

**MERRY CHRISTMAS AND HAPPY NEW YEAR**
**Market Wrap**

The market gathered pace last week, struggling around 1100 points until Wednesday, but then accelerating to touch 1140 points at Friday lunchtime, before settling at 1126.09 points for the weekend close. Volumes also grew later in the week, exceeding \$50m on both Thursday and Friday.

Lukoil was the biggest trader, but lost 1.4% as oil prices flagged and investors migrated to the big government-owned stocks for a winter holiday haven: Sberbank prefs rose 11.4% and Transneft prefs were 11.2% higher, both on large volumes.

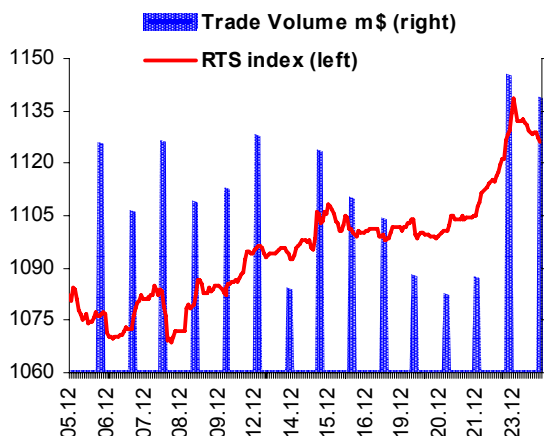
Norilsk was the other big winner last week. The stock was keenly traded and rose 4.9%, helped by its investment-grade rating from Fitch.

Lukoil was not the only blue chip to prove unpopular last week. UES fell 0.4% on unusually low volumes (it was out-traded by Sberbank), and Surgut prefs fell 1.2% on over \$10m trading.

While the urge to play safe was uppermost, some players were willing to take a risk before New Year: shares of Yukos jumped 14.7%, apparently due to a court decision, which reduces chances that the rest of the company will be snapped up by Rosneft. Rumors that Gazprom will buy the Yukos stake in Sibneft were also a factor.

Some further gains up to the New Year are possible, as investors will want to end the year with the best possible portfolio values. Schedule for the work of RTS on holidays has not been set yet.

*Note: Our next Market Weekly will be on January 16, 2006. Nice holidays to everyone!*

**RTS Index & Volume**

**Key Figures**

|                  |          |        |
|------------------|----------|--------|
| RTS Index        | 1 126.09 | 2.43%  |
| RTS Volume (\$m) | 156.73   | -3.16% |
| Ruble / Dollar   | 28.84    |        |

Int'l Reserves (Dec 16) \$171.3b

Weekly data Fri-Fri.

**Winners**

|                         |        |
|-------------------------|--------|
| Russkiye Samotsvety com | +30.9% |
| Iletsksol com           | +25.7% |
| Yukos com               | +14.7% |
| Open Investments com    | +13.6% |
| Sberbank pref           | +11.7% |
| Transneft pref          | +11.2% |

**Top Volumes (\$m)**

|                      |              |              |
|----------------------|--------------|--------------|
| Lukoil com           | 33.8         | 21.5%        |
| Norilsk Nickel com   | 31.5         | 20.1%        |
| Sberbank com         | 20.4         | 13.0%        |
| RAO UES com          | 16.4         | 10.5%        |
| Transneft pref       | 13.0         | 8.3%         |
| Surgutneftegaz pref  | 10.3         | 6.5%         |
| Sberbank pref        | 4.4          | 2.8%         |
| <b>Total (Top 7)</b> | <b>129.8</b> | <b>82.8%</b> |

**Losers**

|                           |        |
|---------------------------|--------|
| Novosibirsk Tin Plant com | -19.3% |
| Sverdlovenenergo com      | -17.6% |
| RITEK pref                | -12.4% |
| Rostovenergo pref         | -9.3%  |
| Mechel com                | -7.7%  |
| Aviastar com              | -6.8%  |

**Sector Statistics**

| Sector Name     | Volume \$          | MC\$'000           | % of MC        | Change -week | Change -month | Change -year   |
|-----------------|--------------------|--------------------|----------------|--------------|---------------|----------------|
| Oil & Gas       | 63 981 582         | 157 542 877        | 47.80%         | 0.71%        | 6.70%         | 78.59%         |
| Metals          | 35 022 679         | 41 612 093         | 12.63%         | 2.38%        | 4.51%         | 139.76%        |
| Banks           | 26 210 768         | 28 246 870         | 8.57%          | 9.01%        | 23.22%        | 192.65%        |
| Power Utilities | 17 954 360         | 35 500 781         | 10.77%         | 0.10%        | 10.63%        | 41.90%         |
| Telecom         | 9 960 610          | 41 591 897         | 12.62%         | 3.10%        | 1.25%         | 229.28%        |
| Engineering     | 1 639 781          | 5 402 330          | 1.64%          | 3.51%        | 12.83%        | 78.43%         |
| Chemicals       | 808 486            | 7 263 654          | 2.20%          | 0.07%        | 4.79%         | 173.67%        |
| Retail          | 633 135            | 8 702 166          | 2.64%          | 1.32%        | 1.99%         | 142.88%        |
| Others          | 412 184            | 1 559 329          | 0.50%          | 14.85%       | 36.05%        | 919.82%        |
| Transportation  | 101 435            | 2 081 363          | 0.63%          | -2.75%       | 8.98%         | 19.45%         |
| <b>Total</b>    | <b>156 725 020</b> | <b>329 590 264</b> | <b>100.00%</b> | <b>1.93%</b> | <b>7.41%</b>  | <b>100.93%</b> |

**VIEWPOINT: STATE-OWNED OIL & GAS: THE FUTURE OF THE MARKET?**

Whatever political analysts and economists may say, investors are bound to be pleased with Russia in 2005. The RTS Index has risen from 600 to over 1100 points in 12 months, making Russia the best performing market of major significance in the world this year. Where do we go from here?

From our current vantage point, there are two obvious market landmarks in 2006. The first is Gazprom share market liberalization, which will go live in mid-January immediately after Russia's extended New Year holidays.

It would be hard to find anyone less suited to play Santa, but Vladimir Putin was clearly trying himself in that role on the day before Christmas Eve when he signed legal amendments to the law "On gas supply", which liberalize trading in Gazprom shares.

There is no guarantee that stock prices of the gas giant will rise quickly in the new conditions: there was almost no price reaction to the Friday news on the St Petersburg Exchange, and we are agreed with many analysts in finding Gazprom generously valued at current levels.

It looks as if the RTS will continue its current arrangement, trading via St Pete, but arrival of the stock on the MICEX will make it more mainstream for onshore investors. As we calculate (see Oil in this Weekly), the current, official ADS volume plus over 20% traded in gray schemes mean that foreigners get access to an extra 15% of the company's stock thanks to the liberalization.

The other obvious landmark for 2006 on the share market is the Rosneft IPO, which is supposed to happen next summer. Indications in recent months suggest ballpark value of the IPO around \$10b.

The Gazprom and Rosneft actions clearly have big potential for expanding Russian share trading volumes. And foreign investors, who buy these

stocks, will presumably also be interested in diversifying their Russia risk by investment in other companies, spreading the benefit across the market (some brand new opportunities on the RTS have been presented in our recent series of stock metrics).

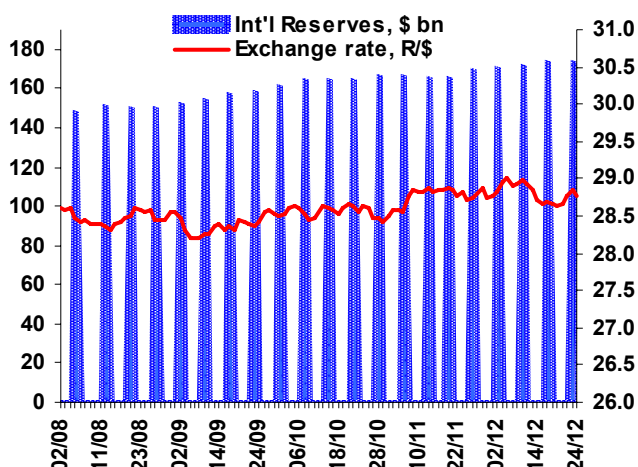
However, we do not see triumphant progress as guaranteed in 2006, as least not based on Gazprom and Rosneft alone. The main problem could be clumsiness in implementation and presentation. We have seen instances of this even before the New Year begins.

On the same day as Putin gave investors the gift of free trading in Gazprom, Russian TV showed the company CEO, Alexei Miller, giving a demonstration of how gas supplies to Ukraine will be shut off from January 1 if agreement on major price rises is not reached. The implications of such a development for Gazprom and its European customers, who receive most of their gas across Ukraine, would be dire. The spectacle was both unwise and gratuitous on a day, when investors and international media should have been focused on a positive image of Gazprom.

