

AB-ICI 2008: Steady decline

Natalia Orlova

(7 495) 795-3677

NOrlova@alfabank.ru

February 2, 2008

www.alfabank.com

Moscow

Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) declined 14% y-o-y in 2008; the RTS has lost close to three-quarters of its value.
- Significant outflow of foreign capital on the back of gradual ruble depreciation depleted Russia's foreign reserves; continuing capital outflow poses a significant risk in 2009

The AB-ICI showed a modest 14% decline in 2008

The AB-ICI declined 14% in 2008

Economic confidence worsened significantly as \$130bln of foreign capital poured out of Russia

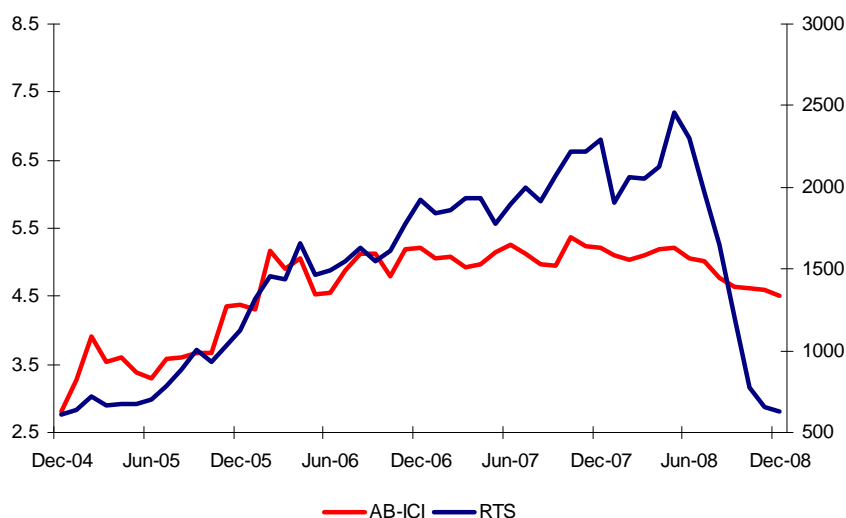
Foreign confidence declined as well as inflows of new investment capital dropped

Market confidence declined 14% y-o-y

The AB-ICI managed to record only a gradual decline despite the catastrophic drop in the RTS in 2008.

- The index's **economic confidence** dropped by 73% in 2008, a very poor performance. This reflects the outflow of capital as well as the higher share of foreign currency denominated deposits in the total bank currency deposits. Furthermore, the government budget surplus at 4% of GDP for 2008 is set to turn into 7% of GDP deficit in 2009;
- **Foreign confidence** was the key driving force behind the index's growth in 2007; this was far from the truth last year. The foreign confidence index declined by 6% y-o-y, reflecting the halt in FDI inflows into the economy;
- **The market confidence** indicator declined 14% y-o-y. A decline in the share of small businesses in the economy reflected the government's focus on the bigger fish in the pond. The steady decline in the RTS dragged down the market confidence index and had a negative impact on the AB-ICI as a whole.

Figure 1: The AB-ICI demonstrated a downward trajectory in 2008, but the decline was relatively insignificant when juxtaposed with that of the RTS



Source: Alfa Bank Research, New School of Economics

RESEARCH DEPARTMENT research@alfabank.ru

The contents of this document have been prepared as Investment Research within the meaning of Article 24 of Commission Directive 2006/73/EC implementing the Markets in Financial Instruments Directive (2004/39/EC). Alfa Bank Group and/or its affiliates does and seeks to do business with the issuers covered in this research report. As a result, investors should be aware that Alfa Bank Group and/or its affiliates may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. For important disclosure information relating to Alfa Bank Group and/or its affiliates' investment banking relationships, if any, with the issuers mentioned in this report and regarding Alfa Bank Group and/or its affiliates' rating system, valuation methods, analyst certification and potential conflicts of interest, please refer to the Disclosure Section at the end of this report.

A new global reality has disabused investors of the previously popular notion of “decoupling” – Russia is feeling the effects of global liquidity constraints

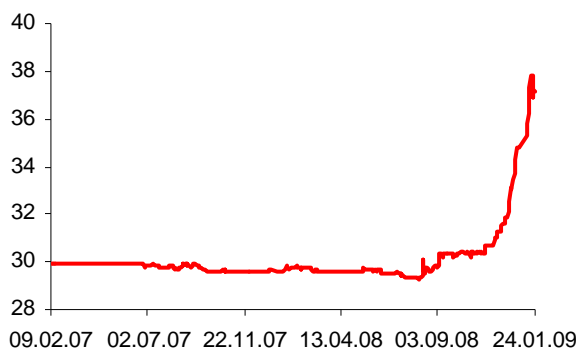
Foreign capital outflow in 2H08 was modest at \$30 bln; main pressure on ruble came from local flight

The AB-ICI, which is a reflection of the fundamental value of the Russian economy, was stagnant for the two years preceding the global financial crisis, despite the strong growth in equity market. However, the dawn of a new reality in the global economy is having a considerable impact in Russia, reflected in the 14% decline of the AB-ICI over the course of 2008. The ruble depreciation, undertaken by the government in the last two months of the year, has been fueling speculation and leading the CBR to spend significant reserves in order to defend the currency, which was reflected in the dramatic decline of the AB-ICI economic component.

