



# Russia 2011-2012

## Lost in Transition or Preparing to Boom?

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- **Russia's economy is growing in 2011**  
*..... but data shows very disjointed progress*
- **Current growth is not sustainable longer term**  
*.....without a big increase in investment spending and effective business reforms*
- **There is a clearer consensus that change is critical**  
*.....crisis years has blown away illusions and complacency*
- **Investors are sceptical and are holding back**  
*.....too many false promises in the past.....its "show me the money" time*
- **Low investment is also partly because of global concerns**  
*.....but domestic economic and political uncertainties are also obstacles*
- **WTO entry will make a difference**  
*.....investors believe it is still on track for late 2011 or early 2012*

➤ **Oil advantage has been “used up”**

..... budget now needs (approx) \$100-\$110/bbl to balance & mainly for social spending

➤ **Economy needs a big pick up in investment**

.....poor perception of Russia as an investment location needs to be changed

➤ **Foreign expertise and experiences plus capital**

.....next decade growth may fall to between 2.5%-3.0% instead of the targeted 5.0%-5.5%

➤ **But, there is a clearer agenda and a greater sense of urgency**

.....there is a stronger consensus about what needs to be done

➤ **Hope is that 2011 is the last transition year**

..... If preparations are complete then Russia can look for an investment led boom '13-'18

➤ **Obvious danger is that “transition” is never completed**

.....in which case, there will be selected growth opportunities but no boom

## ➤ Higher oil has improved the fiscal and budget picture

..... FX reserves are back above \$500 bln

..... Federal Budget balances between \$100 - \$110/bbl (Urals)... YTD ave is \$108/bbl

## ➤ But capital flight is still continuing

..... surveys show that consumers/SMEs still have a low level of confidence

## ➤ Growth, to date\*, is still led by extractive industries

..... manufacturing is being hampered by higher taxes, a strong ruble and rising costs

## ➤ Mixed macro picture so far\*

..... retail sales rising by 5.6% YoY... selected success in industries such as autos

..... real disposable incomes are down 6.5% YoY

..... industrial production is up 4.5% YoY.... but 5.6% growth was expected

..... capital investment is rising slowly, up 2.2% YoY

..... unemployment unexpectedly increased at end April to 7.2%

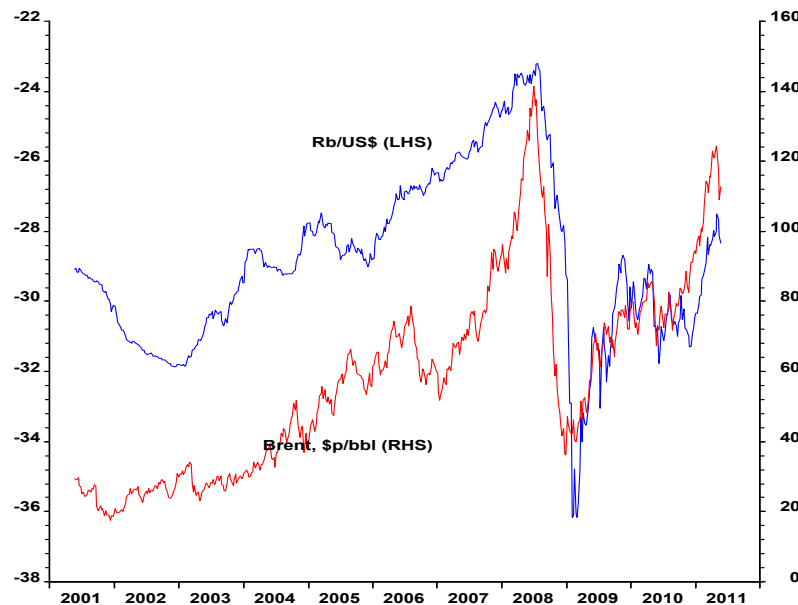
## ➤ Ruble reflects concerns about high oil revenue risk

..... The government will use currency rate targeting to help contain inflation

..... but ability to do so is hampered because of the perceived weak domestic story

