Russian Equity Market: Current Crisis and Outlook

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First Vice-President of IC RUSS-INVEST
1. Key facts.
2. Factors which caused stock market crash.
3. Valuation of Russian stock market.
4. Possible stock market scenarios.
5. Closing remarks.
Table 1. Dynamics of BRIC and Leading World Indices in 2007-2008.

<table>
<thead>
<tr>
<th>Index</th>
<th>Value</th>
<th>52 Week High</th>
<th>52 Week Low</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>RTS</td>
<td>1058.84</td>
<td>2498.10</td>
<td>1058.84</td>
<td>-57.6%</td>
</tr>
<tr>
<td>Mi CEX</td>
<td>853.93</td>
<td>1970.46</td>
<td>789.19</td>
<td>-56.7%</td>
</tr>
<tr>
<td>FTSE Russia Index</td>
<td>328.22</td>
<td>753.21</td>
<td>328.22</td>
<td>-56.4%</td>
</tr>
<tr>
<td>Shanghai Composite Index</td>
<td>1895.37</td>
<td>6124.04</td>
<td>1802.33</td>
<td>-69.1%</td>
</tr>
<tr>
<td>Bombay Sensex</td>
<td>13162.73</td>
<td>21206.70</td>
<td>12514.90</td>
<td>-37.9%</td>
</tr>
<tr>
<td>Bovespa Index</td>
<td>45908.51</td>
<td>73920.30</td>
<td>45859.00</td>
<td>-37.9%</td>
</tr>
<tr>
<td>DJIA</td>
<td>10609.66</td>
<td>14198.10</td>
<td>10595.90</td>
<td>-25.3%</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>1156.39</td>
<td>1576.09</td>
<td>1155.88</td>
<td>-26.6%</td>
</tr>
<tr>
<td>FTSE 100 Index</td>
<td>4912.40</td>
<td>6751.70</td>
<td>4883.30</td>
<td>-27.2%</td>
</tr>
<tr>
<td>DAX</td>
<td>5860.98</td>
<td>8117.79</td>
<td>5818.36</td>
<td>-27.8%</td>
</tr>
<tr>
<td>Nikkei-225</td>
<td>11489.30</td>
<td>17488.90</td>
<td>11301.40</td>
<td>-34.3%</td>
</tr>
</tbody>
</table>

Source: Bloomberg.

Source: Bloomberg.
Some Essentials of Russian Stock Market Downfall.

- Russian stock market experiences one of the most drastic plunge: third after Ukrainian (- 70.6%) and Chinese stock markets (- 69.1%).
- Russian stock market decreased in a short period of time - 86 trading sessions.
- The market broke all key levels of support without any significant upward rebound: 2065, 1870, 1595, 1327 and the last 1069 (RTS marks).
- The fall was even worse than in 1997, though today Russian economy and companies fundamentally are in a much better shape.
- As a result, the capitalization of Russian market declined to 610.7 billion dollars or to 42% of Russian GDP.
- Different stocks plummeted as almost the companies were going to bankruptcy:
  - VTB share price decreased by 81.6% form peak - more than shares of Lehman Brothers or AIG.
  - Some of the stocks fell below their book values (Gazprom, Surgutneftegas, Sberbank, VTB).
- Russian regulators have intervened:
  - Federal Financial Markets Service closed exchanges for a while, forbade marginal trading and short selling.
  - CBR cut reserve requirements.
  - President and Ministry of Finance promised to support stock market.
- S&P revised long-term sovereign credit rating of Russian Federation and some banks to stable from positive.
Figure 1. Decline of Some Russian Stocks from Their Price Peak for September 17, 2008.

Source: Bloomberg.
Global Factors Which Caused Stock Markets to decline.

Chart 2. FRS Federal Funds Rate, ECB Refinancing Rate and BoE Official Rate in 2001-2008.

- **Tightening of monetary policy** by leading central banks in 2004-2007 led to:
  - Rising borrow costs.
  - Relative shrink of global liquidity.

- As a result, major world economies experienced a **deceleration of economic growth** since 2005 and some of them (Germany) got negative figures for second quarter of 2008.

- Markets began to price in future recession.

Source: Bloomberg.
Mortgage and credit crisis in the USA and Europe caused additional pressure at world stock markets including emerging ones due to severe liquidity problems in a leading American and some European banks and financial institutions.

- S&P/Case-Shiller home price index decreased by 18.5% since its peak in 2006.
- Rising homeowners defaults and foreclosures.
- Amounting credit losses and writedowns (table 2) led to periodical government-led risk plans for different financial institutions in the USA.
- Rising borrow costs despite injunction of additional liquidity by the central banks (recent overnight dollar LIBOR jump from 3.1% to 6.4%).
- CDS market is at stake.

