Strategy
Russia

S&P	**BB (Stable)**
Moody's	**Baa3 (Stable)**
Russia 9% 3/04€	**(101.4/101.6, €L+77)**
Russia 9 3/8% 3/05€	**(106.7/106.5, €L+151)**
Russia 8 3/4% 7/05$	**(108.63/108.69, L+135)**
Russia 10% 6/07$	**(117.79/117.98, L+169)**
Russia 8 1/4% 3/10$	**(112.13/112.35, L+216)**
Russia 11% 7/18$	**(135.89/136.52, L+254)**
Russia 12 3/4% 6/28$	**(159.96/160.27, L+309)**
Russia 2.5% 3/30$	**(96.27/96.36)**

Russia

2004 investment outlook

Russia's sound economic fundamentals and the new, post-election political status quo bode well for the country's fortunes for 2004 and the years ahead. We recommend investors maintain Marketweight exposure to Russian sovereign bonds and Overweight the higher-yielding corporate bonds. We see best value in the industrial equipment and consumer-related sector.

Investment strategy

We maintain our Marketweight investment recommendation on Russian sovereign bonds as sound economic fundamentals should prevent further spread widening, but we expect bonds to move sideways ahead of the presidential elections in March.

Across Russian corporate bonds we see best value in the industrial equipment/consumer-related sector, as it is the most diversified and is geared to growth in domestic demand. Banks and Telecoms might face growing competition and decreasing the marginal return on capital investment, while the Oil and Gas sector carries the risk of decreasing oil prices and high net supply of bonds.

Political developments and outlook

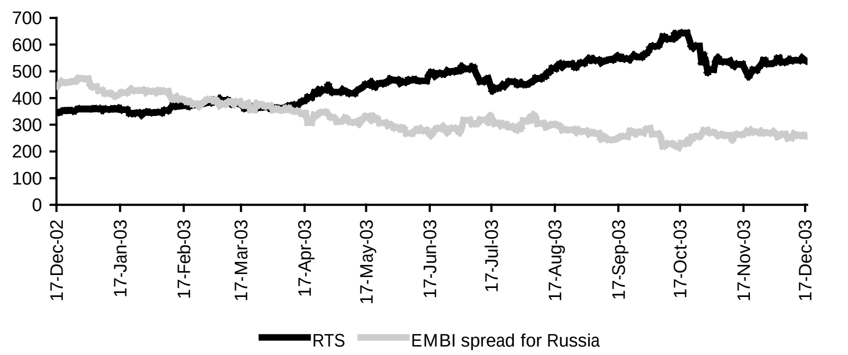
The results of the 7 December 2003 parliamentary elections were as expected and confirmed the broad social support for President Putin's policies. The pro-Kremlin United Russia, together with the long-standing support of the Liberal Democrats, will have a majority in the Duma.

The concentration of political power in the pro-presidential majority should allow faster implementation of economic and political reforms. Sustaining high economic growth and re-establishing Russia's position as an international power are likely to be top priorities for the policy makers.

Economic outlook

We project Russia's fiscal and external accounts to register surpluses in both 2003 and 2004. The country's debt payment capacity and external cash flow picture remain sound as well, and we expect a further accumulation of official FX reserves to $78.0bn by end-2004.

CHART 1: **Russian sovereign credit spread vs RTS equity market index**



Source: Commerzbank Economic Research

Peter Botoucharov
+44 20 7653 7826
peter.botoucharov@commerzbankib.com

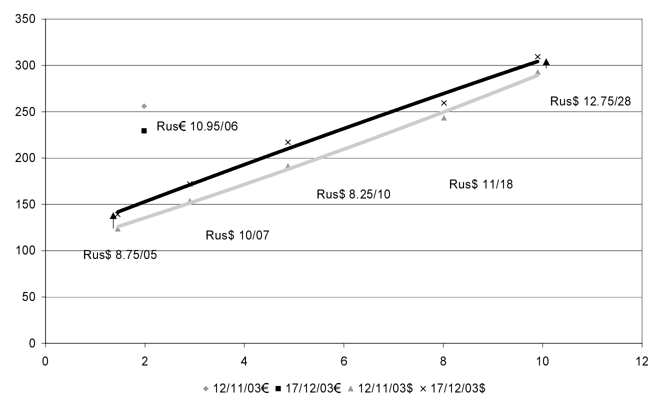
Dmitri Shemetilo
+44 20 7653 7045
dmitri.shemetilo@commerzbankib.com

Investment summary

We maintain our Marketweight investment recommendation on Russian sovereign bonds and our Overweight recommendation on Russian corporate bonds in particular sectors. We expect those related to the production of industrial equipment and services to outperform sovereign bonds.

