AB-ICI July: FDI Offsets Market Weakness

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Investment Summary

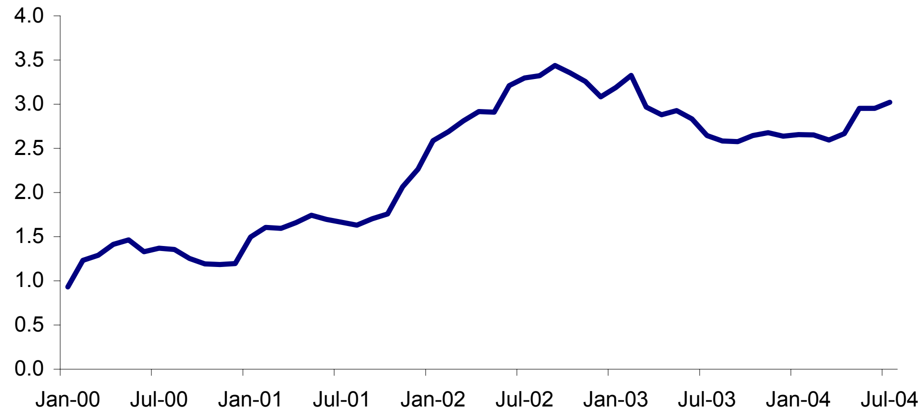
- **AB-ICI increased 2.3% in July as 1H04 FDI inflow grew an encouraging 35% y-o-y**
- **Foreign penetration of banking sector and investment in oil shows strong foreign confidence,…**
- **…which is unsustainable without domestic confidence: capital outflow, deposit runs are threats**

AB-ICI shows surprising 2.3% growth due to FDI

July's AB-ICI increased unexpectedly on $1.9 bln FDI in 2Q04

Alfa Bank's Investor Confidence Index (AB-ICI) rose a surprising 2.3% in July despite the general weakness on Russia's financial markets. The key factor boosting the Index was the substantial FDI inflow, which amounted to $1.9 bln in 2Q04 vs. $1.5 bln in 1Q04.

Figure 1. Alfa Bank Investor Confidence Index: Up 2.3% in July on FDI inflows



Sources: New School of Economics, Alfa Bank

62% of industrial FDI was due to investment in Sakhalin projects,…

In 2Q04 as in 1Q04, the FDI inflow was largely due to investment from the Netherlands. Of the $2.5 bln FDI in Russian industry in 1H04, some $1.5 bln (60%) came from this country. Virtually this entire amount was allocated to the oil industry. Royal Dutch/Shell invested $658 mln in Sakhalin projects in 1Q04 and an additional $800 mln in 2Q04. Thus, the share of the oil industry in FDI inflows was still 62% in 1H04.

…but FDI to non-oil sectors rose from $0.3 bln in 1Q04 to $0.7 bln in 2Q04

Some improvement was seen in terms of FDI to non-oil industrial sectors. While in 2003 Russia's non-oil industries attracted $1.5 bln in FDI, in 1H04 they already received $1.0 bln (see Figure 2). The share of non-oil FDI in total flows also increased substantially. One of the key deals took place in the pulp and paper industry, where $200 mln was invested by Swiss companies.

Figure 2. FDI to Russian non-oil industries is increasing, $ bln

	9M03	4Q03	1Q04	2Q04
FDI to industry	2.2	1.2	1.0	1.5
FDI to industry, ex- oil	1.0	0.5	0.3	0.7
Share of non-oil FDI	45.2%	41.7%	27.6%	45.9%

Source: Goskomstat, Alfa Bank estimates

Should we expect more bad news?

Foreign capital is in a rush to enter Russia: 4.5x book value paid for Delta Bank, new Subsoil Law could help FDI in oil

Unfortunately, the recent growth of the AB-ICI masks divergence between domestic and foreign confidence. Booming commodity prices have increased the attractiveness of the Russian market for foreign capital, which is particularly true with regard to the banking market. GE Capital's recent purchase of Delta Bank took place at a book value of 4.5x, while Sberbank is traded at around 1.4-1.6x. The preparation of the new Law on Subsoil, which is expected to be passed this autumn, will result in substantial centralization of the licensing process on the federal level. This could make life easier for large foreign companies counting on inter-governmental support.

But the domestic mood is a problem: SMEs could be cut from external financing,…

However, the mood among holders of domestic capital seems less optimistic. Lending activity remains weak in private banks and is concentrated among state-owned entities. This typically means that banks will now prefer to focus on large borrowers, and that small and mid-sized enterprises (SMEs) will lose access to external funding. One evident consequence will be an increase in the risk premium of SME bonds, and thus lower SME activity on the corporate bond market. For example, Center Telecom's new bonds were recently placed with 2.5 ppt premium to its previous bond issue.

…private deposits are back under mattresses,…

While the CBR announced that only $1 bln in retail deposits was withdrawn from private banks in June-July (i.e. better than the initial figure of $2 bln), this money appears to remain under mattresses, a reflection of weakened confidence in the banking sector. Slower growth in deposits is also expected in the coming months.

…and capital outflow is expected at $10-12 bln for 2004 vs. $2.3 bln in 2003

Finally, there is now increasing talk about greater capital flight. While the capital outflow figure was $5.5 bln for 1H04 (already double the $2.3 bln in 2003 as a whole), annual projections set the capital outflow at $10-12 bln. We believe that without improved confidence among holders of domestic capital, a recovery of general confidence in the economy – and thus a switch to a sustainable growth trend – is very unlikely. The lack of domestic confidence has prevented the Cabinet from increasing its growth rate projections despite skyrocketing oil prices: the Russian government has kept a modest 6.9% GDP growth forecast for 2004 and only 6.3% for 2005.

The 1998 crisis demonstrated that foreign confidence is unsustainable without domestic confidence

The last time we observed a pessimistic domestic mood while foreign attitudes remained optimistic was in 1998 before the August crisis. While the current economic situation is not comparable with that of six years ago, the key lesson from the 1998 crisis is that the mood among domestic players eventually becomes a catalyst for foreign investors. Thus, FDI inflows are unsustainable in the longer term if they do not coincide with improved domestic confidence.

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