AB-ICI: Following Capital Outflows

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Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) down 2% last month on capital outflow
- FDI inflow reflects shareholder support during the market squeeze, but non-oil FDI still weak at 1.1% GDP

The AB-ICI down 2% on capital outflows

AB-ICI down 2%

The AB-ICI index declined 2% in January, mainly reacting to the drop in economic and market confidence.

$9 bln capital outflow damaged economic confidence

- **The index's economic confidence** indicator declined substantially last month, reflecting the $9 bln capital outflow from the country. This outflow was mainly a reflection of the cut in foreign investors' equity market positions and damaged CBR reserve growth;

Foreign confidence up on foreign banks, FDI penetration

- **Foreign confidence** was slightly up, reflecting the higher penetration of foreign banks into the Russian banking market and accelerated foreign direct investments in 4Q07.

Market confidence low, more weakness expected

- **Market confidence** was down on weak market performance, driven by global markets instability. The slower IPO activity and the fact that small borrowers are likely to be pushed away from the financial markets because of a strong increase in the risks premium, are expected to negatively affect market confidence performance in future.

Figure 1: The AB-ICI down 2% on capital outflow

Source: Alfa Bank Research, New School of Economics

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FDI: Credit Tightening Calls for Repatriation

While the strong FDI inflow to Russia in 4Q07 was one of the supportive factors for AB-ICI last month, we believe that these figures reflect the shareholders' support for their Russia based business.

FDI inflow doubled in 2008, bringing accumulated FDI to 8% GDP

In overall terms, 4Q07 FDI inflows were strong at $8.2 bln, or 29% of the yearly inflow of $27.8 bln. This translated into FDI inflow in the country doubling in nominal terms from $13.8 bln in 2006, and in relative terms increasing from 1.4% GDP to 2.2% GDP. Thus, accumulated FDI reached $103 bln, or 8.0% GDP increasing 1.1ppt from the 6.9% that was observed in 2006.

Russian commodity extraction companies shifted to local funding

The interesting fact is that the quarterly FDI inflows to the mineral extraction sector deteriorated in nominal terms. These sectors accounted for 79% of total FDI inflow in 1Q07 and 58% in 2Q07, but in 2H07 their share substantially declined. In our view this reflects the inability of major Russian energy companies to attract international funding through their foreign subsidiaries to finance domestic projects, and therefore shifting to local funding. Indirectly, this is confirmed by the hike of Dutch FDI (that reflects internal Russian corporate transactions) over 1H07, from 29% in total accumulated FDI to 38%, and its later decrease to 34% at the year-end (see figure 3).

Figure 2: Quarterly FDI inflows by sectors, $ mln

	1Q07	%	2Q07	%	3Q07	%	4Q07	%
Mineral extraction	7,663	79%	3,511	58%	1,427	37%	1,332	16%
Manufacturing	688	7%	1,062	17%	620	16%	1,731	21%
Financial sector	505	5%	132	2%	(195)	-5%	681	8%
Trade	301	3%	344	6%	726	19%	1,885	23%
Construction	49	1%	405	7%	124	3%	313	4%
Real Estate	453	5%	368	6%	827	22%	1,625	20%
Other	97	1%	259	4%	278	7%	586	7%
Total	9,756		6,081		3,807		8,153	

Source: Rosstat, Alfa bank research

Consumer-driven sectors were supported by their shareholders off-shore

As a result, 4Q07 FDI has been redistributed much more evenly across sectors in comparison with 9M07. The increasing share of Cyprus, which is well known as the off-shore residence for Russian capital, from 30% to 34%, points to the idea that over 2H07 repatriation of capital accelerated. Cyprus stands for 54% of FDI in real estate and 48% of FDI in trade, and the strong development of FDI in these particular sectors reflects the direct support of shareholders during the squeezed credit markets situation.

Figure 3: Accumulated FDI by the country of origin, % of total

	2006	1Q07	2Q07	3Q07	2007
Netherlands	28.9%	37.5%	38.3%	36.7%	34.2%
Cyprus	34.1%	29.6%	30.0%	31.2%	34.4%
Germany	4.6%	4.3%	4.4%	4.4%	4.4%
United States	5.6%	4.9%	4.5%	4.1%	3.5%
UK	4.3%	3.6%	3.4%	3.6%	3.3%
BVI	3.1%	2.7%	2.7%	2.7%	2.8%
Other	19.5%	17.5%	16.6%	17.3%	17.4%

Source: Rosstat, Alfa bank research

The level of non-oil FDI is still insufficient to drive economic diversification and AB-ICI growth

Thus, if in 2006 Russian non-oil companies managed to attract $9.2 bln as FDI inflow, in 2007 they observed a 51% y-o-y increase in FDI inflow to $13.9 bln. While the overall trend of growing non-oil FDI is clearly positive, this amount still represented only 1.1% of GDP in 2007 and is clearly insufficient to drive economic diversification or a strong AB-ICI recovery.

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