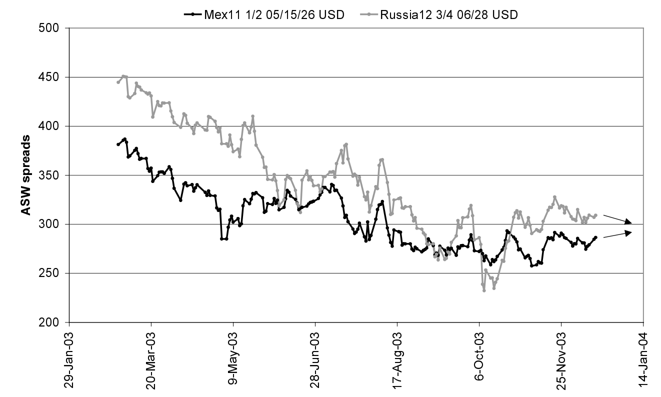
We believe that Russia's sound economic fundamentals will prevent further spread widening and increase the probability of a credit rating upgrade by S&P after the presidential elections in March 2004. This could widen the foreign investor base. Ahead of the elections, however, we expect bond spreads to move sidewise (Chart 2). Some pressure for spread widening might appear if domestic demand switches towards high yield domestic bonds (municipal and corporates) supported by expectations of rouble strengthening and an increase in UST yields. Relative to other countries, e.g. Mexico, we see Russian sovereign bonds as a safe haven with attractive credit spreads (Chart 3)

CHART 2: **Russian sovereign credit curves**



Source: *Commerzbank Securities*

CHART 3: **Dynamics of Russia and Mexico credit spreads**

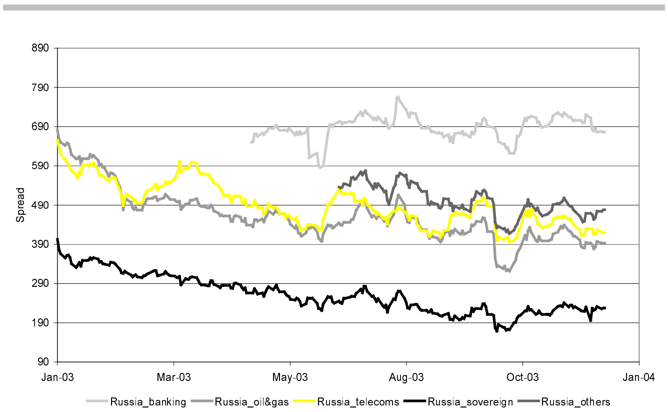


Source: *Commerzbank Securities*

We see best value in the final goods and consumer-related sectors

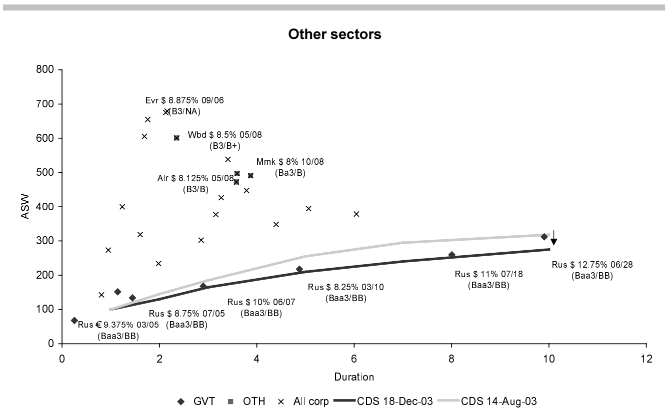
Across the universe of the Russian corporate eurobonds we favour the sub-sector "Others" as being the most diversified and the most related to growth in domestic demand. Banking would gain from the cheaper funding, but would have to take more corporate credit risks and increase the mismatch between asset and liability duration. Telecoms might face growing competition and decreasing the marginal return on capital investment as they move towards the regions to extend coverage. The Oil and Gas sector carries the general risk of the oil price decreasing and growth in the net supply of bonds.