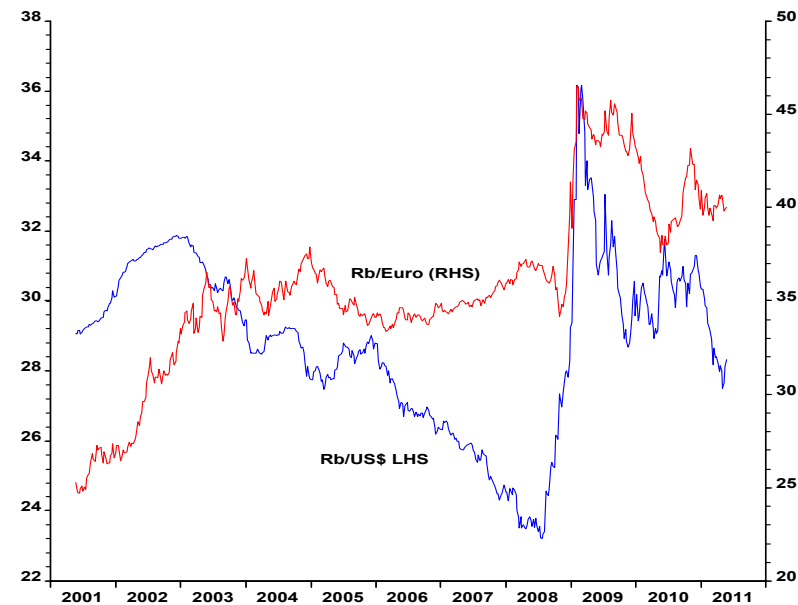
..... main currency driver is the trend in the dollar-euro market

### RB/US\$ -& Crude, \$ p/bbl



Source: DATASTREAM

### RB/US\$ -& Ruble/Euro



Source: DATASTREAM

## ➤ Forecasts for 2011 have been revised

..... *less optimistic despite higher oil*

### Russia's Macro Outlook:

#### Main macroeconomic indicators

	2010	2011 forecasts		
	Actual	USIB new	USIB old*	Official
GDP, YoY, %	4.0	4.3	4.6	4.2
Industrial production, YoY, %	8.2	4.9	5.1	5.4
Fixed investment, YoY, %	6.0	10.0	11.7	6.0
Retail sales, YoY, %	4.4	5.4	6.5	3.8
Real incomes, YoY, %	4.3	3.4	4.2	1.5
Employment, mln people	69.8	69.6	69.0	68.2
CPI, YoY, %	8.8	9.2	9.5	6.5-7.5
Exports, \$ bln	400.1	518.7	407.4	503.8
Imports, \$ bln	248.8	334.0	287.1	308.7
Current account, \$ bln	71.1	92.5	52.2	106.0
Federal budget deficit, % GDP	-3.9	-0.9	-1.5	-1.3
RUB/\$ (average)	30.4	28.6	29.4	28.4
Urals crude (average), \$/bbl	78.2	110.6	83.1	105.0

\*October 2010

Sources: Rosstat, CBR, MED, Uralsib estimates.

## ➤ Revisions

.... *GDP is cut to +4.3%*

.... *Retail sales growth scaled back*

.... *Unemployment staying higher*

.... *Inflation a little better but still +9.0%*

.... *Much better current account*

.... *Conservative budget assumption*

## ➤ Subject to constant scrutiny

..... *inflation impact*

..... *rising energy costs*

..... *unknown effect of QE ending and eurozone sovereign debt crisis*

..... *geo-political events create uncertainty, e.g. Mid East, North Africa, Japan, etc*

..... *china domestic policies*

<b>Growth Forecasts</b>	<b>2009 (actual)</b>	<b>2010 (actual)</b>	<b>2011</b>	<b>2012</b>
<b>World</b>	<b>-0.6</b>	<b>5.0</b>	<b>4.4</b>	<b>4.5</b>
<b>Developed countries</b>	<b>-3.4</b>	<b>3.0</b>	<b>2.5</b>	<b>2.5</b>
<b>Developing countries</b>	<b>3.6</b>	<b>7.1</b>	<b>6.5</b>	<b>6.5</b>
<b>China</b>	<b>9.2</b>	<b>10.3</b>	<b>9.6</b>	<b>9.5</b>
<b>United States</b>	<b>-2.6</b>	<b>2.8</b>	<b>3.0</b>	<b>2.7</b>
<b>Euro area</b>	<b>-4.1</b>	<b>1.8</b>	<b>1.5</b>	<b>1.7</b>
<b>Russia</b>	<b>-7.9</b>	<b>4.2</b>	<b>4.5</b>	<b>4.4</b>