Also last week Russia's Federal Service for Financial Markets warned that it may reduce the limit on share capital that can be go abroad in depositary receipts from 40% to 30%. The idea is to foster growth of an onshore market, but (again) the timing was bad: Gazprom said last week that it will seek to increase the allowable volume of its depositary receipts to the maximum next year. Investors, who are now looking at Rosneft prospects in 2006, will also have been worried.

Popularity of "government-backed" stocks has been evident on the RTS in recent months. But the kind of strategy collisions just described is further proof that a proper stock market has to be dominated by private companies.

### Economic Indicators



Source: CBR

### CBR reserves jumps over \$170b

The CBR reported last Thursday that Russia's foreign currency and gold reserves increased to \$171.3bn in the week from December 9 to December 16.

Total growth since the beginning of the year has been \$46.8b or 37.5%.

#### CBR reserve dynamics

|                             | Dec 16 | Dec 9 | Dec 2 | Nov 25 | Nov 18 |
|-----------------------------|--------|-------|-------|--------|--------|
| Gold & Forex Reserves (\$b) | 171.3  | 169.1 | 168.4 | 167.2  | 163.3  |
| Weekly Change               | 1.3%   | 0.4%  | 0.7%  | 2.4%   | 0.1%   |

Source: CBR

### Narrow monetary base rose to R2104b

The narrow monetary base in Russia rose by 1.9% to R2103.5b as of December 19 from R2063.6b a week earlier, according to the CBR.

The narrow monetary base includes cash in circulation (including cash held at credit institutions) and balances on banks' required local-currency-deposit reserve accounts with the Central Bank.

The narrow monetary base has risen by 28% since the beginning of the year.

#### CBR money supply reports for the last five weeks

|                           | Dec 19 | Dec 12 | Dec 5  | Nov 28 | Nov 21 |
|---------------------------|--------|--------|--------|--------|--------|
| M1 Narrow Definition (Rb) | 2103.5 | 2063.6 | 2015.9 | 2023   | 2037.7 |
| Weekly Change             | 1.9%   | 2.4%   | -0.4%  | -0.7%  | 0.9%   |

Source: CBR

### CPI inflation should be 11-11.2% in 2005

Andrei Illarionov, the economic advisor to President Putin, said at a press conference that he expects full-

### Key Macro Figures

|                         |         |            |
|-------------------------|---------|------------|
| CBR refinancing rate, % | 12      | 26.12.2005 |
| M2, Rbn                 | 5 314.0 | 01.11.2005 |
| M0, Rbn                 | 1 752.0 | 01.11.2005 |
| CPI, %                  | 0.7     | 01.12.2005 |
| Inter'l Reserves, \$bn  | 171.3   | 16.12.2005 |
| One-day MIACR, %        | 3.39    | 23.12.2005 |
| Exchange rate R/\$      | 28.84   | 23.12.2005 |
| Exchange rate R/euro    | 34.11   | 23.12.2005 |
| OFZ yields, % p.a.      | 5.47    | 23.12.2005 |
| GKO-OFZ duration, days  | 1884.47 | 23.12.2005 |
| Eurobonds Russia 07 YTM | 4.960   | 26.06.2007 |

year inflation to be 11-11.2% y-o-y in 2005, down from 11.7% in 2004.

Figures from the Ministry of Economic Development and Trade (MEDT) show that, despite decline of inflation in the past years, the balance between main CPI components has remained unchanged: non-monetary factors (tariffs for natural monopoly services) contribute about 40% of total inflation, and monetary factors contribute 60% (including about 21% due to growth of nominal disposable incomes and about 25% due to money supply increase).

#### Contribution of various factors to CPI in 2005

|                        | Initial target | Expected figure  | Exceeding      |
|------------------------|----------------|------------------|----------------|
| <b>CPI</b>             | <b>8.5</b>     | <b>11.0-11.5</b> | <b>2.5-3.0</b> |
| - monetary factors     | 5.4            | 6.8-7.2          | 1.4-1.8        |
| - non-monetary factors | 3.1-3.3        | 4.2-4.3          | 1.0-1.1        |
| - others               | -0.3-0.0       | 0.0              | 0.0            |

Source: MEDT

A preliminary estimate by the MEDT suggests that CPI in the first 19 days of December was 0.5%, which is twice lower than in the same period of 2004. December inflation will very probably be less than 1%, so Illarionov's full-year range of 11-11.2% seems reasonable.

The official inflation target for 2006 is 8.5%

### CBR lowers refinancing rate to 12%

The CBR reported lowering of its refinancing rate to 12% as from December 26. The previous figure of 13% was set on June 15, 2004. Earlier, the first deputy chairman of the CBR, Alexei Ulyukaev, said that the CBR would cut its interest rate by 0.5 percentage points this year to 12.5% in order to support economic growth. In fact, the full-year reduction has been one percentage point.

The fact that the CBR lowered the interest rate before the end of the year, and by more than expected, shows the urgency of galvanizing GDP growth. But it also suggests that the CBR is satisfied with the full-year inflation figure, which we find hard to understand (the government gradually raised its 2005 inflation target from initial 8.5% to current 11-11.5%).

## Finance Ministry adjusts 2006 budget revenues

Adjusted parameters for economic development in 2006-2008, presented by the MEDT, suggest that the Finance Ministry has increased its estimate of 2006 federal budget revenues by R328.7b (approximately \$11.5b). All other parameters remain unchanged and are as in the table below.

### 2006 federal budget figures

|              | Rb              | \$b          | % of GDP     |
|--------------|-----------------|--------------|--------------|
| Revenues     | 5374.8          | 187.9        | 22.0%        |
| Expenditures | 4270.1          | 149.3        | 17.5%        |
| Surplus      | 1104.7          | 38.6         | 4.5%         |
| <b>GDP</b>   | <b>24 380.0</b> | <b>852.4</b> | <b>100.0</b> |

Source: Finance Ministry

## Stabilization Fund should total R1450b by end of year

The finance minister, Alexey Kudrin, said that the Stabilization Fund should reach about R1446b (approximately \$50.5b) or 6% of GDP by the end of 2005. This figure may be lower depending on the outcome of negotiations with creditor countries on possible \$3-5b foreign debt repayment in coming days.

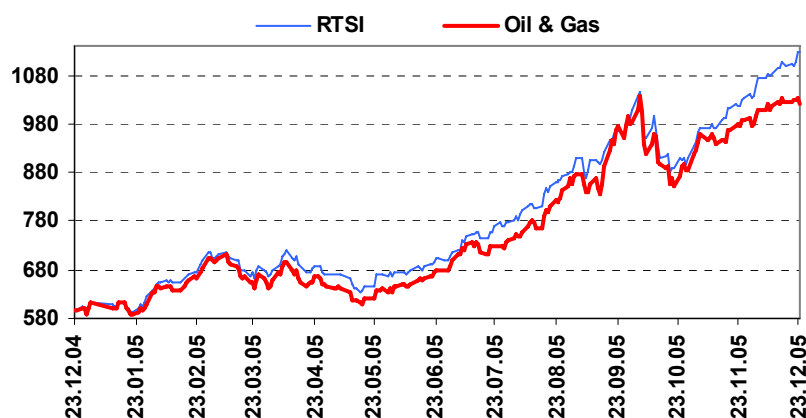
On December 1 the Stabilization Fund contained \$1236.5b (about \$43.2b), having risen by 137% or R714b (approximately \$25b) since the start of the year.

Alexei Kudrin said that the Stabilization Fund should not be spent on anything except foreign debt and that the cut-off level for oil prices, above which extra revenues from tax on oil exports are paid to the Fund, should not be raised.

