



RUSSIA: CONVINCING RELATIVE VALUE... ...BUT RISKS PRECLUDE A POSITIVE VIEW



Vladimir Savov, Senior Equity Strategist, URALSIB Financial Corporation, explains the current view of his brokerage on the market, while emphasising that despite fundamental upside, Yukos scare and other risks may prevent significant recovery from current levels.

From a fundamental perspective, we believe the market could easily have another 10-15% of upside until year-end, and see the main support factors in compelling valuations, a high oil price and stabilising, albeit tighter, foreign and domestic liquidity. Unfortunately, the shadow of Yukos and other risks are offsetting these positive factors for now.

YUKOS – OUT OF THE FRYING PAN...

After a brief bout of optimism about the fate of Yukos – which

was initially spurred by President Vladimir Putin's evasive comment at the Tashkent summit of the Shanghai Development Organisation in mid-June – the market is coming back to agreement that even if Yukos is to avoid bankruptcy, it will pay a dear price. Indeed, the recent news flow around Yukos has been remarkably negative, and in our opinion suggested that while some sort of negotiations between the company and the government may

have been held, an agreement is far from near. Hence, Yukos is seeing further pressure in order to yield, and even if the bankruptcy scenario were eventually avoided, a lot of the company's value would be spent on the settlement.

VOLATILITY TO STAY FOR A WHILE

The problem is that we are still to see the market decoupling from Yukos, despite our hopes. Until there is clarity about the endgame of the Yukos affair, there will likely



Country	Average 2004E P/E
Romania	16.9
Mexico	14.6
Argentina	12.6
S. Africa	11.9
Average	11.7
Turkey	11.1
India	11.1
Indonesia	10.5
Brazil	10.1
Russia	9.4
China	9.2
S. Korea	7.4



be more volatility to come, and market performance will suffer. The situation could be exacerbated by other factors – such as lower foreign and domestic liquidity, as money becomes more expensive in the wake of Fed’s tighter monetary policy.

COMPELLING COMPARATIVE VALUATIONS...

At current levels, the RTS Index implies relative valuations that are among the lowest in the GEM universe, with 2004E P/E of 9.4. The average GEM multiple is currently 11.6, and we attribute the 20% discount of Russia to the GEM average to be almost largely driven by the depressed valuations of the oil sector, which in turn suffer mostly from the ‘Yukos contagion.’

...AND 15% AVERAGE UPSIDE TO TARGET PRICES

According to our price targets, the weighted average upside in the Russian market is 15%. Therefore, it would not be far-fetched to say that the Russian market is borderline to a Buy – but then, as we discuss below, sentiment has changed for the worse.

IMPROVING DOMESTIC LIQUIDITY?

According to the Central Bank, Russia’s international reserves rose from 11 June to 18 June by \$1.2b to \$87.4b. The increase is consistent with the CBR’s recent forecast that reserves would grow by \$20-25b this year. The growth is driven by Russia’s current account surplus, which again started to rise following a reduction in capital flight volumes, and suggests that we are likely to see significant improvements in liquidity on the Russian market in the coming months, which is encouraging.

Indeed, over the past few months, the market has suffered – among other factors – from falling domestic liquidity.

SOME MILD TRIGGERS POSSIBLE

Triggers to watch for until year-end are Russia’s possible upgrade to investment grade and the dismantling of Gazprom’s ring-fence, the latter now looking more realistic, given Gazprom CEO Alexei Miller’s comment at the 25 June AGM that the ring-fence may be eliminated by year-end.

YUKOS-STILL FRAUGHT WITH DANGER

BETTER WITHOUT BANKRUPTCY, BUT...

When, in early May 2003, we assessed the two major scenarios for Yukos – “bankruptcy” or “deal” – we concluded that the deal scenario was the more beneficial for all parties involved, and hence the more likely. With the conflict apparently heading toward a deal, we still believe that while clearly better – especially from the market perspective – the deal scenario may not necessarily mean that minority shareholders will be left with the same fundamental value they enjoyed while holding the ‘old’ Yukos.

...RESIDUAL VALUE TO MINORITIES IS STILL UNCLEAR

Indeed, the deal scenario does not negate the large and looming risk of being hit with back tax claims in addition to the \$3.4b (as demonstrated by the Moscow Arbitrage Court decision of 29 June), the level of dilution minority shareholders would need to accept if ownership is restructured, the

possibility that Yukos might be forced to sell assets in order to meet its obligations – to say nothing of the prices (fair or rigged) at which these assets would be sold. Clearly, any of these risks could have a significant impact on the company’s shares.

GOVERNMENT BENEFITS IN ANY SCENARIO

Under any – bankruptcy or deal – scenario, government coffers would benefit from the back taxes for which Yukos is all but certain to be liable to pay. In addition, other large taxpayers will likely become much more ‘cooperative’ in the future. Under the ‘deal scenario’, which would most certainly involve a significant restructuring of Yukos ownership, the government would achieve a core objective of the attack against the company – namely, the economic neutralisation of Group Menatep. Not least, by ‘saving’ Yukos from bankruptcy, the government will avoid wreaking social unrest and unemployment and, arguably, most importantly, prevent the investment climate in Russia from deteriorating.