## ➤ Russia was best major equity market in Q1

.....investors viewed Russia as an oil proxy

.....Russia also benefited from events in Japan, Mid East and North Africa

..... but seven of the top ten stocks were in the oil and gas sector...domestics mainly ignored

## ➤ Hopeful but waiting

*Russia is still a high-beta global market theme*

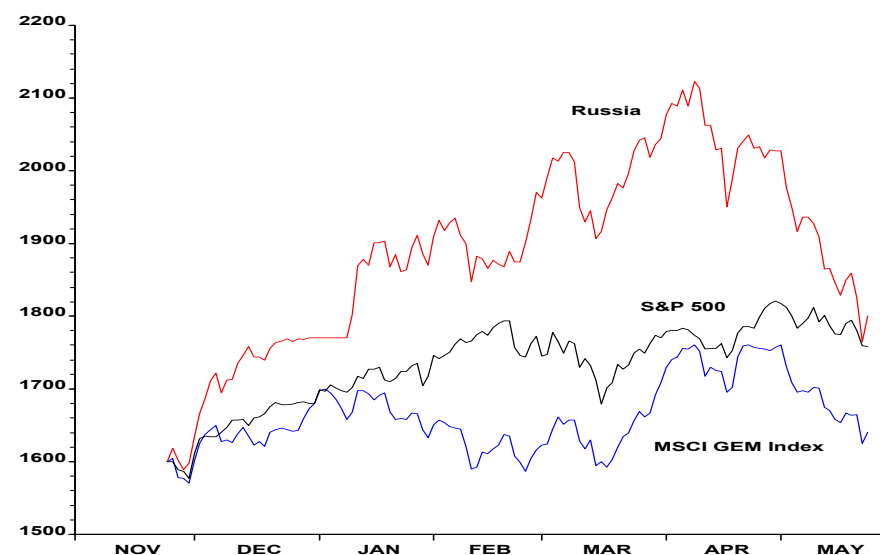
*concerns about continuing capital flight and a slow pick up in the economy outweigh fiscal and budget benefits of higher oil*

*perceived political risks*

*waiting for evidence of real progress in promised reforms, etc*

*steady stream of equity issuance is soaking up available cash – and causing concerns about valuations*

### Equities in 2011: Russia, GEM, S&P



Source: DATASTREAM

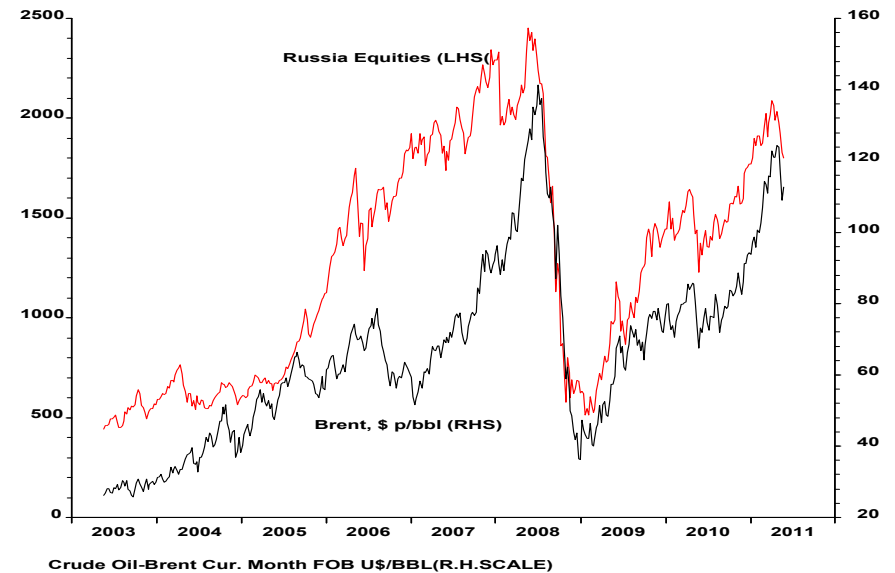


- **Until Russia starts to cut dependency on oil – the oil price will remain the biggest constraint for portfolio investors**

