Investment Business

Investing in Russia: Risks or Opportunities?

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Agenda

- Russia’s economy: key figures, charts, trends
- Global slowdown: how vulnerable Russia is
- Capital Flows: does macro matter at all?
- How risky Russia is: the Russian investment case
- Is risk mispriced and thus presents an opportunity?

Russia's economy: key figures, charts, trends

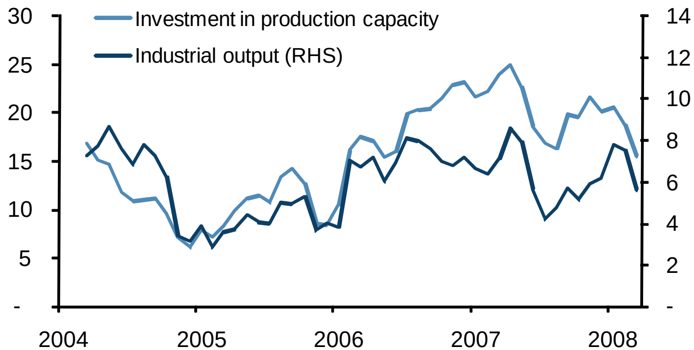
- USD1.3 trillion economy with 8.1% y/y GDP growth in 2007, strong economic drivers, inflation is a challenge
- FX reserves USD581bn. Current account surplus 5.9% of GDP, budget surplus 5.4% of GDP, net private capital inflows 6.3% of GDP in 2007

Main indicators	2005	2006	2007	2008F
CPI (pavg, %Y/Y)	12.7	9.7	10.5	13.1
GDP (real, %Y/Y)	6.4	6.7	8.1	8.0
GDP (USDbn)	763	988	1290	1789
Budget balance (Federal, %GDP)	7.5	7.4	5.4	6.2
Government debt (%GDP)	13.3	8.4	7.4	5.2
o.w. domestic	3.9	3.9	3.8	3.4
Current Account (%GDP)	11.1	9.6	6.0	7.2
International reserves (USDbn)	182	304	476	630
External debt (%GDP)	33.7	31.4	38.9	37.5

Russia's economy: key figures, charts, trends

- Real economy is driven by consumption and investment growth
  - Investment increased at close to 17%y/y in H1 2008 and government ambitious investment projects to support it in the medium-term
  - Real wages increase at close to 13%y/y in H1 2008 boosting consumption but threatening productivity growth

