

AB-ICI: Slightly up despite domestic weakness

Natalia Orlova

(+7 495) 795-3677

NOrlova@alfabank.ru

October 31, 2013

www.alfa-bank.com

Moscow

Investment Summary

- The AB-ICI is up somewhat, +0.5%, mostly on improving external market conditions
- Russia's impressive Doing Business ranking supported sentiment but belies poor domestic growth
- Poor 9M13 data on the real economy limit AB-ICI upside and undermine the RTS Index's fair value

AB-ICI increased a little in September (+0.5%) despite continuous deterioration in economic confidence

Savings rate fell further, reflecting expectations of less macro stability

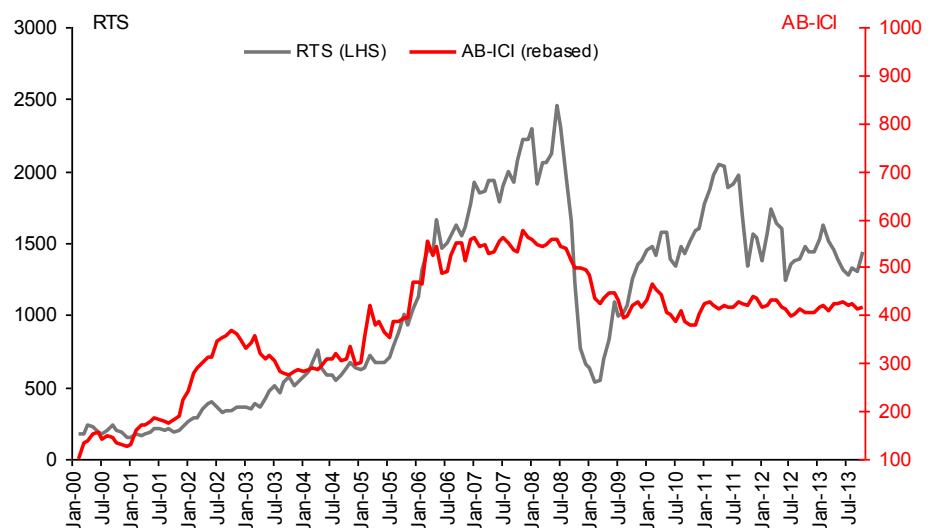
Russia benefited from expectations of a delay in tapering, but weak domestic growth may worry investors

AB-ICI was slightly up in September

The AB-ICI index somewhat increased in September: +0.5%, mostly due to more favorable external conditions. As markets expect tapering to be off the table at least until 1Q14, conditions in EMs eased considerably, with Russia benefiting. As we expected, domestic factors were a major drag: economic confidence fell significantly, mostly due to weak savings. This divergence between internal and external factors is likely to continue as mixed signals from the monetary authorities raise concerns about future stability.

- **Economic confidence** dropped even further in September as the savings rate continued to fall. The slowdown in retail deposit growth signals a decline in expectations of macroeconomic stability in the short-to-medium run. The slight fall in the share of dollarized deposits and slower capital outflow averted an even sharper drop in economic confidence. We expect these phenomena to be short-term, however, as currency market stability remains in question.
- **Foreign confidence** was flat in September, as no new data have been released yet. Taking into account the news flow, we expect the foreign confidence component to decrease in the near term.
- **Market confidence** increased considerably, preventing a further fall in the AB-ICI. The US budget crisis played a key role in improving external conditions, as the shock was not enough to trigger a financial crisis but was sufficient to lead investors to expect a delay in QE3 tapering. Thus, we expect easy access to foreign liquidity in the short run. Internal factors may give rise to country-specific doubts among investors, however.

Figure 1: AB-ICI slightly up in September, +0.5%



Source: New School of Economics, RTS, Alfa Research

Poor domestic trend poses threat to AB-ICI

Weak domestic dynamics continue to drag the index down

As we expected, deterioration in internal economic factors played a key role in dragging down the AB-ICI. The low credibility of Russia's economic policy continues to raise concerns over future economic stability, diminishing incentives to invest and grow businesses and undermining productivity and economic growth.

9M13 data on the real economy surprised on the downside...

According to the government's latest estimates, Russian economic growth failed to accelerate in 3Q13, growing a mere 1.2% y/y, in line with the second quarter rate of 1.2% y/y. Recently released 9M13 data explain this weak growth fairly well. Investment continued to fall despite positive base effects, down 1.6% y/y in September after a sharp 3.9% y/y drop in August. This contraction is likely to continue as the tariff freeze leads to cuts in state corporations' investment plans. Manufacturing slumped by 0.8% y/y in 3Q13 after zero growth in 1H13, yielding 0.1% y/y overall industrial growth in 9M13. Despite state support, the industrial sector remains depressed, making the increase in budget expenditures expected towards the end of the year less likely to have a substantial effect on industrial growth.

