

## AB-ICI April: Two IPOs Pushed the Index Up

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### Investment Summary

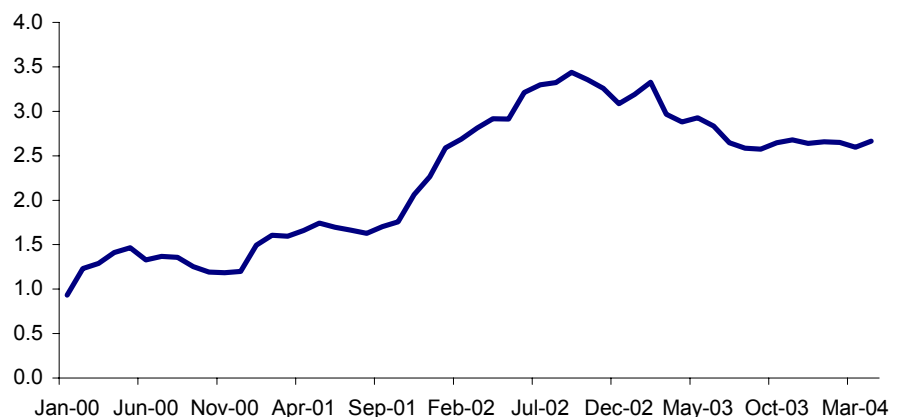
- IPOs by Irkut and Kalina sent a positive signal to investors, pushing the AB-ICI up 3% in April
- Capital outflows negatively affected the Index in April, but should stop due to high oil prices
- RTS reacted to the liquidity squeeze with a 26% correction; real estate prices stopped growing

### AB-ICI increased 3% in April after two IPOs

**IPOs of Irkut and Kalina totaling \$180 mln showed an investor-friendly attitude in the Russian business sector**

Important positive factors that supported the Alfa Bank Investor Confidence Index (AB-ICI) in April were the IPOs of two small-cap companies, the aviation manufacturer Irkut and the cosmetics producer Kalina. Irkut placed a 23% stake in the company at the end of March, while Kalina placed 25% of its capital in April. While no more IPOs can be expected in the near future because of the dramatic correction in stock prices, the examples of these two companies clearly show an investor-friendly attitude in the Russian business sector. Since the beginning of 2000 there have been eight IPOs on the Russian market for a total amount of \$3.8 bln.

**Figure 1. Alfa Bank Investor Confidence Index Up 3% in April**



Sources: New School of Economics, Alfa Bank

**Capital outflow prevented faster growth of the Index**

Growth in the Index would have been even higher had Russia managed to maintain the capital inflow. However, in March short-term capital began to leave the country, leading to a decline in CBR reserves and ruble depreciation to a level of R29/\$ in April. This change in the exchange market trend was due to (1) expectations of a U.S. interest rate hike, and (2) a decline in domestic interest rates, which reduced the relative attractiveness of Russian assets.

**Exchange rate dropped on U.S. interest rate expectations and the CBR's announcement**

It should be noted that the CBR's position was crucial for the market dynamic and did not prevent the ruble from falling. In early April CBR officials indicated that they would consider a change in their exchange rate policy in order to target the ruble versus a basket comprised of the dollar and the euro compared to the current policy, which targets only the dollar. This statement was immediately taken by market participants as a sign to short the ruble.



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**Asset prices dropped on liquidity squeeze**

***Capital outflow resulted in 26% RTS correction...***

The capital outflow coincided with and even somewhat exacerbated the correction seen on the Russian equity market. From its peak on April 12 until May 11 the RTS Index dropped 26% among the most liquid names due to foreign client redemptions and weak support from domestic investors.

***...and stagnation of real estate prices in Moscow after 46% growth in 2003***

Another illustration of how the liquidity squeeze has impacted the Russian economy is the stagnation of real estate prices since April. Prices of real estate in Moscow, which rose on average 46% in 2003 and a further 10% in 1Q04, are now showing signs of weakness due to a lack of demand. While faster mortgage development may still provide support at current levels, we believe that without an increase in ruble liquidity (i.e. growth in CBR reserves), a further rise in real estate prices would be unrealistic.

***New liquidity creation is questionable; currency regulation will prevent it,...***

As we mentioned in our previous Index, there is still no certainty regarding the dynamic of CBR reserves in the second half of the year. On the one hand the new currency regulation, which takes effect from June 18, will allow Russian companies to keep accounts abroad, thereby affecting domestic liquidity.

***...but high oil prices may lead to greater repatriation of revenues***

On the other hand, the current increase in oil prices will clearly boost export revenues, and thus the supply of foreign currency. In a rush to increase export capacity, oil companies will repatriate a substantial share of this money to purchase additional equipment. As a reminder, in 2003 the construction of railway cars picked up by 35%, as commodity producers used this alternative route to increase export volumes.

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**Demand for durable goods slowed in 4M04**

***Decline in demand for durable goods is weighing on the machine-building and construction sectors***

Yet regardless of the level of liquidity in the Russian economy, in the long-term development will be sustainable only if the real sector experiences accelerated growth. Industrial output growth of 7.4% in 1Q04 was supported mainly by stable recovery in the fuel sector, which increased at a rate of 8.4%, alongside 10.4% expansion of food production. However, growth in the domestic machine-building and construction materials sectors slowed to 8.6% (vs. 15.3% last year) and 7.3% (10.4%), respectively.

***Large business is now more focused on social obligations, not investment***

We believe that these numbers signal a decline in long-term demand in both final consumption and investment. This trend could still change should large companies become more focused on domestic investment. However, after the Yukos affair and because of continuing rumors about tax claims on Interros, large businesses may remain cautious regarding investment. In particular, the discussion of social obligations among businesses is now more prominent than the issue of creating long-term sources of growth.

***FDI activity is important for both long-term growth and the AB-ICI***

Thus, the FDI inflow to Russia remains an important catalyst for long-term growth in Russia, and we believe the recovery of the AB-ICI in 2004 has mainly been a function of FDI activity.

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