

October 2007

Renaissance
Capital

Euromoney

Where Next In Russia's Financial Revolution?

**Moscow
4 October 2007**

- **What is Russia's Financial Revolution?**
- **What Is The Impact Of The Credit Crunch?**
- **What Will Happen In The Future?**

Russia...

- Has had one of the fastest rates of decapitalisation in any non-war period
- Requires enormous investment into everything from retail to roads
- Enjoys a vibrant private sector economy which is capital constrained from expansion.

Yet...

- Is sitting on USD450 bn of reserves and a USD120 bn of stabilisation fund
- Is increasing the money supply by 50% per annum, yet has inflation of less than 10%
- Enjoys domestic interest rates which are below the level of inflation.
- Is plugging into the most globalised financial market in history

And

- Has an underdeveloped domestic commercial banking sector
- Is still under-penetrated by the international banks.
- Has just liberalised capital controls for the first time in its history

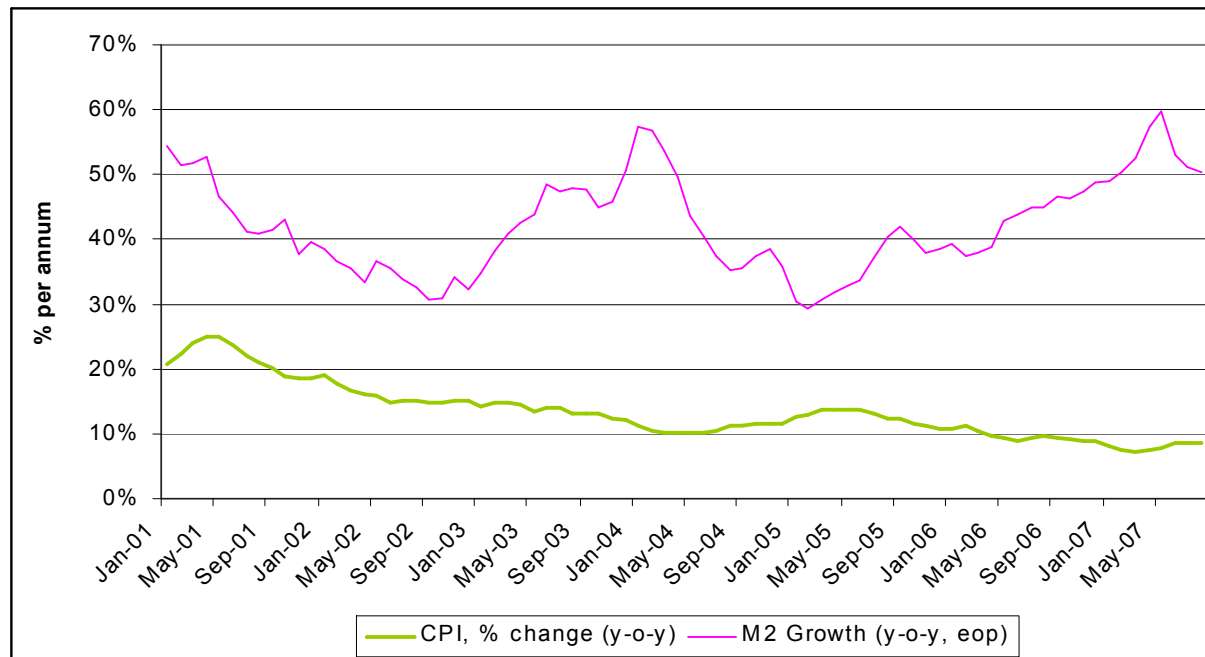
High commodity prices together with a managed exchange rate system has meant that money supply growth has been rapid...

...the money supply has been growing on average by 40% per annum since 2001. More recently it has been 50%.

This has had a number of effects...

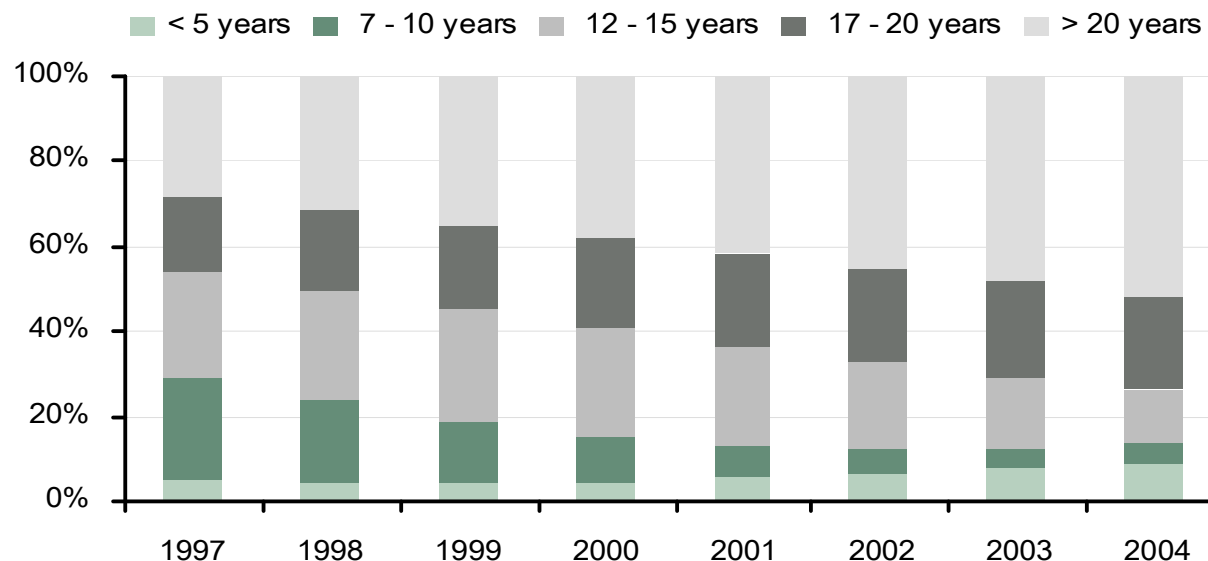
1. Nominal interest rates are roughly 300 bps beneath inflation
2. Asset price growth has been rapid
3. Inflation remains too high