### Stabilization Fund forecast 2006-2008

|                         | 2005E  | 2006F  | 2007F  | 2008F  |
|-------------------------|--------|--------|--------|--------|
| Stabilization Fund, Rb  | 1446.0 | 2638.8 | 3239.4 | 3900.4 |
| Stabilization Fund, \$b | 50.2   | 91.7   | 112.6  | 135.5  |

Source: Finance Ministry

**Oil & Gas Index vs. RTS Index**

**Oil & Gas Key Figures**

| Indicator                                     | Value | Wk Change |
|---|-------|-----------|
| Urals (\$/b)                                  | 53.4  | -0.1%     |
| Brent (\$/b)                                  | 56.7  | -0.8%     |
| OIX (CBOE oil index)                          | 530.5 | 0.2%      |
| Dow Jones Energy Index                        | 430.1 | 0.0%      |
| US crude inventory change (EIA data) m bbl    | 322.5 | 0.4%      |
| US gasoline inventory change (EIA data) m bbl | 204.1 | -0.1%     |
| Tatneft ADR                                   | 67.8  | -2.7%     |
| Lukoil ADR                                    | 60.0  | -2.0%     |
| Surgutneftegaz ADR                            | 53.0  | -1.6%     |
| Yukos ADR                                     | 7.9   | 15.1%     |
| Sibneft ADR                                   | 18.8  | 1.3%      |

**Sector Wrap**

- Russneft bought the production company Saratovneftegaz, the oil refinery Orsknefteorgsintez, the tank farm and gasoline retail company Orenburgnefteprodukt, the lubricants producer Neftemaslozavod from TNK-BP and 75% of shares in Krasnodareconeft.
- Sibneft won an auction for rights at the Elleisky block in Tomsk region. The company agreed to pay R294m (\$10.3m) to obtain a license for development at Elleisky.
- Rosneft outbid Surgutneftegaz and Sibneft in an auction to develop the East Sugdinsky oil & gas field in Siberia's Irkutsk region. The company offered \$260m for rights to explore and develop the deposit, whose possible reserves are 42bcm of gas and 1.5b bbl of oil.
- Newport Capital, which owns a 1.5% stake in Rosneft's subsidiary, the Komsomolsk Refinery, has sent a letter to the Rosneft BoD, complaining that appraisal of company shares by Deloitte and Touche is seriously below fair value. Komsomolsk valuation is absurd on the background of high profitability of the oil refining business, and also considering future deliveries of crude oil from Sakhalin projects.
- Russian President Vladimir Putin signed the law "On gas supply" last Friday, removing the 20% barrier for foreign ownership, so that foreign investors will be able to buy Gazprom shares on the Russian domestic market as well as buying depository receipts outside Russia.

**Sector Statistics**

| Issue                    | Issue RTS Code | Mid Market Price, \$ | Weekly Change, % | Weekly Volume, \$mln | Market Cap, \$mln | 52 week Low, \$ | 52 week High, \$ | P/S 04 | P/E 04 |
|--------------------------|----------------|----------------------|------------------|----------------------|-------------------|-----------------|------------------|--------|--------|
| Lukoil com               | LKOH           | 60.200               | -1.4             | 33.766               | 51 165.83         | 28.700          | 61.800           | 2.60   | 12.79  |
| Megionneftegaz com       | MFGS           | 41.500               | -1.2             | 0.104                | 5 434.40          | 18.000          | 48.000           | 5.14   | 173.44 |
| Megionneftegaz pref      | MFGSP          | 36.050               | -2.6             | 0.083                |                   | 10.500          | 37.700           |        |        |
| Sakhalinmorneftegaz com  | SKGZ           | 14.375               | 9.3              | 0.069                | 1 049.49          | 5.850           | 14.000           | 3.95   | 33.21  |
| Sakhalinmorneftegaz pref | SKGZP          | 10.200               | 6.3              | 0.760                |                   | 3.800           | 10.500           |        |        |
| Sibneft com              | SIBN           | 3.780                | 1.9              | 1.060                | 17 685.05         | 2.900           | 4.050            | 2.96   | 8.01   |
| Surgutneftegaz com       | SNGS           | 1.081                | 0.6              | 1.623                | 45 456.63         | 0.660           | 1.120            | 5.37   | 34.44  |
| Surgutneftegaz pref      | SNGSP          | 0.900                | -1.2             | 10.262               |                   | 0.512           | 0.921            |        |        |
| Tatneft com              | TATN           | 3.425                | -2.0             | 0.673                | 7 545.20          | 1.430           | 3.950            | 1.58   | 20.39  |
| Tatneft pref             | TATNP          | 2.150                | -0.5             | 0.131                |                   | 0.760           | 2.440            |        |        |
| Udmurzneft com           | UDMN           | 562.500              | 0.0              |                      | 1 206.65          | 260.000         | 360.000          | 2.56   | 100.55 |
| Udmurzneft pref          | UDMNP          | 440.000              | 19.7             |                      |                   | 160.000         | 510.000          |        |        |

**Russneft buys TNK-BP (BUY com, HOLD pref) assets**

Russneft bought the production company Saratovneftegaz (RTS: SNFG: N/R; SNFGP: N/R), the oil refinery Orsknefteorgsintez (RTS: ORFE: N/R; ORFEP: N/R), the tank farm and gasoline retail company Orenburgnefteprodukt (RTS: ORNE: N/R; ORNEP: N/R), and the lubricants producer Neftemaslozavod from TNK-BP (RTS: TNBP: \$3.10 BUY; TNBPP: \$2.48 HOLD) for an undisclosed price, which we estimate at \$0.9-1b. The assets minus Orsknefteorgsintez were valued at \$476m earlier this year, before TNK-BP consolidation, but the final price should be higher due to current high prices for crude oil and oil products. If our estimate is correct, we see the sale as positive for TNK-BP, since profitability of the assets was below the average level for the holding.

We value Saratovneftegaz (with daily production of 42 000 barrels of oil equivalent and 163 million boe of proven and probable reserves) no lower than \$500m, which is 20% higher than its current MCap. The value of Orsknefteorgsintez based on current refining of 3.6mt per year is about \$250m, but we believe that the company could increase refining to 6.7mt, and therefore value the refinery at \$400m. Orenburgnefteprodukt has 101 filling stations and 37 oil tank farms, and we believe that the company has potential for growth, but it looks a little overvalued based on EV/Filling station at 1.3x. We suggest that the company's fair value is about \$110m. We believe that fair value of Neftemaslozavod is not far from \$80m, at which it was valued by Deloitte before consolidation into TNK-BP.

Russneft president Mikhail Gutseriev said that the deal will strengthen and complement Russneft's existing assets portfolio, which seems true. The company should now be able to step up oil production volumes, expand and improve its retail logistics and enter the promising regions of Saratov and Orenburg. Purchase of Orsknefteorgsintez makes Russneft a significant oil refiner, staking the company's claim to be a vertically integrated holding. Russneft now has 30 production, 2 refining and 2 transportation assets as well as a modern network of 300 retail service stations, located in 17 regions of Russia and the CIS. Acquisition of the TNK-BP assets will raise Russneft's annual production to 15-17mt and its total extractable oil reserves will be 630mt.

According to Vedomosti newspaper, Russneft has also bought 75% of shares in Krasnodareconeft, a refinery with estimated 2.2mt refining in FY05 and total capacity of 3.1mt. We estimate the refinery to be

worth \$100m, so a fair price for the stake would be \$75m.

It has also been reported that Russneft wants to purchase the Slovak pipeline company Transpetrol from Yukos (RTS: YUKO: \$5.54 Spec. BUY). We think that Russneft may have to press ahead with an IPO to raise money for that purchase, since the company's annual report for 2004 shows net debt of R21.7b (\$776m), which is more than 3.8 times more than company book value (\$204m). In addition, Russneft placed R7b (\$243m) of bonds in December 2005, and stated in the issue prospectus that it used credit from the international trader, Glencore, for earlier asset purchases.

An IPO could be a major strategic goal for Russneft in any case, now that it has emerged as a vertically integrated company.

**Sibneft (HOLD) increases reserve base**

Sibneft-Vostok LLC, a production subsidiary of Sibneft (RTS: SIBN: \$3.8 HOLD) (now owned by Gazprom (RTS: GSPBEX: \$6.019 SELL)), won an auction for rights at the Elleisky block in Tomsk region. The company agreed to pay R294m (\$10.3m) to obtain a license for development at Elleisky. This seems to be a very low price for a field with forecast recoverable reserves of 47.24mt (346.3m bbl). Elleisky is conveniently close to Transneft's (RTS: TRNFP: \$2200 HOLD) main pipeline system and to other fields (Archinskoye, Urmanskoye and Shinginskoye), which are also being developed by Sibneft-Vostok.

In separate news, Sibneft completed acquisition of a 75% interest in TNK-Sakhalin LLC, which holds a license for geological exploration of the Lopukhovskiy offshore block near Sakhalin Island in Russia's Far East. The block covers 3500 square kilometers and contains estimated reserves of up to 730 million boe. Seismic exploration work at the site has already been carried out.

We find this news positive for Sibneft, which continues to increase its reserve base and to enlarge its presence in regions of strategic importance for Gazprom. We keep our HOLD recommendation for Sibneft unchanged.

**Rosneft wins auction for East Sugdinsky deposit**

Vedomosti reported that Rosneft outbid Surgutneftegaz (RTS: SNGS: \$1.04 HOLD; SNGSP: \$0.83 SELL) and Sibneft (RTS: SIBN: \$3.8 HOLD) in an auction to develop the East Sugdinsky oil & gas field in Siberia's Irkutsk region. The company offered \$260m for rights to explore and develop the deposit, whose possible reserves are 42bcm of gas and 1.5b

bbl of oil. That implies \$0.365 per boe of reserves, which is 20% higher than our estimate of field value.