CHART 4: **Dynamics of Russian credit indices**



Source: *Commerzbank Securities*

CHART 5: **Position of credit spreads for selected corporates**



Source: *Commerzbank Securities*

Political developments and outlook

The concentration of political power in the pro-presidential majority in the State Duma should allow faster implementation of economic and political reforms in the years ahead. The parties that represent the majority in the Duma have not yet announced a clear long-term political and economic programme, but we expect to see policies directed toward: economic growth; increasing the role of the state in the economy; further centralisation of power; and re-establishing Russia as a regional power.

Election outcome

Pro-Kremlin parties hold the majority in the new State Duma

The results of the 7 December 2003 parliamentary elections were as expected and confirmed the broad social support for President Putin's policies. The pro-Kremlin United Russia won 37.1% of the vote, distantly followed by the opposition left-of-centre Communist Party with 12.7%. Only two other parties – the nationalist Liberal Democrats of Vladimir Zhirinovsky and Motherland (Rodina) party – passed the 5% minimum threshold required for representation in the new Lower House of the Parliament (State Duma).

The preliminary results of the elections are summarised below – and it is important to note that elections to the 450-seat State Duma are made up of two parts. Half of the seats are awarded on the basis of the national party lists, while the other half are distributed to winners in individual constituencies. The preliminary results and MPs' seats are as follows:

TABLE 1: **December elections: Outcome and distribution of MP seats**

Political party	Orientation	% of vote	MP seats
United Russia	Centre, pro-presidential	37.1	222
KPRF	Left-of-centre	12.7	53
LDPR	National-liberal	11.6	38
Motherland	Moderate nationalists	9.1	29
Independent			65
Others (Yabloko, URF, etc)	Right-of-centre		43

Source: Commerzbank Securities

The election results show a few important political shifts:

- Nearly half of the MPs will be representatives of the pro-Kremlin United Russia, which together with the long-standing support of the Liberal Democrats will have a majority in the Duma.
- The Communist party lost considerable ground as it polled only 12.7% of the vote compared with 24% in 1999.
- There is a clear shift among voters from communist to nationalist parties (Liberal Democrats and Motherland (Rodina). The LDPR remains the only party lobbying for the business professional interest. The Motherland block is in fact a counterweight to the communists and the party could attract more votes in future, mainly from the communists' electorate. The Motherland programme is populist and oriented toward redistribution of natural resource assets, addressing some of the anomalies resulting from the privatisation experience.
- Finally, neither of the right-of-centre, liberal parties, Yabloko (4.3% of the vote) or the Union of Right Forces (SPS) (3.9%), passed the 5% threshold, thus becoming marginal political forces in the new Duma.

The next major political event will be the Presidential elections, which are set for 14 March 2004. We expect President Putin to win without major opposition.

Political outlook

A more united Duma and powerful President bodes well for policy making

The election results are likely to have a positive impact on economic policy making as the concentration of power around President Putin and a more united Duma should allow more efficient legislative work. The government is now likely to control more that 60% of the votes, allowing President Putin to bring any legislation he finds useful for the country through the parliament.

We expect Russia's international and domestic policies in 2004 and thereafter to be directed toward rebuilding the Russian Federation's political and economic power in the international arena, and toward a deepening of market-oriented reforms in the direction of the European "state capitalism" model. In international politics we expect Russia to make more use of economic factors such as control over natural resources (gas, oil, and electricity). Therefore all reforms in this sector will probably leave control over the distribution of these resources in state hands.

State capitalism model in the works

In our opinion, future political trends in Russia will lead towards the development of "state capitalism" similar to the continental European model, where a strong government exerts control over the economy and provides larger social guarantees. We expect:

- Growth and economic recovery to be a top priority for the policy makers. In addition, we expect more efforts toward establishing a market-based legislative framework, especially in the fields of utilities, banking, and tax legislation.
- The centralisation of political power is likely to continue, leading to the redistribution of a significant share of regional income.
- Russia will continue increasing its economic influence in the region, especially among the FSU countries. The natural monopolies, most probably Gazprom and RAO UES, are likely to be used as instruments of foreign policy.
- Restructuring of the natural monopolies is to be done in such a way as to leave distribution networks under state control.