Money Supply And Inflation



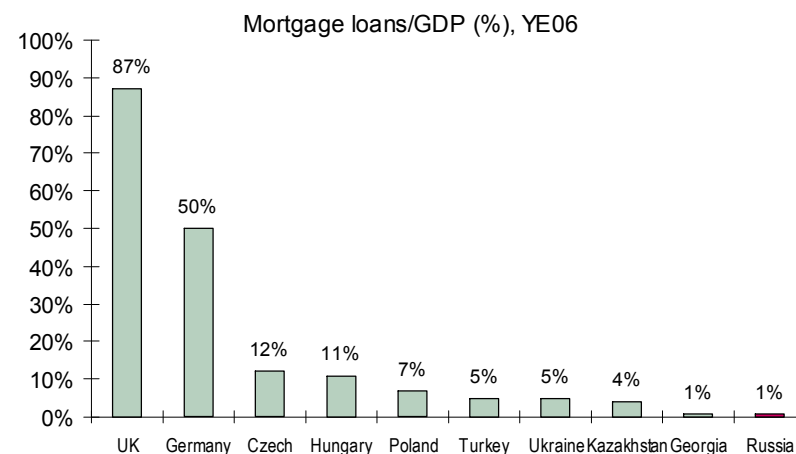
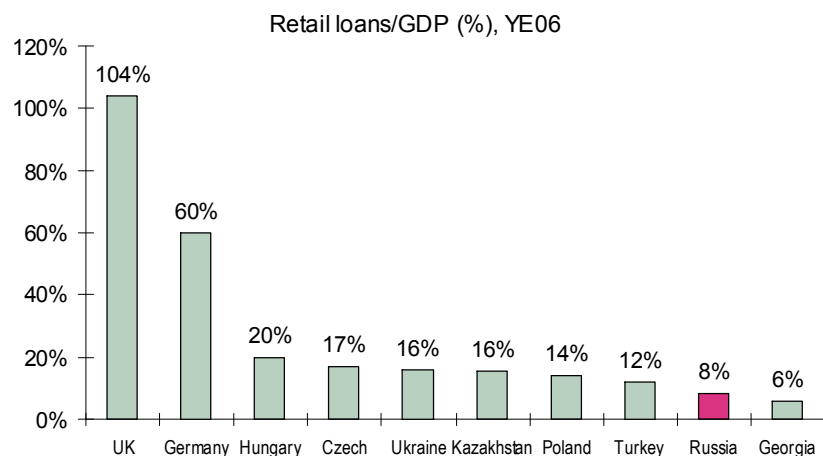
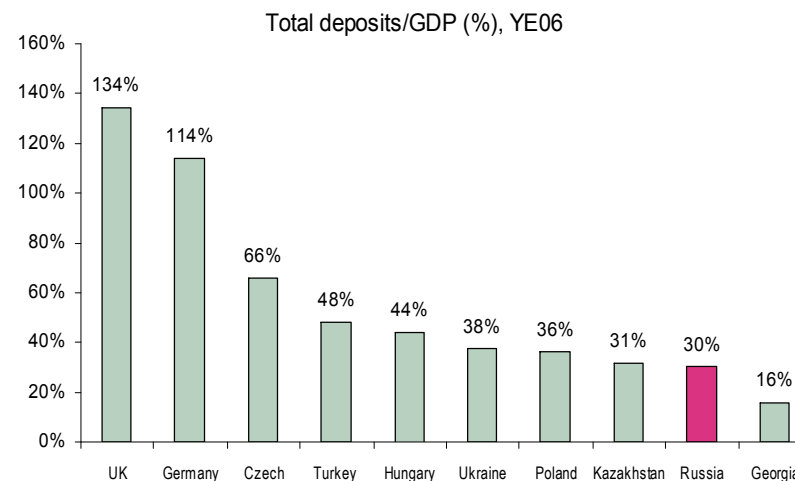
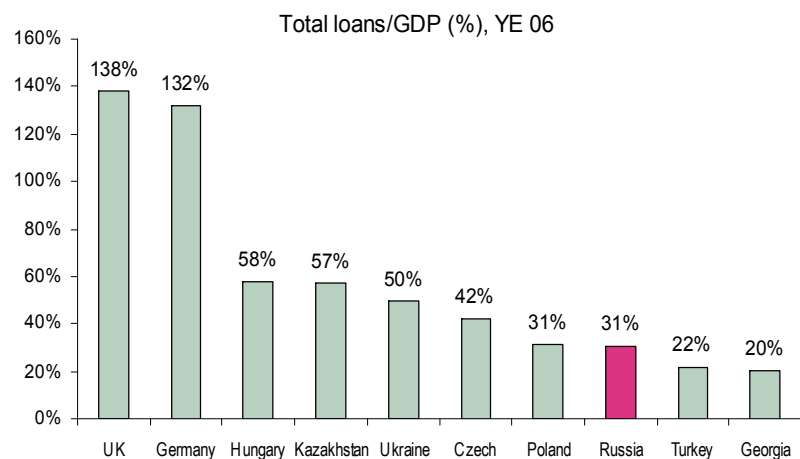
- However, at the same time, there is enormous demand for capital across Russia
- Depreciation has been higher than investment for the last 20 years...
- ...as a result, infrastructure is literally collapsing.
- Growth is already being constrained because of infrastructure weakness

