



New Life in the OFZ Market

London – CBonds Russia & CIS Fixed Income Conference

September 2010



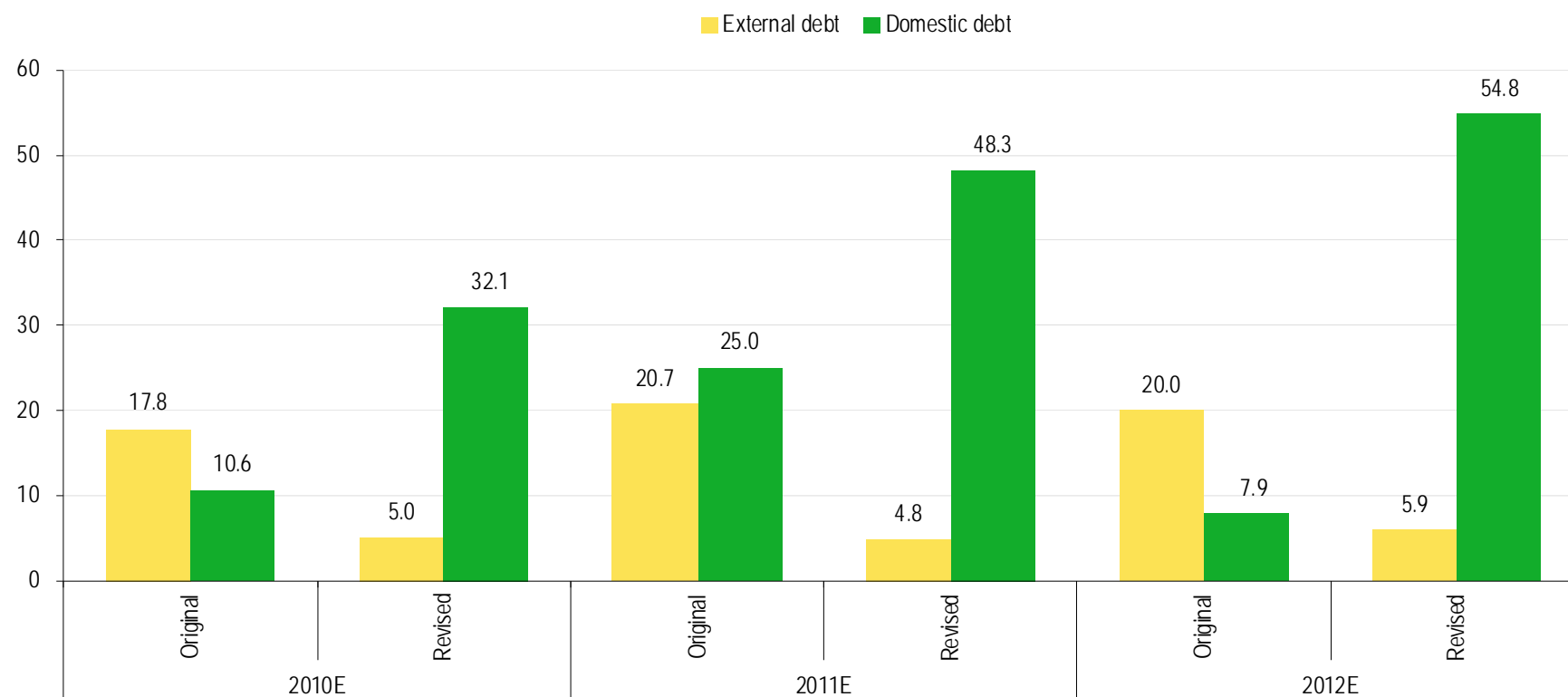
Dmitry Dudkin, CFA, Head of Fixed-Income Research, URALSIB Capital, dudkindi@uralsib.ru

- In 2010, the unsold volume of external sovereign bonds (\$12.8bn) was transferred by the MinFin onto the local market
 - ⇒ Apart from \$5 bln in April, there are no more dollar-denominated issues this year
 - ⇒ The expected amount of OFZs on offer for full-year 2010 is more than RUB1 tln
- OFZ auctions every Wednesday
- The schedule of OFZ auctions to be announced a quarter in advance
- In July, deputy finance minister Dmitry Pankin said Russia may cease usage of its reserve fund to finance a budget deficit in 2H10
- A ruble-denominated Eurobond might be considered
- Full focus on domestic borrowing

MinFin Revises its Debt Policy

Focus on domestic market

MinFin's forecast of external and domestic borrowings, \$bn

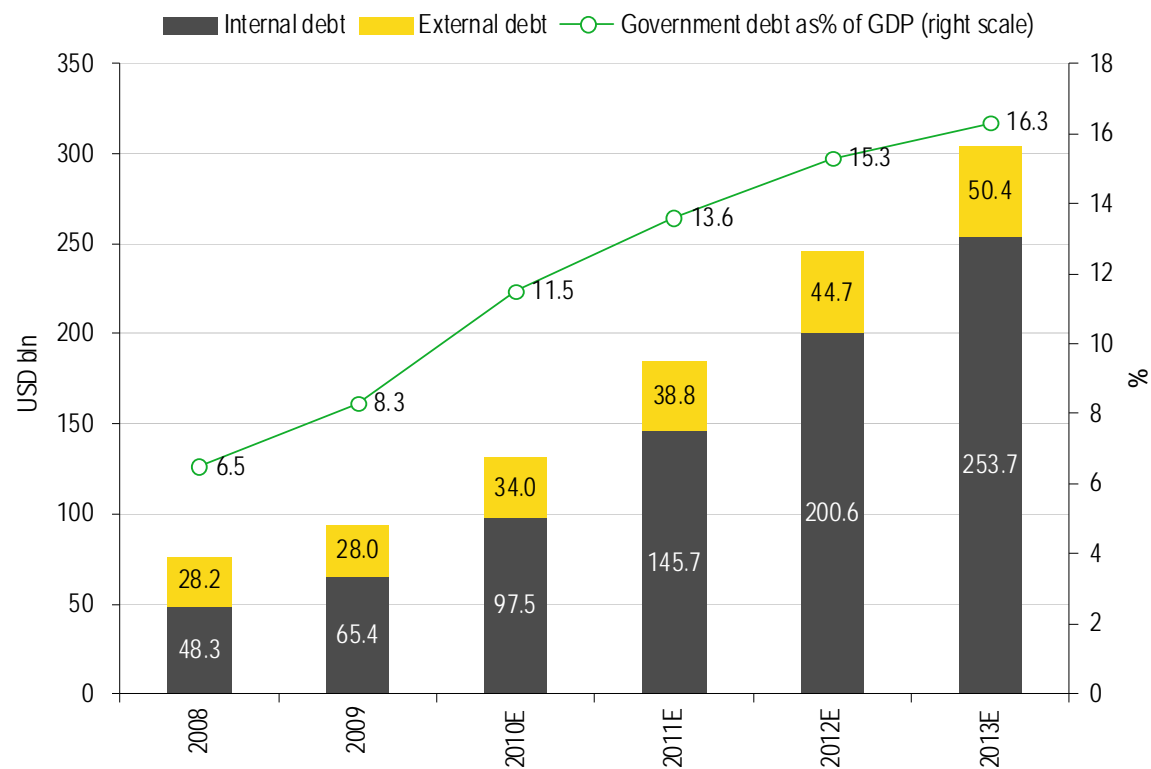


Source: MinFin

Gradual Debt Burden Growth Expected

Total debt to GDP will top 16%

Government debt of Russia according to MinFin forecast



Source: MinFin, URALSIB estimates

MinFin Expects 5.4% Budget Deficit in 2010

The deficit of 2010–2013 is set to notably increase government debt

MinFin's budget forecast

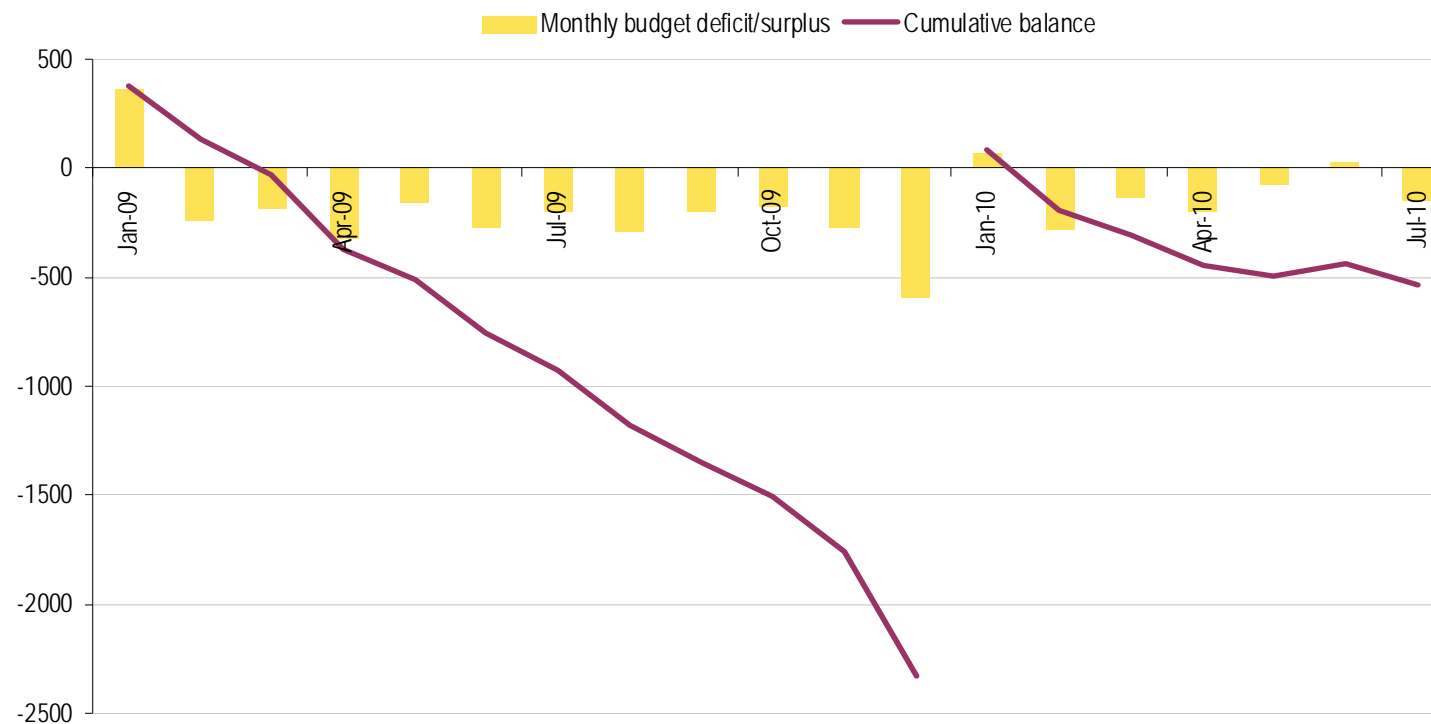
	2008	2009	2010E	2011E	2012E	2013E
Federal budget surplus/deficit, RUBbn	1705	-2322	-2429	-1767	-1713	-1765
Deficit%GDP		5.9	5.4	3.6	3.1	2.9
Use of reserve fund, RUBbn		3028	1419	242		
Use of national wellbeing fund, RUBbn				200	230	300
Net increase in OFZ-GSO, RUBbn	173	547	934	1337	1490	1474
Issue of sovereign Eurobonds, \$bn			5.0	4.8	5.9	5.7