...especially slower retail trade growth

The deceleration in retail trade growth to 3.0% y/y in September from 4.0% y/y in August was a major negative surprise, especially as the Russian labor market is very tight, with September's 5.2% unemployment rate underpinning continued strong salary growth. Nevertheless, strong private demand and rising state support have failed to boost economic growth, shifting the focus to Russia's low productivity and overregulation.

Better Doing Business ranking not reflected in improved economic performance

The slowing growth rate is particularly surprising because it contradicts the World Bank's Doing Business index, released in late October, which showed a considerable improvement in Russia's overall economic environment. The country rose 19 places in one year, from 92nd to 111th, putting Russia above all the BRICS countries except South Africa. Though this performance is indeed impressive, the degree to which these indicators reflect the true interests of the business community is not clear. Russia's close-to-trend weak economic performance confirms that barriers to the smooth operation of core business activities, which weigh on investment growth and overall economic expansion, are still in place. Therefore, the support for market sentiment from the higher Doing Business ranking is unlikely to herald a future improvement in the AB-ICI.

Russia's Doing Business rank	2008*	2009*	2010*	2011*	2012*	2013*
Overall rank	120	120	123	120	111	92
Dealing with construction permits	180	182	182	178	180	178
Getting electricity	n/a	n/a	n/a	183	188	117
Trading across borders	161	162	162	162	162	157
Protecting investors	88	93	93	111	113	115
Getting credit	109	87	89	98	105	109
Starting a business	65	106	108	111	100	88
Paying taxes	134	103	105	105	63	56
Resolving insolvency	n/a	n/a	n/a	60	53	55
Registering property	49	45	51	45	46	17
Enforcing contracts	18	19	18	13	10	10

Source: World Bank, Vedomosti; * - year of publication

Abundant international credit could lift RTS in the near term, but the index's fundamental value is under pressure

While market confidence will remain strong thanks to the external news flow, we still believe the AB-ICI's performance will be limited by low economic confidence. Poor economic data reflect deterioration in key sectors of the economy, and, with state support becoming less effective in boosting growth, the economic outlook is gloomy. As a result, the AB-ICI is likely to be under pressure in the coming months. The RTS may diverge significantly from its fundamental value in the near term, but this only increases the risk of a later correction.

RATING DEFINITIONS

Alfa Bank applies a three-tier rating system for stocks under coverage. These ratings are based on the expected total stock return, which is the sum of the return to the target price and the expected dividend yield.

The ratings are:

Overweight (O/W):	Expected total stock return > 15%
Equal Weight (E/W):	Expected total stock return < 15% and > 0%
Underweight (U/W):	Expected total stock return < 0%

Owing to price volatility and our policy of not changing our ratings in response to frequent, short-term misalignments with expected returns, our ratings may sometimes not conform with the ranges indicated above.

In addition to the ratings above, we may occasionally assign the following classifications to stocks covered:

Restricted (R):	A rating, target price or financial forecasts are not disclosed owing to compliance or other regulatory considerations.
Under Review (U/R):	In response to recent or pending news flow requiring a significant overhaul or amendment of a company's financial model, the previous rating and/or target price is temporarily not disclosed.
Coverage in Transition (I/T)	Due to changes in the research team, the disclosure of a stock's rating and/or any other stock-specific information is temporarily suspended. The stock stays in Alfa Bank's coverage universe and usual disclosures will be resumed in due course.
Not Rated (N/R)	The stock is not in Alfa Bank's coverage universe at the time the research product referring to it is published.