Russia's Capital Base

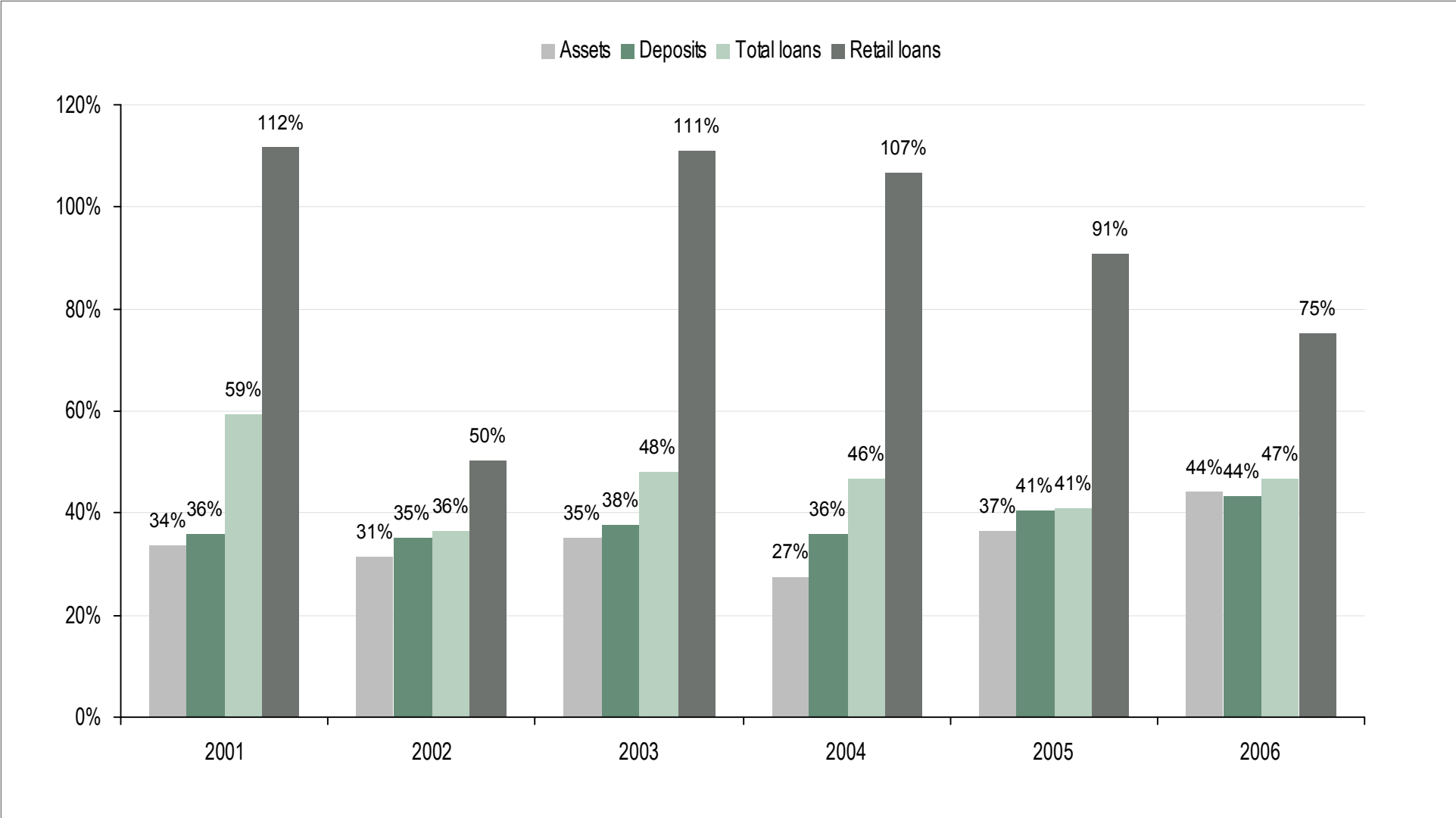


Source: Russian Institute for Economics, Policy and Law in Science and Technology

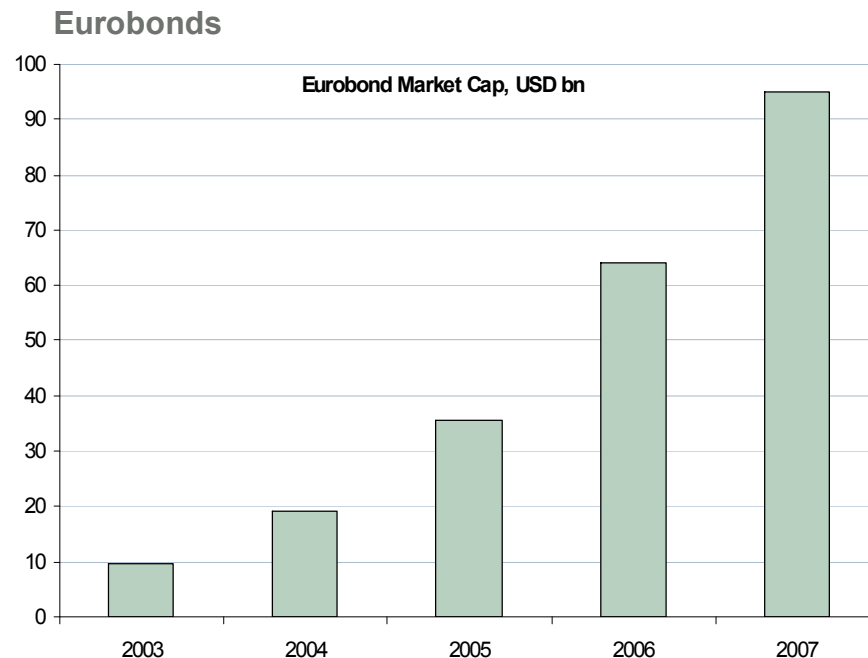
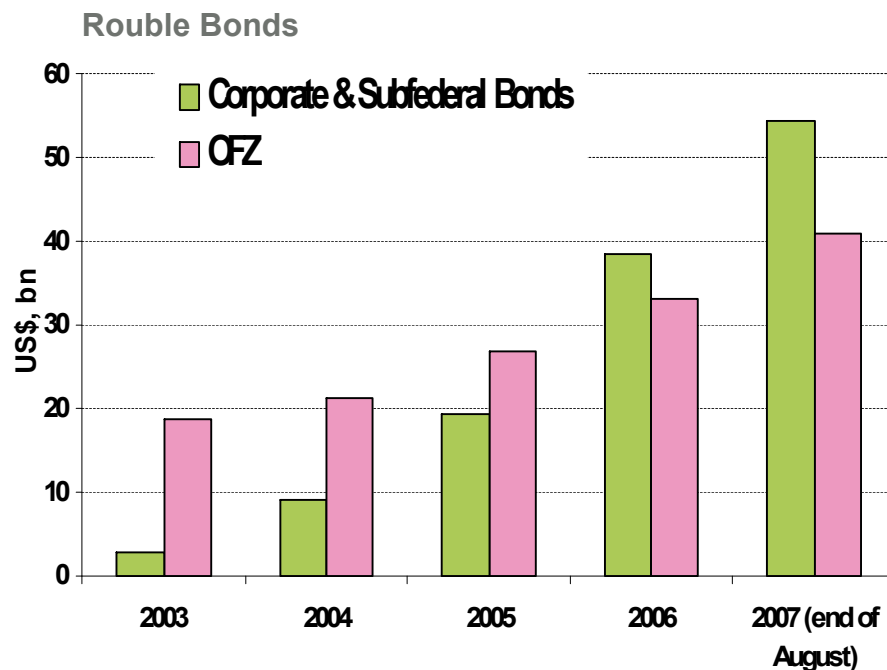
Russian market penetration, still plenty of room for growth