Source: MinFin, URALSIB estimates

Budget Deficit is Overstated by MinFin

As of end-July the deficit is 2.5% of GDP, we expect the budget to be balanced as of year end

Budget deficit, RUBbn

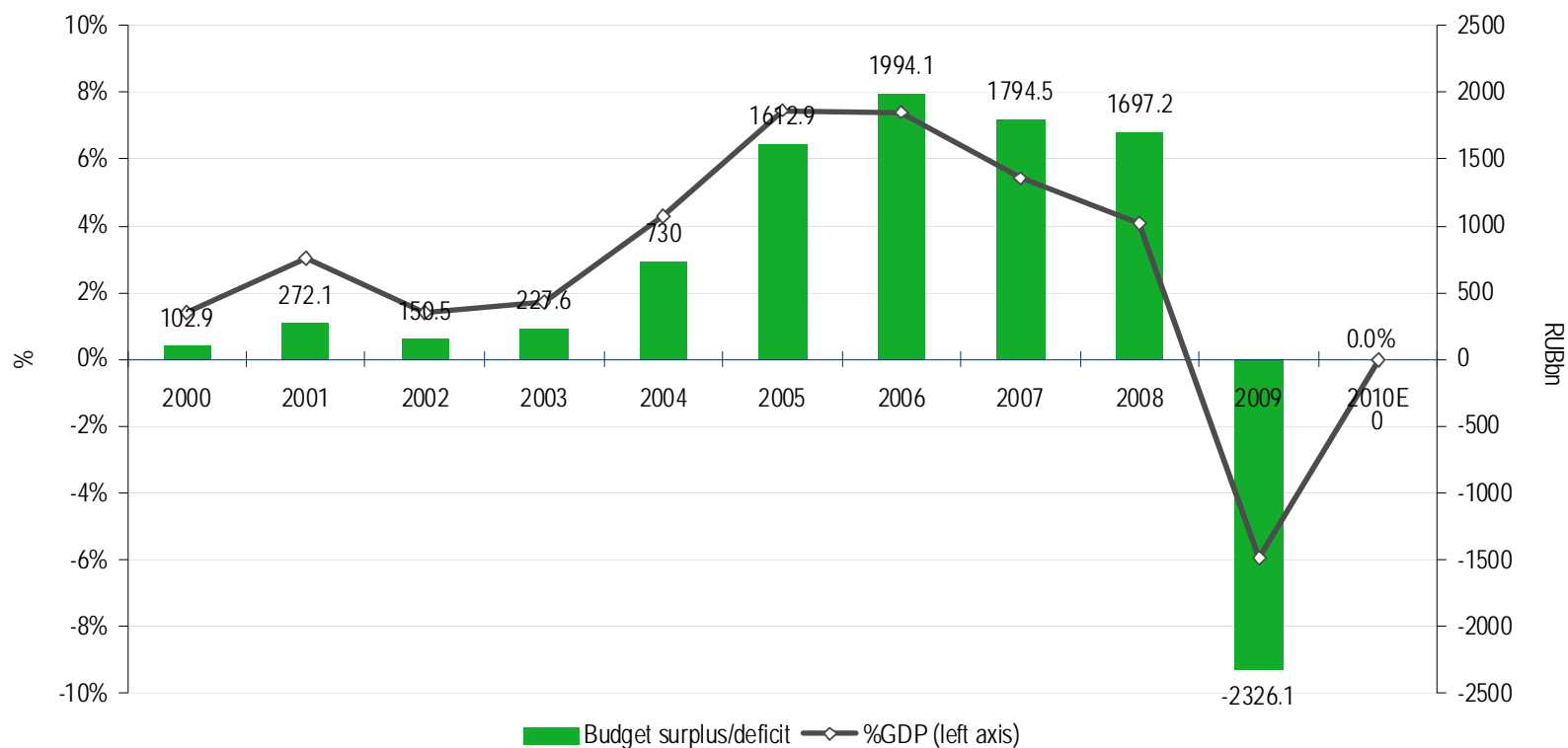


Source: Rosstat

We Expect a Balanced Budget in 2010

Budget is expected to be almost balanced in 2010

Historical Russian budget surplus/deficit

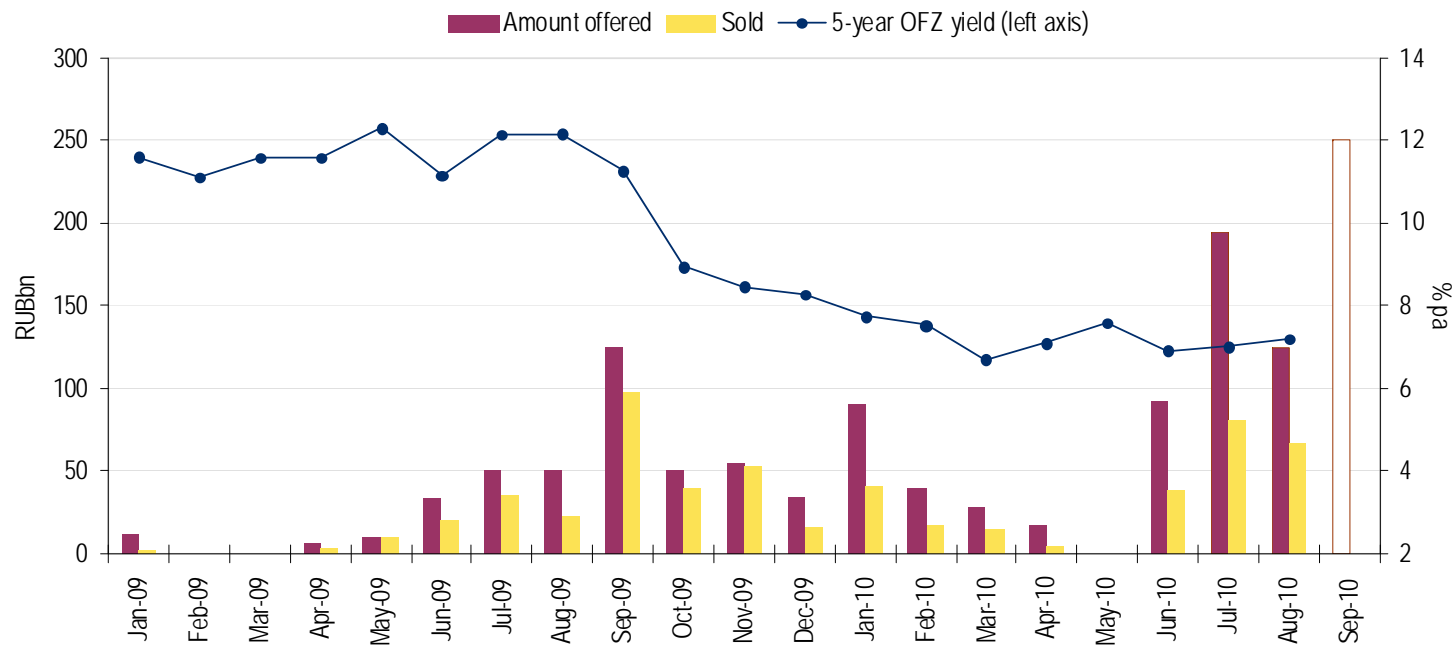


Source: Bloomberg

MinFin Systemically Sells Less than it Offers

It will be an achievement if RUB500bn of new OFZs is sold this year

Monthly OFZ auctions

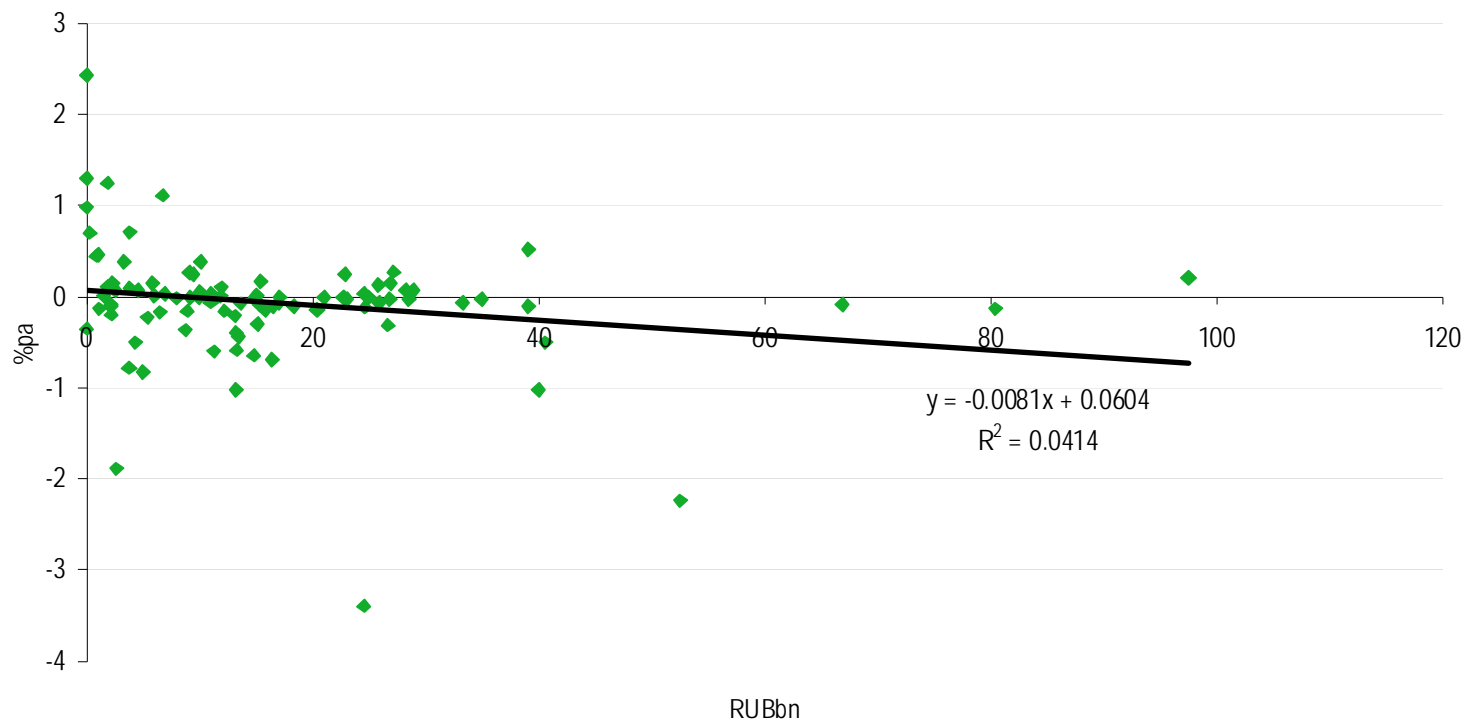


Source: MinFin, CBR, MICEX

No Effect of Past Placements on Yield

Dependence is non-significant and even reverse

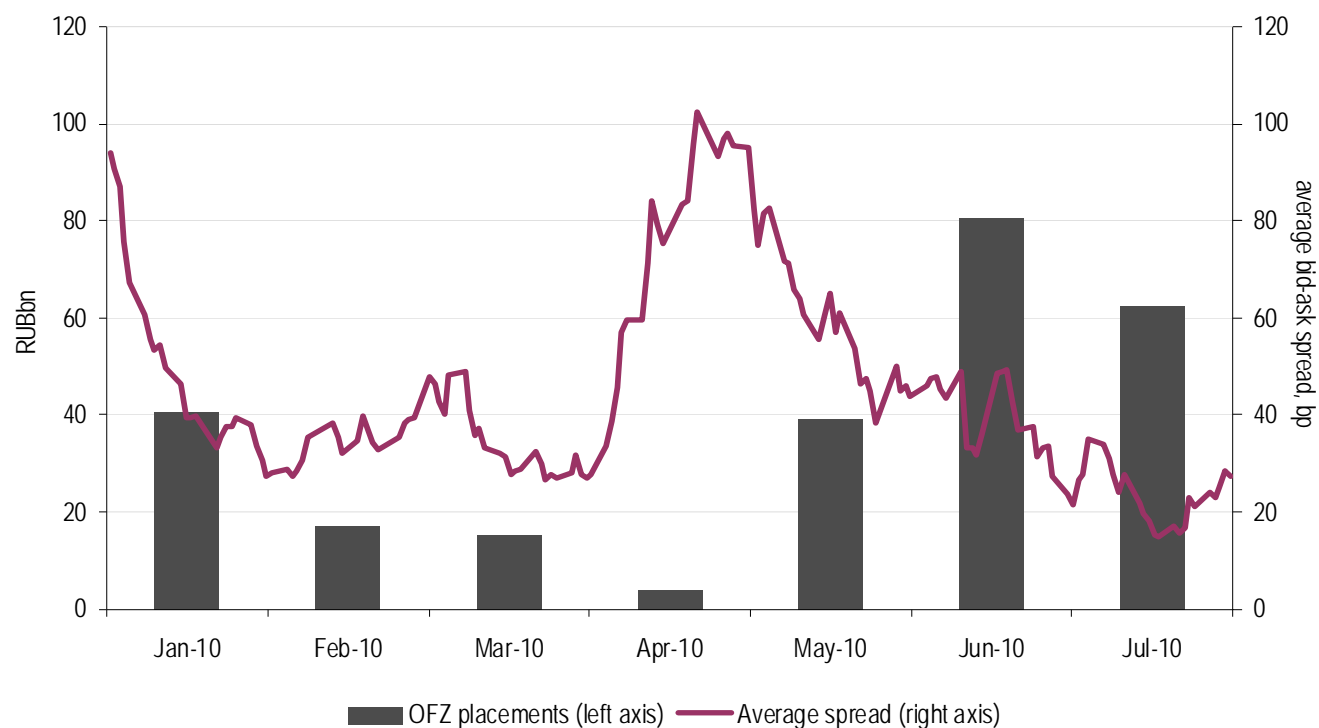
Monthly 5-year OFZ yield change (%pa) versus monthly OFZ placements (RUBbn), 2003-2010



Source: CBR, MICEX, URALSIB estimates

New primary placements boost market liquidity

OFZ auctions and average bid-ask spread in the government section on MICEX

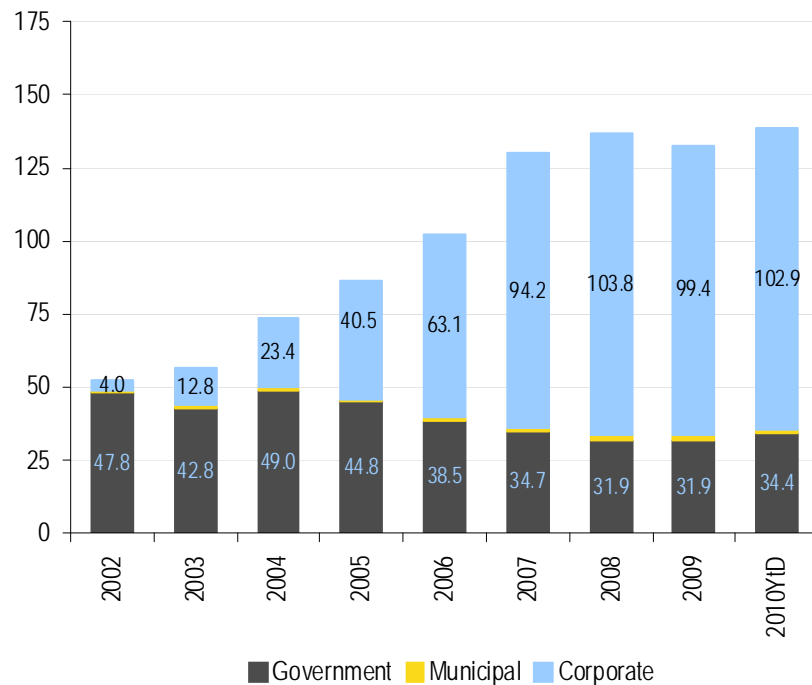


Source: CBR, URALSIB

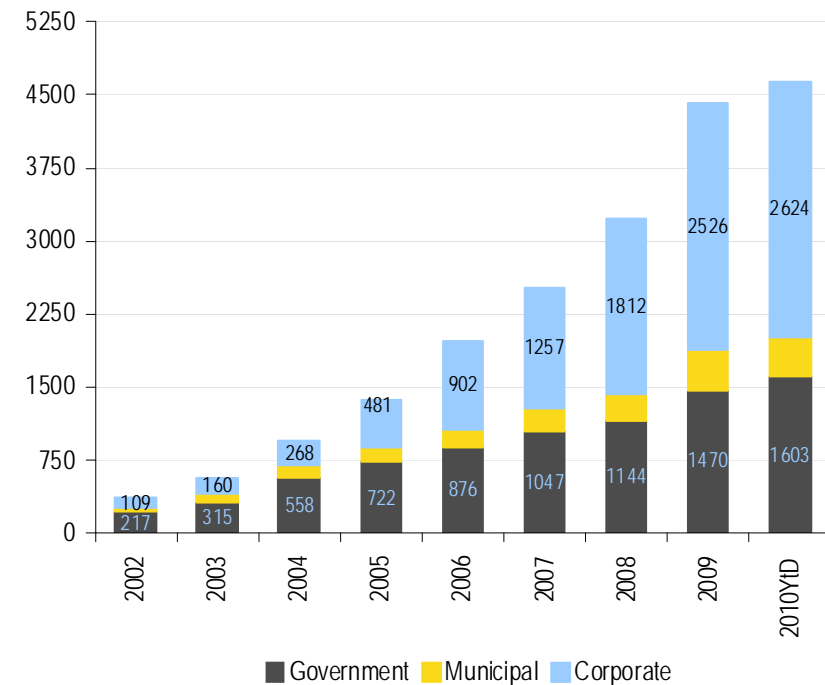
Local Market Surpasses External One in Size