The election outcome is also likely to raise some risks:

- The increased influence of President Putin and the United Russia party on the economy is not necessarily conducive to fast restructuring of the natural monopolies, and may lead to the state retaining influence over key assets. We expect the presidential administration to have a stronger influence on the Duma's committees at all stages of the legislative process.
- Some legislative delays are likely, due to conflicts of interest among different groups inside parties, as happened to the Law on Mortgage Securities.
- Enlargement of the sphere of economic interests might lead to an unexpected increase in public expenditure, especially in the case of unification with Belarus and the implementation of assistance programmes for Transdnestria and Abhasia.
- Possible increase in military expenditure.
- Significant capital outflow if policies unfriendly toward business are enacted or external shocks, such as the price of oil and other primary commodities falling.

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Progress on key financial legislation

Following up on our latest in-depth analysis on Russia – *Russia: Economic trend favours corporates* of 15 September 2003) – we provide an update on the legislative progress of the key financial laws:

- **The Law on Deposit Insurance** – this law was approved by the parliament on 10 December 2003 and is now awaiting the President's signature.
- **The Law on Bankruptcy of Credit Organisations** is still in parliament but should be passed in the spring.
- **The Law on Financial Derivatives** is suffering from a conflict of interests between the Central Bank and the Security Exchange Commission, even though the **Law on Mortgage Securities** passed its third reading and was written into law on 11 November 2003.
- **The Law on Currency Regulations** was approved by both houses of parliament on 26 November 2003 and signed by the President on 16 December 2003.
- We do not expect any significant progress on the **Law on Financial Derivatives** since it might be conditional on the creation of a single regulating financial authority.

Economic outlook

Strong growth momentum and lower inflation

Robust economic performance in 2003…

In line with our expectations Russia's robust economic and financial performance has been sustained through 2003, and we expect a similar outcome in the year ahead. The latest economic data suggest continued high growth and strong fiscal and external accounts in 2003. Real GDP growth reached 6.5% in January-September 2003 compared with 4.7% in the same period last year. The key drivers for this were strong export growth, rising corporate investment and strengthened private consumption.

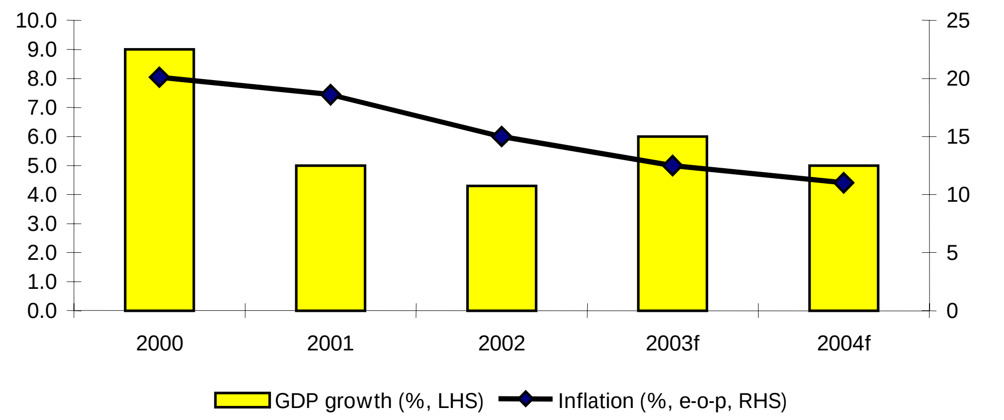
… is likely to continue next year

We maintain our projections for 6.0% growth this year and 5.0% in 2004, and expect further improvement in the growth structure, as fixed investments have already become the main growth-driving factor in the economy, supported by healthy exports and private consumption. For 2004 we revise upwards our projection for investment demand growth to 10% and expect only a slight decline in private consumption growth from 7.0% this year to 5.0% in 2004. A further reduction of the tax burden next year and recovery in the euro-zone are likely to provide a base for the favourable cyclical trend to continue. Further impetus should result from fresh reform momentum after the presidential election next year. In addition, the recent success in attracting foreign direct investment in the Energy sector should encourage the government to improve investment conditions further.