Strong balance sheet growth across the board, retail leading the way

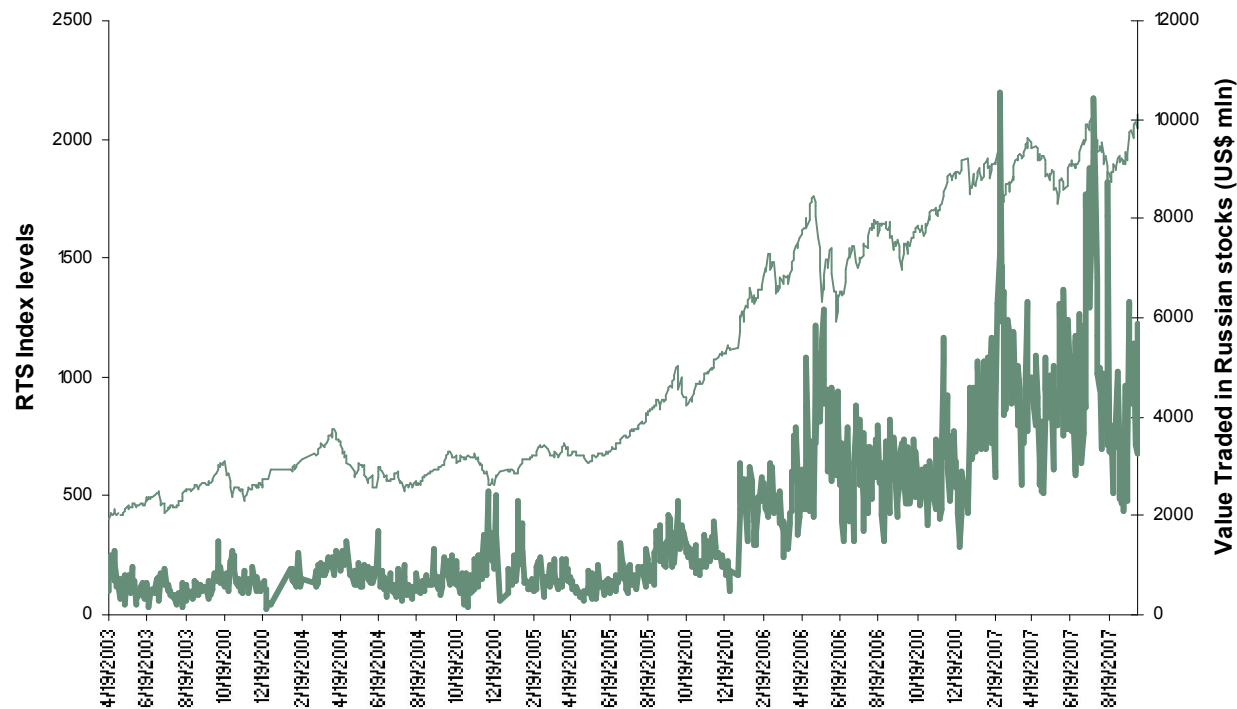


- Eurobond market has grown from 9 fold to USD90 bn from 2003-2007
- Growth in rouble bonds has been even more impressive, from virtually non existent in 2003 to over USD50 bn by end of August...
- ...and issuance continues to accelerate



Strong balance sheet growth across the board, retail leading the way

- In 2000, average daily turnover was around USD50 mn...
- ...today, the average is closer to USD5 bn, and can touch above USD10 bn.



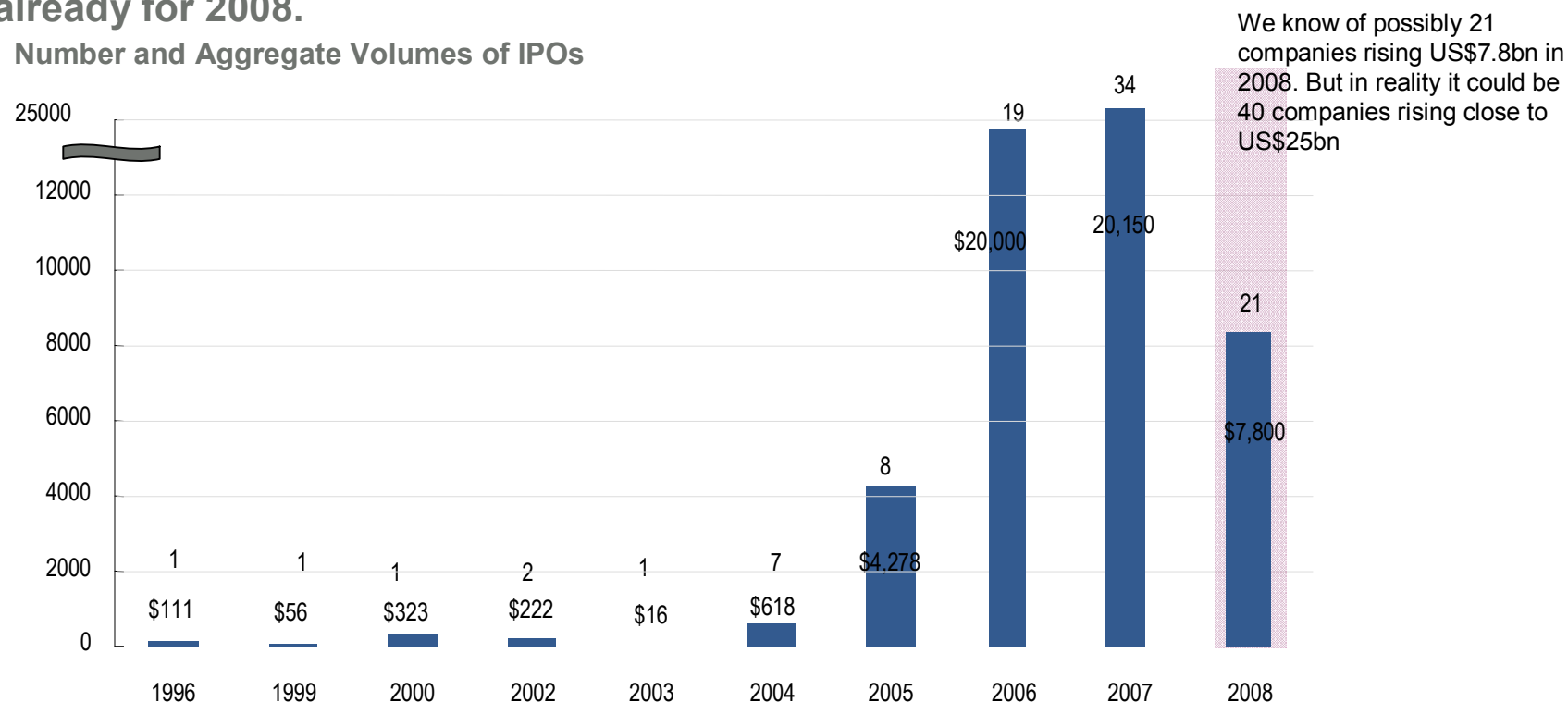
Between 1992 and the end of 2004, 13 companies IPO'd, raising around USD1.4 bn...

...in 2005, issuance rose to USD4.3 bn...

...in 2006, there were 19 companies listed, raising USD20 bn...

