AB-ICI: A Crisis of Confidence

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Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) was down 5.2%, responding to capital outflow.
- Negative international developments, a shift in domestic expectations are causing a crisis of confidence.
- Expectations for 2009 lending growth cut to 20%, GDP 6%; AB-ICI to remain under pressure.

The AB-ICI was down 5.2% last month

AB-ICI declined more steeply

The AB-ICI index was down again last month in line with worsening economic trends and unstable markets.

Economic index was down on significant capital outflows

- **The index's economic confidence indicator** was down significantly this month. A drop in CBR reserves of $14.3 bln in August reflect a capital outflow, combined with slowing industrial growth figures and mounting inflationary pressure. The high producer price index growth (5.4% in July) was very bad news;

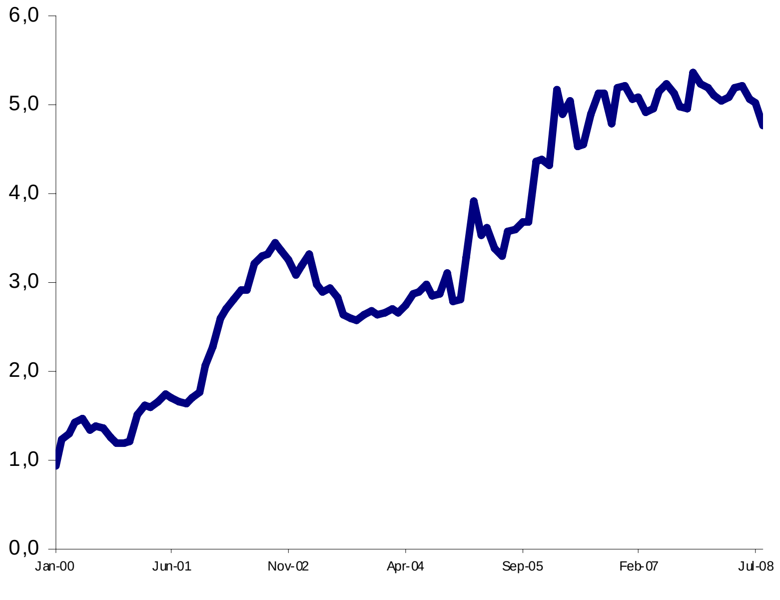
Foreign confidence continues to fall

- **Foreign confidence** was flat on lack of new statistics. However, we do not expect growth in foreign investments given the liquidity constraints on global markets.

Market confidence remains under pressure

- **Market confidence** reflected a significant deterioration of all market trends; in particular, there are increasing concerns over defaults on the corporate rubel bond market, where close to R390 bln are coming due before year end.

Figure 1: AB-ICI was down 5.2% last month



Source: Alfa Research, New School of Economics

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Crisis of confidence hit the banking sector

With the U.S. financial crisis as a backdrop to global woes, the AB-ICI is likely to decline further

Given the precarious state of the U.S. financial system, with the U.S. government failing to bailout Lehman Brothers and the difficulty of reaching an agreement in the U.S. Congress on the $700 bln bailout package just one month before a major federal election, the tenuous and tight liquidity situation is likely to plague international financial markets, causing further difficulties for Russian markets as well. We see the drop in the AB-ICI index as a reflection of these negative trends and anticipate this to put the index under pressure due to negative developments on local markets.

Deteriorating local trends and a drop in the RTS resulted in a crisis on confidence on the interbank market

Deteriorating local trends (increase in interest rates, the volatility in the ruble exchange rate, and weak economic growth) became the basis for a deep drop in the RTS index, triggered by negative international news. This resulted in a crisis of confidence on the interbank market. Even now, only the largest banks have access to the interbank markets, while second and third tier banks are unable to access this option.

The Russian government responded with a series of measures aimed at inject liquidity and calming investors

The Russian government responded proactively. The first key measure was a cut in the reserve requirement, which provided banks with R300 bln. Secondly, the Ministry of Finance injected an additional R800 bln through deposits to 28 of the country's largest banks. Third, an extension of deadlines for VAT tax payments removed some of the pressure stemming from the R1.8 trln to be paid back to the Finance Ministry before the end of October. An increase of deposit insurance coverage from R400,000 to R700,000 and a pledge by PM Putin on Tuesday to lend up to $50 bln through the VEB on the foreign debt payments was a positive piece of news.