Disinflation trend to continue

CPI inflation has been slowing through the year and is likely to drop to 12.5% by end-2003 from 15.0% at the end of last year. The larger-than-expected seasonal decline in food prices in the summer months led to the first monthly decline in eight years in August. In November the monthly CPI came in at 1.0% leading to a drop in the year-on-year inflation rate to 12.4%. For 2004, the expected administrative price hikes – e.g. gas prices, set to increase by 25%, electricity prices by 15% and railway tariffs by 12% – are likely to slow down the disinflation process, but we still project 2004 CPI to drop to 11.0% by year-end.

CHART 6: **Russia: Economic growth and infation**



Source: Commerzbank Securities

Fiscal performance on track for another strong year

We expect a central government fiscal surplus of 1.0% of GDP in 2003

Russia's fiscal performance is also on track for another strong year, with central government operations registering a surplus of RUB 267bn (1.4% of GDP) in the first nine months of the year. As discussed in our earlier analysis, we expect a slight undershooting of the government's 2003 budget surplus target of 1.4% due to higher spending in the pre-election period. We expect a fiscal surplus of 1.0% this year, while next year's draft budget envisages a budget surplus of 0.5% of GDP.

A conservative 2004 budget targets a surplus of 0.5% of GDP…

The government's 2004 budget is based on conservative assumptions, underlining the prudent fiscal policy stance maintained over the few past years. The key variables are 5.2% GDP growth and average inflation of 9.0%. The average price for Urals Blend is projected at $22/barrel, which implies a Brent Blend price of around $23.5/barrel and is in line with our projections. We estimate that it would require a drop in the oil price to below $20/barrel for a sustained period of time before spending cuts became necessary to avoid a shift into deficit. Fiscal revenues are projected to decline by 1.9% of GDP, due mainly to the cut in the VAT rate from 20% to 18% as of 1 January 2004. The Ministry of Finance is planning to raise gas export duties and oil extraction taxes to offset some of the lost revenues.

… and aims to increase the fiscal reserve account to $10bn by end-2004

The 2004 budget draft also envisages a further increase in the fiscal reserve account to $10bn. The government aims at maintaining a good buffer of financial resources to support future fiscal needs in case of a slump and sustained low international oil prices. The budget also assumes principal repayments on external debt of $9.0bn, which is to be financed in equal parts by privatisation revenues and domestic and international borrowing.

Balance of payments remains in considerable surplus

Russia's current account is likely to show a surplus of 8.2% of GDP in 2003 and 5.5% in 2004

Russia's BoP is likely to remain in considerable surplus in 2003. The current-account surplus reached $29.3bn (9.0% of GDP) in the first nine months of the year, up from $21.3bn (7.8% of GDP) in the same period of 2002. The trade account surplus reached $43.3bn, or higher than the total trade account surplus for 2002. We revised our external account projections upwards in September and maintain our annual projections for trade and current account surpluses of $47.0bn (11.1% of GDP) and $34.8bn (8.2% of GDP). Russia's robust external account performance is likely to continue through 2004, and we expect the trade surplus to remain high at around $42.0bn with a still sizeable current-account surplus of $28.0bn (5.5% of GDP).

Strong external cash flow picture

Russia's external cash flow picture remains very strong as well. Our analysis on uses and sources of financing suggests considerable accumulation of FX reserves both this year and next. 2003's external cash flow surplus of nearly $20.0bn should lead to official foreign exchange reserves growing to $70.0bn. Next year's external cash flow surplus is likely to be less than half this year's at $8.5bn but should still allow accumulation of FX reserves.