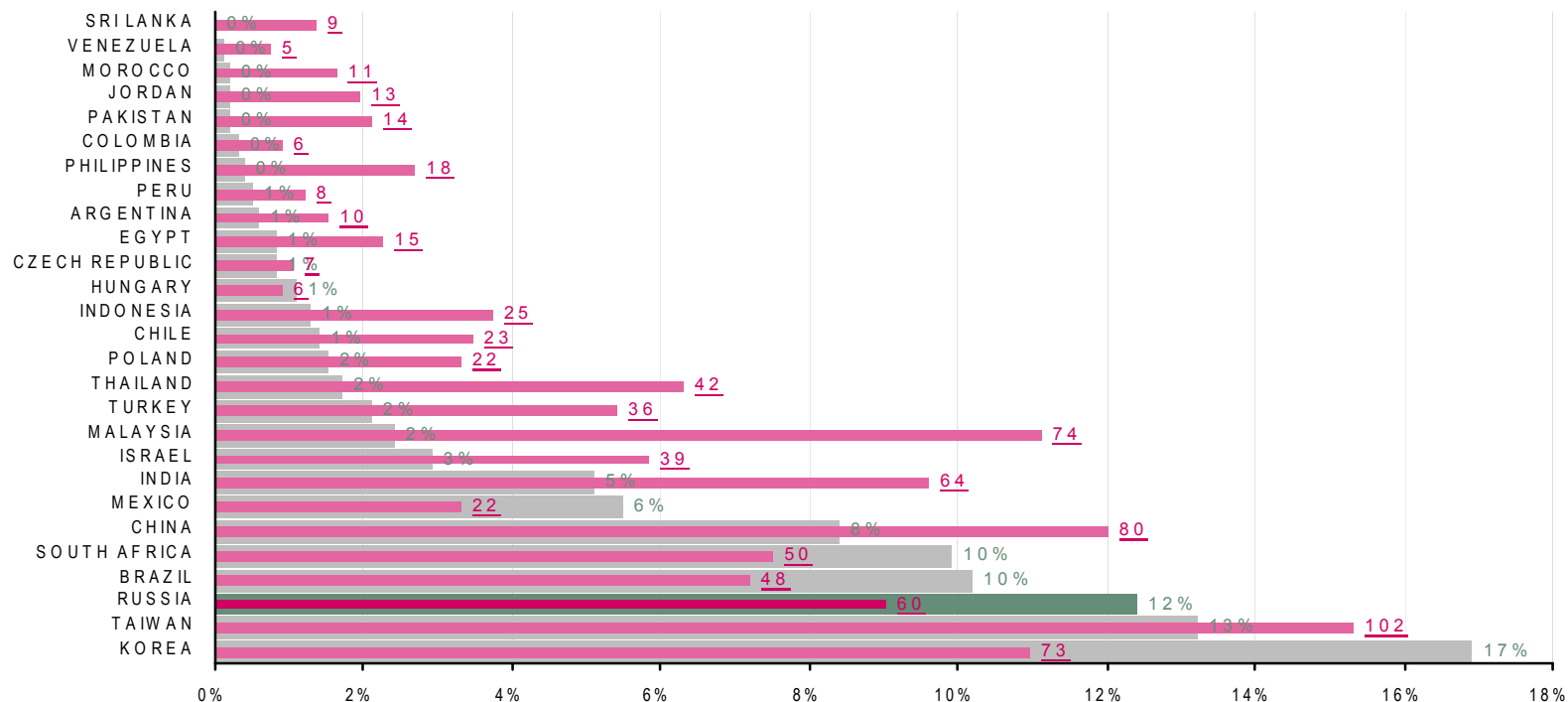
... in 2007, there were 34 companies planned to issue, with a strong pipeline already for 2008.

Number and Aggregate Volumes of IPOs



- The scale and number of IPOs is revolutionising the Russian equity market. At the end of 2005, there were 19 companies in the MSCI...
- ...by the end of 2008 there will be around 60.

Russia In The MSCI



IPO Pipeline, Current.

Company	Industry	2007 Size, USD mm	
Bank Zenit	Financials	2007	500
TGK-9	Utilities	2007	500
M. Video	Consumer and Retail	2007	400
Novorossiysky Port	Transport	2007	250
Teorema	Real Estate	2007	550
LSR	Real Estate	2007	1,000
TGK-1	Utilities	2007	1,200
OGK-4	Utilities	2007	1,700
Lenta	Consumer and Retail	2007	500
Bank of St.-Petersburgh	Financials	2007	200
OGK-6	Utilities	2007	600

Company	Industry	2008 Size, USD mm	
Rusal	Metals & Mining	2008	8,000
ST Group	Real Estate	2008	1,000
STT Group	Real Estate	2008	2,000
Coalco	Real Estate	2008	1,000
Don Story	Real Estate	2008	1,500
Gazprombank	Financials	2008	2,000
Sibur	Petrochemicals	2008	2,000

Strong macro backdrop, banking sector is booming

- Commodity fuelled growth and wealth enhancement looks set to continue

Banking sector enjoying early boom stage

- From a low base, 2005/06 were years of strong growth for the Russian banking sector

Retail banking is driving the wave

- Predominately consumer loans as well as SME lending are spearheading growth across the sector

A spate of recapitalisations in 2007

- Many banks are set to replenish capital levels in 2007, which bodes well for another year of strong growth.

Competition is coming

- Natural side effect is increased competition. Foreign banks are flowing into the Russian market with some (SocGen & Raiffeisen) going beyond dipping their toe in the water with top 10 franchises.

Asset Quality and margin pressure key concerns

- Some very aggressive lending policies apparent while price competition a key tool for the first time this year.

Liquidity Risk vs Economic Risk

- Approximately 12 Russian eurobonds have been postponed since August, and another 17 rouble bonds
- There is at least USD10 bn of financing due before the end of the year.

USD bonds delayed since start of credit crunch

Issuer	Estimated size of the deal, USD mn.
Rosneft (RU)	1500
SIBUR (RU)	500
Technosila (RU)	200
Bank of Moscow (RU)	500
Industrial Union of Donbass (UA)	300
Finance and Credit Bank (UA)	200
Ukrainian railways (UA)	500
Bank Kaspiysky (KZ)	200
KazKommertsBank (KZ)	500
Azerbaidjan (AZ)	500
Amtel (RU)	200
Aeroflot (RU)	200
Locko Bank (RU)	200
OGK-2 (RU)	300
Rusal (RU)	500
Rusfinance Bank (RU)	300
URSA Bank (RU)	400
UTAIR Aviation (RU)	150
Total estimated volume of the delayed deals	7150

Rouble bonds delayed since start of credit crunch

Issuer	Estimated size of the deal, RUR bn
Penza Region-2	1
Kedr	2.5 - 3
MIR	3
Kazan-4	2
DVTG-Finance-2	5
MIA-4	2
Generating Company, 1	2
VMK-Leasing-1	1
Proviant-1	1
Sitronics-1	3
Golder-Electronics	1
Khanty-Mansiysk StroyResurs-1	3
Senator	1
Zheldoripoteka-1	1.5
Pharmacy chain 36.6-2	1
KAMAZ-Finance-3	6.5
Deutsche Bank Russia-1	3
Total est.:	RUB 40bn

Spreads have widened

- Until very recently, debt markets were largely closed to Russian issuers
- The one entity that pushed for financing got it at 14.5% - setting an unfortunate bench mark
- Russian banks are small, but their rate of growth has almost certainly built in weaknesses through poor risk management or monitoring
- Without the Fed and Kudrin, we would have anticipated a default before end year.