In 2009 local market became the primary venue to trade Russian debt

External public debt volume, \$bn



Domestic public debt volume, RUBbn

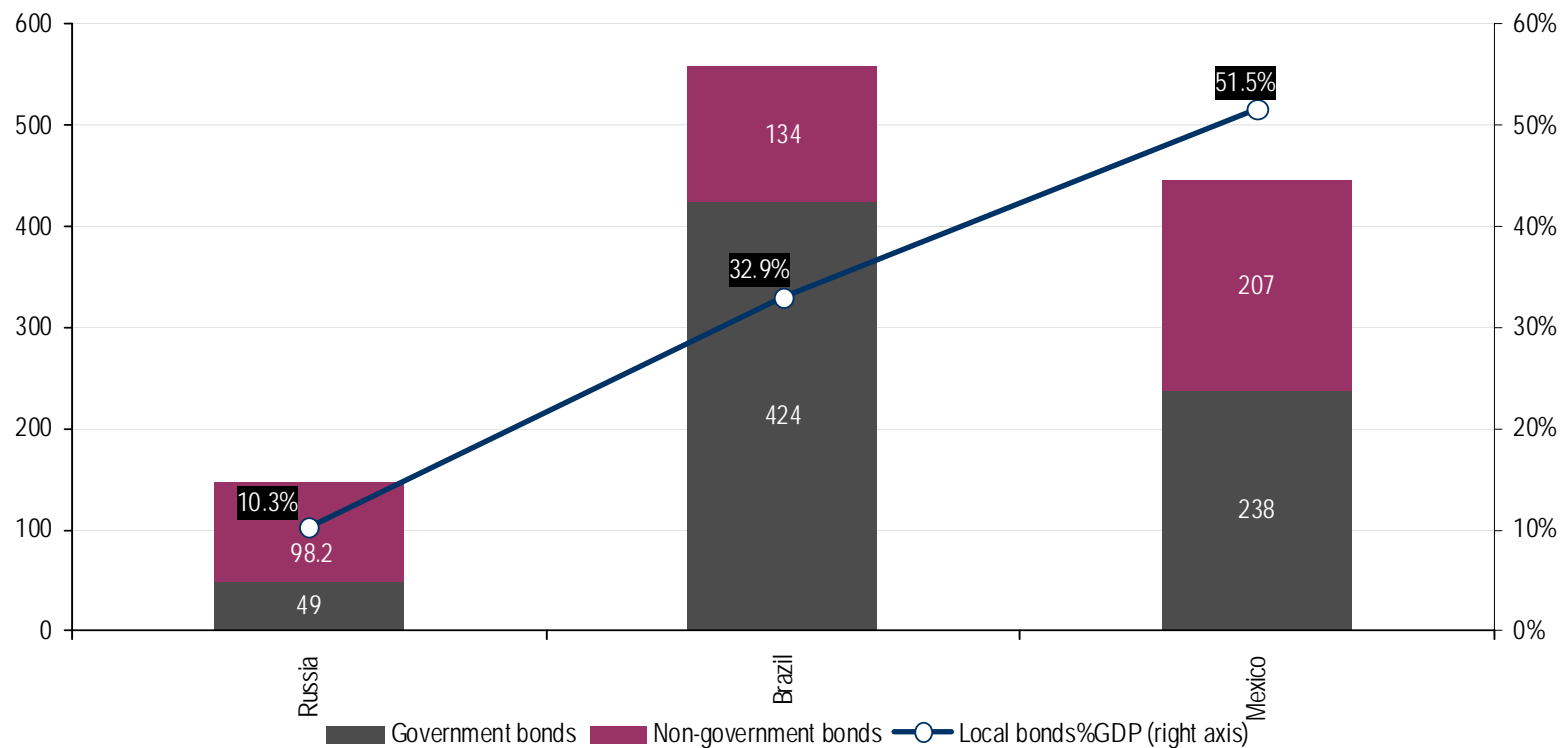


Source: Cbonds

Russia's Local Market Compared to Peers

Russian local bond market has a large potential for expansion

Size of local bond markets of Russia and its EM peers, \$bn



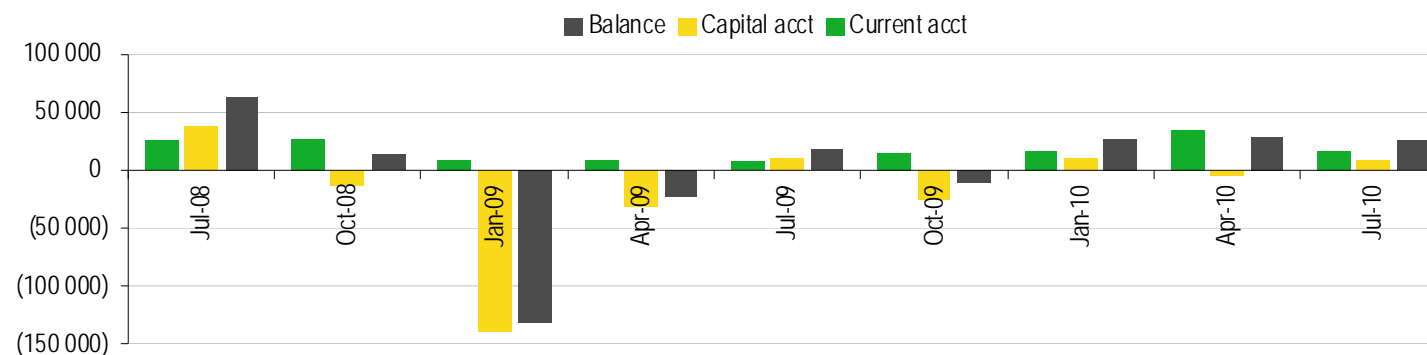
Source: Bloomberg, Reuters

- New policy – much more local currency borrowing
- The MinFin expects government debt/GDP ratio to top 11% this year
- Official forecast of the budget deficit for 2010 is still 5.4% of GDP
- We expect Russia's budget to be balanced
- A lot less of the volume of OFZs will be sold than is offered this year
 - ⇒ Out of RUB588 bln offered in Jan-Aug 2010, only RUB262 bln was sold
 - ⇒ We hope the MinFin can sell RUB500 bln of new OFZs this year
- Statistically, we saw no impact from past placements on the yield
- Primary supply boosts trading liquidity
- The local bond market surpassed Eurobonds in size in 2009
- Russia's local bond market is still small, even compared to EM peers

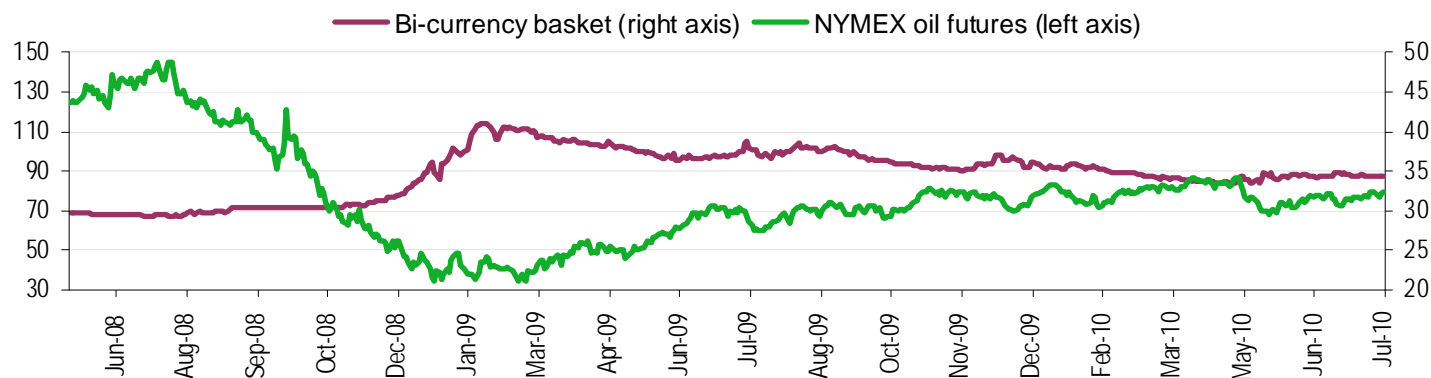
Back to Growing Reserves on Trade Surplus