The high price could be justified because reserves may be larger than the current appraisal (East Sugdinsky is adjacent to the Verkhnechonsk field, the license for which is held by Verkhnechonskneftegaz). Last month Rosneft bought a 26% stake in Verkhnechonskneftegaz from Interros and is now seeking to buy an 11% stake from the Irkutsk regional administration.

Expansion in Eastern Siberia is a strategic priority for Rosneft.

### **Komsomolsk Refinery (BUY) minorities complain to Rosneft BoD and government**

Newport Capital, which owns a 1.5% stake in Rosneft's subsidiary, the Komsomolsk Refinery (*RTS: KNPR: \$366.82 BUY; KNPRP: \$256.77 BUY*), has sent a letter to the Rosneft BoD, complaining that appraisal of company shares by Deloitte and Touche for purposes of conversion to Rosneft stock is seriously below fair value. Deloitte's appraisal has not yet been officially published, but Vedomosti newspaper reported figures in November 2005, which were confirmed from a number of sources, and the Komsomolsk Refinery share price fell by four times as a result. According to Vedomosti, the Komsomolsk Refinery is worth \$40.1m and minority share value is only \$8m. Valuation of the refinery is 10 times lower than valuation of another Rosneft subsidiary, the Tuapse Refinery (*RTS: RSTY: \$37.74 BUY, RSTYP: \$28.30 BUY*), which has less capacity (for more information see a [RMG Weekly #550](#)).

The head of Newport Capital points out that the valuation is due to Rosneft's treatment of the Komsomolsk Refinery as a cost center. In 2001 Rosneft bought the Refinery's main facilities at a price many times below what they were worth and leased them back to the refinery. The Refinery's net profit has declined by seven times since 2001.

Newport Capital also sent copies of its letter to the Russian Prime Minister Mikhail Fradkov and the head of the Federal Service for Financial Markets, Oleg Vyugin. The company suggests that the Komsomolsk valuation is absurd on the background of high profitability of the oil refining business, and also considering future deliveries of crude oil from Sakhalin projects. We fully agree with this opinion and find that Komsomolsk has upside potential of 150% at current prices based on a Price/Throughput (\$/t) multiple of x63 (even using a discount of 30% to the sector average).

The Komsomolsk Refinery refines 6.5mt of crude annually. We believe that appraisers of Rosneft subsidiaries are bound to reflect this capacity and high demand for oil products in the Far East region in their valuation of the company. Moreover, in 9M05 the company's book value, sales and net income were \$41.8m, \$44.7m and \$4.1m respectively. We keep our BUY recommendation for the Komsomolsk Refinery.

### **Putin signs law on Gazprom (SELL) share market liberalization**

Russian President Vladimir Putin signed the law "On gas supply" last Friday, removing the 20% barrier for foreign ownership, so that foreign investors will be able to buy Gazprom (*RTS: GSPBEX: \$6.019 SELL*) shares on the Russian domestic market as well as buying depository receipts outside Russia.

Before the signing Gazprom officials held a conference call, disclosing some technical details of the upcoming liberalization of trading in Gazprom shares, which is now expected in January. Foreign investors will have to open accounts with Gazprombank, which will remain a central depository for Gazprom shares, in order to trade the stock onshore. According to Vladimir Tatsiy, head of the Gazprombank depository center, such an account can be opened in one day if all documents are filled out correctly.

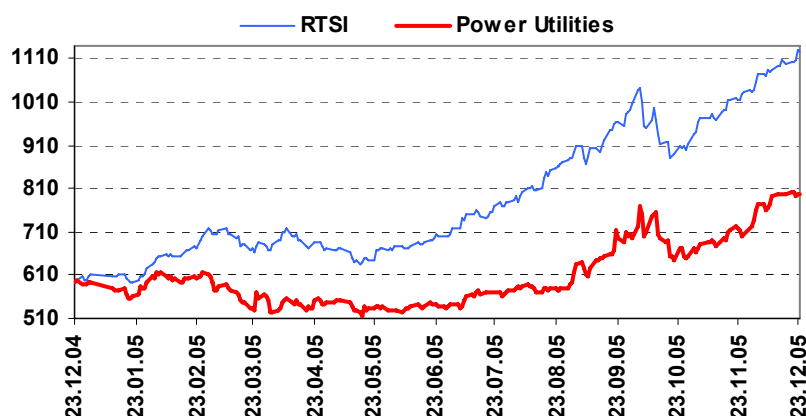
The officials also said that Gazprom will discuss expansion of its ADS program with the Federal Service for Financial Markets (FSFR) and Bank of New York. Gazprom said that it expects to complete expansion of the ADS program in 1H06, increasing the ADS limit to 40% of share capital, as currently allowed by Russian law for other companies.

Even assuming (as is generally believed) that about 20% of Gazprom shares are already owned by foreign investors via "gray schemes" in addition to the current ADS program, which covers 4.42% of company capital, the liberalization and expansion of the ADS scheme will make about 15% more shares in the company available to foreign investors.

In other positive news, Gazprom has received the last payment from Rosneftegaz for acquisition of a 10.7% stake in Gazprom, and Gazprom has repaid about \$8b out of \$13b, which was borrowed for purchase of Sibneft (*RTS: SIBN: \$3.8 HOLD*).

We take a positive view of Gazprom, but the company's shares are overvalued, according to our fundamental analysis. Our recommendation is SELL.

### Power Utilities Index vs. RTS Index



### Power Utilities Key Figures

| Sector indicators: median     | Russia | Discount to emerging markets |
|-------------------------------|--------|------------------------------|
| MC / Net sales                | 0.50   | 75%                          |
| EV / EBITDA                   | 4.30   | 64%                          |
| MC / Owned inst. capacity     | 185.05 | 80%                          |
| MC / Retail supplies of elec. | 23.41  | 80%                          |

| ADRs of Russian power utilities | Last sale | Wk change |
|---------------------------------|-----------|-----------|
| RAO UES                         | 42.510    | -0.2%     |
| Mosenergo                       | 14.650    | 0.8%      |
| Irkutskenergo                   | 16.400    | 0.9%      |

### Sector Wrap

- UES showed decline of IFRS profit in 6M 2005 due to reorganization and changes in reporting standards.
- The UES BoD approved a starting price for auction of Taimyrenego and ratios for single share conversion within OGKs -1,-4 and -6.
- A 31% stake in Pskovskaya GRES has reportedly changed hands.
- Complex Energy Systems has agreed steps with the Federal Grid Company to help boost capitalization of electricity distribution companies.
- In one line: - Mosenergo BoD approved a \$250m, 12-year credit from the EBRD (a first tranche is expected to be provided in February 2006) as well as two bond issues worth total R10b (\$350m) with 5- and 10-year maturities - RTS launched trades with four ex-energo power generating and four ex-energo electricity sales companies last week (see separate RMG desknote).

### Sector Statistics

| Issue               | Issue RTS Code | Mid Market Price, \$ | Weekly Change, % | Weekly Volume, \$mln | Market Cap, \$mln | 52 week Low, \$ | 52 week High, \$ | P/S 04 | P/E 04 |
|---------------------|----------------|----------------------|------------------|----------------------|-------------------|-----------------|------------------|--------|--------|
| Bashkirenergo com   | BEGY           | 0.655                | 0.2              | 0.024                | 705.77            | 0.290           | 0.655            | 0.94   | 28.78  |
| Irkutskenergo com   | IRGZ           | 0.396                | 0.1              | 0.334                | 1 875.74          | 0.201           | 0.445            | 2.95   | 58.33  |
| Lenenergo com       | LSNG           | 0.630                | 0.0              |                      | 226.75            | 0.570           | 0.999            | 0.22   | 7.77   |
| Lenenergo pref      | LSNGP          | 0.605                | 0.0              |                      |                   | 0.375           | 0.560            |        |        |
| Mosenergo com       | MSNG           | 0.144                | -1.7             | 0.044                | 3 954.91          | 0.060           | 0.150            | 1.28   | 55.56  |
| Permenergo com      | PMNG           | 4.350                | 0.0              |                      | 145.39            | 5.200           | 5.400            | 0.23   | 3.00   |
| Permenergo pref     | PMNGP          | 4.300                | 0.0              |                      |                   | 1.700           | 1.700            |        |        |
| RAO UES com         | EESR           | 0.424                | -0.4             | 16.442               | 18 217.30         | 0.258           | 0.436            | 0.77   | 16.43  |
| RAO UES pref        | EESRP          | 0.363                | 0.6              | 0.036                |                   | 0.239           | 0.365            |        |        |
| Samaraenergo com    | SAGO           | 0.143                | 1.1              |                      | 550.62            | 0.110           | 0.143            | 0.70   | 36.03  |
| Samaraenergo pref   | SAGOP          | 0.114                | 3.2              | 0.023                |                   | 0.050           | 0.116            |        |        |
| Sverdlovenergo com  | SVER           | 0.375                | -17.6            | 0.032                | 162.12            | 0.415           | 0.690            | 0.16   | 7.55   |
| Sverdlovenergo pref | SVERP          | 0.340                | 0.0              |                      |                   | 0.100           | 0.230            |        |        |

**UES (SELL com, HOLD pref) reports 6M 2005 financials under IFRS**

UES (RTS: EESR: \$0.370 SELL; EESRP: \$0.333 HOLD) reported further growth of consolidated revenues in 6M 2005 under IFRS, almost unchanged operating income and EBITDA (in dollar terms) and significant deterioration in the bottom line. Worsening of results is mainly due to sector reorganization, but is also partly due to some changes in IFRS standards.

