AB-ICI September: Recovering with the Markets

Natalia Orlova (7 095) 795-3677 NOrlova@alfa-bank.com

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Investment Summary

- **AB-ICI increased 2% in September on higher confidence in the ruble alongside market growth**
- **Capital inflows to be supported by FSFM efforts and corporate borrowing, but concerns linger**

AB-ICI up by 2% as all economic trends improve

AB-ICI increased in September,…

The Alfa Bank Investor Confidence Index (AB-ICI) rose by 2% in September, reflecting improvement in its economic and market components:

…reflecting higher confidence in the ruble

- The Index's **economic confidence** indicators increased significantly, reflecting higher capital inflows and the declining share of foreign currency in total savings. We generally link this positive result to greater confidence in the ruble.

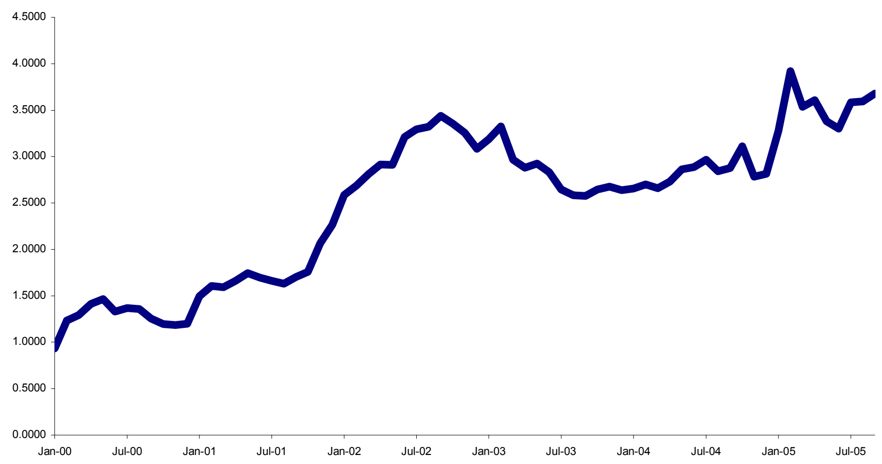
The foreign component of the Index was flat,…

- **Foreign confidence** indicators were flat, as no new information was published recently. The CBR's figures on FDI flows underscore the still significant interest on the part of foreign companies in the Russian market.

…while the market confidence component improved

- The **market confidence** component continued to be driven by the RTS and the rise in bond prices.

Figure 1. AB-ICI up 2% in September



Sources: New School of Economics, Alfa Bank

Capital inflow to Russia is a key factor for Index growth; trend uncertain for 2006

All in all, capital inflows to Russia remain the key driving force for the AB-ICI, as reflected in higher capital flows *per se* alongside higher market valuations. Nevertheless, the trend for 2006 seems uncertain, as conflicting factors could affect short-term capital flows.

Capital inflows in 2006: Pros and cons

On the positive side, Russian companies will continue to increase foreign borrowing

The key factor supporting the expectation of a higher capital inflow is the corporate appetite for foreign borrowing. While the state is cutting its exposure to international markets while the size of sovereign foreign debt (9% of GDP) will be fully covered by the Stabilization Fund by 2007, the corporate segment is still under-leveraged. Total corporate debt represents just 35% of GDP and could potentially double to reach the average level of other emerging markets.

Figure 2. Russia's Corporate Debt, $ bln and % of GDP

	1998	1999	2000	2001	2002	2003	2004	2005F
Foreign debt, $ bln	19.6	21.1	21.8	24	33.6	55.1	77	115
Domestic debt, $ bln	15.6	16.5	28.1	42.5	54.6	91.8	129	150
Share of GDP	12.9%	20.7%	19.8%	22.0%	26.1%	33.9%	35.3%	35.8%

Sources: CBR, Alfa Bank estimates

FSFM intends to increase domestic market volumes

Another positive factor is that the Federal Service for Financial Markets (FSFM) continues to implement measures to encourage Russian companies to launch IPOs domestically. In 2005 ten Russian companies have already attracted $8 bln from the markets, and 60% of trading volumes this year have been registered locally vs. just 20-30% in 2004.

However, back tax claims will continue to appear,…

Meantime, capital inflows are likely to be constrained by the authorities' intention to continue collecting back taxes. In 2004 the additional amount collected from back tax claims represented 2% of GDP, and in 2005 it is likely to stay around 1.0-1.5% of GDP.

…while the CBR prefers a weak ruble

The CBR's exchange rate policy is also unlikely to favor strong capital inflows. Despite all official discussion regarding the need to control inflation, the weak ruble is a clear priority for the Cabinet. First, it is hard to imagine that the CBR will allow the ruble to appreciate in order to affect the imports component of price growth. Since the creation of the Stabilization Fund, growth in the monetary mass has been merely in line with the increase of GDP. While the ratio of M2 to GDP jumped from 19% in 2003 to 22% in 2004, this year it remains slightly below 23%. Another alarming signal for the CBR is that banking indicators, including the ratio of assets, loans and deposits to GDP, have remained flat this year, marking the first time this has occurred since the 1998 crisis.

Thus, capital inflows will remain significant in the coming months and into next year but still below their potential size pending further efforts to make the domestic investment climate more attractive.

Contact Information

Alfa Bank (Moscow)

Head of Equities	Dominic Gualtieri
Telephone	(7 095) 795-3649
Facsimile	(7 095) 745-7897

Research Department

Telephone	(7 095) 795-3676
Facsimile	(7 095) 745-7897
Head of Research, Telecoms	Andrei Bogdanov
Strategy Team	Chris Weafer; Erik DePoy
Oil & Gas	Anisa Nagaria
Macroeconomics, Banking	Natalya Orlova
Utilities	Roman Filkin
Telecoms	Andrei Bogdanov; Svetlana Sukhanova
Metals & Engineering	Maxim Matveev, CFA; Natalya Sheveleva
Consumer Goods, Retail, Media	Svetlana Sukhanova; Elena Borodenko
Russian Product	Angelika Henkel; Vladimir Kravchuk
Fixed Income	Ekaterina Leonova; Marina Vlasenko
Technical Analysis	Vladimir Kravchuk
Editorial Team	Erik DePoy; Brendan Franich
Translation Team	Rinat Gainoulline
Production Team	Brendan Franich, Dmitry Taskin

Equity Sales & Trading

Telephone	(7 095) 795-3712
Facsimile	(7 095) 745-7897
International Sales	Kirill Surikov, Mikhail Shipitsin
Domestic Sales	Oleg Martynenko; Alexander Nasonov; Konstantin Shapsharov; Dmitri Sadoviy
Equity Capital Markets	Armen Petergov; Alexander Svinov; Elena Kapustina
Address	12 Akad. Sakharov Prospect, Moscow, Russia 107078

Alfa Capital Markets (London)

Telephone	(44 20) 7588-8500
Facsimile	(44 20) 7382-4170
Sales	Maxim Shashenkov; Mark Cowley
Equity Capital Markets	Simon Roache
Sales Trading	Steve Downer
Address	City Tower, 40 Basinghall Street, London, EC2V 5DE

Alfa Capital Markets (New York)

Telephones	(212) 421-8564 / (1 212) 721-7500
Facsimile	(212) 421-8633
Sales	Sabrina Ricci
Sales Trading	Harold Warren
Address	540 Madison Avenue, 30th Floor, New York, NY 10022