Capital account balances near zero; Russia returns to reserves accumulation

Russia's balance of payments, \$mln



Bi-currency basket, RUB; NYMEX oil futures, \$/b

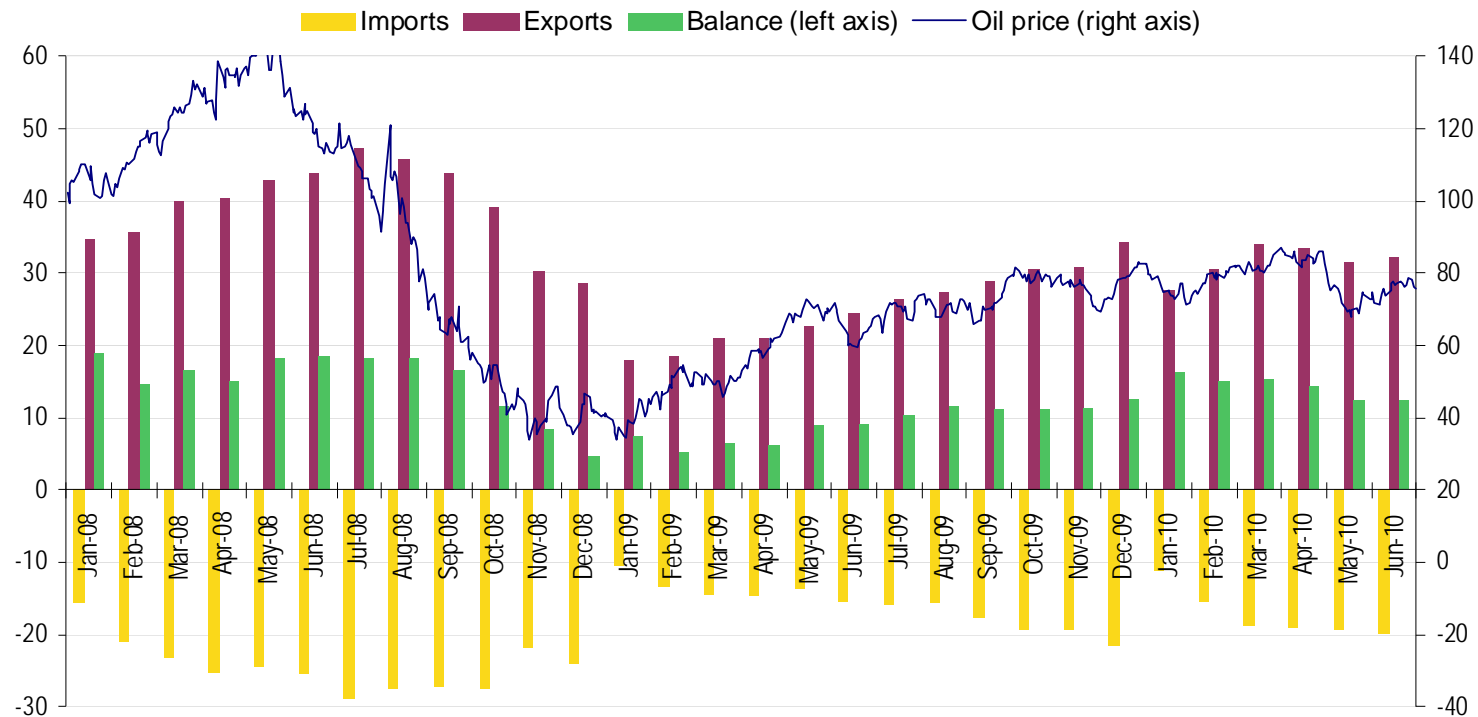


Source: CBR, Bloomberg

Stable Oil Provides Stable Net Exports

Stable trade surplus of more than \$10bn/month

Russian trade balance, \$bn; oil price, \$/b

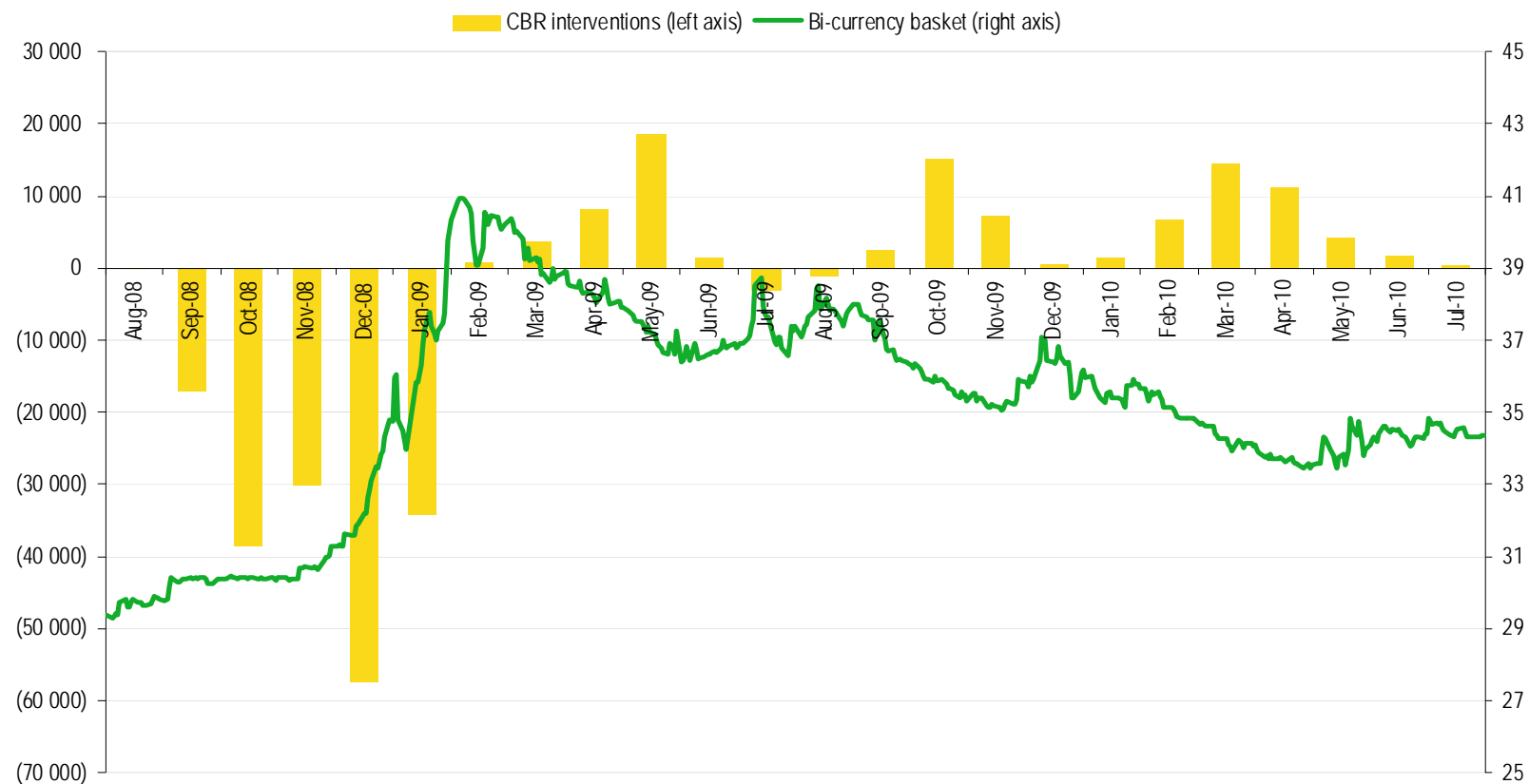


Source: CBR, Bloomberg

Low Rouble Volatility – Effect of Stable Oil

Bank of Russia attempts to intervene as little as possible

CBR interventions, \$mln; bi-currency basket, RUB



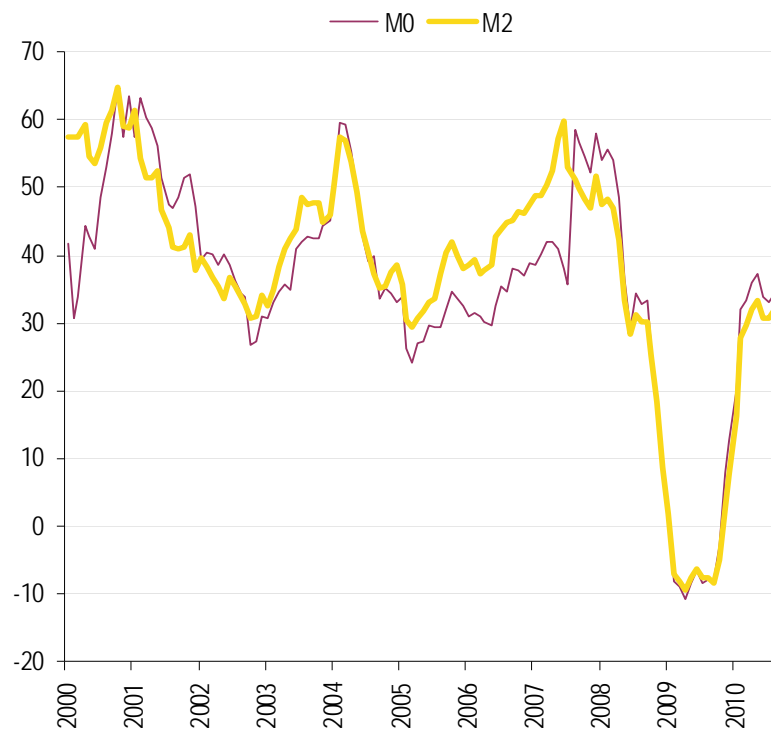
Source: CBR, Bloomberg

- Capital account balances near zero starting from 2Q09
- Russia returns to reserves growth
- Stable exports – function of stable oil; trade surplus exceeds \$10 bln a month this year
- CBR currency interventions are weakening
 - ⇒ Lower interest rates suppressed speculative pressure
 - ⇒ Still, stable oil is the main factor
- Our macro team forecasts the bi-currency basket at RUB32 for the end of 2010
- We expect a CA surplus of \$88 bln in 2010 (oil – \$79/bbl) and \$104 bln in 2011 (oil – \$84/bbl)
- Therefore,
 - ⇒ a dependence on oil remains
 - ⇒ a tendency towards gradual ruble appreciation if oil stays in the current range, i.e. above \$70/b

Money Supply – Growth versus Inflation

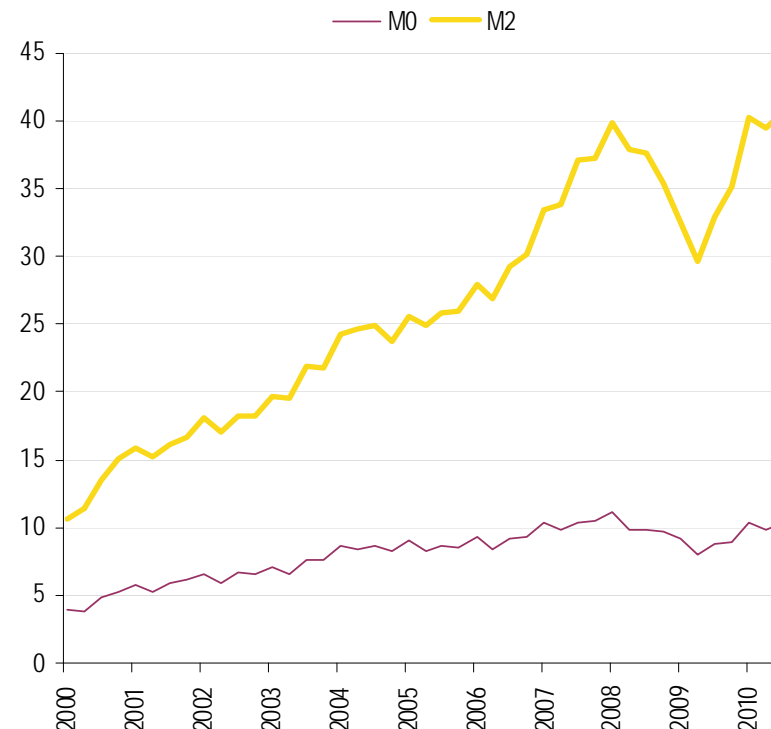
Money supply growth lower than pre-crisis