Operating costs include \$240m increase of minority interest due to restructuring (referred to appearance of preferred shares at some newly established entities), without which operating costs would increase in line with revenues (by 17%) and operating margin would be the same as in 6M 2004. The company also showed an abnormally high effective tax rate of over 50% (38% in the same period of 2004) because newly created companies were unable to recognize deferred tax assets. These items are non-recurrent and the effect will be diminished or disappear in future periods.

**UES consolidated 1H 2005 P&L results (IFRS)**

|                                  | 1H05, \$m | 1H04, \$m | Change, % |
|----------------------------------|-----------|-----------|-----------|
| Revenues                         | 13 924.5  | 11 861.7  | 17%       |
| Operating costs                  | 12 451.3  | 10 413.4  | 20%       |
| Operating income                 | 1 473.2   | 1 448.3   | 2%        |
| - Operating margin               | 11%       | 12%       |           |
| EBITDA                           | 2 667.2   | 2 610.3   | 2%        |
| - EBITDA margin                  | 19%       | 22%       |           |
| Income before tax and minorities | 1 181.6   | 1 245.5   | -5%       |
| Income tax                       | 598.6     | 477.0     | 25%       |
| - Effective tax rate             | 51%       | 38%       |           |
| Minority interest                | 202.3     | 234.8     | -14%      |
| Net income                       | 380.8     | 533.7     | -29%      |
| - Net margin                     | 3%        | 4%        |           |
| Capex                            | 1 495.5   | 923.6     | 62%       |

Source: Company data, RMG estimates

UES also showed increase of financial costs by nearly 40%, mainly attributable to interest payments by UES and its subsidiaries, which indicates growing expansion of credit operations by the power holding (this was generally anticipated).

Similar changes are reflected in the UES balance sheet. The company also showed a 20% rise of accounts receivable due to seasonal increase of power supplies to customers on account.

Capital expenditures grew substantially in 6M 2005 (by 62%), confirming UES commitment to increasing investments in highly depreciated production assets, although a part of the 6M 2005 investments (about 10%) reflects acquisitions by UES subsidiaries of

power assets in other countries (a 75% stake in Sangtudinskaya GES, 51% of Moldavskaya GRES, and 100% of the Armenian electricity grid).

**UES consolidated 1H 2005 BS results (IFRS)**

|                           | 1H05, \$m | FY04, \$m | Change, % |
|---------------------------|-----------|-----------|-----------|
| Current assets            | 7 779.5   | 7 012.5   | 11%       |
| - cash & cash equivalents | 1 035.1   | 1 291.7   | -20%      |
| - accounts receivable     | 4 960.1   | 4 008.9   | 24%       |
| - inventories             | 1 484.1   | 1 512.0   | -2%       |
| Non-current assets        | 33 456.9  | 33 601.9  | 0%        |
| - PP&E                    | 31 672.6  | 32 177.4  | -2%       |
| ST liabilities            | 7 514.0   | 6 938.7   | 8%        |
| - accounts payable        | 3 258.8   | 3 022.3   | 8%        |
| - ST debt                 | 2 416.6   | 2 376.7   | 2%        |
| LT liabilities            | 3 570.3   | 3 357.7   | 6%        |
| - LT debt                 | 1 002.7   | 722.4     | 39%       |
| Minority interest         | 8 462.0   | 8 203.4   | 3%        |
| Equity                    | 21 690.2  | 22 114.6  | -2%       |

Source: Company data, RMG estimates

**UES indicates starting price for Taimyrenergo**

The UES BoD (RTS: EESR: \$0.370 SELL; EESRP: \$0.333 HOLD) approved R5950m (\$208m) starting price for sale of Taimyrenergo (100% owned by UES). The BoD previously decided that this asset can be sold to its sole customer: almost 100% of Taimyrenergo's electricity is consumed by Norilsk Nickel subsidiaries. An auction will presumably be held in mid-2006.

Taimyrenergo has two hydropower stations with total installed capacity of 1041MW, electricity transmission and distribution lines (total length of nearly 1000km) and heat distribution infrastructure (details of the heat assets are unknown). Based on our estimates we believe that Taimyrenergo electricity lines could be valued at \$30 000 per one km, which suggests total value of \$30m. Subtracting this figure from the starting price the implied price for generating assets would be roughly \$180m, or \$170 per one kW. That matches current valuation of GESs on the market, although our fair value for Russian hydropower units is lower (about \$100/kW).

**UES approves conversion ratios for OGK-1, OGK-4 and OGK-6**

The UES (RTS: EESR: \$0.370 SELL; EESRP: \$0.333 HOLD) BoD also approved coefficients for conversion of shares of power stations merging into OGK-1, OGK-4 and OGK-6. OGK-1 should unite six fuel-fired power stations, of which only GRES-4 (RTS: N/R) (divested from Mosenergo (RTS: MSNG: \$0.034 SELL)) has minority shareholders, while the

other five are wholly owned by UES. The conversion coefficient for GRES-4 implies fair price of \$0.009 per common share and EV/Capacity ratio at \$141/kW, which is nearly double our fair value estimate of \$76/KW and \$0.005 per share.

OGK-4 should unite five fuel-fired power stations, three of which have minority shareholders. Shaturuskaya GRES-5 (*RTS: N/R*), which emerged from Mosenergo division, was valued at \$131/kW, based on the reported conversion ratio (\$0.005 per common share); Smolenskaya GRES (*RTS: SMGS: \$0.191 HOLD; SMGSP: \$0.133 HOLD*) valuation implies EV/Capacity at \$174/kW (\$0.458 per common share and \$0.419 per preferred share); and Yaivinskaya GRES (*RTS: N/R*) valuation implies \$178/kW (\$2.289 per common share and \$2.096 per preferred share). All three figures are substantially higher than our fair values for these power stations, which are \$40/kW, \$69/kW and \$104/kW respectively (\$0.002 for Shaturuskaya GRES-5, \$0.191/\$0.133 for Smolenskaya GRES and \$1.390/\$0.973 for Yaivinskaya GRES).

OGK-6 should amalgamate six fuel-fired power stations with presence of minority shareholders in two of them. Based on the reported conversion ratio GRES-24 (*RTS: N/R*) of the former Mosenergo was valued at \$138/kW compared to \$110/kW under our estimates (\$0.002 per common share vs. \$0.001), and Cherepovetskaya GRES (*RTS: N/R*) valuation implies \$125/kW vs. \$60/kW by our findings (\$3.871 and \$1.870 respectively).

The differences may have arisen because we leave out heat generating and supplies in our valuation, but they may also be due to more optimistic scenarios used by appraisers in valuation of Russian power generating.

### **Significant stake in Pskovskaya GRES changes hands**

The head of Halcyon Advisors, David Herne (who also heads the UES (*RTS: EESR: \$0.370 SELL; EESRP: \$0.333 HOLD*) strategy and reforms committee), was reported by Interfax as saying that a stake of 31% in Pskovskaya GRES (*RTS: N/R*) has changed hands. The stake was reportedly obtained by a group of western investment funds for more than \$30m, which implies that the whole power station was valued at \$97m, or \$225/kW. We find this valuation excessive: our estimate of Pskovskaya GRES fair value is \$113/kW, which is two times lower. The price also looks high compared with current valuation of the most liquid power generators, which are valued at \$160/kW on average by EV/Capacity ratio.