..... the memory of 2H '08 is still very clear



### Russia RTS and Oil Price



## ➤ **Russia funds attracted more new money than other EMs**

..... *Russia dedicated funds attracted \$4.5 bln over the first four months of 2011\**

..... *most other big emerging market (EM) country funds lost money*

## ➤ **Speculative ETFs dominate**

..... *over 70% of the new investment came via Exchange Traded Fund (ETF) instruments*

..... *most of that is using Russia as an oil theme or hedge*

..... *ETFs create a great deal of volatility and uncertainty – are short-term rather than long-term*

## ➤ **Portfolio investors are still over-weight Russia but now holding**

..... *investors are hopeful of the future but are waiting for evidence/actions*

..... *most still view Russia as a global recovery theme rather than as a strong domestic story*

## ➤ **In 2010 portfolio investors started to diversify**

..... *investors were more willing to add 2<sup>nd</sup> tier “domestic/infrastructure” names to portfolios*

..... *list of stocks in an average Russia portfolio has greatly expanded since 2008*

## ➤ **Mixed picture for 2011**

..... *five successful IPOs raised \$3,288 mln*

..... *five officially launched IPOs – worth \$3,980 mln - failed to attract investors*

.....*investor experience with Russian IPOs has, on average, been poor*

## ➤ **Still a significant mis-match between buyers and sellers**

.....*still in a buyers market*

.....*investors want a bigger discount to “cash-out” a core shareholder*

.....*greater interest in “new economy” companies rather than for extractive industries*

## ➤ **Very big demand from Russian issuers**

.....*possible demand of up to an additional \$15 bln in 2011*

.....*longer term need to raise approximately \$50 bln to restructure over-leveraged balance sheets*

## ➤ **State plans \$30 - \$50 bln privatizations**

..... *VTB SPO - \$3.3 bln in February – was first. Sberbank may be next in 2011*

..... *Still a lot of uncertainty over the programme*

## ➤ **Era of oil funded growth is ending**

.....*Russia earned approximately \$1.5 tln from oil & gas exports since 2000*

.....*Today, the budget needs \$100/bbl to balance*

.....*State industries dominate the economy – private enterprise is too small a share*

## ➤ **Investment will have to lead next decade's growth**

.....*Russia needs both foreign capital and, especially, foreign expertise to maintain growth*

.....*investment will have to come in industries outside of the state dominated sectors*

.....*this reality is a strong driver of the reform process and of WTO entry later this year*

## ➤ **Evolution is consistent with Putin's outline of development**

.....*Putin has been very consistent with basic goals for Russia's development*

.....*Putin's presidency focused on "preparation" – now its about "investment"*

## ➤ **Major obstacles, domestic and international, to be overcome**

.....*International investor perception of Russia is poor*

.....*Corruption, bureaucracy, poorly drafted legislation, demographics are major obstacles*

- **Average 3.0% annual growth without major new investment**
- **Demographic deterioration will have to be compensated with higher investment**

Uralsib long-term forecast, % YoY										
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
GDP	4,3	4,0	3,3	2,7	2,4	2,5	2,6	2,5	2,5	2,6
Industrial production	4,9	3,5	3,0	2,5	1,9	2,0	2,1	2,1	2,2	2,2
Retail sales	5,4	6,8	7,0	6,8	7,0	6,9	6,7	6,6	6,5	6,5
Real incomes	3,4	6,8	6,2	5,5	5,1	4,6	4,2	4,0	3,9	3,9
CPI	9,2	8,4	6,8	6,9	6,6	6,5	6,5	6,4	6,4	6,4
Federal budget deficit, % GDP	(0,9)	2,1	1,6	1,1	0,9	0,7	0,5	0,3	0,1	0,1
RUB/\$ (average)	28,6	28,7	28,7	29,5	30,2	31,0	31,9	32,9	34,0	35,1
Urals crude (average), \$/bbl	110,6	108,1	110,1	111,9	114,2	116,5	118,8	121,2	123,7	126,2

