0.61	0.57	5.5%	26.1%

Source: Bloomberg, Arbat Capital

Russian stock market – cheap valuations



- ✓ Our internal models show that MSCI Russia is extremely undervalued from both historical and relative perspectives
- ✓ Fed Model (Earning yield minus Risk free rate) shows that Russian stocks are 22% and 28% cheaper than local and global risk free bonds (16% and 21% relative to 12mth average) – it is at an all time low since 1998 crisis (marked in green round)
- ✓ Over the last market cycles even lower spread resulted in positive stock market in subsequent period of time in both absolute and relative to other EM terms (MSCI Russia Performance and Relative to MSCI EM)
- ✓ Other models also indicate that implied equity risk premium is significantly above not only average levels but also almost two times higher than maximum. In a result P/Book of absolutely “clean from CDOs” Russian companies is below 1x and discounts negative earning growth



Source: Bloomberg, Morgan Stanley, Arbat Capital

Despite to new high set on 19.05.08, Russian stock market ended 2008 year with loss more than 70% year-on-year basis and was named among top 10 worst performing markets. Such ugly performance of Russian stocks was caused by several reasons:

- **Oil prices collapse in the 2nd half of 2008**

Skyrocketing in the 1st half of the year to almost \$150 per barrel oil prices crumbled to less than \$40 in December. Apart from the fact that such oil prices dynamic undermined Russian energy companies (60% of stock market) financials it raised the questions about overall stability of Russian economy.

- **Significant rouble devaluation**

Russian rouble (RUR) lost approximately 1/3 against US dollar from its high in July, 2008 after the Central Bank attempt to keep the rouble pegged to two-currencies (USD & EUR) basket failed in October, 2008. Recent drop of Rouble below 31,0 to USD shows change of CB policy.

- **Relations between government and private business are not the best**

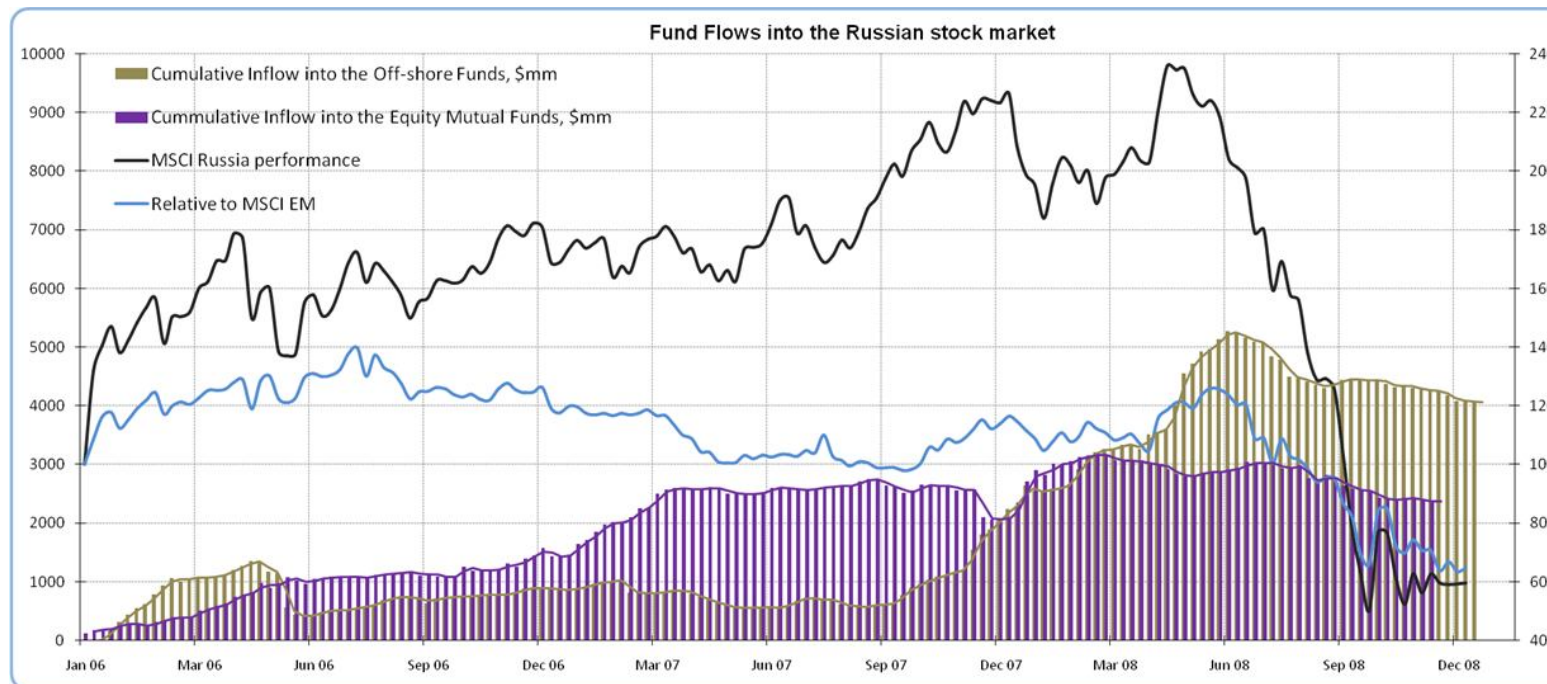
Last year provided several examples of government attack on private business (Mechel, Uralkaliy, British Petroleum as TNK-BP shareholder). Obviously, such actions called to life the ghost of Yukos and new wave of de-privatization fears that wrecked the investment climate.