Rouble issues*

Issue	Maturity	Duration, years	Spread as of 19 Sept, bpts	Spread as of 10 Sept, bpts	Spread as of 29 June, bpts	Currency
Gazprom-4	10-Feb-10	2.2	125.6	71.8	34.3	RUB
Gazprom-8	27-Oct-11	3.5	83.1	75.3	56.2	RUB
Lukoil-2	17-Nov-09	2.0	98.4	91.0	55.9	RUB
Lukoil-3	8-Dec-11	3.7	100.0	94.7	81.6	RUB
WBD-2	15-Dec-10	2.8	205.9	210.1	218.6	RUB
AvtoVAZ-3	22-Jun-10	0.7	211.5	240.6	235.0	RUB
Russian Standard-4	3-Mar-08	0.5	895.1	736.8	233.5	RUB
Russian Standard-8	13-Apr-12	1.0	576.3	851.6	238.2	RUB
HOFB-4	12-Oct-11	1.0	729.8	684.0	335.8	RUB
Mirax-1	19-Aug-08	0.9	623.4	457.5	317.2	RUB
Mirax-2	17-Sep-09	1.8	400.7	409.5	325.0	RUB

Note: the spreads are calculated to OFZs

* Numbers are before the rally generated by Finance Minister Alexei Kudrin's announcement on Friday evening

Eurobonds and CLNs

Issue	Maturity	Duration, years	Spread as of 19 Sept, bpts	Spread as of 10 Sept, bpts	Spread as of 29 June, bpts	Currency
Gazprom 13 (Series 1)	1-Mar-13	4.4	196.3	229.8	125.2	USD
Gazprom 34	28-Apr-34	12.1	176.2	212.0	151.9	USD
Lukoil 17	7-Jun-17	7.2	251.9	288.8	175.3	USD
Lukoil 22	7-Jun-22	9.2	268.7	297.0	189.9	USD
WBD 08 (8.5%)	21-May-08	0.6	375.3	361.5	169.0	USD
AvtoVAZ 08	20-Apr-08	0.5	463.0	451.1	256.5	USD
Rus. Standard 08	21-Apr-08	0.6	619.3	729.5	250.5	USD
Rus. Standard 10	7-Oct-10	2.7	679.7	710.0	376.4	USD
Rus. Standard 15	16-Dec-15	5.7	675.9	708.8	470.6	USD
HOFB 08 (9.125%)	4-Feb-08	0.4	676.8	707.7	287.1	USD
HOFB 10	11-Apr-10	2.3	663.4	697.7	390.8	USD
Mirax 11 (put)	20-Mar-11	1.4	631.3	633.1	405.6	USD

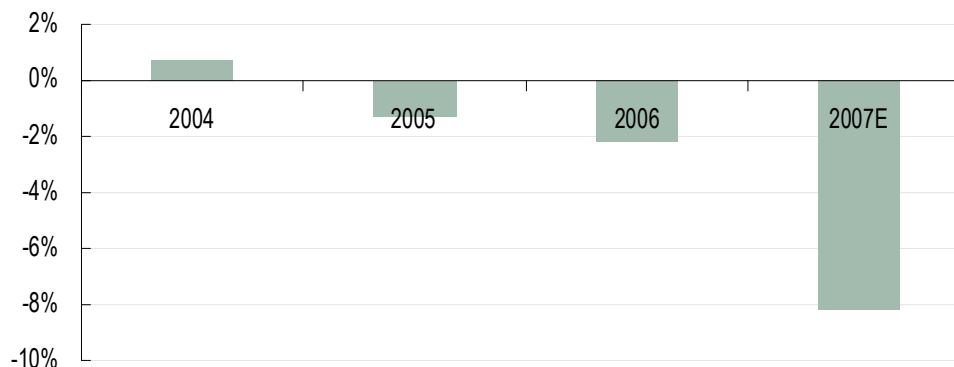
Note: the spreads are calculated to UST

Balance of payments outlook is far from bright

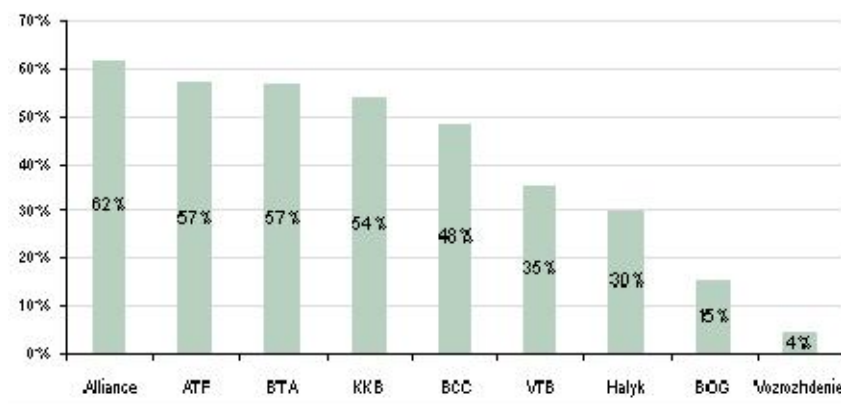
- **Kazakhstan suffers from a growing current account deficit**
- **FDI flows are net-negative as a result of a repatriation of investments and dividends from operational projects**
 - The pause of the Kashagan project, inflows will likely be reduced by a further \$700mn, or so, per quarter
- **The only source of external financing was banking sector borrowing, but that has halted, resulting in depreciation pressures and NBK having to sell reserves**

With banks overexposed to external borrowing and real estate sector, banking sector is likely to experience serious liquidity problems, while the KZT is expected to weaken