Money supply change, %YoY



Current growth rates are due to low base effect

Money supply to nominal 12-month GDP, quarterly, %

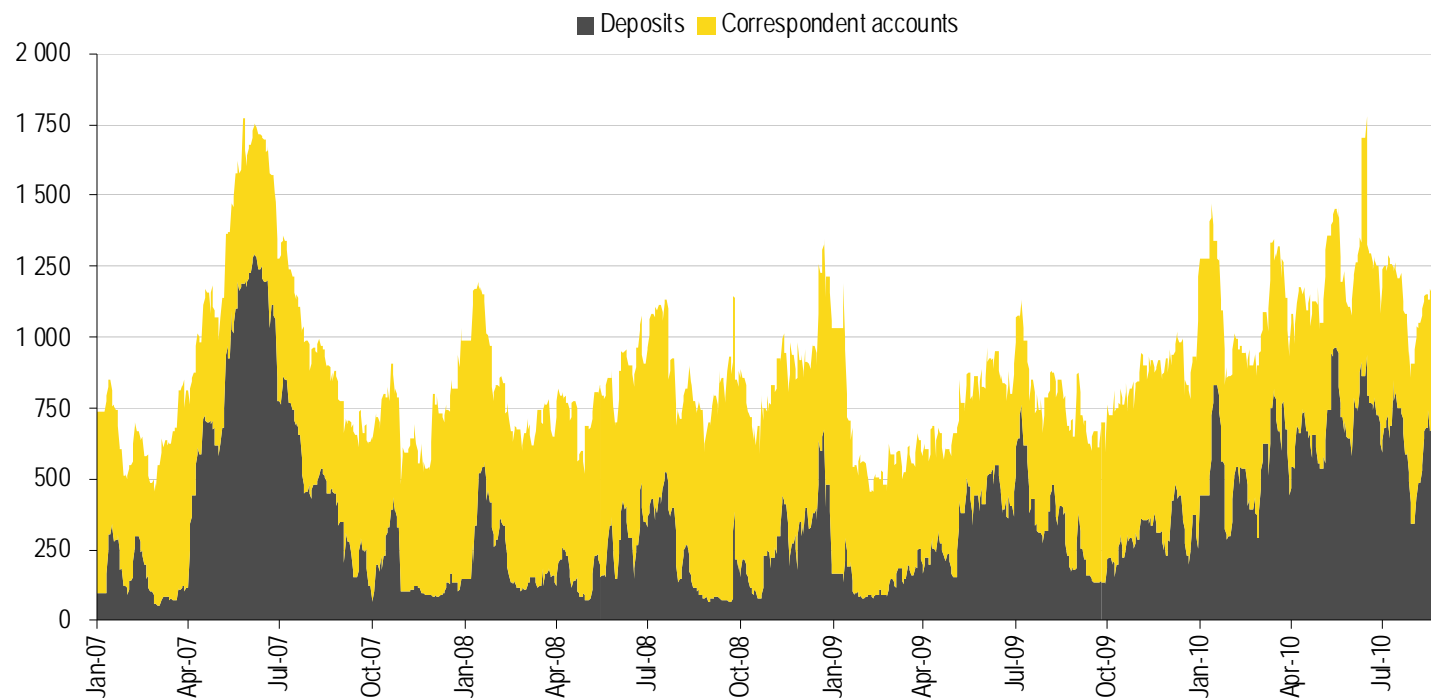


Source: Rosstat, Bloomberg

Banks' Reserves Stopped Growing

Liquidity stabilises

Voluntary reserves of Russian banks with the CBR, RUBbn

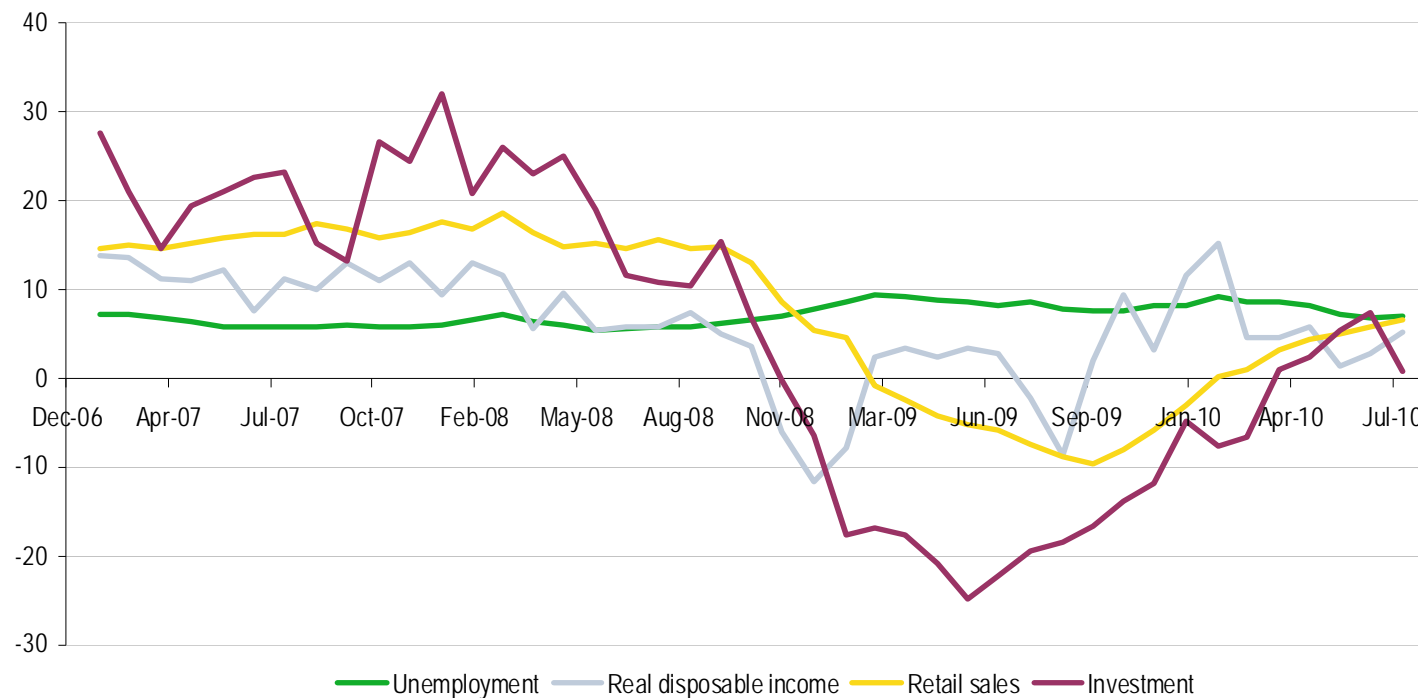


Source: CBR

Signs of Recovery Slowdown

Robust domestic demand, an uptick in unemployment and a fall of investments in July

Key economic drivers: unemployment, %; real income, retail sales, investment, %YoY