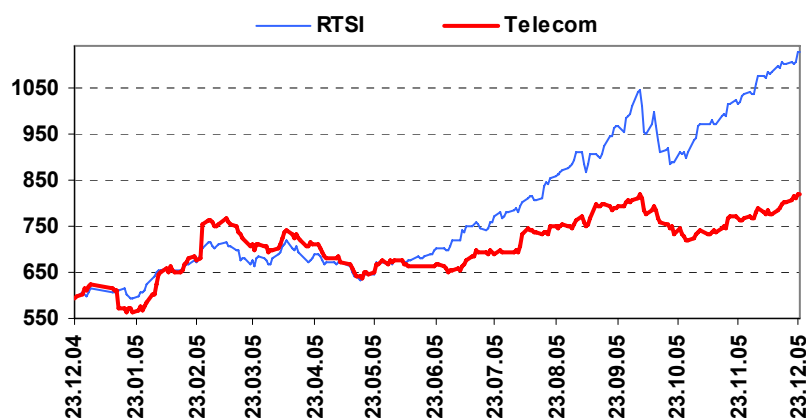
### **Strategics aim to increase capitalization of electricity distribution companies**

Complex Energy Systems (CES) said that it has signed an agreement with the Federal Grid Company (FGC, UES 100% subsidiary) on cooperation and joint actions to help raise market cap of electricity distribution companies. CES has significant stakes (in some cases exceeding 25%) in about 10 electricity distributors, mostly former energos, which retained electricity distribution grids while other assets were divested.

In particular the partners will work on a new tariff regulation system, based on return on assets instead of the cost plus system, which has been used to set Russian energy sector tariffs in the past. This should be very positive for electricity distributors, since our analysis suggests that their market value is much dependent on tariff regulation.

CES and the FGC will also work out standards for financial reporting by electricity distributors, and CES will consolidate its stakes in these companies in a special fund to help manage share liquidity.

## Telecom Index vs. RTS Index



## Telecoms Key Figures

| Sector indicators: median | Russia | Discount to emerging markets |
|---------------------------|--------|------------------------------|
| EV / EBITDA               | 6.0    | -19%                         |
| EV / Net sales            | 1.8    | 14%                          |
| EV / Access lines         | 340    | 79%                          |
| EBITDA / Access lines     | 63     | 77%                          |

| ADRs of Russian telecoms | Last sale | Wk change |
|--------------------------|-----------|-----------|
| Rostelecom               | 13.640    | 1.4%      |
| MTS                      | 35.250    | 2.4%      |
| Vimpelcom                | 44.160    | 3.7%      |

## Sector Wrap

- South Telecom received a \$32m back-tax claim for 2002-2003. The claim relates to agreements between operators concerning interconnection and ILD/DLD traffic transfer.
- Rostelecom was included in a list of “significant operators” by the Telecom Supervision Authority (Rossvyaznadzor).
- The CEO of AFK Sistema Vladimir Evtushenkov criticized MTS management during the investor conference. Evtushenkov said that Sistema has taken the necessary decisions and made some changes in MTS management.
- The Telecom Supervision Authority issued LD licenses to five more operators, including Vimpelcom.

## Sector Statistics

| Issue                      | Issue RTS Code | Mid Market Price, \$ | Weekly Change, % | Weekly Volume, \$mln | Market Cap, \$mln | 52 week Low, \$ | 52 week High, \$ | P/S 04 | P/E 04 |
|----------------------------|----------------|----------------------|------------------|----------------------|-------------------|-----------------|------------------|--------|--------|
| Center Telecom com         | ESMO           | 0.505                | 1.9              | 0.183                | 1 034.47          | 0.288           | 0.513            | 1.19   | neg    |
| Center Telecom pref        | ESMOP          | 0.427                | 2.2              | 0.156                |                   | 0.206           | 0.450            |        |        |
| Dalsvyaz com               | ESPK           | 2.460                | 4.0              | 0.195                | 307.53            | 1.100           | 2.500            | 1.09   | 10.95  |
| Dalsvyaz pref              | ESPKP          | 2.250                | 2.3              | 0.068                |                   | 1.190           | 2.250            |        |        |
| Moscow City Telephone com  | MGTS           | 18.250               | -0.9             | 0.540                | 1 658.85          | 12.000          | 18.250           | 2.87   | 19.49  |
| Moscow City Telephone pref | MGTSP          | 13.950               | 6.1              | 0.136                |                   | 9.000           | 13.900           |        |        |
| North West Telecom com     | SPTL           | 0.843                | 1.5              | 0.088                | 919.35            | 0.495           | 0.835            | 1.46   | 62.00  |
| North West Telecom pref    | SPTLP          | 0.769                | 0.8              | 0.116                |                   | 0.355           | 0.775            |        |        |
| Rostelecom com             | RTKM           | 2.250                | 0.0              | 0.620                | 2 057.85          | 1.702           | 3.280            | 1.56   | 10.61  |
| Rostelecom pref            | RTKMP          | 1.710                | 0.6              |                      |                   | 1.380           | 1.890            |        |        |
| Siberia Telecom com        | ENCO           | 0.073                | 5.5              | 0.249                | 1 109.69          | 0.048           | 0.073            | 1.47   | 12.95  |
| Siberia Telecom pref       | ENCOP          | 0.062                | 6.5              | 0.329                |                   | 0.036           | 0.063            |        |        |
| South Telecom com          | KUBN           | 0.142                | -1.6             | 0.277                | 515.60            | 0.073           | 0.145            | 0.85   | neg    |
| South Telecom pref         | KUBNP          | 0.105                | -2.1             | 0.608                |                   | 0.054           | 0.109            |        |        |
| Ural Svyazinform com       | URSI           | 0.037                | 2.1              | 0.526                | 1 428.76          | 0.033           | 0.042            | 1.44   | 11.14  |
| Ural Svyazinform pref      | URSIP          | 0.029                | 6.1              | 0.157                |                   | 0.022           | 0.031            |        |        |
| Volga Telecom com          | NNSI           | 3.905                | 1.8              | 0.513                | 1 241.71          | 3.090           | 4.200            | 1.66   | 42.10  |
| Volga Telecom pref         | NNSIP          | 3.480                | 3.3              | 0.214                |                   | 2.120           | 3.540            |        |        |

**South Telecom (Spec. BUY) receives \$32m back-tax claim**

South Telecom (*RTS: KUBN: \$0.181 Spec. BUY; KUBNP: \$0.123 Spec. BUY*) received a R916.6m (\$32m) back-tax claim for 2002-2003, of which 74% are actual liabilities (R677.7m or \$23.4m) and the rest are penalties and fines for late payment.

The company said that the claims reflect an attempt by tax authorities to review the conditions of agreements between operators concerning interconnection and ILD/DLD traffic transfer. The charges are similar to those served on other operators in 2004 and 2005, including some Svyazinvest subsidiaries, notably Far East Telecom.

South Telecom said that it will contest the liabilities in court. We believe that South Telecom has good chances of winning its case, since courts of first instance have ruled in favor of its peers (including Far East Telecom) against tax authorities on the same issue.

The Telecom Ministry expressed support for South Telecom and said that the claims are due to a "mistake" by tax authorities. We think that regulators will also support the company, since South Telecom has made interconnection agreements based on Telecom Ministry instructions.

We are therefore hopeful that the tax claim will not have serious negative impact on the company financials, and view the news as neutral.

**Rostelecom (BUY) included in list of main operators**

Rostelecom (*RTS: RTKM: \$2.86 BUY; RTKMP: \$2.06 BUY*) was included in a list of "significant operators" by the Telecom Supervision Authority (Rossvyaznadzor). A company is included in the list for a particular region if it and its affiliates own no less than 25% of network capacity in that region and can transfer no less than 25% of traffic via its network. For significant operators, the tariffs for call initiation and termination, and traffic transfer are regulated by the Telecom Supervision Authority.

Rostelecom meets both conditions, so its inclusion in the list is natural and may be viewed as a simple formality. The company said in a press-release that this fact may pose some risks for Rostelecom revenues and margins, as regulation of interconnect tariffs by the Telecom Supervision Authority may clash with tariffs set by the Federal Tariff Service. However, we do not view this as a serious risk and doubt any negative impact on Rostelecom financials.

**Sistema (N/R) CEO criticizes MTS (BUY) management**

The CEO of AFK Sistema (*RTS: AFKS; LSE: SSA: N/R*) Vladimir Evtushenkov criticized MTS (*RTS: MTSS; NYSE: MBT: \$48.097 BUY*) management during the investor conference following publication of Sistema's 9M05 results. "Unfortunately, MTS management has committed a number of mistakes. Though the company achieved good results in 2005, the management was left behind in PR. As a result, MTS grew slower than the market in general," Evtushenkov said.

Evtushenkov said that Sistema has taken the necessary decisions and made some changes in MTS management, which should reverse the negative trend seen this year. He also said that a number of "interesting deals" concerning MTS are currently being prepared.