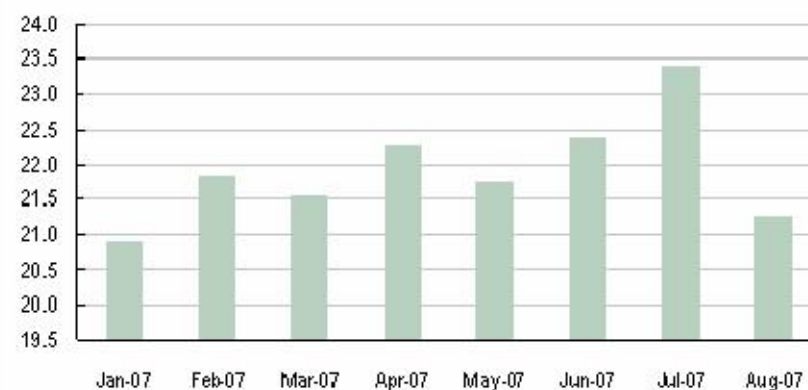
Current account balance, % of GDP



Kazakh banks external funding % in a CIS context

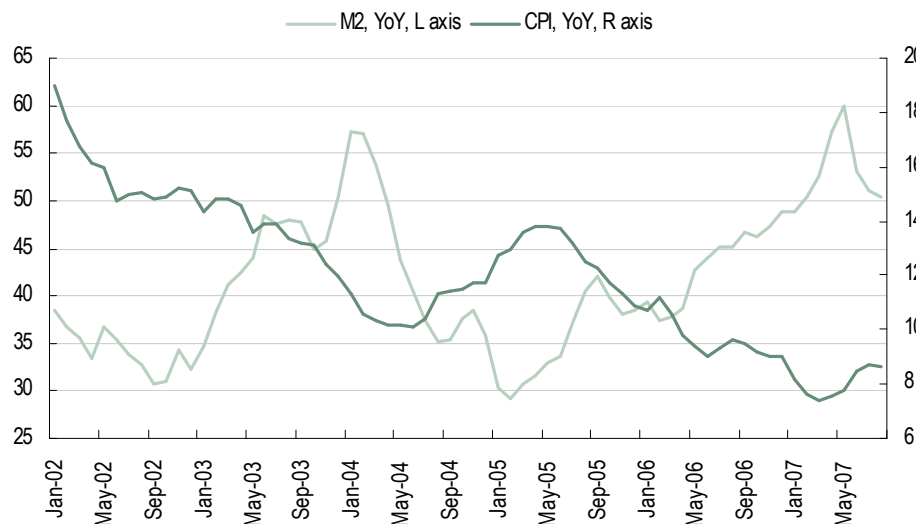


NBK reserves, USD bn

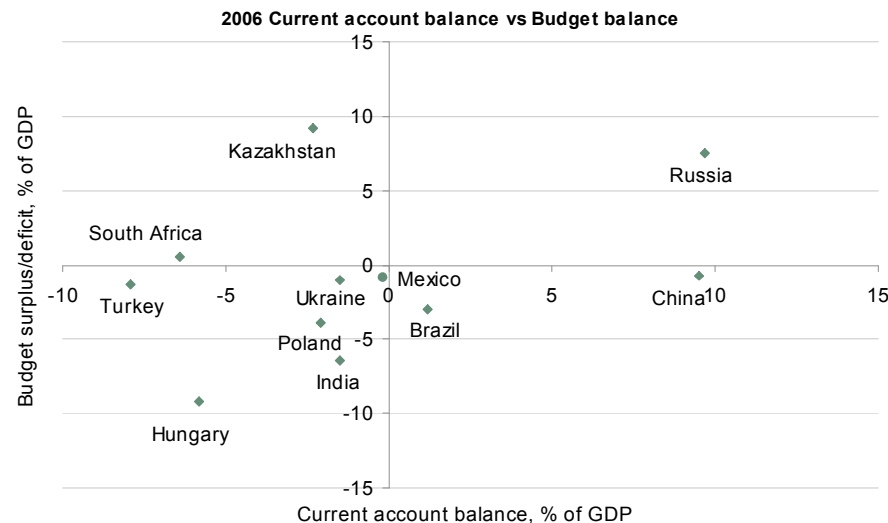


- **Within the context of potential global meltdown, Russia looks like a safe haven...**
 - Arguably the biggest source of macroeconomic instability in the first six months was USD50 bn of short-term capital inflow
 - An outflow of capital and a weakening of the exchange rate is welcomed by the CBR
 - With USD416 bn of reserves, USD133 bn of stabilisation fund and a 7% of GDP budget surplus, Russia is in a fantastic financial situation.