Source: UralSib Research

## ➤ **Crisis has led to greater urgency and pragmatism**

.....*There were almost no mechanisms in place to support Medvedev's plan in 2008*

.....*Only as a result of the long crisis – and its revelations – have attitudes changed*

## ➤ **Government is more focused on efforts to attract investors**

.....*Much more aware of the PR disasters of the last decade*

.....*WTO entry is now a high priority*

.....*Russia needs foreign management expertise*

## ➤ **Progress is slow but following a clearer path**

.....*Don't expect any major changes until after the next government is formed*

.....*Legislation and bureaucracy still need to be changed*

.....*major problem is that "people in charge" are state, not private sector, orientated*

## ➤ **For the next administration it should be a case of "one-step forward and two or three sideways". Better than the "one-step forward and four or five sideways" of the last decade.**

## ➤ **Putin has been consistent about his basis goals for Russia**

Inherited a country in chaos

Believes in a step-by-step orderly development

Recognises that Russia needs both international capital and expertise

## ➤ **Fix problems, then attract investors**

First term priority was regaining political control

Second term priority was establishing control over strategic industries & setting investment rules

Medvedev's presidency was to mark the start of the "investment" phase

This step-by-step progress has slowed pace of change up to now

## ➤ **Legacy problems hard to shake off**

High profile negative publicity. YUKOS is far from over

Investment concentration is still on oil & gas and in state sectors generally

A lack of consensus at the top of government over key economic and investment priorities

Administration is still dominated by "old school" administrators and "old school" attitudes

## ***\*As set out in his April address in Magnitogorsk***

1. lower the cost to businesses of employing staff
2. introduce a mechanism for examining complaints and allegation of corruption against state agencies
3. Dept of Economic Development will get new powers to propose the repeal of any regulations that obstruct business and investment activity
4. each federal district in Russia will get an investment ombudsman whose job it will be to assist companies to carry out investment projects
5. ban the practice where state officials responsible for industry regulation also sit on the boards of companies operating in those industries
6. minority shareholders to get better access to information about the companies in which they have invested
7. set up a \$10 bln direct investment fund that will co-invest with foreign investors in major projects in Russia
8. reduce the scope and definition of so-called strategic industries that have preferential protection in Russia
9. drastically improve the quality of services provided to business in Russia, e.g. customs, postal services, visa and work permit issuance, etc.
10. set up mobile reception offices across the country so that people may direct their complaints and concerns directly to a representative of the Russian President.