### Table 2. Writedowns and Credit Losses Versus Raised Capital, billions of dollars.

<table>
<thead>
<tr>
<th>Area</th>
<th>Loss</th>
<th>Capital</th>
<th>Deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Worldwide</td>
<td>514.90</td>
<td>363.10</td>
<td>-151.80</td>
</tr>
<tr>
<td>Americas</td>
<td>260.60</td>
<td>184.10</td>
<td>-76.50</td>
</tr>
<tr>
<td>Europe</td>
<td>230.10</td>
<td>156.90</td>
<td>-73.20</td>
</tr>
<tr>
<td>Asia</td>
<td>24.20</td>
<td>22.10</td>
<td>-2.10</td>
</tr>
<tr>
<td>Total</td>
<td>1 029.80</td>
<td>726.20</td>
<td>-303.60</td>
</tr>
</tbody>
</table>

Banks

<table>
<thead>
<tr>
<th>Banks</th>
<th>Loss</th>
<th>Capital</th>
<th>Deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citigroup</td>
<td>55.10</td>
<td>49.10</td>
<td>-6.00</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>52.20</td>
<td>29.90</td>
<td>-22.30</td>
</tr>
<tr>
<td>UBS</td>
<td>44.20</td>
<td>27.60</td>
<td>-16.60</td>
</tr>
<tr>
<td>HSBC</td>
<td>27.40</td>
<td>5.10</td>
<td>-22.30</td>
</tr>
<tr>
<td>Wachovia</td>
<td>22.70</td>
<td>11.00</td>
<td>-11.70</td>
</tr>
</tbody>
</table>

Source: Bloomberg.
Declining commodity prices:
- Oil (Brent) - 37.6%.
- Nickel - 67.5%.
- Copper - 21.4%.
- Steel - 30.9%.
- Aluminum - 23.5%.
- CRY-Reuters Index - 27.9% from its peak.

Stock markets absorbed negative commodity price expectations.
Risk Aversion caused emerging markets capital outflow and flee to quality.

Chart 5. The Dynamics of Russian, Turkish and Brazilian Credit Spreads in 2008.

Source: Bloomberg.

<table>
<thead>
<tr>
<th></th>
<th>Brasil</th>
<th>Russia</th>
<th>India</th>
<th>China</th>
<th>Emerging Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>June</td>
<td>-157</td>
<td>562</td>
<td>-425</td>
<td>-1,603</td>
<td>-3970</td>
</tr>
<tr>
<td>July</td>
<td>-247</td>
<td>-429</td>
<td>-533</td>
<td>911</td>
<td>-1179</td>
</tr>
<tr>
<td>August</td>
<td>-192</td>
<td>-385</td>
<td>-4</td>
<td>161</td>
<td>-362</td>
</tr>
<tr>
<td>September</td>
<td>1</td>
<td>-103</td>
<td>-129</td>
<td>-335</td>
<td>-452</td>
</tr>
<tr>
<td>Total</td>
<td>-595.00</td>
<td>-355.00</td>
<td>-1,091.00</td>
<td>-866.00</td>
<td>-5,963.00</td>
</tr>
</tbody>
</table>


Source: MSCI, Bloomberg.

Source: EPFR Global.
Domestic Factors Which Led to Stock Market Crash.

- **Political risks:**
  - War in Georgia.
  - Current standoff between Russia, on the one side, and the USA and European Union, on the other side.

- **Liquidity:**
  - In January-August 2008 M2 grew by 7.1%.
  - Correspondent accounts balances of credit institutions in the CBR increased by 21.6% in 2008.
  - While Russian CDS as well as interbank, REPO and credit rates are rising:
    - Climbing inflation led to negative real yield in almost all segments of financial markets.
    - Some banks failed to meet REPO obligations.
  - In a narrow market any considerable sales of stocks by foreign portfolio investors and unit investment funds creates downward pressure.
  - Margin calls.

![Chart 7. Russian Credit Spreads Versus RTS Index in 2008.](source: Bloomberg)

Source: Central Bank of Russia.


Source: Central Bank of Russia, Bloomberg.

Source: Central Bank of Russia.


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Economic risks, which could lead to worsening economic situation in Russia:

- Simulative monetary police, which caused economic expansion at initial stage of recovery (1999-2004), today, when industrial capacities are almost at full use, causes inflationary pressure and leads to some economy overheating.
- Negative changes in the structure of Russian GDP (share of corporate net income is declining since 2004 while share of profit and import duties is rising - reflection of increasing state interference and tight fiscal policy).
- Lack of capital, machinery and skilled labour are becoming an obvious constraints of economic growth.
- Despite low level of foreign debt gross foreign debt of Russian companies and banks was rising quite fast (though it was hedged by their growing assets outside the country).
- Export growth was supported by rising commodity prices while there was physical growth of import followed by increased prices.
- Falling commodity prices caused a shrink of balance of payments surplus.
- Productivity is on rise, but it’s growth rate is lower than growth rate of disposable income.
- Inflation is becoming more and more a critical problem.
- Slow structural reforms.
- All these problems combined with current credit squeeze in Russia could cause a cyclical slowdown of Russian economy.

Growing corporate risks:

- TNK-BP and Mechel cases.
- Low level of corporate governance in Russian companies.
Valuation of Russian Stock Market.