IN THE AFTERMATH, NOT THE SAME COMPANY

In retrospect, we recall the Yukos of June 2003, just before the bells and whistles of the impending Yukos affair – which began with the arrest of Platon Lebedev – hit the market. At that time, Yukos was widely held as the darling of investors – in terms of management, profitability, transparency and liquidity, and was unanimously deemed the unquestionable Buy recommendation in the Russia market. We do not want to repeat ourselves, but invite investors to consider the current risks surrounding the company, and how



the situation in any of the areas that formed the core of the company's investment case, have changed – or are bound to change, after an agreement with the government is reached. Put simply, we believe Yukos will not recover to be the same company it used to be – at least not in the medium term, and possibly never.

OTHER RISKS WOULD DETER BIG RALLY

RUSSIA-SPECIFIC RISKS NOW LOOMING LARGE...

Leaving aside the very positive top-down outlook and attractive valuations, the Russian market in 2004 has clearly shown that the country is still undergoing significant institutional changes, which could be accompanied with significant volatility. Indeed, the 5% YTD performance of the RTS Index is highly telling, given that it had risen by 33% until early April, only to drop

by 42% in June. In our view, this has been more than enough to change investor perception of Russia from being the best pick among global emerging markets, to just another emerging market.

... GOVERNMENT INTEREST TOWARDS BIG BUSINESS IS UNNERVING

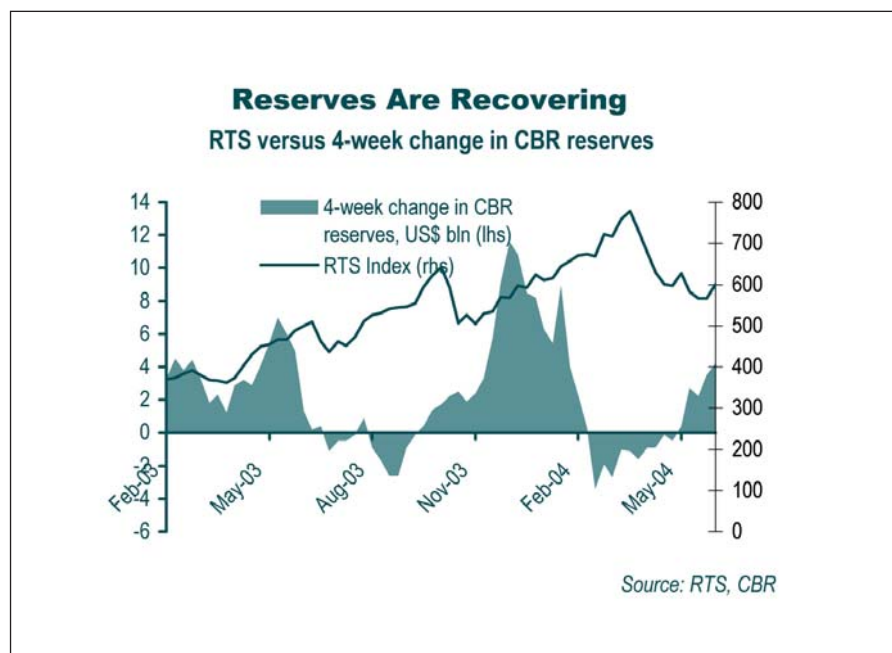
The recent news that the Audit Chamber could recommend revision of certain privatisation deals (such as Sibneft, MGTS, TNK) makes us nervous, given the current political environment and fresh and still painful memory of the attack on Yukos. Should harsher enforcement of the 'new model' of relationship between the state and big business take place, the market could remain depressed for longer.

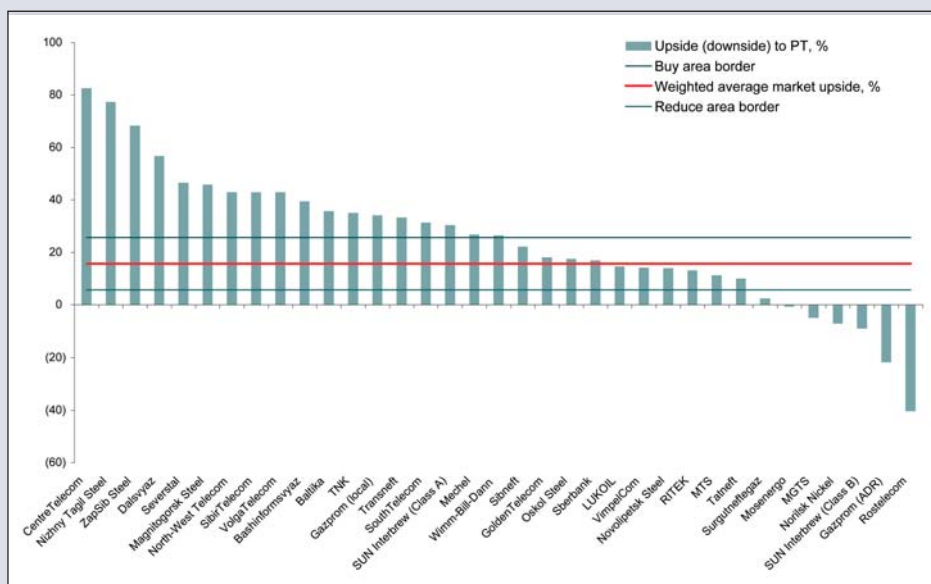
DECLINE IN GLOBAL RISK APPETITE MEANS FEEBLE INFLOWS