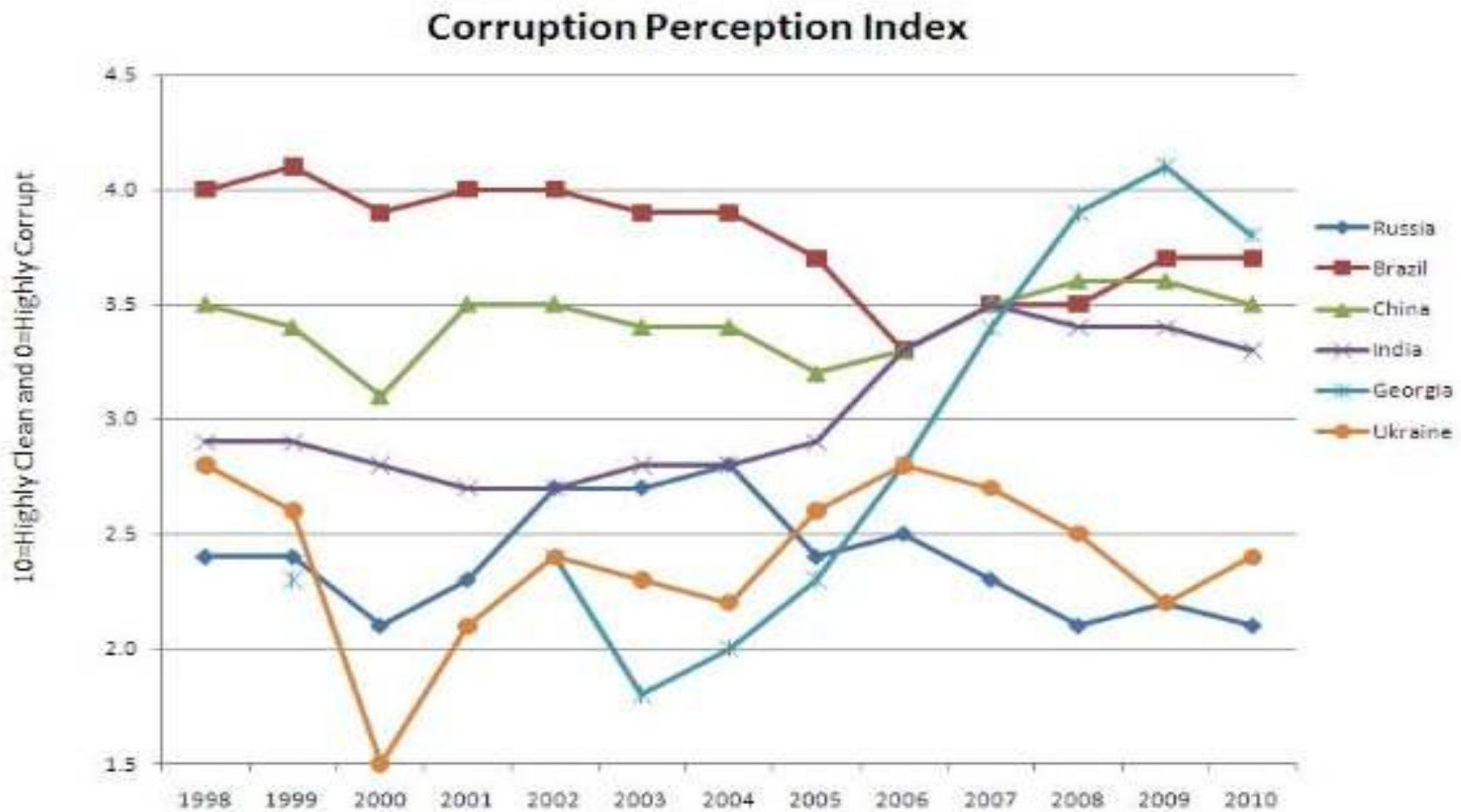


## ➤ **Key investment priorities over the medium term include;**

- 1. *Moving up the value chain in raw material industries – refineries, petro-chemicals, LNG, smelters, timber processing plants, etc***
- 2. *Investment in basic infrastructure – electricity, gas, communications, transport***
- 3. *Event driven projects, e.g.***
  - 1. *APEC Forum - 2012***
  - 2. *Kazan University Games - 2013***
  - 3. *Sochi Winter Olympics and Grand Prix – 2014***
  - 4. *World Cup - 2018***
- 4. *Import substitution, e.g. agriculture, pharmaceuticals, food processing and basic technologies***
- 5. *Financial market/services***
- 6. *Health care and education***
- 7. *Leisure industries – including Sochi***

- **Corruption & cumbersome bureaucratic procedures**
- **Poor legal protection and redress**
- **Skilled workers have been lost and education standards have fallen**
- **Very poor productivity from existing industries**
- **Federal revenues are critically dependent on oil & gas**
- **Poor “PR” in western markets**
- **Deteriorating demographics**
- **Role of SMEs in economy is too small**
- **Middle class sector is increasing but still small**
- **Wealth gap remains very high**