How low will it go? Ruble depreciation and capital outflow

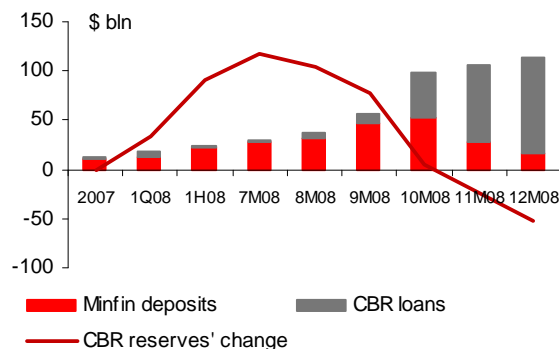
There appears to be considerable confusion in the market regarding the logic of ruble depreciation and its ultimate end goal. The paradox is that while the market tends to think the pressure on the ruble comes from the decline in oil prices, we believe the drop in the ruble rate is mainly the result of capital outflow, observed through the second half of 2008. We estimate that foreign capital outflow in 2H08 was a modest \$30 bln; the majority of the outflow came from local players. This outflow was so large because the Central Bank injected a huge amount of liquidity to deal with the liquidity squeeze in October-November. In sum, we assess that around \$60-70 bln were transferred from rubles to dollars by local companies, banks and households.

Figure 2: Ruble exchange rate to the basket



Source: CBR, Alfa Research

Figure 3: State liquidity and capital outflow



Source: CBR, Alfa Research

We do not believe the weaker exchange rate will help economic growth

Capacity utilization of 80% makes 2008 different from 1998

Today in Russia, salaries and savings are denominated in rubles

Another myth is that the market consensus seems to reflect the expectations that the weaker ruble exchange rate will help to restore economic growth in 2009. This belief is based on Russia's experience in 1998, but we think this assumption is inaccurate in the current environment; the likelier scenario is the deeper the fall in the ruble, the sharper the subsequent economic slowdown in Russia.

The key argument against the 1998 scenario is in the capacity utilization ratio, which was 55% in 1998 and is currently staying around 80%. This means that in 1998 ruble depreciation prompted a switch in local demand from import goods to the local market; essentially, domestic firms were able to increase output without investing. This year, the situation is completely different – under the current capacity utilization ratio, Russian companies cannot increase production without material investments, which can not be financed because of credit constraints.

The second point is that while in 1998 some households were paid in dollars and savings were largely kept “under the mattress,” today salaries and savings are ruble-denominated. Thus, a weaker ruble today is sure to have an adverse impact on consumption, considerably more so than in 1998.



Russia's large foreign debt offsets the advantages of ruble depreciation

Today, foreign demand is weak and will not be stimulated by a weaker ruble

Ruble depreciation will result in weaker economic growth, which will be reflected in the performance of the AB-ICI in 2009

It is important to note that it makes sense for a country to devalue its currency when the size of its local debt is large and the foreign debt is modest. Russia, with \$540 bln in foreign debt and a local bond market of just \$50-60 bln, represents the opposite case; Russia's large foreign debt offsets the potential advantages of ruble depreciation.

Last, but not least, in 1998 ruble depreciation allowed some companies to become more competitive on international markets. Today, foreign demand is weak and will not be stimulated by a weaker ruble. The bottom line is that Russia needs to generate savings, not devalue the purchasing power of its households.

We believe that ruble depreciation will result in weaker economic growth and higher inflation, all things being equal. This will likely be reflected in the poor performance of the AB-ICI in 2009. In recent years the AB-ICI lagged behind the RTS index, which was a reflection of the overheating of the Russian financial markets. Now the opposite seems to be true; the sudden drop in the RTS better reflects the trends for 2009.

Contact Information

Alfa Bank (Moscow)

Head of Equities
Telephone (+7 495) 795-3649
Facsimile (+7 495) 745-7897

Research Department

Telephone (+7 495) 795-3676
Facsimile (+7 495) 745-7897
Head of Research
Strategy Ronald P. Smith
Oil & Gas Ronald P. Smith, Erik DePoy
Macroeconomics, Banking Konstantin Batunin, Natalia Pushkina
Telecoms, Technology, Internet Natalia Orlova, Olga Naydenova
Utilities Ivan Shuvalov
Metals & Mining Alexander Kornilov, Elina Kulieva
Consumer Goods, Retail, Media Chirvani Abdoullaev, Maxim Semenovkyh
Real Estate Brady Martin, Vitaly Kupeev
Transportation, Fertilizers, Machine-Building Brady Martin, Alexey Kryuchkov
Kazakh Product Roydel Stewart, Andrei Fedorov
Fixed Income Rinat Gainouline
Technical Analysis Ekaterina Leonova, Pavel Simonenko
Russian Product Vladimir Kravchuk, Ph.D.
Editorial Angelika Henkel, Ph.D., Vladimir Dorogov, Vladimir Kravchuk, Ph.D.
Translation David Spencer
Production Anna Sholomitskaya, Dmitry Dolgin
Aleksei Balashov