We are pleased by Evtushenkov's statements, which prove that Sistema is keen to improve MTS performance. We believe that performance improvement will indeed be seen, with positive effect on the MTS share price. We reiterate our BUY recommendation with target price of \$48.097.

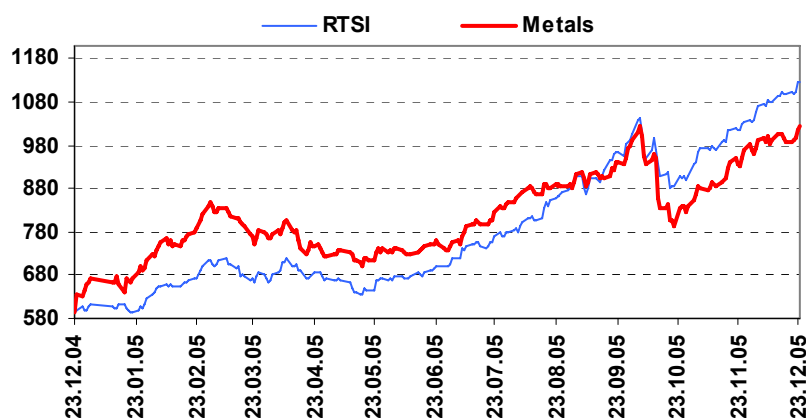
**Telecom Supervision authority issues five more LD licenses**

The Telecom Supervision Authority issued LD licenses to five more operators, including Vimpelcom (*RTS: VIMP; NYSE: VIP: \$56.543 BUY TOP PICK*). Other companies, which received licenses are O.S.S.-Telecom (Moscow), Mobifon-2000 (Ekateriburg), Start Telecom (Moscow) and Arktel (Moscow).

The Authority has already issued 10 LD licenses: to Multiregional Transit Telecom (MTT), TransTelecom (TTK), Golden Telecom (*NASD: GLDN: \$30.164 HOLD*), Equant, Investelectrosvyaz, Online-Telecom, LanRusinvest, Centerinfocom, Mir Telecom (Far East) and InfoPlus. However, receipt of a license is not sufficient to start offering LD services. Companies must first prove that they match a number of criteria. Multiregional Transit Telecom and TransTelecom currently appear to be the only companies capable of competing with Rostelecom (*RTS: RTKM: \$2.86 BUY; RTKMP: \$2.06 BUY*) on equal terms, while Golden Telecom and Equant have potential as niche players. However, we do not expect any of these companies to become serious threat for Rostelecom before 2008.

We reiterate our positive view on Rostelecom and confirm our BUY recommendation with target price of \$2.86 for common shares and \$2.06 for prefs.

## Metals Index vs. RTS Index



## Metals & Machinery Key Figures

| Ferrous metals indicators: median | Russia | Discount to emerging markets |
|-----------------------------------|--------|------------------------------|
| MC / Net profit                   | 5.58   | -43%                         |
| EV / EBITDA                       | 2.65   | -46%                         |
| EV / Net sales                    | 1.04   | 7%                           |
| EV / Steel                        | 0.35   | -32%                         |

| ADRs               | Last sale | Wk change |
|--------------------|-----------|-----------|
| Norilsk Nickel     | 94.00     | 8.0%      |
| Evrazholding       | 18.10     | -0.8%     |
| Mechel Steel Group | 23.47     | -1.1%     |
| NLMK               | 14.28     | 0.6%      |
| OMZ, EUR           | 4.40      | 2.3%      |

## Sector Wrap

- Mechel reported net income and margin declines in 9M05 y-o-y due to company consolidation, high investment activity and steel prices decreasing.
- Government promises strong state support for AvtoVAZ. EGM has appointed new BoD members with state majority and new CEO and head of BoD appointed by renewed BoD.
- Norilsk Nickel has received the highest investment rating among private Russian companies, is going to reduce share capital.
- EADS has signed components production contracts with VASO and Irkut. Majority part of contracts will receive Irkut corporation.
- NTMK will pay dividends for 3Q05 of R2.14 per share and has reduced BoD from 11 to 9 members.
- Power Machines plans to increase order book from India to \$2.5b for 2-3 years and to extend activity in Vietnam.
- UGMK continues to consolidate subsidiaries. We expect further consolidation and company's IPO.
- Mashinostroitelny Zavod has prolonged long-term contracts with two Swiss nuclear stations.

## Sector Statistics

| Issue                  | Issue RTS Code | Mid Market Price, \$ | Weekly Change, % | Weekly Volume, \$mln | Market Cap, \$mln | 52 week Low, \$ | 52 week High, \$ | P/S 04 | P/E 04 |
|------------------------|----------------|----------------------|------------------|----------------------|-------------------|-----------------|------------------|--------|--------|
| Avtovaz com            | AVAZ           | 35.875               | 1.1              | 0.146                | 1 060.88          | 23.000          | 38.900           | 0.23   | 29.47  |
| KamAZ com              | KMAZ           | 0.900                | 5.5              | 0.122                | 715.03            | 0.455           | 0.910            | 0.60   | 42.06  |
| Silovye Mashiny com    | SILM           | 0.078                | 1.5              | 0.208                | 570.14            | 0.042           | 0.079            | 0.94   | 21.93  |
| GMK Norilsk Nickel com | GMKN           | 89.700               | 4.9              | 31.506               | 19 368.35         | 51.100          | 90.800           | 2.86   | 10.82  |
| Nizhny Tagil Metal com | NTMK           | 1.740                | 1.5              | 0.175                | 2 253.21          | 0.963           | 1.780            | 1.39   | 8.11   |
| Novolipetsk Steel com  | NLMK           | 1.433                | 0.5              | 0.533                | 8 570.31          | 0.995           | 1.615            | 2.08   | 6.63   |
| Severstal com          | CHMF           | 9.905                | -0.5             | 2.090                | 5 468.33          | 7.080           | 10.300           | 1.05   | 6.41   |

## Mechel (BUY) reports net income and margin decline in 9M05 y-o-y

Mechel (RTS: MTLR: \$12.5 BUY) reported revenue increase by 17.6% y-o-y in 9M05, but 25.2% decline of net income. Operating margin was 4.9 percentage points lower y-o-y, EBITDA and net margins fell by 8 and 6.2 p.p. respectively.

### Mechel 3Q 2005 P&L results (GAAP)

|                    | 3Q05, \$m | 3Q04, \$m | Change, % |
|--------------------|-----------|-----------|-----------|
| Revenues           | 2 910     | 2 475     | 17.6%     |
| Operating costs    | 1 852     | 1 507     | 22.9%     |
| Operating income   | 452       | 509       | -11.1%    |
| - Operating margin | 15.5%     | 20.6%     |           |
| EBITDA             | 569       | 619       | -8.0%     |
| - EBITDA margin    | 19.6%     | 25.0%     |           |
| Net income         | 315       | 421       | -25.2%    |
| - Net margin       | 10.8%     | 17.0%     |           |

Source: Company data, RMG estimates

### Mechel 3Q 2005 BS results(GAAP)

|                    | 3Q05, \$m | 3Q04, \$m | Change, % |
|--------------------|-----------|-----------|-----------|
| Current assets     | 1 405     | 2 103     | -33.2%    |
| Non-current assets | 2 180     | 1 575     | 38.4%     |
| ST liabilities     | 823       | 889       | -7.4%     |
| LT liabilities     | 624       | 731       | -14.6%    |
| Minority interest  | 140       | 215       | -34.9%    |
| Equity             | 2138      | 2058      | 3.9%      |

Source: Company data, RMG estimates

The company had net debt of \$180m at the end of the third quarter, compared with net cash of \$326m at the beginning of the year. This is explained by \$883m investment spending.

Revenue is as we had expected but the net income result is disappointing. Operating and EBITDA margins are also lower than our forecasts. We estimate FY 2005 revenue at \$3.8b, EBITDA at \$851m and net income at \$495. We keep our fair price for Mechel at \$12.5 per share despite the third quarter figures.

## Norilsk Nickel (HOLD) receives investment rating ...

Fitch Ratings Ltd., the international rating agency, gave a senior unsecured BBB- rating with stable outlook to Norilsk Nickel (RTS: GMKN: \$71.38 SELL). The rating is investment grade and is the highest obtained by any private company in Russia (Moody's gives Norilsk at Ba1 rating and the Standard & Poor's rating is BB+). Fitch said that its decision reflected the company's unique resource base and excellent financial results.

Our fair price estimate considers divestment of Polyus from January 1.