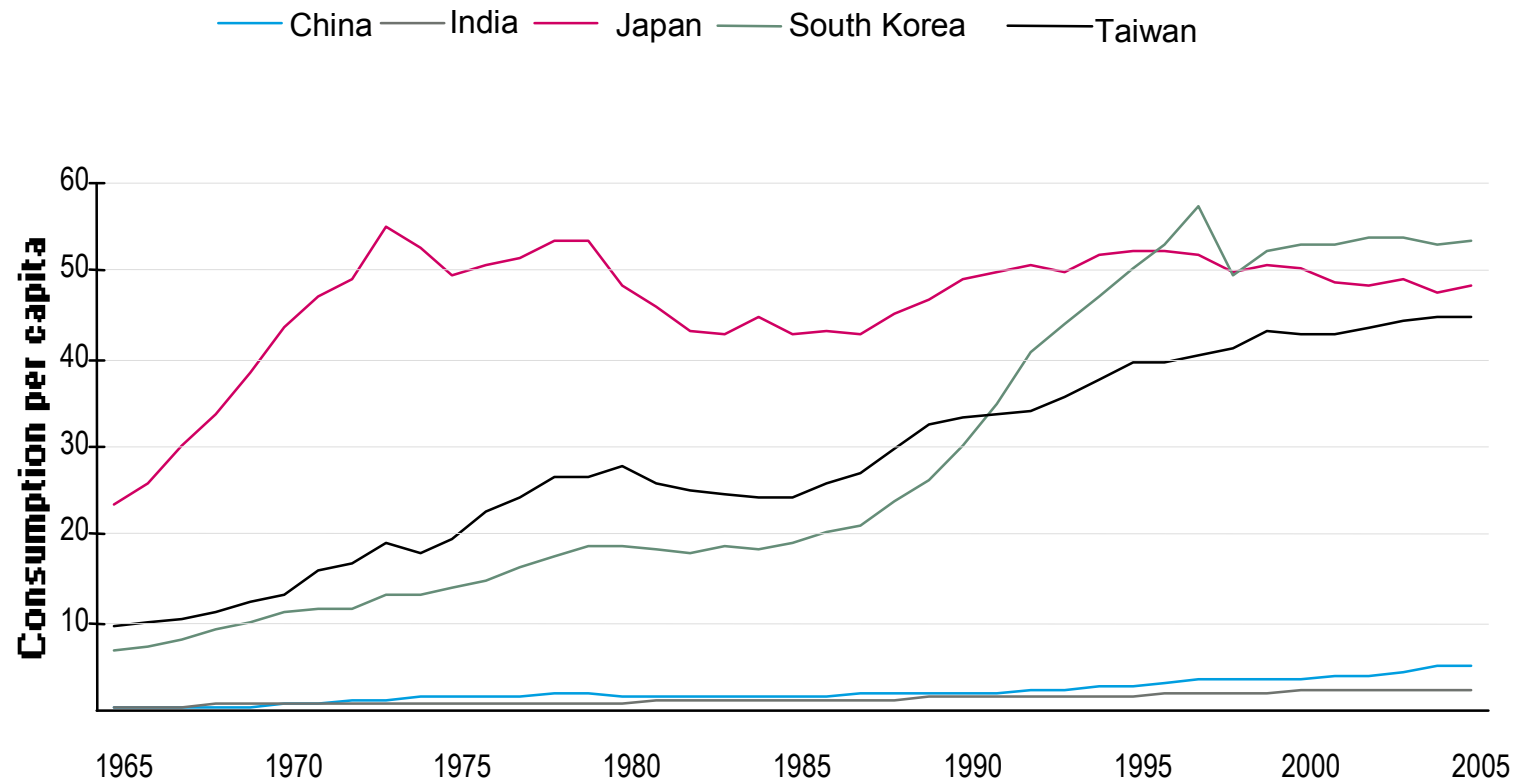
Money supply vs Inflation



Budget surplus vs current account



History Of Oil Consumption



Source: World Bank

The Future

Likely Implications

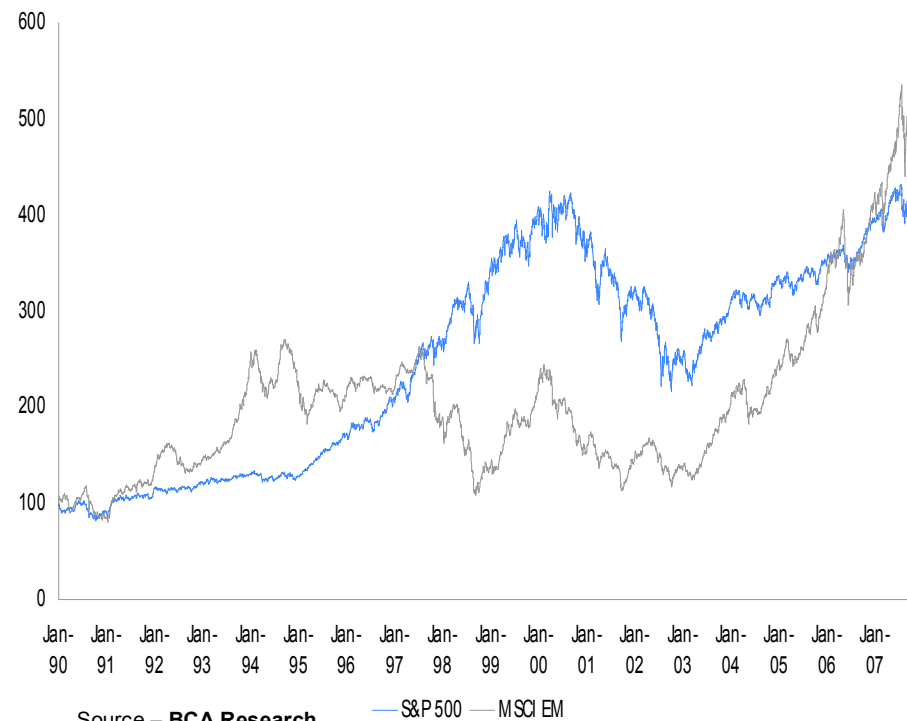
- Increase in borrowing costs across the board – yes
- Bank failures – yes
- Bond default – yes
- Decrease in consumption demand – yes
- Decrease in commodity prices – probably

Unlikely Implications

- Banking sector failure – no
- Closure of global credit markets – no
- Closure of IPO markets - no
- Recession – no
- Equity market fall of more than 20% - probably not

- In every cycle in the last twenty years, the bursting bubble has been solved by an increase in credit...
- ...which has catalysed a new bubble. It is not impossible (at all) that EM equity can benefit.

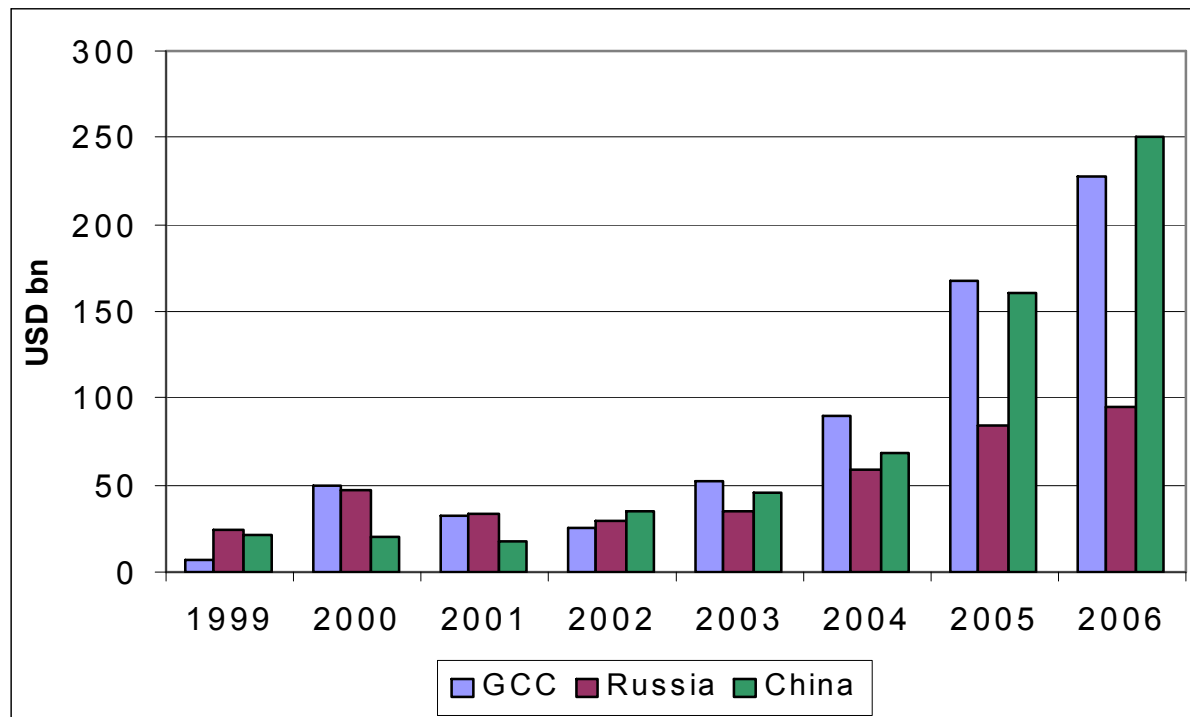
Russia to repeat S&P post 1998?



Source – BCA Research

- While over the next few months, Russia's big problem in the financial markets will be lack of liquidity...
- ...but there is so much money that could come in from both international flows and re-invested domestic flows, that the problem could actually be the opposite in the future.

Capital Outflow from EM



Source – IMF

- Between 2003 and June 2007, Russia's financial markets have boomed
- For a whole range of reasons, Russia is well situated for longer-term development...
 - Potential scale of the economy
 - Need for investment
 - Moscow as hub for the CIS region
- The recent liquidity squeeze has illustrated the dangers of financial globalisation, particularly in markets with a relatively underdeveloped financial sector.
- However, once the liquidity squeeze is out of the way, Russia in general, and Moscow in particular, will likely enjoy large capital inflows...
- ...which puts it in an excellent position still to become one of the two financial centres of Europe.

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