Investment and industrial output, y/y %

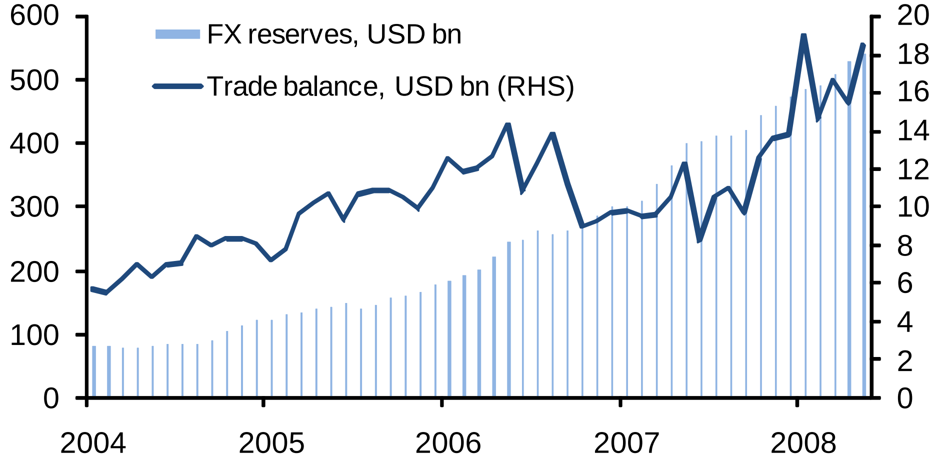


Real wages and real retail sales growth,

Russia's economy: key figures, charts, trends

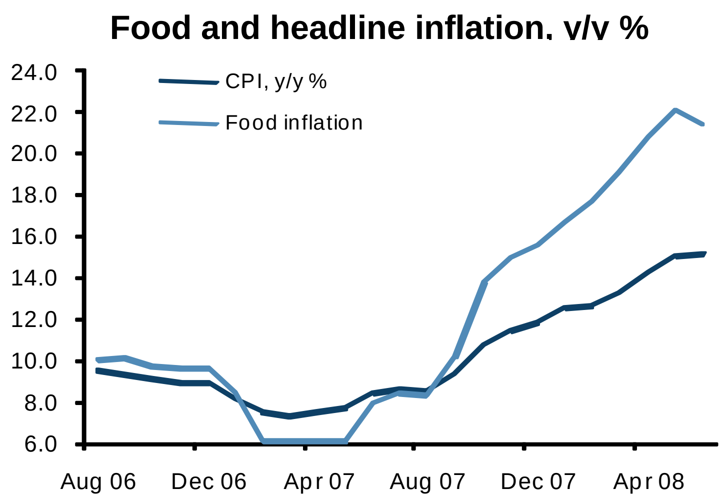
- Strong commodities contributed to building robust external position
  - Booming oil prices boosted FX reserves to USD581.1bn as of August 2008. Russia runs third-largest FX reserves after China and Japan.
  - Current account surplus to reach USD129bn or 7.2.0% of GDP this year. Improved terms of trade help to compensate for surging import (close to 40%y/y in Q1 2008).

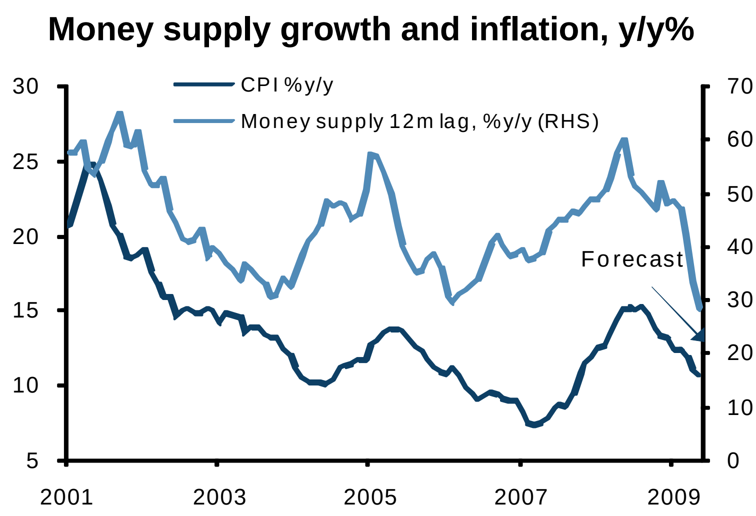
FX reserves and trade balance, USD bn



Russia's economy: key figures, charts, trends

- Russia: Inflation is the main challenge, but there is light at the end of the tunnel
  - Inflation has reached 14.7% y/y in July 2008 on food prices and monetary pressures resulting from ample last year's net private capital inflows (USD81bn in 2007). However, inflation has likely peaked as money supply growth moderated substantially this year and food prices subside.
  - Food contributes 32.6% of Russian CPI basket. Food inflation slightly softened to 19.7% y/y July from the peak of 22.1% y/y in May but is still much higher than 6.1% y/y in mid-2007. Recent correction in global food prices and good harvest prospects are helping





Global slowdown: how vulnerable Russia is

- 1H2008 real GDP growth of 8.0% YoY
  - in the1q2008 GDP grew 8 ½ % YoY while in 2q2008 GDP it slowed to 7.6% YoY. In our view this is rather positive development as concerns of overheating and price pressures ease