IMPORTANT INFORMATION

The contents of this document have been prepared by Open Joint Stock Company Alfa Bank ("Alfa Bank"), as Investment Research within the meaning of Article 24 of Commission Directive 2006/73/EC implementing the Markets in Financial Instruments Directive 2004/39/EC ("MiFID"). Alfa Capital Markets ("ACM") is distributing this document to its clients in the EEA and accepts no responsibility towards any other classes of recipient. Alfa Bank and ACM have in place appropriate conflicts of interest policies and procedures aimed at ensuring the objectivity of the information contained in this document. The information contained in this document is provided for information purposes only and is not a marketing communication, investment advice or personal recommendation within the meaning of MiFID. The information must not be used or considered as an offer or solicitation of an offer to sell or to buy or subscribe for any securities or financial instruments. In the UK, this document does not constitute a Financial Promotion within the meaning of section 21 of the Financial Services and Markets Act 2000 (as amended). ACM is regulated by the Financial Services Authority ("FSA") with FSA registration number 416251, for the conduct of UK investment business and is the trading name of the UK branch of Alfa Capital Holdings (Cyprus) Limited ("ACC"), which is authorized by the Cyprus Securities and Exchange Commission under license number CIF 025/04. This document is not for distribution to retail clients as defined by MiFID and may not be communicated to such persons. This document is not for distribution or use by any person or entity in any jurisdiction where such distribution or use would be contrary to local law or regulation or which would subject Alfa Bank, ACC, ACM or any other group entity to authorization, licensing or other registration requirements under applicable laws. The information contained in this document is the exclusive property of Alfa Bank. Unauthorized duplication, replication or dissemination of this document, in whole or in part, without the express written consent of Alfa Bank is strictly prohibited. Although the information in this document has been obtained from, and is based on, sources Alfa Bank believes to be reliable, no representation or warranty, express or implied, is made by Alfa Bank, ACM or the authors. ACM and its officers and employees do not accept any responsibility as to the accurateness or completeness of any information herein or as to whether any material facts have been omitted. All information stated herein is subject to change without notice. ACM makes no warranty or representation that any securities referred to herein are suitable for all recipients and any recipients considering investment decisions should seek appropriate independent advice. Nothing in this document constitutes tax, legal or accounting advice. Alfa Bank, ACC and their associated companies, officers, directors or employees (excluding any financial analysts or other personnel involved in the production of research), from time to time, may deal in, hold or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to the securities, financial instruments and companies mentioned in this email, or may have been, or may be represented on the board of such companies. If such circumstances arise, ACM, Alfa Bank, ACC and their associated companies have in place appropriate conflicts of interest policies and procedures to ensure that investment research remains independent and objective. A summary of ACC's conflicts of interests policy (which also covers ACM), containing details relevant to investment research, is available upon request from ACC or ACM. ACC and ACM have arranged for Alfa Bank and other relevant group entities involved in the production of research to implement equivalent policies. This document is distributed in the United States by Alforma Capital Markets, Inc., a subsidiary of Alfa Bank, which accepts responsibility for its contents. Alforma Capital Markets, Inc. did not contribute to the preparation of this report and the authors are neither employed by, nor are associated persons of, Alforma Capital Markets, Inc. The issuing entity and authors may not be subject to all of the disclosures and other US regulatory requirements to which Alforma Capital Markets, Inc. and its employees are subject. Any US person receiving this report who wishes to effect transactions in any securities referred to herein should contact Alforma Capital Markets, Inc., not its affiliates.

Alfa Bank is incorporated, focused and based in the Russian Federation and is not affiliated with US-based Alfa Insurance.

Head of Equities Alfa Bank
 Michael Pijolis 12, Akad. Sakharova Pr-t
 +7 (495) 795-3712 Moscow, Russia 107078

Research Department		+7 (495) 795-3676	
		research@alfabank.ru	
Macroeconomics		Retail, Real Estate, Transportation	
Natalia Orlova, Ph.D.	norlova@alfabank.ru	795-3677	Andrei Nikitin
Dmitry Dolgin	ddolgin@alfabank.ru	780-4724	Alexander Novikov
Sergey Egiev	skegiev@alfabank.ru	795-3612	ainikitin@alfabank.ru
Financial Sector		anovikov3@alfabank.ru	
Jason Hurwitz	jhurwitz@alfabank.ru	783-5005	641-3673
Marina Karapetyan	mkarapetyan@alfabank.ru	795-3740	974-2515
Oil & Gas		(ext. 8568)	
Alexander Kornilov, CFA	akornilov@alfabank.ru	788-0334	Alfa-Direct Research
Ekaterina Malkova	emalkova@alfabank.ru	795-3725	Geldy Soyunov
Metals & Mining		gsoyunov@alfabank.ru	
Oleg Iuzefovych, CFA	olegiuzefovych@alfabank.kiev.ua	+380 (44) 239-9135	Alan Kaziev
		akaziev@alfabank.ru	
		641-3673	
		974-2515	
		(ext. 8568)	
		Editorial & Production	
		David Spencer	
		dspencer@alfabank.ru	
		745-7153	
		Translation	
		Anna Martynova	
		amartynova@alfabank.ru	
		795-3676	
		Stanislava Ovcharenko	
		sovcharenko@alfabank.ru	
		783-5020	

Equity Sales & Sales Trading (Moscow)		+7 (495) 223-5500	
International		223-5522	
Michael Kotov	kotov@alfabank.ru	223-5500	Domestic Institutional
Alfa-Direct Sales		+7 (495) 795-3680	
Sergey Rybakov	srybakov@alfabank.ru	ext. 6399	Dmitry Demchenko
Valeriy Kremnev	vkremnev@alfabank.ru	ext. 7083	ddemchenko@alfabank.ru
Alfa Capital Markets (London)		+44 (0) 20 7588-8500	
Sales		Sales Trading	
Robert Szucsich	r.szucsich@alfa-cm.com	7382-4174	Yan Gloukhovski
Alforma Capital Markets (New York)		+1 (212) 421-7500	
Sales			
Justin Landau	jlandau@alformacap.com	421-8564	y.gloukhovski@alfa-cm.com
		7382-4179	