AB-ICI: Supported by the ruble, hit by FDI

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Investment Summary

- The AB-ICI recovery was driven by capital inflow, favorable market mood at the beginning of the year
- We expect a strong ruble will support the AB-ICI via accelerating dedollarization of retail deposits
- Banking sector weakness is still an obstacle for GDP and AB-ICI recovery this year

AB-ICI up 6% in January on dedollarization

The AB-ICI increased 6% m-o-m as Russians switched from foreign-currency...

After declining in 1H09 followed by a flat performance in 2H09, our AB-ICI index has begun to recover over the past few months. In January, positive market sentiments and dedollarization were the key factors behind a strong recovery of 6% m-o-m.

- **The economic confidence indicator** was up, reflecting increased trust in the ruble exchange rate. The share of foreign-currency retail deposits declined to a new low of 26.2% of total deposits. Despite the modest decline in CBR reserves in January, dedollarization had a strong impact on the index's dynamics.

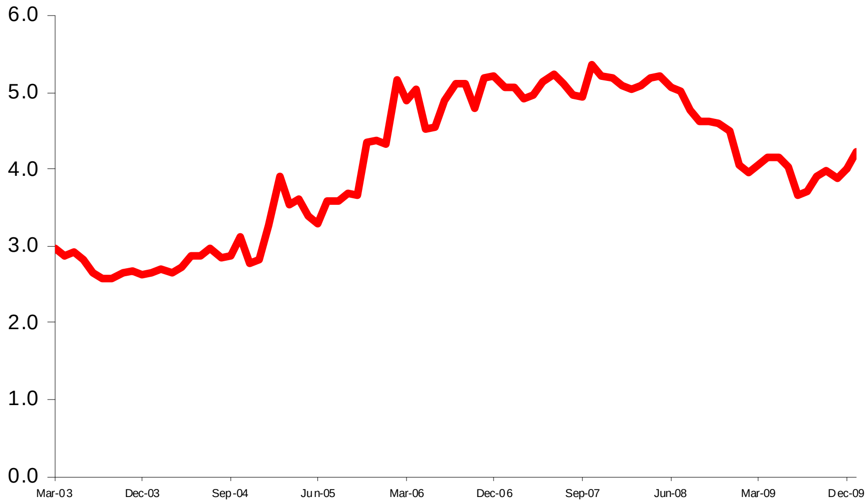
…despite declining presence of foreign-banks

- **Foreign confidence** declined, reflecting foreign banks' reduced presence on the Russian market. This trend does not come as a surprise as the majority of foreign players in Russia were exposed to the retail lending market, which contracted 11% last year;

Recovery also due to market growth

- **The market confidence indicator** reflected the decline in bond yields and the fact that Russian markets were stronger than other EM peers.

Figure 1: AB-ICI up 6% last month



Source: New School of Economics, Alfa Research

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Strong ruble helps, banking sector a concern

Strong ruble is positive

We expect that the AB-ICI's performance will be volatile over the next few months. On the positive side, we believe that a strong ruble exchange rate will have a favorable influence on the index trend through dedollarization. January banking statistics suggest that there is increased trust in the ruble as a savings currency, which is in line with last year's trend. According to the CBR, the share of foreign currency deposits has declined by 10 ppts in the retail and corporate sectors over the past 12 months, which is linked to the 16% appreciation of ruble over the period. Dedollarization continued in January in retail deposits, even despite a slight weakening of the national currency over the last three months, reflecting Russians' confidence in the ruble.

Weak FDI in 2009 reflects the painful conditions faced by Russian businesses

The key concern, however, is the behavior of the Russian corporate sector. Even though profits increased 14% in 2009, this was due to the huge loss of over RUB800 bln in December 2008, creating a lower base effect for 2009. Moreover, annual foreign investment statistics indicate a substantial reduction in capital inflows to the economy. The inflow from Cyprus and the Netherlands, which traditionally represents the repatriation of capital, weakened by $14.5 bln, or 42%. We believe that this reduction in shareholder support to companies reflects the challenging state of the economy and is the reason for the 41% decline in FDI, which fell from $27.0 bln in 2008 to $15.9 bln in 2009. Overall, this suggests a significant slowdown in the economy.

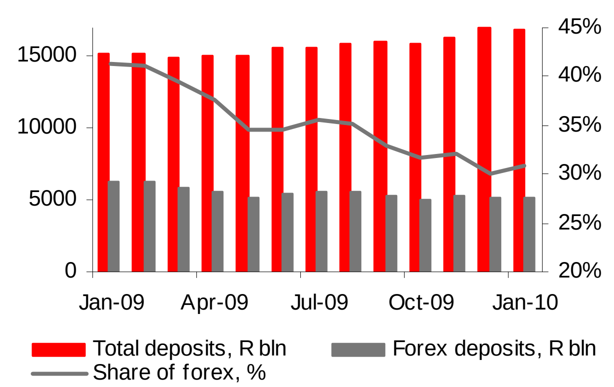
Demand for loans is limited

Weak demand for loans is further confirmation that companies need to adjust their strategy to a period of modest market growth. Faced with uncertainties over foreign demand and domestic consumption, Russian companies are reluctant to take risks by entering into new investment projects. This reduces demand for loans and accelerates repayments of accumulated debt. We believe this is the reason behind weak loan book performance even with excess liquidity and cheap short-term money in the banking sector.

Banks have little influence on the price of loans to companies

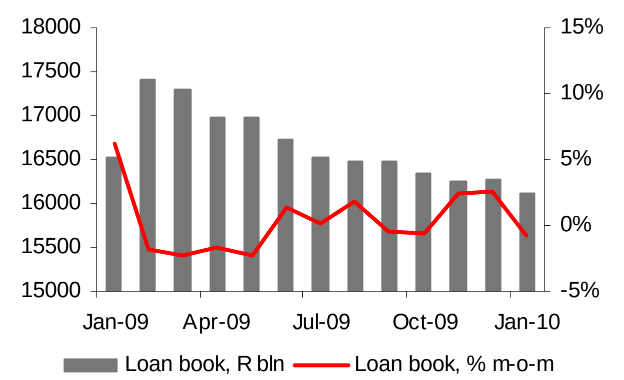
Effectively, this means that there is little banks can do on the supply side to increase loans. Loan prices will depend on further inflation dynamics, as the CBR's refinancing rate trails price growth in the real economy. We believe that by 2Q10, inflation could slow to 6.0-6.5%, prompting a cut in the refinancing rate to 7.5%. However, even though the CBR's refinancing rate is continually being reduced, the bankers' ability to transmit lower rates to borrowers is limited due to a lack of long-term funding. Moreover, if price growth accelerates again in 2H10, the CBR will be forced to tighten its policy, further reducing the chances of cheaper or more available credit resources to the corporate sector. We expect the weak lending pattern to limit the AB-ICI's performance.

Figure 2: Share of foreign currency deposits



Source: CBR, Alfa Bank

Figure 3: Monthly loan book growth



Source: CBR, Alfa Bank

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