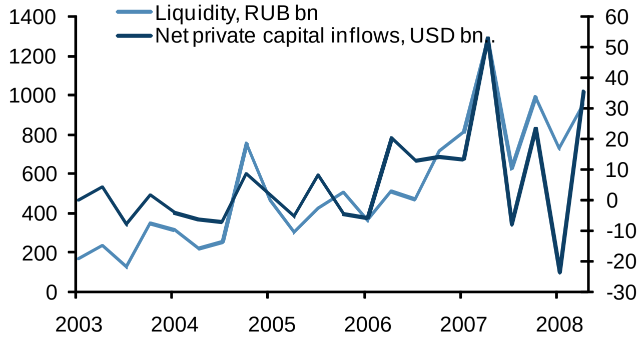
- Investment growth slowed in 1H2008 to 16.9% but its composition shifted towards infrastructure investment and construction. Both are unlikely to slow as the state made it top-priority to rebuild infrastructure

- Consumption remains solid as real wage growth posted 13% gains YoY in the 1H2008

Capital Flows: does macro matter at all?

- Russian reserves fell by $16b the week beginning August 8, the largest weekly drop since 2006 when Russia repaid much of its Paris club debt. Heightened political risk for equities and lower commodity prices have contributed to outflows as many ruble long bets have been closed
- Decrease in reserves is largely explained by changes in the value of assets, not just outflows - in that week, the Euro fell 4% against the dollar and gold lost 8% - revaluation of Russia's euro and gold assets could wipe 10% off reserves total - meaning that capital outflow may be closer to $6 billion. Further sharp falls of reserves are unlikely unless the USD firms strongly against the EUR
- Russia had Net inflows in excess of $30 billion in the first seven months of this year and Russian officials still expect net inflows of at least $40 billion for the year as a whole and expect current outflow situation to be short-lived (Ulykayev)
- Despite outflows - Russia has a large stock of foreign exchange reserves (over $580 billion). Furthermore, we believe inflows from oil may offset outflows
- Russia is an island of stability given undervalued ruble, equities and prospect for high oil prices (and revenues) for medium term. But Russia is vulnerable to short-term flow volatility

Net private capital inflows (USD bn) and ruble liquidity (RUB bn)



How risky Russia is: the Russian investment case

- What worries investors now?

- The South Ossetia conflict and heavily anti-Russian campaign in the western media
- Mechel: the Russian government may have wanted to do the right thing but communication was bad and came at a very vulnerable time
- Financial markets remain under considerable stress which is evident from money markets – swap spreads are staying at year’s highs as deleveraging continues
- TNK-BP: UK is biased on Russia and with their unfolding political crisis cannot afford to give in to the Russians. And take into account that BP is a national champion there, national pride … and now Russian oligarchs want to bend them to their will? So publicity is markedly bad for Russia
- Oil price dynamics. We believe there is an optimal price which satisfies both exporters and importers and it is somewhere around $100

How risky Russia is: the Russian investment case

- The world economy has been and will keep being driven by developing, or emerging, economies which are in the middle of breakout to become developed ones
- There are lots of different valuation approaches one of which is P/E ratio. For the market with 2008 EPS growth of 20-30 percent to have P/E of 8 ½ is difficult to justify rationally. To compare, the closest proxy, Brazilian Equity Index Bovespa - also heavy on commodities index – trades at P/E of more than 13 ½ which is 60% higher.
- David Swensen, a legendary portfolio manager of Yale Endowment, instructed that contrarian investing presents superb opportunities to purchase assets at prices significantly below fair value. As the Russian market remains out-of-favor it presents unique opportunity to buy value at discount. In fact, according to our estimates most names upside potential to fair value, is well above 50%!

Is risk mispriced and thus presents an opportunity?

- We believe that risks listed above are mispriced by the market:
- Mechel case has resolved in only $33m fine by FAS
- The conflict around South Ossetia sparked a lot of rhetoric reminiscent of Cold War but we very much doubt that we are going there:
  - Russia is no longer a communist country – in fact it is ‘very’ capitalist one
  - No one will benefit from any sanctions against Russia as the world economy needs the Russian consumer now, Russian capitals and Russian commodities
  - Politically it is impossible to stand up to world’s challenges without Russia given its history, reputation and geographical stretch
- Volatility is persistent and the speed with which commodity prices came down made consensus shift. We have been consistent in our calls on oil and think that fundamentally justified price of WTI is around $100

Thank you for your attention

- Q & A