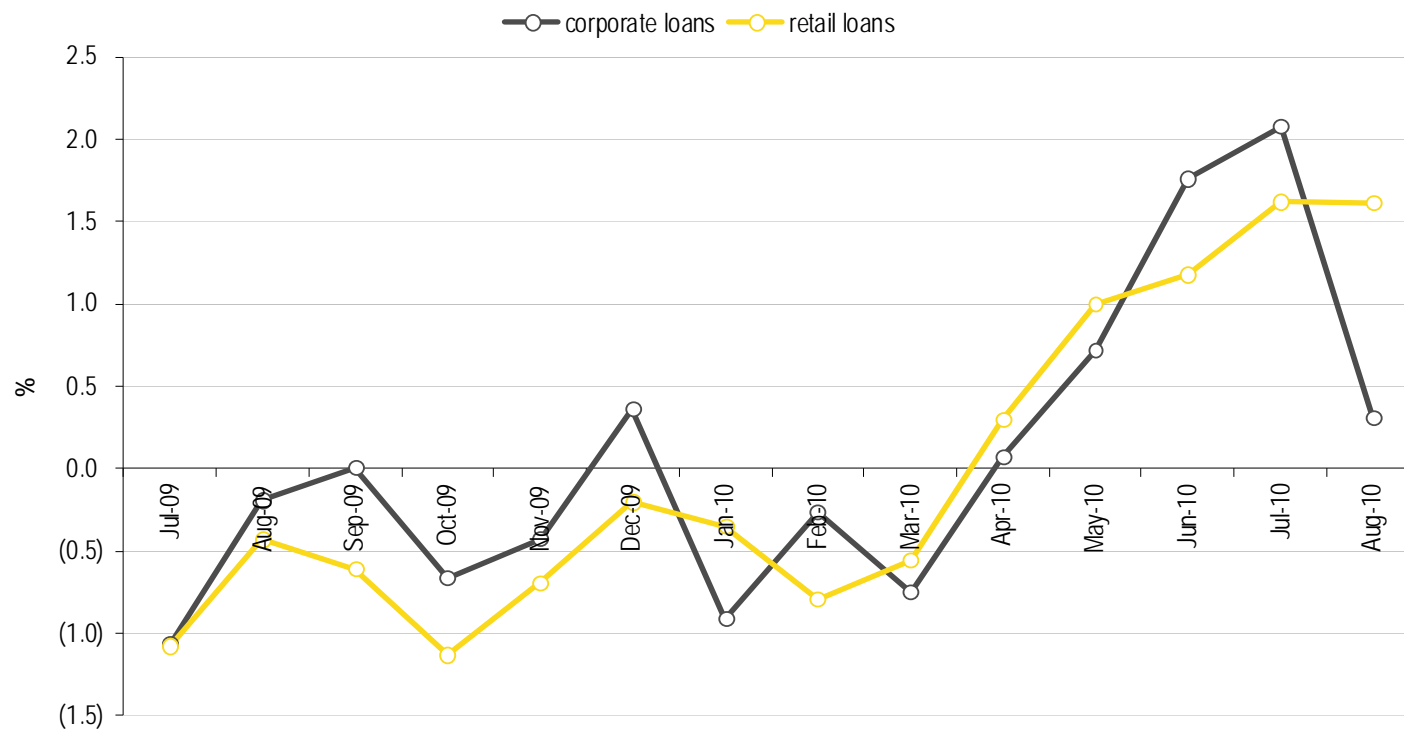


Source: CBR, Bloomberg

Credit Expansion Questionable

Provision of corporate loans slows down in August

Loan books at Russian banks, %YoY

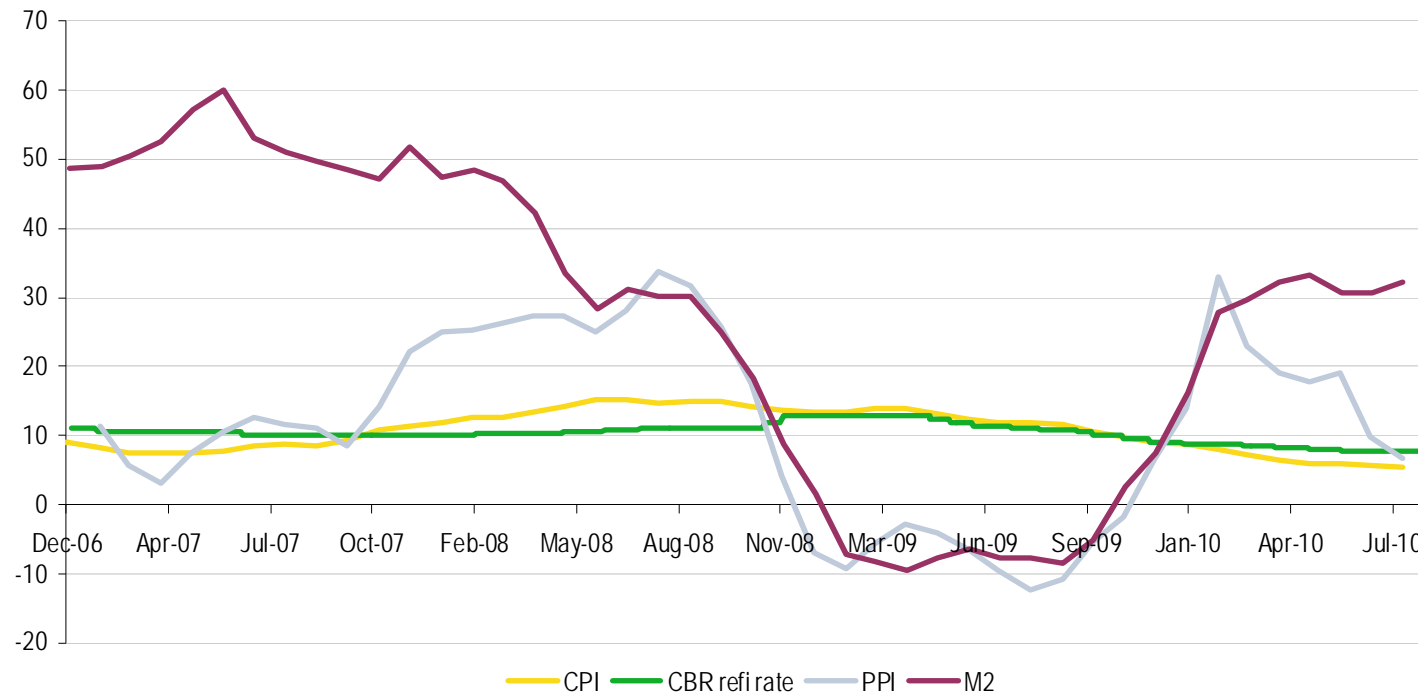


Source: Rosstat

Fundamental Inflation Risks are Moderate

Producer prices are moderating following a jump from low base

CPI, PPI, M2 change, %YoY; CBR refinancing rate, %pa



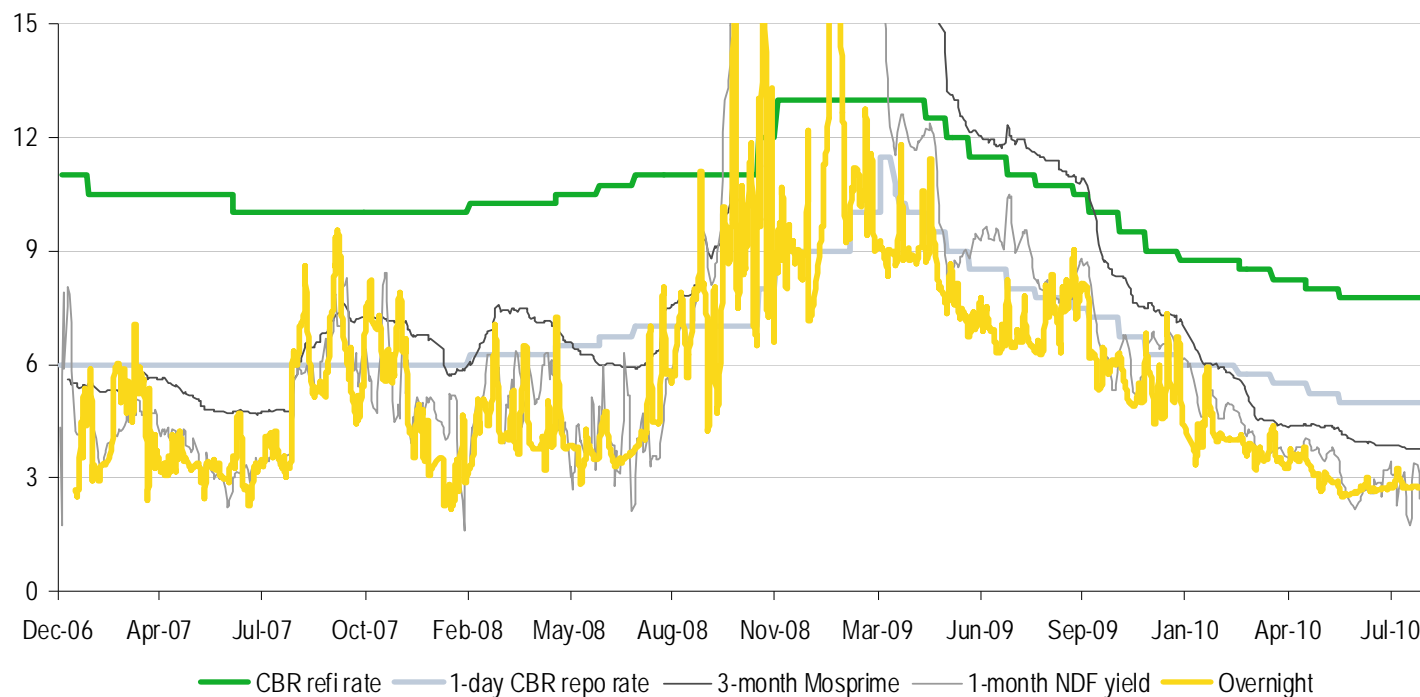
Source: CBR, Bloomberg

- Money supply growth rates are lower than pre-crisis levels
- Even these growth rates are due to a low base effect
- Banks stopped accumulating free cash
- Signs of recovery slowdown in July (more of that in August)
 - ⇒ An uptick in unemployment
 - ⇒ A fall in investments
- Provision of corporate loans slows in August following the credit expansion of June-July
- Producer price growth is moderating after a jump from a low base
- **Therefore,**
 - ⇒ Fundamental inflation risks are moderate
 - ⇒ The effect of the drought is likely to be transient (2-3 months)
 - ⇒ The focus must be on fighting inflationary expectations
 - ⇒ Our inflation forecast for 2010 is 7.5% and 8% for 2011

Money Market on Top Form

Key money-market rates are generally below pre-crisis levels

CBR refinancing rate, 1-day repo rate, 1-month implied NDF yield and 3-month Mosprime, %pa