# Corruption is Getting Worse



Source: Transparency International Annual Corruption Index report

## ➤ **Economically active population keeps shrinking**

.....a more than 10% decline is expected in 2010-2020

.....*that can destroy between 1.0% and 1.5% of GDP in the 2013-2018 period*

## ➤ **Government can no longer afford to ignore demographics**

.....a likely increase in retirement age

.....a more flexible migration policy

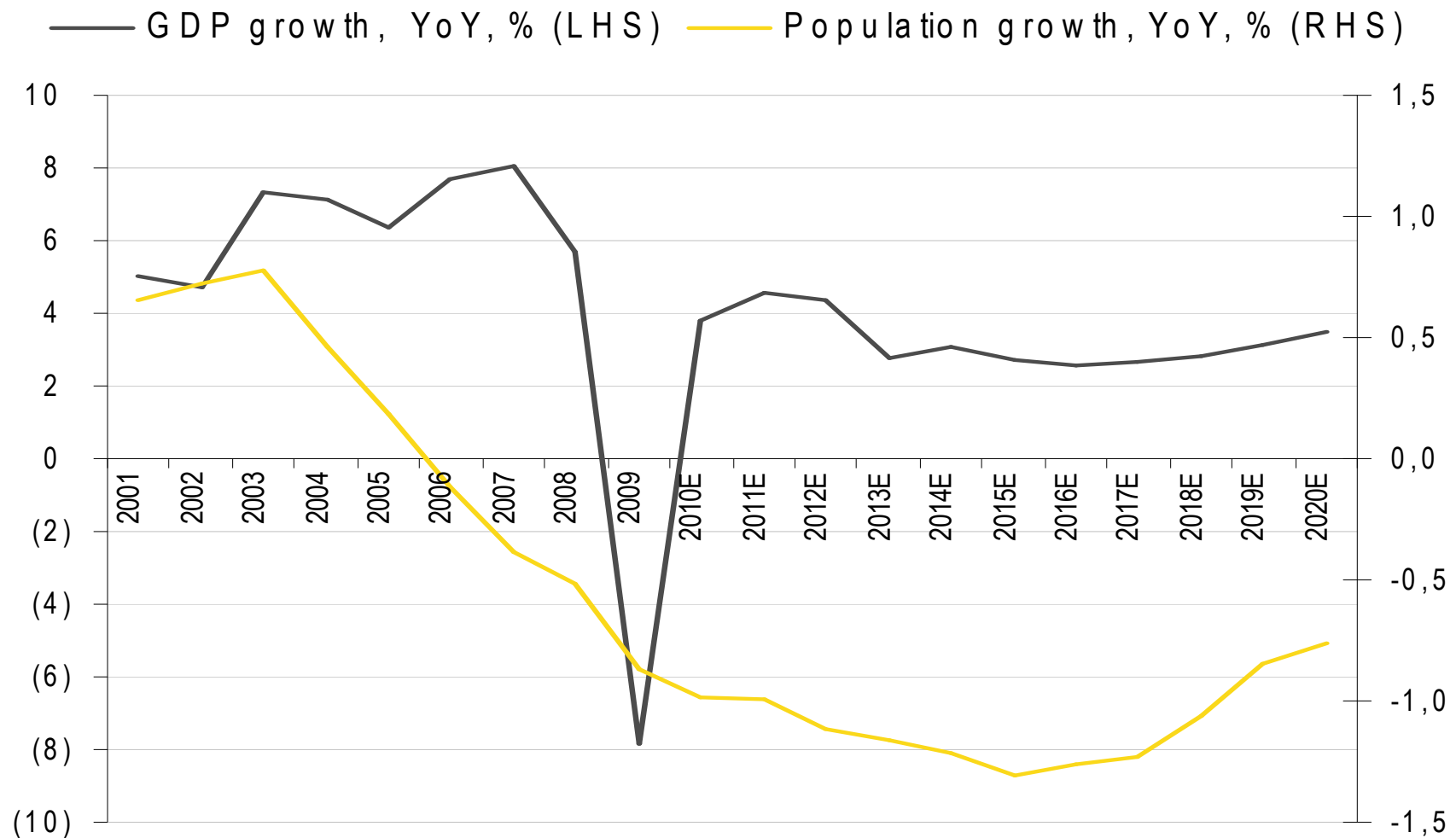
.....possible pension cuts

## ➤ **Next government will have to make unpopular decisions**

.....after the current election cycle and new government takes office

.....but very early in the life of the next government

## Economically active population and growth dynamics



## ➤ **High commodity dependency**

- Corruption is ranked among the worst in the world.....Russia fell further in the 2010 survey\*
- Highly dependent/vulnerable to imported food (30%+ of consumption), medicines and technology.
- Agriculture is very inefficient , e.g. over 20 mln hectares of arable land are currently idle and productivity in the sector is less than 50% of the EU average.\*\*
- Key infrastructure (e.g. electricity) has suffered from decades of under investment.
- Small- and medium-sized enterprises make up only 15-20% of the economy\*\*, i.e. versus 50-70% in a developed economy.\*\*\*
- Wealth gap is still very high. The richest 10% of the population account for 31% of total income and the poorest only 1.9%.\*\*\*
- Bureaucracy, red tape and a lack of effective legal protection for investors/business is regularly cited in surveys.
- Workforce is shrinking.
- Demographics still poor – population is still on a declining trend, albeit the trend has recently stabilized
- Pensions liability is growing
- Investor perception of Russia is very poor – that limits the pool of available investors.