- **War conflict in South Ossetia**

In August of 2008 the Georgian's war actions in Caucasian region and consequent Russia's recognition of South Ossetia and Abkhazia as independent states, hit relations between Russia and US, EU and therefore significantly increased risks of investing to Russia for global institutional investors.

Russian stock market – reasons for free-fall

- ✓ There was a net outflow of off-shore funds capital from Russia & CIS during the 2nd half of 2008 amounted for \$1.1bn. However, there is still a net inflow of \$2.1bn YTD.
- ✓ Purely looking at Russian Mutual Funds over the course of 2008 they have had net inflows to the tune of almost \$0.5bn, although the 2nd half of the year was marked by net outflow as well.
- ✓ Russian stock market is very sensitive to foreign capital flows due to the fact that foreign investors hold about 60% of Russian equities total free-float.



Source: Bloomberg, Morgan Stanley, Arbat Capital

- **Russian equities start 2009 on a very low level relative to other stock markets**

In modern history Russian stock market is usually named among top 10 worst (1998, 2004, 2008) or top 10 best (1996, 1997, 1999, 2001, 2002, 2003, 2005, 2006) performing markets on year basis and never it was among outsiders for two years in row. So, Russian equities has a good chance to confirm statistic data and become a top performer even in the case of further weak market conditions in the 1st half of the year of 2009.

- **Gloom oil and world economy outlook will restrain market growth in the 1st half of 2009**

As global investors still consider Russian equities as high-risky asset class there is very little hope to see them returning to the market earlier than there will be strong evidences of oil market and Russian economy recovering. We expect that weak oil market will continue at least till summer'09.

- **Positive longer-term outlook for commodities provides growth potential for Russian stocks**

Current underinvestment in raw materials (oil, gas, metals) green-fields caused by financial crisis means nothing more but future supply shortfalls and therefore delayed commodities prices sharp growth. Despite to we don't know whether it will be new bubble like it was recently or it will be more steady growth, but anyway it will result in Russian raw material producers solid financials.

- **A crisis is an excellent buying opportunity**

Although it sounds like a well-known truth but a few are brave enough to realize it. After more than 75% correction from recent highs Russian equities provide a brilliant chance to triple or quadruple investments at 4 - 6 years time horizon.

- Despite to a number of industries booming in recent years **Energy** is still the core of the Russian economy. As far as we have positive longer-term outlook for oil prices, we prefer liquid Energy stocks, which we believe will recovery first.
- We're more cautious on **Basic Materials** due to more elastic metals prices to income. Especially weak will be steel producers, who suffer greatly from domestic demand reduction.

We recommend the following sector allocation

	Arbat Capital	MSCI	RTS
Energy	62.0%	56.4%	59.5%
Financial	20.0%	14.4%	15.2%
Basic Materials	10.0%	12.6%	14.8%
Utilities	3.0%	11.6%	4.6%
Communications	5.0%	4.5%	2.9%
Consumer Staples	0.0%	0.0%	1.6%
Consumer Discretionary	0.0%	0.6%	0.8%
Industrials	0.0%	0.0%	0.6%

Source: Arbat Capital, RTS, Morgan Stanley

- **Financial** still looks fragile, but two largest state banks provide value and benefit from being “first under God” and receiving relatively cheap financial resources from the State.
- **Communications** and **Utilities** are very good from valuation point of view, but suffer greatly from devaluing rouble. Moreover, Utilities have too extensive CapEx programs and should face to non-payments problem.
- We don't like both **Consumer** and **Industrial** stories, cause these two are driven by domestic demand expansion and are subject to rouble devaluation risk.