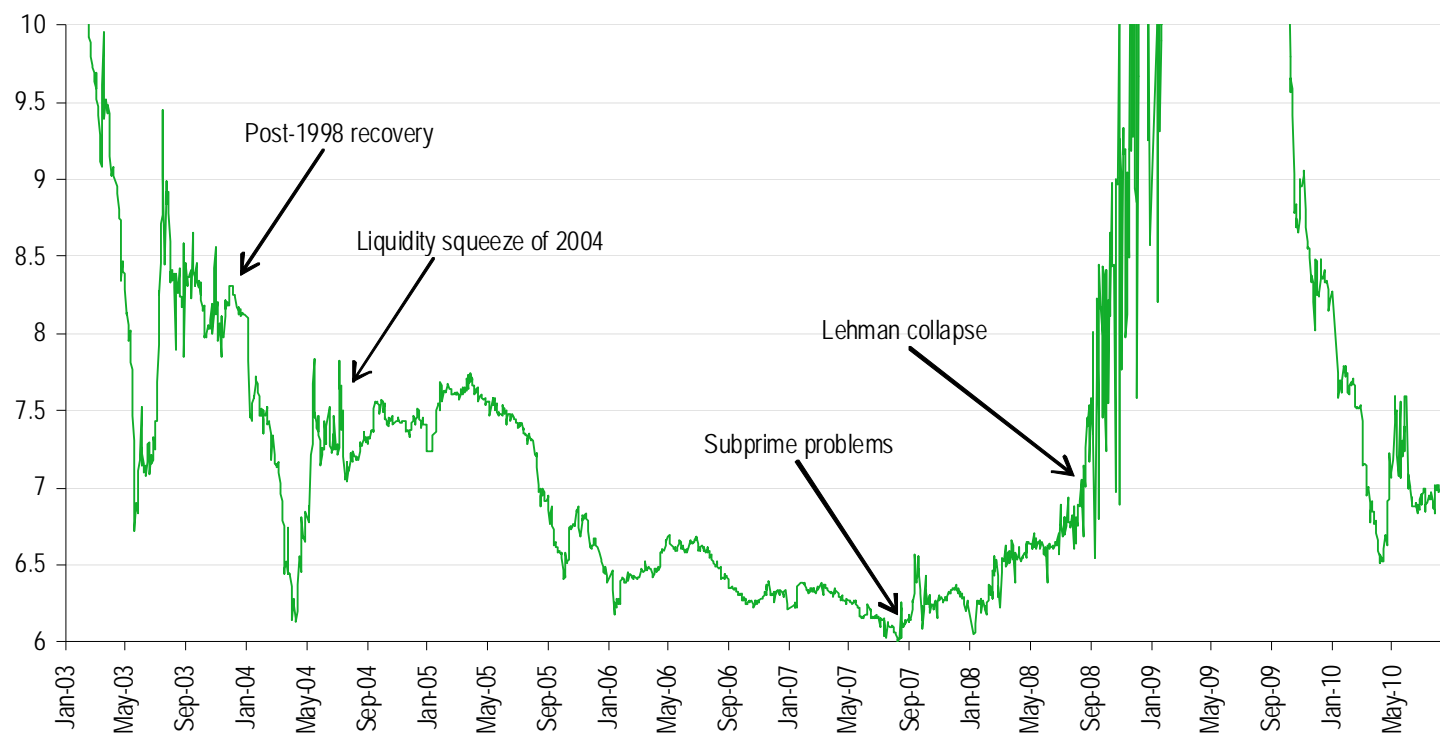


Source: CBR, Bloomberg

Ruble Yields are High Historically

Long-term rouble rates are higher than in 2006–2007

5-year OFZ yield



Source: Bloomberg

Yield Curve is Very Steep

Yield curve slope steepest since 2005

5Y-1Y OFZ spread, bps



Source: Bloomberg

A Wide Spread over CBR repo

Carry trade conditions largely unprecedented

Spread of 5Y OFZ over 1-day CBR policy rate, smoothed, bps

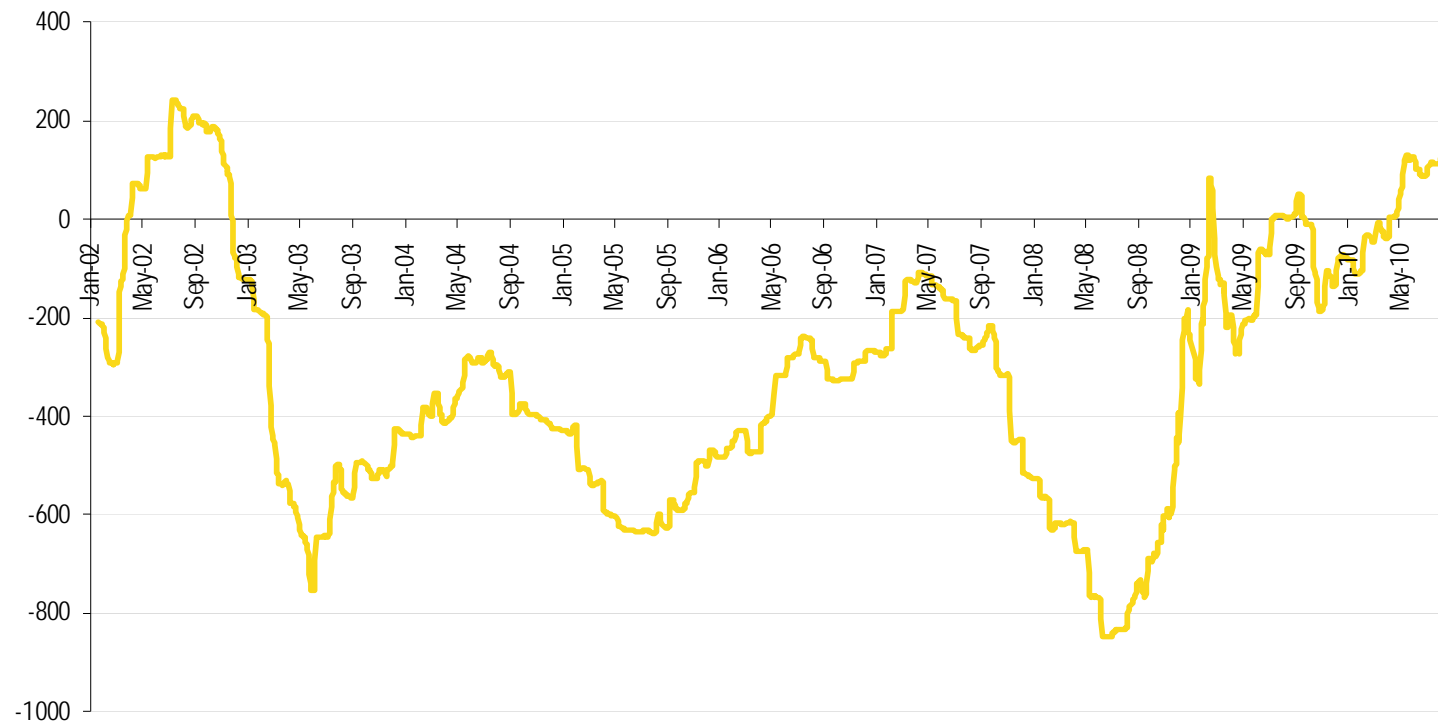


Source: Bloomberg

Positive Real 5Y Rate

Premium over inflation for the first time since 2002

Spread of 5Y OFZ yield over 12M CPI inflation, smoothed, bps



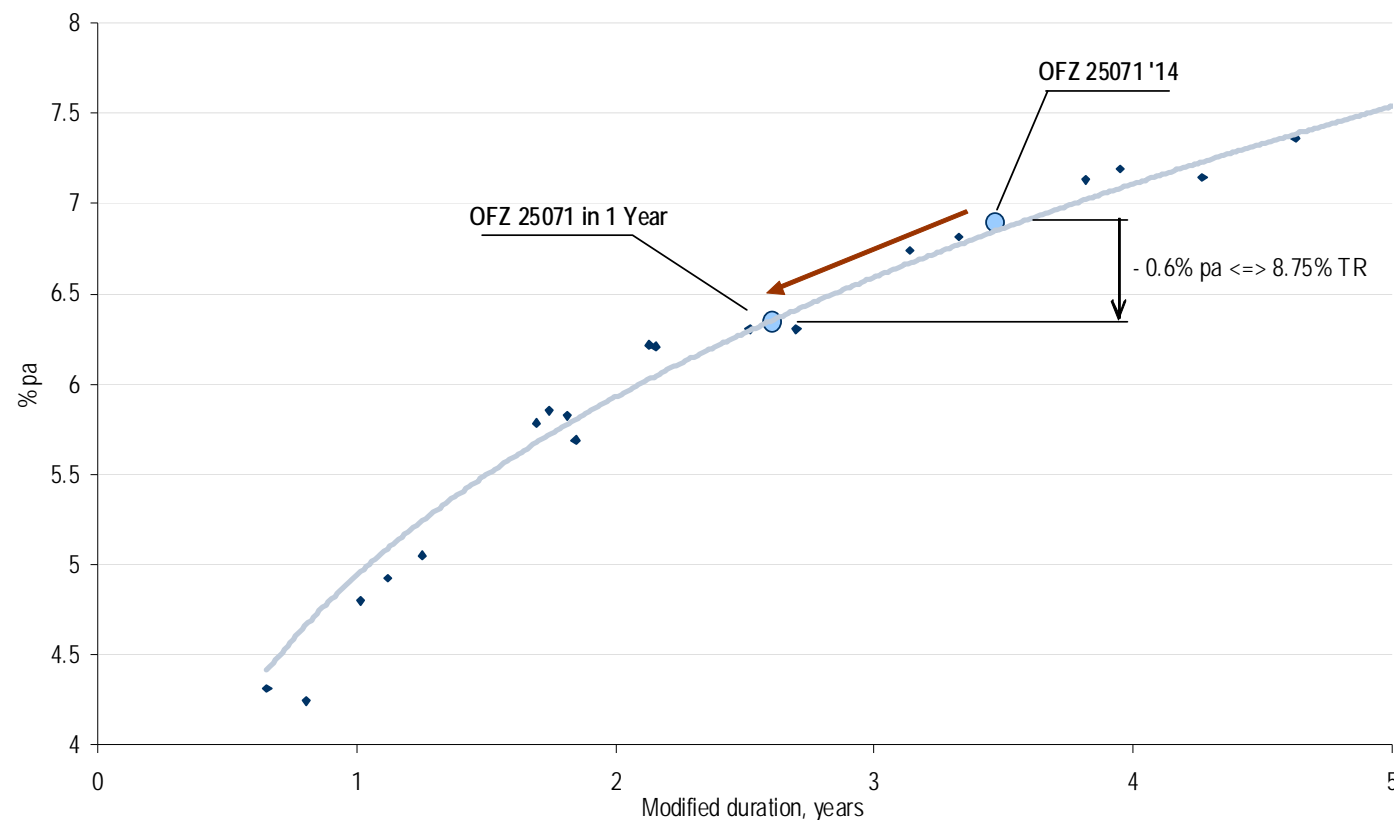
Source: Bloomberg

Yield Curve Steepness Can be Exploited

- Example: OFZ 25071 due in 2014, trading at 6.9%, with 8.1% coupon (price 104.8)
- Without any market movement, the curve does not change, OFZ 25071 will be trading at a yield of 6.3% in 1 year (price 105.5)
- Despite pull-to-par, the price of the bond actually increases with time
- This provides an excess return of 0.65% on top of 8.1% coupon – for a holding period return of 8.75%
- The theoretical 1-year total return of 8.75% is higher than OFZ 25071's current YtM (6.9%)
- This exercise provides the best results with 3-5-year paper

Steep curve slope boosts total return

OFZ yield curve

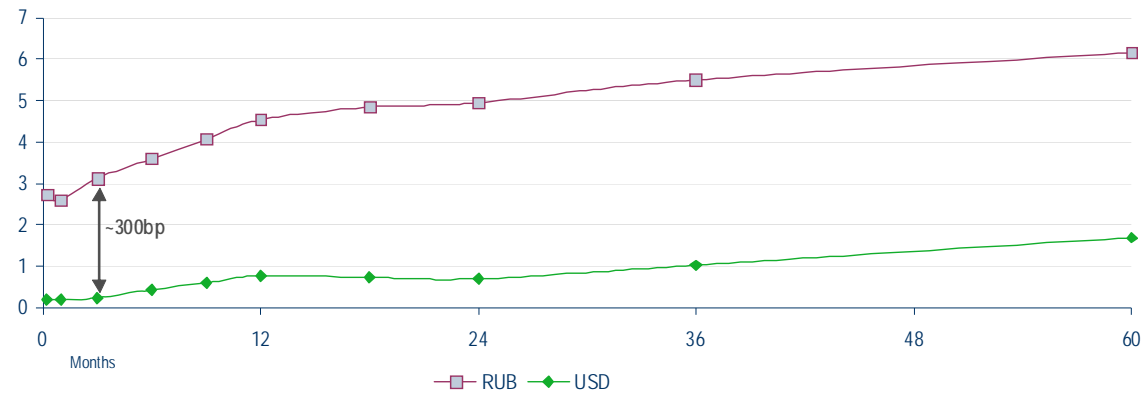


Source: MICEX, URALSIB estimates

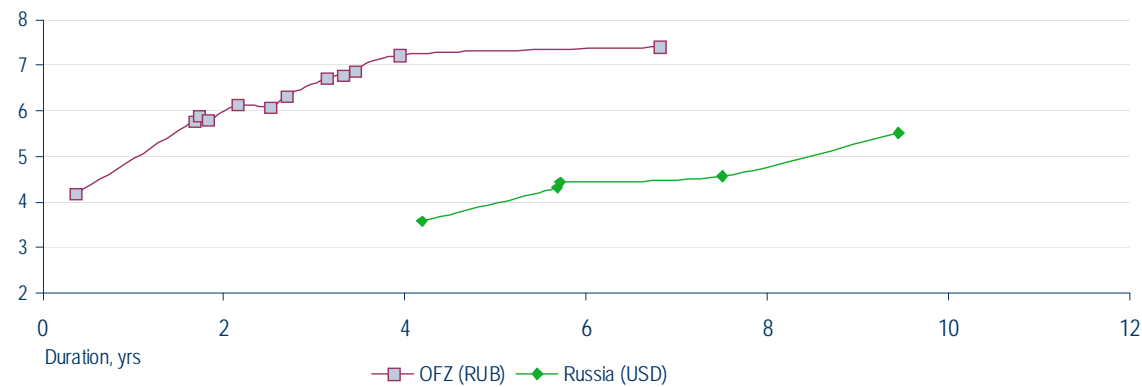
OFZ Curve Does not Look Expensive vs USD

OFZ exposure hedged into USD corresponds to Russia's sovereign USD yields

Money-market rates, %pa



Russian yield curves, %pa



Source: Bloomberg, MICEX

- Ruble bond yields (including OFZ) are higher than pre-crisis ...
 - ... while money-market rates are generally lower
 - Inflation in 2010 is expected to be the lowest in Russia's history
 - Larger OFZ supply does not necessarily mean higher yields
 - The slope of the ruble yield curve is very steep
 - The ruble yield curve does not look expensive if hedged into USD
-
- ⇒ We believe long-term yields are protected from rising
 - ⇒ We recommend 3-5 year duration

Economy Turns The Corner ...

Russia's macro dynamics and forecast, YoY%

	2008	2009	2010F*
GDP	5.6	(7.9)	5.5
Industrial production	2.1	(10.8)	8.1
Fixed investment	9.1	(17.0)	3.6
Retail sales	13.0	(5.5)	4.6
Real incomes	2.7	2.3	4.1
CPI	13.3	8.8	7.5
PPI	(7.0)	13.9	13.8
Federal budget deficit, % GDP	4.1	(5.9)	0.8
Exports, \$ bln	471.2	303.7	409.7
Imports, \$ bln	291.9	191.8	255.1
Current account, \$ bln	98.9	49.0	88.5
RUB/\$ (average)	24.9	31.7	29.1
Urals crude oil price, \$/bbl (average)	94.7	61.3	79.2

... Led By Exports and Consumer Demand

Main indicators, YoY%			
	2008	2009	Jul-10
Exports	33.1	(35.6)	32.5*
Imports	30.6	(34.3)	20.9*
Retail sales	13.0	(5.5)	6.6
Industry	2.1	(10.8)	5.9
Real incomes	2.7	2.3	5.2
Transport	0.7	(10.2)	1.2
Fixed investment	9.1	(17.0)	0.8
Services	4.8	(4.2)	(0.4)
Construction	12.8	(10.7)	(2.5)
Agriculture	10.8	1.2	(5.9)

*Preliminary data

Source: Rosstat, The Ministry of Economic Development



URALSIB Securities Ltd
Tower 42, 25 Old Broad St., London EC2N 1HQ, UK
Telephone: +44 (0)20 7562 8000
Fax +44 (0)20 7562 8099
Authorised and Regulated by FSA
Member Firm London Stock Exchange



URALSIB Capital LLC
8 Efremova Street, Moscow, Russia 119048
Telephone: + 7 (495) 788 0888
Fax: + 7 (495) 705 7010



Auerbach Grayson & Co.
25 West 45th Street, 16th Fl., New York,
New York 10036
Tel: 212-557-4444, Fax: 212-557-9066

Disclaimer