TABLE 2: **Russia: External cash flow**

$bn	2003E	2004E
Uses of financing	**3.4**	**-4.7**
Current account surplus(+)/deficit(-)	34.8	28.0
Bond and loan amortisation	-31.4	-32.7
o/w medium and long term	9.1	8.5
o/w short term	22.3	24.2
Sources of financing	**16.5**	**13.2**
Financial reserve account	6.3	4.0
Budget surplus	5.0	1.0
Equity investment, net	5.0	4.7
FDI	4.5	4.0
Portfolio investment	0.5	0.7
Multilateral loans (IMF, WB, EBRD)	0.2	0.3
Other bilateral financing	0.0	0.2
Eurobond issuance	0.0	3.0
Financing surplus (+)/deficit(-)	**19.9**	**8.5**

Source: Commerzbank Securities, IIF

Sustained high debt payment capacity

Russia's debt payment capacity has improved tremendously over the past few years on the back of massive fiscal and current account surpluses, and pro-active debt management operations. The country's foreign debt-to-GDP ratio fell from 94.5% in 1999 to 43.2% at end-2002 and is projected to drop further to around 35% of GDP by end-2004. Public sector debt is expected to decline to 33.8% of GDP (including external debt of 27.8% of

GDP) by end-2003 and further to 29.9% (external debt 23.5% of GDP) by end-2004. The government's debt management strategy for 2004/05 is aimed at increasing further the share of domestic debt in total public debt.

Russia's debt service repayments remain sizeable in nominal terms – $14.5bn in 2004 and $15.4bn in 2005 –- but the debt service ratio had dropped from 28.5% in 1998 to 12.7% in 2003, and is projected to drop to below 10% by 2006.

TABLE 3: **Russia: External debt obligations**

$bn	2003E	2004E	2005E	2006E	2007E
Original amount due	19.5	12.9	15	13.25	13.5
Projected amount due, of which	**15.7**	**14.5**	**15.4**	**13.25**	**13.5**
Principal	9.1	9.0	9.7	8.5	8.8
Interest	6.6	5.5	5.7	4.75	4.7
Total debt service (% of GNFS)	**12.7**	**11.3**	**11.4**	**9.5**	**9.3**

Source: Commerzbank Securities, IIF

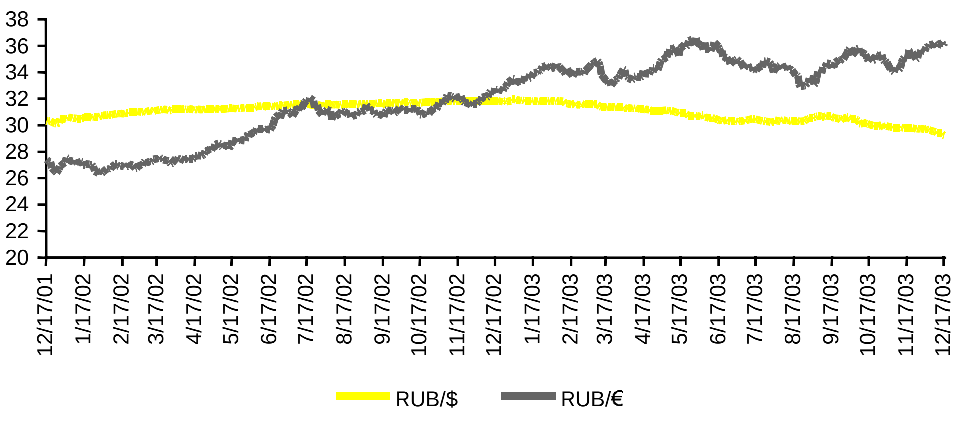
Monetary policy and the rouble

Monetary policy likely to become tighter in 2004

The Central Bank of Russia has been in an easing monetary cycle since early 2003 with the deposit rate dropping to 0.5% in November from 9.0% at end-2002. The sharp rate cuts, together with generally non-sterilised foreign exchange interventions, led to a year-on-year M2 growth rate of around 50%. This loose monetary policy led to strong domestic credit growth of around 40% on an annualised basis. For 2004 we expect the Central Bank to aim for a tighter monetary stance and target annualised broad money growth of 20%-25%.

Since the beginning of the year the rouble (RUB) has appreciated by over 7% in nominal terms against the dollar but has depreciated versus the euro. Thus, euro strength has kept the rouble unchanged in nominal trade-weighted terms. In real terms, however, the rouble has appreciated versus both the dollar and the euro, leading to concerns about competitiveness. For 2004 we project a nominal depreciation of around 3.0% against the dollar to 30.4 and 6.0% against the euro to 38.3. Despite the expected lowering of pressure on the currency due to a moderate decline in oil prices in 2004 and lower fiscal and current account surpluses, the real appreciation is likely to remain higher than the central bank's medium-term target range of 4%-6%.