- Drastic decline of Russian stock market fundamental values (P/BV and P/E).
- Russia became one of the cheapest emerging markets.
- Ratio valuation:
  - P/BV of 1.5 is equal to RTS index about 1667.
  - P/E of 8.5 is equal to 1603.
- Statistics:
  - Linear regression analysis - 1639 (RTS).
  - Rising standard deviation in 2008 and high correlation with MSCI EM and S&P ADR Indices and Russian Eurobond spreads imply high volatility.
- RTS fair value 1897.

Source: Bloomberg.
Figure 3. Comparison of Emerging Stock Market Indices by P/ BV, September 22, 2008.

Source: Bloomberg.
Figure 4. Comparison of Emerging Stock Market Indices by P/E, September 22, 2008.

Source: Bloomberg.
Technical analysis

- The long-term (since 2001) and mid-term (since 2005) upward trends were broken in July-August 2008.
- There is a short-term downward trend:
  - Current support levels (RTS index): 1178, 1060.
  - Current resistance level (RTS index): 1370, 1430, 1560.
  - Exponential moving averages.
    - RTS Index 21-day – 1413.
    - RTS Index 60-day – 1718.
    - RTS Index 200-day – 1935.
  - Current volatility range: 1178-1567.
- It’s a bear market.
- So far - no indications of possible switch of downward trend due to:
  - Investors are overburdened by expensive long positions.
  - Low trading volumes near dips.
  - Negative sentiments.
  - No sign of divergence.
- There is an opportunity of upward correction to a level of 1370-1390 in RTS index in a short run.
- Downward targets: 960-1060.
Scenarios
(based on combined fundamental, statistical and technical analysis for next 12 months)

1. **The worst-case scenario** – RTS index target **840-890 (− 35.1%)**:  
   ✓ Political tension between Russia and NATO will grow.  
   ✓ External economic environment will worsen (continuation of mortgage and credit crisis combined with a recession in the USA and EC).  
   ✓ Russian macroeconomic situation will worsen (GDP annual growth about 3%, disposable income will have a growth rate below 5%, diminishing surplus of balance of payments and federal budget).  
   ✓ Prolonged credit squeeze in Russia.  
   ✓ Oil prices will fall to a level of 60 dollars per barrel. Falling metal prices.  
   ✓ M2 annual growth - less than 15%.

2. **Neutral scenario** – RTS index target **1640-1690 (+ 30.5%)**:  
   ✓ Political tension between Russia and NATO will grow.  
   ✓ Mortgage and credit crisis in the USA and Europe will fade away. Mild or no recession.  
   ✓ Russian GDP annual growth rate 5-6%, disposable income 7-8%, balance of payment and federal budget surpluses will remain stable).  
   ✓ Oil prices will be above 70 dollars per barrel, stable metal prices.  
   ✓ M2 annual growth - 25%.

3. **The best-case scenario** – RTS Index target **1980-2030 (+ 56.7%)**:  
   ✓ Political stability and improved relations with the USA and EU.  
   ✓ GDP growth rate - 7%.
   ✓ M2 annual growth – 30% .  
   ✓ Oil price - 80 dollars, stable metal prices.
Closing Remarks.

- Stock market crash in Russia had not fundamental macroeconomic causes.
- The CBR intervention will maintain liquidity in financial system and help to stabilize a situation in the banking sector.
- Intervention of Russian regulators will support Russian stock market in a short-term period of time and will be short-lived.
- In turbulent international environment it will not help to stop exodus of portfolio investors, if the confidence does not restore and investment climate in Russia worsens.
- Administrative rules (like prohibition of short sales) in a long run will artificially cut volatility and lead to diminishing turnover in Russia and will increase ADR trading volumes in London.
- Possible buybacks and substitution of foreign investors by residents (like at GKO-OFZ market in 1999-2001) will help to switch downward trend.
- The crisis helped to discover risk-management problems in Russian financial institutions and the constrains of existing stock exchange technologies.
About IC RUSS-INVEST.

- Moscow-based company engaged in dealing, brokerage, custodian, trust, asset-management operations and corporate finance projects (holds five licenses issued by Federal Financial Markets Service in Russia).
- IC RUSS-INVEST is a member of RTS and MICEX stock exchanges.
- Net assets of IC RUSS-INVEST are equal to 174 million U.S. dollars (mid 2008).
- IC RUSS-INVEST has been among top 20 Russian investment companies in 2002-2007 in term of:
  - Equity & Reserves (2-3).
  - Net Income (1-3).
  - Assets (5-20).
- Credit rating (Fitch):
  - Long-term – “B”.
  - Short-term – “B”.
- Credit rating (National Rating Agency) – “AA-”.
- In 2007 IC RUSS-INVEST has been listed among top 500 Russian companies in terms of market capitalization (173) according to Expert Rating Agency.
- According to survey of “Expert” magazine IC RUSS-INVEST is one of five the fastest growing Russian companies.
- IC RUSS-INVEST was named as TOP-1 for the best corporate governance practices of Europe (small/medium cap) by technical criteria in 2006 edition of IR Global Rankings™.
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