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s) about the subject. The lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. Opinions, estimates and projections in this report constitute the present judgment of the undersigned lead analyst(s) as at the date of the report. They do not necessarily reflect the opinions of URALSIB and are subject to change without notice. Name of lead analyst: Dmitry Dudkin, CFA (fixed-income).

This report is provided for informational purposes only. Under no circumstances is it to be used or considered as an offer or a solicitation of an offer to buy or sell securities.

Information and opinions contained in this report have been compiled by URALSIB from sources believed to be reliable and while all reasonable care has been taken in the preparation of this report, URALSIB makes no representation or warranty, express or implied, to its accuracy or completeness. Neither URALSIB nor its principals, employees, agents or affiliates accept any liability for any direct or consequential loss arising from any use of this report or its contents. Investors should make their own investment decisions using their own independent advisors, as they believe necessary and based upon their specific financial situations and investment objectives when investing. The information is the exclusive property of "URALSIB Capital LLC" and may not be reproduced or distributed without prior written permission.

URALSIB, their principals, employees, agents or affiliates may have positions or effect transactions in the securities referred to in this report and may engage in securities transactions with respect to securities covered by this report. They may also sell to or buy from customers on a principal basis and may serve as a director of issuers of such securities. Disclosures of conflicts of interest, if any, are listed below.

Investing in Russia and Russian securities may not be suitable for all investors and involves a high degree of risk. Investors should perform their own due diligence before investing, having due regard to their investment objectives and financial situation. Exchange rate fluctuations may affect the value of, and/or income from, securities denominated in currencies other than an investor's currency. Past performance is not an indication of future results necessarily. Prices of securities, income from an investment, liquidity and availability of securities are subject to change without notice. URALSIB has no obligation to modify, amend or update this report, nor to otherwise notify a reader of this report should any opinion, projection, forecast, estimate or other matter change or subsequently becomes inaccurate or if research coverage of the company by URALSIB ceases.

This report is not intended for the use of Private Customers as that term is defined under the Financial Services and Markets Act 2000. This report has been approved for publication in the United Kingdom by URALSIB Securities Limited, authorised and regulated by the Financial Services Authority and a member firm of the London Stock Exchange.

Additional information available upon request.

© URALSIB Capital 2009

This report has been prepared by the correspondent of Auerbach Grayson & Company Incorporated named above on the date listed above. We are distributing the report in the U.S. and accept responsibility for its content subject to the terms as set within the report. Any U.S. person receiving this report and wishing to effect transactions in any security discussed herein should do so only with a representative of Auerbach Grayson & Company Incorporated. Additional information on recommended securities is available on request.