CHART 7: **RUB/€ and RUB/$ exchange rates**



Source: Commerzbank Securities

COMMERZBANK SECURITIES

TABLE 4: **Russia; Main economic indicators and projections**

	1999	2000	2001	2002	2003f	2004f
Nominal GDP (RUB bn)	4,545	7,063	9,041	10,831	12,997	15,206
Nominal GDP ($bn)	182.2	251.0	309.7	345.3	423.4	507.7
Nominal GDP (EUR bn)	171.1	271.5	345.7	364.7	375.1	408.8
Real GDP growth (%)	**5.4**	**9.0**	**5.0**	**4.3**	**6.0**	**5.0**
Inflation (%, end-of-period)	36.7	20.1	18.6	15.0	12.5	11.0
Fiscal balance (% of GDP)	**-1.2**	**2.5**	**2.9**	**1.4**	**1.0**	**0.5**
Primary fiscal balance (% of GDP)	1.8	5.3	5.5	3.5	2.5	2.1
Trade balance ($bn)	34.4	59.8	45.8	42.1	47.0	42.0
Trade balance (% GDP)	18.9	23.8	14.8	12.2	11.1	8.3
Current account balance ($bn)	22.0	44.2	30.1	27.0	34.8	28.0
Current account balance (% GDP)	**12.1**	**17.6**	**9.7**	**7.8**	**8.2**	**5.5**
Foreign exchange reserves ($bn)	8.5	24.3	32.5	44.1	70.0	78.0
External debt/GDP ratio	94.5	64.3	48.9	43.2	38.2	35.2
RUB/$, e-o-p	27.55	28.16	30.5	31.95	29.5	30.4
RUB/$, average	24.95	28.14	29.19	31.37	30.7	29.95
RUB/€, e-o-p	27.75	26.81	27.14	33.51	36.15	38.3
RUB/€, average	26.56	26.01	26.15	29.7	34.65	37.2

