

AB-ICI November: Accelerating at Year's End

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December 22, 2004

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Investment Summary

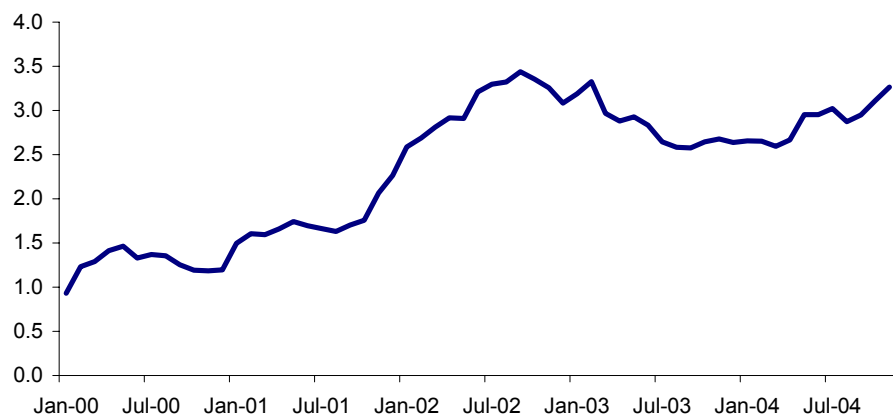
- AB-ICI is just 5% below its all-time high of September 2002, when WTO talks accelerated
- Index was supported by higher domestic liquidity accumulated before the YuganskNG auction
- Higher FDI and two recent IPOs fundamentally justify the latest AB-ICI trend

AB-ICI is now just 5% below its all-time high

AB-ICI continued to grow in November; the Index is now just 5% below its all-time high

The Alfa Bank Investor Confidence Index (AB-ICI) continued to recover in November, reaching a level only 5% below its all-time high reached in September 2002. At that time, the Index was being driven by expectations that a stronger political dialog with the US and negotiations on WTO entry would help Russia's efforts to integrate with the global community. The reality was of course different, as Russia's importance for the world economy increased largely in step with mounting oil prices, which attracted foreign capital to the country despite some uncertainty regarding the government's economic policy. As we anticipated in our previous AB-ICI note, November was rich in good news in terms of foreign investment and domestic liquidity.

Figure 1. AB-ICI: Up 8% as fears following banking crisis have receded



Sources: New School of Economics, Alfa Bank

AB-ICI reflected better liquidity accumulated before the Dec. 19 auction of YuganskNG

First, the CBR's official data show a continuing increase in liquidity in the banking sector as of the end of November. However, we believe this increase may be artificially inflated as a result of the December 19 auction of Yuganskneftegaz. The increase in deposits at the CBR, and in CBR bonds in particular, seems to reflect the accumulation of liquidity before the auction by major state-owned or affiliated banks. The same reason, i.e. participation in the auction, is behind the ruble's fast appreciation in November-December and explains the faster capital inflow, which pushed CBR reserves up to a record \$120.3 bln as of December 10. However, this money should eventually flow into budget coffers, and thus we do not believe the increase in domestic liquidity indicates a longer-term trend.

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Figure 2. Monetary Base by Component, \$ bln

	Dec-01	Dec-02	Dec-03	Aug-04	Sep-04	Oct-04	Nov-04
Cash in circulation	20.7	25.6	41.6	47.0	47.0	48.4	50.4
Correspondent accounts	4.8	5.3	10.4	7.3	7.8	8.3	9.9
Obligatory reserves	5.2	6.3	9.1	3.9	4.0	4.1	4.2
Deposits at the CBR+CBR bonds	0.1	1.5	3.0	1.1	1.6	3.8	7.8
Reverse repo	0.0	0.0	1.0	3.0	2.4	2.4	1.4
Reserves on foreign operations	0.0	0.0	0.0	0.1	0.0	0.1	1.0
Total in banks	10.1	13.2	23.4	15.5	15.8	18.7	23.6

Source: CBR, Alfa Bank estimates

Share of foreign banks in total capital up from 5.9% to 6.1%

The actual good news was two-fold: an increase in FDI, and foreign banks' participation in local banking capital in 3Q04. Both factors were accounted for in the calculation of November's AB-ICI. The share of foreign banks in total capital of the Russian banking sector rose from 5.9% to 6.1% due to acceleration of their businesses in response to the summer banking crisis.

We now target \$10 bln in FDI for 2004 as a whole

The FDI inflow to Russia reached \$5.9 bln in 9M04 vs. \$6.8 bln for all of 2003. While around 60% of this amount was directed to the oil sector (in particular through investments by Royal Dutch/Shell in Sakhalin projects), non-oil sectors have also been targeted for foreign participation. We now target \$10 bln in FDI for 2004 as a whole.

Figure 3. Key FDI Deals in 2004

Sector	Deal
Oil	ConocoPhillips purchased the state's 7.59% stake in LUKoil for \$2 bln, and subsequently spent approximately \$650 mln to raise this to 10%. The company plans to buy an additional 10% on the open market within the next few years. Together with LUKoil, Conoco recently won European approval to set up a joint venture that will invest as much as \$5 bln to tap Russia's arctic oil fields.
Oil	France's Total is expected to spend around \$1 bln for a 25%+1 share stake in Russia's number-two gas producer NOVATEK.
Banking	BNP Paribas purchased a stake in Russsky Standard Bank.
Banking	GE Capital bought the consumer-oriented Delta Bank
Banking	Rosbank is in talks with the Italian bank UniCredito
Brewing	Heineken purchased three Russian breweries.
Brewing	Interbrew paid \$660 mln to buy India's SUN Group out of its stake in a Russian-Ukrainian joint venture
Pharmaceuticals	German drugs producer Stada said it plans to buy Russian pharmaceuticals company Nizhpharm for \$110 mln.

Source: Bloomberg, Reuters, Alfa Bank

Interest in IPOs revived

Last but not least, we note two IPOs in recent months, by Mechel and Seventh Continent. The previous round of IPOs took place in March and April, and thus this latest interest in the equity market sends a positive signal as regards the investment climate, despite the wave of negative media coverage of late.

AB-ICI is being driven by foreigners; domestic confidence must improve

All in all, the resumption of growth in the AB-ICI in recent months indicates that the Russian economy is sufficiently capable of dealing with the summer's crisis of confidence in the banking sector, as well as concerns about the corporate sector as a result of the Yukos/Menatop affair. However, as we noted previously, the key fundamental factors behind future growth in the AB-ICI are foreign interest in Russian markets and acceleration of FDI. Having said that, they will not be enough to ensure sustainable longer-term growth without greater domestic confidence. What is needed now is more market-oriented reforms (such as of the power sector) on the Cabinet's agenda.

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