Historically Russian companies going to raise money abroad turned to London (LSE + AIM). Such popularity of English stock exchanges was driven by two key reasons: (1) highest level of transparency and credibility, given to Russian companies and controlling shareholders to place shares/ADRs/GDRs at one the major international exchanges, (2) going public Russian companies used mostly US & European investment banks as advisers.

Despite to the fact that now Hong Kong Stock Exchange (HKEx) is still inferior to London in many terms, HKEx listing has its own **advantages** that could encourage Russian companies:

- ☑ Grants a good entry point to Asian-Pacific region due to Hong Kong strategic location and general recognition as a regional fast growing financial center.
- ☑ Gives a good entry point to mainland China and provides great opportunities to benefit from presence at large-scale Chinese domestic market.
- ☑ Is more affordable than London and furthermore New York
- ☑ Supplies simple and loyal taxation including no taxes on dividends and capital gain and low death-duties.
- ☑ Has less bureaucratic standards of disclosure that lower costs of preparation for public offering.
- ☑ Ensures relatively higher valuation due to still higher regional multiplies (especially P/E) and continued investment flows from mainland China with significant portion of private investors.
- ☑ Provides a good set of international institutional investors at public offering and balanced post-IPO institutional shareholders structure.

Public offering at HKEx – benefits for Chinese investors

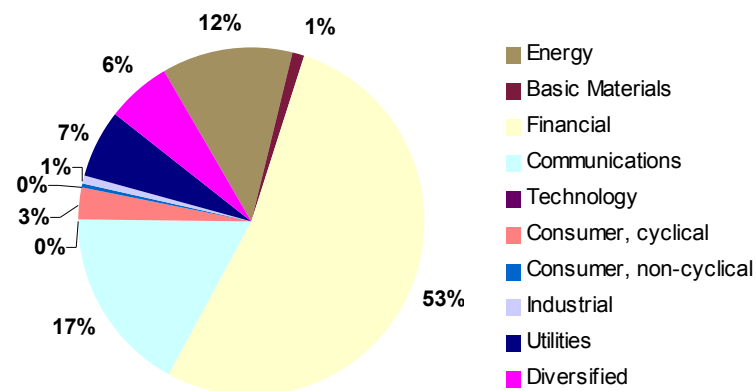


Today all raw material producers accounts only for 13% of Hong Kong Stock Exchange Index (HSI) and for 34% of Shanghai Composite Index. Moreover, Basic Materials accounts for only 1% of HSI and for 7% of Shanghai Composite.

Despite to current weak market conditions, there is no doubts there that Chinese stock market lacks Energy and Basic Materials equities, because Chinese economy is one of the top world raw materials consumers. And the share of Chinese consumption in total world consumption of oil, steel, copper etc. will constantly increase longer-term.

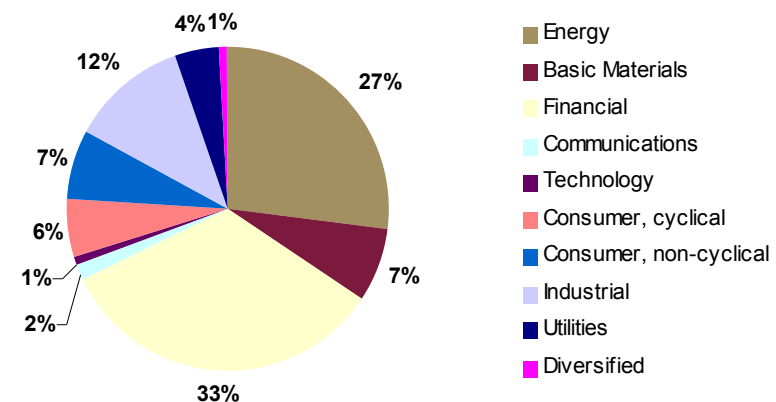
There are significant amount of large-cap Energy and Basic Materials companies at the Russian stock market that can place their receipts at HKEx and that are traded now much cheaper comparing with Chinese raw producers. There is little doubts there that Russian raw producers are the best possible choice to satisfy the hunger of Chinese and other Asian investors for commodity play.

Hong Kong Stock Exchange Index Structure



Source: Arbat Capital, Bloomberg

Shanghai Stock Exchange Index Structure



Source: Arbat Capital, Bloomberg

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