Source: Commerzbank Securities, IIF, IMF

TABLE 5: **USD denominated Russian corporate bonds**

Bond	**Prices Bid**	**Ask**	**Yields Bid**	**Ask**	**ASW Bid**	**Ask**	**Govt Spds Bid**	**Ask**	**Price chg (%, bps) 1D**	**1W**	**1M**	**ASW cng (bps) 1D**	**1W**	**1M**	**Spds to sovereign Bid**	**Ask**
Oil and Gas																
Rosnef $ 12.75% 11/06 (B2/B)	115.31	115.66	6.853	6.612	458	434	368	344	1	1	1	(15)	(1)	(18)	371	355
Sibnef $ 11.5% 02/07 (Ba3/B+)	111.75	112.13	7.244	6.992	476	452	408	383	1	0	3	(2)	18	(65)	278	263
Gazpru $ 9.125% 04/07 (NA/BB-)	110.00	110.25	5.786	5.630	311	295	261	246	0	0	1	5	11	(13)	132	127
Tmenru $ 11% 11/07 (Ba3/BB-)	114.63	114.94	6.649	6.479	386	369	348	331	0	0	1	0	15	15	218	212
Sibnef $ 10.75% 01/09 (Ba3/B+)	112.13	112.26	7.803	7.746	455	449	464	458	1	0	3	(9)	15	(31)	190	192
Gazpru $ 10.5% 10/09 (NA/BB-)	116.75	117.07	6.952	6.833	353	341	379	367	0	0	2	6	17	(5)	105	101
Gazpru $ 9.625% 03/13 (NA/BB-)	110.25	110.38	8.024	7.987	380	376	383	380	0	0	2	3	14	2	212	216
Telecoms																
Mobtel $ 10.95% 12/04 (Ba3/B+)	106.25	106.32	4.472	4.348	312	299	269	256	0	0	(0)	(5)	(9)	(17)	133	129
Vip $ 10.45% 04/05 (B3/NA)	106.00	106.25	5.737	5.363	419	382	395	358	0	0	0	(1)	6	(11)	260	230
Mobtel $ 9.75% 01/08 (Ba3/B+)	108.25	108.63	7.380	7.176	436	417	421	401	0	1	2	2	10	(23)	291	281
Sisfin $ 10.25% 04/08 (NA/B-)	105.75	106.13	8.618	8.414	547	529	545	525	0	0	3	6	18	(32)	415	405
Mobtel $ 8.375% 10/10 (Ba3/B+)	102.21	102.41	7.946	7.871	394	388	478	471	0	1	2	3	2	(5)	348	351
Banking																
Alfaru $ 10.75% 11/05 (Ba2/B)	104.50	104.75	8.147	7.868	619	593	637	609	0	0	0	3	15	17	501	481
Mdmbk $ 10.75% 12/05 (Ba2/NA)	103.75	103.88	8.650	8.514	662	649	687	673	1	1	1	(26)	(53)	(34)	551	545
Uralsi $ 8.875% 07/06 (NA/B-)	98.75	99.00	9.437	9.210	686	666	766	743	0	0	2	5	29	(35)	630	615
Zenit $ 9.25% 06/06 (B1/B-)	99.75	99.91	9.363	9.219	686	674	758	744	0	1	1	(2)	(8)	(15)	622	616
Sberru $ 0% 10/06 (Baa3/NA)	98.50	98.75	3.523	3.335	0	0	36	17	0	0	0	0	0	0	38	27
Gazpru $ 9.125% 04/07 (NA/BB-)	110.00	110.25	5.786	5.630	311	295	261	246	0	0	1	5	11	(13)	265	257
Others																
Evraz $ 8.875% 09/06 (B3/NA)	100.04	100.29	9.043	8.827	621	602	726	705	0	0	2	12	21	(42)	458	447
Alrosa $ 8.125% 05/08 (B3/B)	99.75	100.00	8.190	8.052	482	470	502	489	0	0	2	1	15	(13)	372	369
Wbdfru $ 8.5% 05/08 (B3/B+)	100.25	100.50	8.428	8.290	506	494	526	512	(0)	(2)	(2)	15	70	79	252	246
Mmkfin $ 8% 10/08 (Ba3/B)	97.82	98.01	8.555	8.458	495	487	539	529	0	0	2	9	17	(12)	265	263

Source: Commerzbank Securities

TABLE 6: **Euro-denominated Russian corporate bonds**

Bond (Moody's/S&P)	**Prices Bid**	**Ask**	**Yields Bid**	**Ask**	**ASW Bid**	**Ask**	**Govt spds Bid**	**Ask**	**Price cng (%, bps) 1D**	**1W**	**1M**	**ASW cng (bps) 1D**	**1W**	**1M**	**Spds to sovereign Bid**	**Ask**
Banking																
Gazfin 9.75% 10/05 (Ba2/NA)	106.50	106.57	5.783	5.712	319	312	290	283	0	(0)	(1)	1	16	43	178	190
Oil and Gaz																
Gazpru 7.8% 09/10 (NA/BB-)	103.06	103.19	7.203	7.156	321	316	335	330	0	0	3	2	10	(23)	320	334
Municipals																
Citmos 10.25% 10/04 (Ba2/BB)	104.75	105.19	4.330	3.325	211	107	178	78	0	0	0	16	(14)	(52)	109	82
Citmos 10.95% 04/06 (Ba2/BB)	112.50	112.75	5.138	4.928	240	219	225	204	0	0	1	(2)	(2)	(26)	113	111

Source: Commerzbank Securities

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DLZ - Gebäude 2, Händlerhaus Mainzer Landstraße 153 60327 Frankfurt	60 Gracechurch Street, London EC3V 0HR	Myslikova 31 110 00 Praha 1 Czech Republic	Tokio Marine Building, Shinkan 9F, 1-2-1 Marunouchi, Chiyoda-ku, Tokyo 100-0005	1251 Avenue of the Americas, New York, NY 10020-1104
Tel: + 49 69 136 44440 Fax: + 49 69 136 40357	Tel: + 44 20 7653 7000 Fax: + 44 20 7653 7400	Tel: +420 2 2190 8111 Fax: +420 2 2190 8119	Tel: + 81 3 5293 9000 Fax: + 81 3 5293 9327	Tel: + 1 212 703 4350 Fax: + 1 212 703 4301