

AB-ICI 2006: Lagging Optimistic Market Growth

Natalia Orlova

(7 495) 795-3677

NOrlova@alfabank.ru

January 23, 2007

www.alfabank.com

Moscow

Investment Summary

- The AB-ICI was up by just 20% in 2006, well below the 70% equity market growth.
- Net capital inflow was at a historic high, but its volatility led to a poor contribution to index growth.
- We expect modest FDI in 2007, making the AB-ICI vulnerable to the liquidity situation.

The AB-ICI increased by 20% in 2006

The AB-ICI was up 20% in 2006

The Alfa Bank Investor Confidence Index (AB-ICI) rose 20% in 2006, mainly thanks to substantial capital inflows. Foreign and market confidence remained relatively modest:

Capital inflows were at a historic high, but remained sensitive to oil prices and ruble appreciation...

- The index's **economic confidence** component improved substantially in the beginning of 2006, but was volatile for the rest of the year. Despite the fact that net capital inflow to Russia reached a historic high of \$42 bln, it still remained very volatile due to dropping oil prices and the appreciating ruble, thus limiting its contribution to index growth. This component provided the most substantial contribution to index growth.

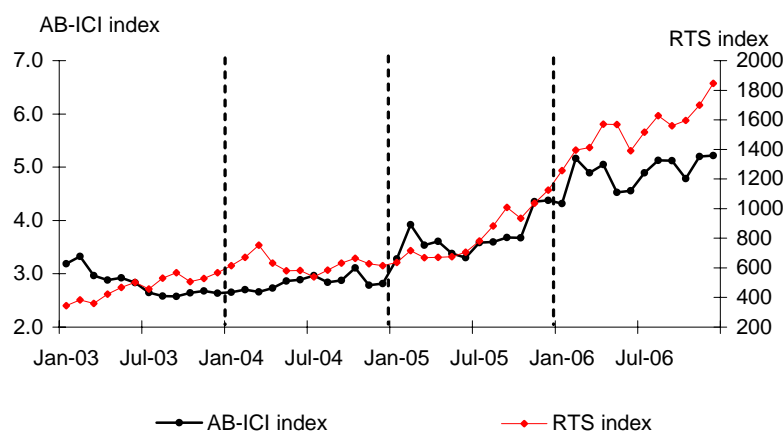
The contribution from foreign confidence was low

- **Foreign confidence** did not contribute substantially to index growth. The Russian government's clear preference toward using its national capital in the commodity sector seems to have reduced the role of foreign capital in index growth.

The lack of structural changes in the financial markets resulted in a poor increase in market confidence

- **Market confidence** also contributed modestly to index growth. This is mainly due to the lack of structural changes in the Russian financial markets, in particular, market concentration on large companies. Increasing IPO activity was the main factor driving improvements in market confidence.

Figure 1: AB-ICI up 20%, well below the 70% equity market growth



Sources: New School of Economics, Alfa Bank Research

RESEARCH DEPARTMENT research@alfabank.ru

Alfa Bank Group and/or its affiliates does and seeks to do business with the issuers covered in this research report. As a result, investors should be aware that Alfa Bank Group and/or its affiliates may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. For important disclosure information relating to Alfa Bank Group and/or its affiliates' investment banking relationships, if any, with the issuers mentioned in this report and regarding Alfa Bank Group and/or its affiliates' rating system, valuation methods, analyst certification and potential conflicts of interest, please refer to the Disclosure Section at the end of this report.

2007 Outlook: Liquidity risks postponed to 2H07

The AB-ICI's 20% increase in 2006 was weak

In 2000-2004, the AB-ICI performed well due to improving macroeconomic trends, while in 2005, the sudden jump in IPO activity became the main driving force for substantial growth in the index. However, in 2006 both of these factors failed, resulting in index growth of only 20% y-o-y.

The Russian government clearly prefers to use local capital to finance strategic projects, thus FDI is unlikely to rise significantly

The outlook for 2007 is also mixed. Last year, historically high capital inflow played the most important role in defining index growth. The increase in FDI, expected in previous years is now becoming much less realistic, as in 2006 the Russian government clearly expressed a strong preference for using local capital for a number of strategic projects that were previously expected to utilize foreign investment. Due to this trend, we do not expect a substantial increase in foreign confidence in 2007. The only positive trend in foreign confidence we see as possible would be an increasing share of foreign banks in total banking assets.

We expect substantial volatility in net capital inflow in 2007

Our main concern is about the volatility of capital flows. The recent decline in oil prices may fuel concern regarding the continuing appreciation of the ruble, and thus reduce the attractiveness of local assets. Under weak FDI, the most important share of net capital inflow to Russia would be short-term flows, which can change direction very quickly.

Under a weaker ruble, the preference for ruble savings could drop

Fears of a ruble depreciation will also affect local confidence via the savings structure. While previously we have been seeing the Russian population switching from dollars to rubles, we expect a change in the ruble trend could once again strengthen the preference for currency savings. This factor could also negatively affect the AB-ICI.

The CBR's liquidity injection into Sberbank in 1H07 should delay risks

The positive news in all this is that we do not expect any of these risks to materialize before 2H07. In the coming month, the local market will receive a liquidity injection from the CBR, which will be participating in Sberbank's additional share placement. This will force monetary authorities to raise the ruble exchange rate, which is likely to provide positive reinforcement for the index. However, Russia's strong dependence on oil could damage index growth in 2H07.