## ➤ **Still moving forward**

- Putin chose a reformer to be his successor – government is committed to long-term reforms.
- Reform momentum is picking up – WTO entry in 2011/12 after seventeen years of dithering/opposition
- Russia has adopted a more benign foreign policy in order to help attract greater foreign investment flows
- Country has world's third largest financial reserves – has daily oil & gas revenues of almost \$1 billion\*
- Reserve (budget deficit) Fund is still worth close to \$28 bln and Wellbeing fund is worth \$94 bln.\*\*\*\*
- World's biggest metals producer/exporter.\*\*
- World's biggest energy producer/exporter.
- Population is largest in Europe – birth-death balance is now close to stabilizing
- Current average income per capita is steadily raising towards the EU average will provide opportunities for investors.
- Expected to be Europe's largest car and largest mobile phone market within two-three years.\*\*\*
- Geographically well positioned.
- Global status is important – a powerful incentive to work within accepted rules.
- People want a better lifestyle – no going back.

# Macro Trends

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011F	
												UralSib	Govt
GDP \$ bln	251	312	355	433	580	764	989	1,289	1,671	1,231	1,526	1,729	
YoY, %	10.0	5.1	4.7	7.3	7.1	6.4	7.4	8.1	5.6	-7.9	4.0	4.3	4.2
Federal budget Surp/Deft, % of GDP	1.4	2.4	1.4	1.7	4.3	7.5	7.4	5.4	3.7	-5.9	-3.9	-0.9	-1.3
Industrial prod. % YoY	11.1	4.9	4.0	7.3	6.4	4.0	6.3	6.3	2.1	-10.8	8.2	4.9	5.4
Capital investment, % YoY	17.7	8.7	2.6	12.5	11.7	10.7	13.5	21.1	9.1	-17.0	6.5	10.0	6.0
Current account, \$ bln	46.3	34.8	29.8	35.8	60.0	84.2	94.5	76.6	98.9	49.0	72.6	92.5	106.0
Trade balance, \$ bln	60.7	49.6	46.6	60.4	87.0	118.0	139.2	146.4	180.2	114.2	149	185	195
FDI, \$ bln	4.4	4.0	4.0	6.8	9.4	13.1	13.7	27.8	27.0	15.9			
Retails sales, % YoY	9.0	11.0	9.3	8.8	13.3	12.8	13.0	15.2	13.0	-5.5	5.8	5.4	3.8
Ruble/\$1 rate, year-end	28.1	30.1	31.8	29.5	27.7	28.1	26.3	24.55	29.39	30.19	28.1		
Ruble/\$1 rate, average	28.1	29.2	31.4	30.7	28.8	28.3	27.2	25.58	24.85	31.7	30.4	28.6	28.4
CPI, % change YoY	20.2	18.6	15.0	12.0	11.7	11.0	9.0	11.9	13.3	8.8	8.8	9.2	7.0
CBR reserves, \$ bln	28.0	36.6	47.7	76.9	124.5	182.0	303.7	476	427	439			
Foreign debt, \$ bln	144	135	122	112	98	85	52	48.9	40.5	42.3			
% of GDP	57.1	43.4	34.4	25.9	16.9	11.1	5.3	3.8	2.4	3.4			
Oil Price - Brent \$/bbl	28.9	24.7	25.2	28.8	38.2	55.0	65.0	72.7	97.0	63.0			
-Urals \$/bbl	26.5	22.9	23.0	27.2	34.2	51.5	61.0	69.8	94.7	61.3	78.2	110.6	105.0
-Population mln	145.5	145.3	145.2	144.7	143.5	143.0	142.5	141.7	141.9	141.1	140.9	140.9	
GDP per capita US\$	1,725	2,140	2,445	2,992	4,042	5,314	6,912	9,097	11,776	8,724	10,830	12,271	



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