## ... and will reduce share capital

Norilsk Nickel said that it will reduce share capital to reflect divestment of its subsidiary, the gold producer Polyus immediately after New Year. Shareholders who did not participate in the EGM on November 30 or voted against the Polyus spin-off sold 10 799 433 shares (5.1% of share capital) to the company. Added to other repurchases Norilsk bought total 12 478 704 of its own shares (5.8% of charter capital) in 2005. The capital reduction from current 213 905 884 shares to 190 627 747 shares (by 10.9%) will be put to an EGM on February 17, 2006.

## AvtoVAZ (SELL) receives state support ...

Federal Industry Agency head Boris Aleshin presented various aspects of the Agency's short- to medium-term strategy for AvtoVAZ (RTS: AVAZ: \$32 SELL, AVAZP: \$28 SELL):

- ✓ AvtoVAZ needs government protection and will receive it;
- ✓ AvtoVAZ's R&D for new vehicle models and engines should be given the status of a federal program and related expenses should be partly financed by the state budget;
- ✓ Protectionist measures suggested by former CEO Vladimir Kadannikov should be supported by the government. These measures include adjustment of the income tax rate depending on profitability, government guarantees for AvtoVAZ borrowings, tax-free component imports, and inclusion of R&D expenses in production COGS for tax purposes;
- ✓ AvtoVAZ shares, which are currently held by company subsidiaries, should be bought for cash to eliminate cross-ownership, simplify the current ownership structure, and prepare for an IPO on international markets;
- ✓ Aleshin supports rapid transfer of AvtoVAZ social liabilities to regional and local authorities and possible conversion of current debt to the government into investment.

Some of these proposals should help the company to increase productivity, but others are very general and will probably need a long process of document production and approvals before they can be realized. Also, the government strategy does not address the key business issue – is AvtoVAZ capable of developing good-quality models at a cheap price?

Our doubts therefore concern implementation. We reiterate our SELL recommendation.

### ... and appoints new CEO and head of BoD

The AvtoVAZ BoD appointed Igor Esipovsky, a head of department at the state-owned military equipment exporter, Rosoboronexport, as chief executive officer. Vladimir Artyakov, the deputy head of Rosoboronexport, was appointed to head the BoD. The new chairman and CEO say that they will not carry out a purge of other senior management, but that new appointments will be made.

### EADS signs components production contracts with VASO(N/R) and Irkut (BUY)

The Russian aerospace companies VASO (*RTS: VASO: N/R*) and Irkut (*RTS: IRKT: \$0.85 BUY*) signed agreements with EADS (European Aerospace Defense and Space Company) for production of components for Airbus aircraft. The total contract price is \$200m and contract duration is 10 years. Two thirds of the contract will be assigned to Irkut, which will produce fuel tank walls for the A-320, some wind elements for the A-330 and A-340, and wind components for the A-380. VASO will supply pylon parts for the A-320. The contracts will be signed in 1Q06.

We view this news positively and recommend to BUY Irkut shares with fair price at \$0.85.

### NTMK (U/R) pays dividends for 3Q05

An EGM of the steel plant NTMK (*RTS: NTMK: U/R*) on December 16 approved 3Q05 dividends of R2.14 per share. The EGM also decided to reduce its BoD from 11 persons to 9. Shareholders extended the right of Evraz (owner of NTMK) (*LSE: EVR: \$17.95 HOLD*) to act as the NTMK management company and set the annual fee for this service at R33.32m (\$1.16m).

### UGMK continues to consolidate subsidiaries

UGMK, one of the largest Russian non-ferrous holdings, consolidated some of its enterprises: 67.2% of Elektrozinc (*RTS: ELZM: \$55.4 BUY*), 38.8% of Styatogor, 51% of Katur-Invest and 72% of Dragma. On October 2005, company consolidated 100% of the mining and ore processing company Uchalinsky GOK (*RTS: UGOK: \$9.37 HOLD*).

UGMK combines around 30 enterprises, mainly in non-ferrous metallurgy. The holding controls 40% of Russian production of cathode copper, 25% of non-ferrous rolled metal and 50% of the European market for copper powder.

### Machinostroitelny Zavod (N/R) continues long-term contract

Machinostroitelny Zavod (*RTS: MASZ: N/R*) and Framatome ANP (joint venture between AREVA and Siemens) extended their framework agreement on supply of nuclear fuel for Western European nuclear stations. The Swiss government chose MASZ as nuclear fuel supplier until 2016 for the Gesgen Station and until 2020 for the Beznay Station. This is much longer than 2-3 year contracts, which are usual practice. MTZ already supplies nuclear fuel to nine nuclear stations in Europe.

### Power Machines (BUY) plans to increase order book from India to \$2.5b

Igor Klochko, the Power Machines (*RTS: SILM: \$0.09 BUY*) CEO, said in an interview to the Russian magazine Profil that Power Machines will increase its order book thanks to increase of sales to India. The company has signed Indian contracts worth \$740m and expects \$2-2.5b over the next 2-3 years. Klochko said that India is the company's main international market, and that Vietnam also has much potential. Power Machines will take part in construction of India's Shonla HPS, which will be the largest hydro station in South-West Asia. Approximate contract price is \$300-500m. Power Machines is targeting increase of Vietnam orders to \$1b.

We take a positive view of Power Machines development, particularly after the recent deal, which gives a major stake to UES, and we look forward to probable purchase of a minority stake by Siemens. But we are not convinced that Power Machines will be able to play a major role at Shonla. Many participants have announced their interest in this tender, and Power Machine will probably need a partner to improve its chances of winning the contract. We reiterate our BUY recommendation with fair price at \$0.09.

## Wimm-Bill-Dann (HOLD) places bonds, S&P raises outlook

Wimm-Bill-Dann (*RTS: WBDF: \$19.61 HOLD*) successfully placed ruble bonds for R3b (\$104m). The bonds have five-year maturity and 10 biannual coupons. The coupon rate set at auction is 9% and yield to maturity is 9.2%.

Standard and Poor's rating agency confirmed its ratings for WBD, but upgraded the rating outlook to stable from negative. S&P explained the outlook revision by improvement of financial policies and growth of financial and operating results in 9M05. Long-term credit ratings were confirmed at B+. The long-term rating on the national scale is ruA+.

## Pyaterochka (HOLD) places bonds for R3b

The retail chain, Pyaterochka (*LSE: FIVE: \$16.253 HOLD*), carried out a bond placement for R3b (\$104m). The five-year bonds have 10 biannual coupons. The coupon rate was set at 9.3%.

Pyaterochka says that it will spend the cash on refinancing of short-term debt and working capital. Pyaterochka also needs money to finance expansion of its retail network.

## IPO managers turn down option on 4.1% of Amtel-Vredestein

Vedomosti newspaper reported that IPO managers of Amtel-Vredestein N.V. (the Dutch company which owns the Russian tyre-maker Amtel) did not exercise their option to purchase 4.1% of company shares at the end of the stabilization period, during which they were required to maintain the share price above the placement level. As a result the Amtel share price fell by 13% over 10 days to December 22, when it stood at \$9.2. Amtel placed 27% of its shares on the LSE in November at \$11 per GDR, which was below the bottom limit of the target price range.

There may be a change of shareholder structure in 2006 if Amtel does not keep within specific debt limits by December 31 and does not achieve a certain level of EBITDA. Alfa Capital Holding and Aranda Investment (subsidiary of the investment fund Temasek), which own 6.34% and 3.52% respectively, have an option to purchase a block of Amtel shares at face-value (€ 0.01) from Amtel Luxemburg, owned by company founder Sudhir Gubta, if the targets are not met. However, the size of the block is not known and Alfa has said that it is small.

Amtel-Vredestein made an issue of three million shares in favor of its 100% owner, Amtel-Vredestein N.V., which is located in Holland. The issue was bought at par value of R1000 (\$34) per share, making a total of \$105m. The transaction increases share capital of Amtel-Vredestein to \$191m. In addition, the company charter was amended to allow placement of further 15m shares in the future.

The placement gives a sign of owners' confidence in the future of Amtel, despite recent signs of weakness, and provides funds for investment and acquisitions. The placement also improves the debt-equity ratio of the holding in Russia.

The company hosted a conference call last week to discuss its short-term strategy and give financial guidance for 2005, but we did not find any new interesting information. We retain our view that Amtel shares are overvalued.

## Lukoil (BUY) to sell 17.37% of Petrocommerzbank (N/R) to affiliate

Lukoil (*RTS: LKOH: \$64.0 BUY*) plans to sell 17.37% of Petrocommerzbank (*RTS: PETR: N/R; PETRP: N/R*) to an affiliated company, IFD Capital, for \$36m subject to approval by the Central Bank of Russia. Petrocommerzbank was ranked 14 among Russian banks by assets in nine months of 2005.

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