Equity Sales & Trading

Telephone (+7 495) 795-3712
Facsimile (+7 495) 745-7897
International Sales Kirill Surikov, Mikhail Shipitsin, Shani Kogan, David Johnson, Michael McAtavey
Domestic Sales Alexander Nasonov, Konstantin Shapsharov, Vsevolod Topolyansky
Address 12 Akad. Sakharov Prospect, Moscow, Russia 107078

Alfa Capital (Kiev)

Research Department

Telephone (+380 44) 490-1600
Strategy, Macroeconomics, Fixed Income Sergiy Kulpinsky, Ph.D.
Metals & Mining Oleh Yuzefovych
Engineering, Chemicals Denis Shauruk
Utilities Maksym Nikulyak, Kateryna Ruskykh
Consumer Goods Tetyana Orlova
Banking Andrey Zaripov
Real Estate, Small-Cap Strategy Andriy Gubachov
Editorial Orysia M. Kulick

Equity Sales

Sales Sergey Grigorian, Ivan Shehavitsov, Anfisa Anikushina
Telephone (+380 44) 490-1600

Alfa Capital Markets (London)

Telephone (+44 20) 7588-8500
Facsimile (+44 20) 7382-4170
Sales Maxim Shashenkov, Mark Cowley
Sales Trading Ross Hassett, Douglas Babic
Address City Tower, 40 Basinghall Street, London, EC2V 5DE

Alfa Capital Markets (New York)

Telephones (+1 212) 421-8563 / (+1 212) 421-7500
Facsimile (+1 212) 421-8633
Sales Robert Kaplan, Roman Kogan
Sales Trading Roman Kogan
Address 540 Madison Avenue, 30th Floor, New York, NY 10022

Copyright Alfa Bank, 2008. All rights reserved.

IMPORTANT INFORMATION

The contents of this document have been prepared by Open Joint Stock Company Alfa Bank ("Alfa Bank") as Investment Research within the meaning of Article 24 of Commission Directive 2006/73/EC implementing the Markets in Financial Instruments Directive 2004/39/EC ("MiFID"). Alfa Capital Markets ("ACM") is distributing this document to its clients in the EEA and accepts no responsibility towards any other classes of recipient. Alfa Bank and ACM have in place appropriate conflicts of interest policies and procedures aimed at ensuring the objectivity of the information contained in this document. The information contained in this document is provided for information purposes only and is not a marketing communication, investment advice or personal recommendation within the meaning of MiFID. The information must not be used or considered as an offer of solicitation of an offer to sell or to buy or subscribe for any securities or financial instruments. In the UK, this document does not constitute a Financial Promotion within the meaning of section 21 of the Financial Services and Markets Act 2000 (as amended). ACM is regulated by the Financial Services Authority ("FSA") with FSA registration number 416251, for the conduct of UK investment business and is the trading name of the UK branch of Alfa Capital Holdings (Cyprus) Limited ("ACC") which is authorized by the Cyprus Securities and Exchange Commission under license number CIF 025/04. This document is not for distribution to retail clients as defined by MiFID and may not be communicated to such persons. This document is not for distribution or use by any person or entity in any jurisdiction where such distribution or use would be contrary to local law or regulation or which would subject Alfa Bank, ACC, ACM or any other group entity to authorization, licensing or other registration requirements under applicable laws. The information contained in this document is the exclusive property of Alfa Bank. Unauthorized duplication, replication or dissemination of this document, in whole or in part, without the express written consent of Alfa Bank is strictly prohibited. Although the information in this document has been obtained from, and is based on, sources Alfa Bank believes to be reliable, no representation or warranty, express or implied, is made by Alfa Bank, ACM or the authors. ACM and its officers and employees do not accept any responsibility as to the accurateness or completeness of any information herein or as to whether any material facts have been omitted. All information stated herein is subject to change without notice. ACM makes no warranty or representation that any securities referred to herein are suitable for all recipients and any recipients considering investment decisions should seek appropriate independent advice. Nothing in this document constitutes tax, legal or accounting advice. Alfa Bank, ACC and their associated companies, officers and directors (excluding any financial analysts or other personnel involved in the production of research), from time to time, may deal in, hold or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to the securities, financial instruments and companies mentioned in this email, or may have been, or may be represented on the board of such companies. If such circumstances arise, ACM, Alfa Bank, ACC and their associated companies have in place appropriate conflicts of interest policies and procedures to ensure that investment research remains independent and objective.