Before the end-October, some R1.4 trln has to be paid to the budget and returned to the Ministry of Finance

Despite government measures, October-November will still be difficult for banking liquidity. Russian banks and companies will still face an outflow of some R1.4 trln to the budget, of which R403 bln is Finance Ministry deposits coming to maturity and the rest is tax payments. In November, in addition to huge tax payments, the market is also facing R120 bln redemptions on the ruble corporate bond market, which is likely to reveal additional defaults. Given these expectations for October-November, market confidence is likely to remain low.

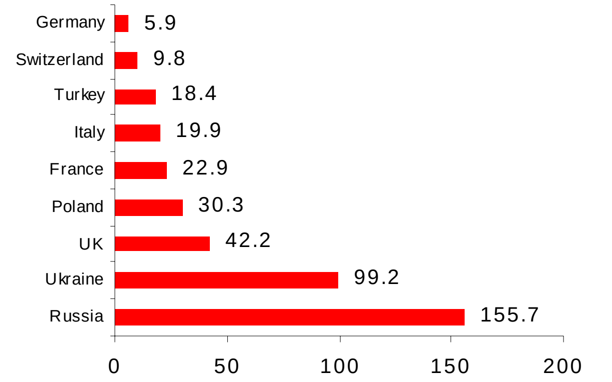
Revised 2008 lending growth rate figures forecast 40% y-o-y growth, down from 48%

Remaining instability in the markets is leading banks to create a liquidity cushion, which they are expected to maintain in the coming two months. We are revising our 2008 lending growth rate forecast from 48% to only 40% y-o-y. We also believe that in the medium term, the Finance Ministry and state entities should reduce deposits with banks, which total $60 bln. This support was made available to prevent a liquidity crisis, not to fund lending growth. We are looking for a conservative 20% lending growth for 2009.

The Russian construction sector is the most vulnerable to the credit crunch

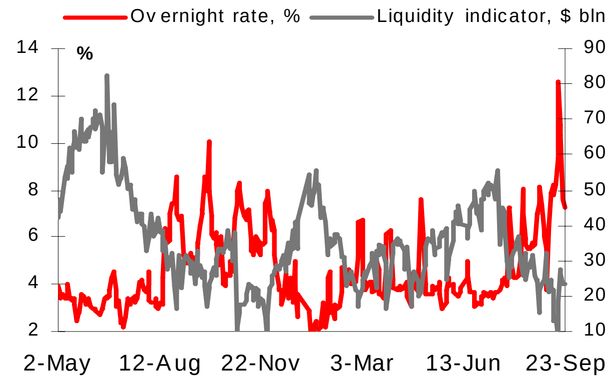
Lending restrictions will likely cause problems for the construction sector, which is the most vulnerable to the credit crunch. Loans to construction companies currently account for 14% of the entire corporate lending portfolio, and a large number of banks have stopped lending to construction companies in recent weeks. In addition, real estate in Russia is extremely expensive by global standards. The Global Property Guide's indicator, which is the cost of a 100 sq m apartment divided by GDP per capita, is 156 for Russia (the highest for all countries surveyed) vs. 99 for Ukraine (the second-highest). With the recent global drop in residential real estate prices, we anticipate that demand will decline dramatically.

Figure 2: House price to per capita GDP, x



Source: Global Property Guide

Figure 3: Liquidity and interbank rates



Source: CBR, Alfa Research

A slowdown in the Russian construction sector will lead to a decline in investment growth

We cut our GDP growth forecast for this year to 7.0% from 7.5%. This implies modest growth of 5.0% in 4Q08 as a result of the credit crunch. For 2009, we cut our GDP growth forecast to 6.0%, on the expectation of a further slowdown in the construction sector and therefore diminishing investment growth. As residential real estate prices are not likely to fall until 1H09 and inflation should remain high at around 14%, consumption is likely to remain strong, at least in 1H09.

AB-ICI will continue to be under pressure, in line with deteriorating economic trends

In conclusion, the continuing deterioration of economic trends and the nervous financial markets will cause the AB-ICI to remain under pressure in the coming months, declining in line with the drop in Russia's financial markets.

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