Expectations about the Federal Reserve tightening the money supply

are building, and should hit to some extent liquidity in high-risk assets, in our view. Fears that China is putting the brakes on its heated economy also contribute to declining sentiment towards emerging markets, in general.

Date	RTS Index (rhs)	CBR reserves
04/01/2002	276.85	36.70
01/02/2002	288.01	36.50
01/03/2002	305.47	36.70
05/04/2002	358.91	38.10
03/05/2002	402.89	41.70
07/06/2002	353.79	43.60
05/07/2002	322.80	42.60
02/08/2002	347.39	44.40
06/09/2002	342.11	45.40
04/10/2002	348.94	46.40
01/11/2002	361.15	48.20
06/12/2002	356.40	48.10
03/01/2003	370.91	51.40
07/02/2003	368.58	54.50
07/03/2003	402.84	57.70
04/04/2003	467.10	64.70
02/05/2003	509.07	64.90
06/06/2003	473.08	64.60
04/07/2003	541.19	62.00
01/08/2003	594.26	62.40
05/09/2003	526.46	65.40
03/10/2003	569.59	74.50
07/11/2003	611.10	84.10
05/12/2003	670.14	86.40
02/01/2004	716.55	83.70
06/02/2004	631.11	82.70
05/03/2004	583.17	85.40





29/04/2004	Ticker	Price	Target	Up/ Down	Up/ Down against market	Rec
		(US\$)	(US\$)	(%)	(%)	
CentreTelecom	ESMO	0.35	0.63	83	76	Buy
Nizhny Tagil Steel	NTMK	0.62	1.10	77	71	Buy
ZapSib Steel	ESPK	1.01	1.70	68	62	Buy
Dalsvyaz	zsmk	150.00	235.00	57	50	Buy
Severstal	trko	870.00	1274.55	47	40	Buy
Magnitogorsk Steel	GSPBEX	2.20	3.20	46	39	Buy
North-West Telecom	KUBN	13.50	19.30	43	37	Buy
SibirTelecom	CHMF	70.00	100.00	43	37	Buy
VolgaTelecom	TRNFP	0.11	0.15	43	37	Buy
Bashinformsvyaz	NNSI	0.50	0.70	39	33	Hold
Balika	PKBA	3.02	4.10	36	29	Buy
TNK	ENCO	0.40	0.54	35	29	Buy
Gazprom (local)	SUGA GR	2.90	3.89	34	28	SpB
Transneft	VIP	120.00	160.00	33	27	SpB
SouthTelecom	BISV	0.05	0.07	31	25	Buy
SUN Interbrew (Class A)	MBT	6.68	8.70	30	24	Hold
Mechel	LKOH	14.99	19.00	27	20	Hold
Wimm-Bill-Dann	magn	0.09	0.11	26	20	Hold
Sibneft	SIBN	43.00	52.50	22	16	Hold
GoldenTelecom	GLDN	1.30	1.54	18	12	Hold
Oskol Steel	MECH	28.20	33.15	18	11	Buy
Sberbank	nlmk	3.02	3.53	17	11	Buy
LUKOIL	SPTL	2.09	2.40	15	8	Buy
VimpelCom	SUG GR	27.17	31.00	14	8	Hold
Novolipetsk Steel	SNGS	0.67	0.76	14	8	SpB
RITEK	RITK	0.80	0.91	13	7	Hold
MTS	SBER	400.00	445.00	11	5	Hold
Tatneft	WBD	96.40	106.00	10	4	SpB
Surgutneftegaz	oamk	124.00	127.00	2	(4)	Hold
Mosenergo	TATN	0.08	0.08	(1)	(7)	Hold
MGTS	GMKN	58.70	56.00	(5)	(11)	Hold
Norilsk Nickel	MSNG	13.95	13.00	(7)	(13)	Hold
SUN Interbrew (Class B)	MGTS	9.53	8.70	(9)	(15)	Hold
Gazprom (ADR)	OGZPF	30.60	24.00	(22)	(28)	Hold
Rostelecom	RTKM	2.18	1.30	(40)	(47)	Reduce