Overall Strategic Outlook for 2008

Moderate Optimism and the Right Choice

AntantaPioglobal
investment group

Overall Strategic Outlook for 2008: Moderate Optimism and the Right Choice

We retain our moderately upbeat outlook for the Russian stock market in 2008. Our year-end 2008 forecast for the RTS Index is 2,700, which implies overall market growth of no more than 20%. That said, the second-tier and greenfield stock segments hold potential for heftier gains. The most important thing is to zero in on the most promising sectors and single out the right companies for investment targets.

Our moderate forecast for the RTS Index is underpinned by the following factors:

- In spite of red hot crude-oil prices, coupled with a heavy tax burden, the rising cost of oil extraction and greenfield development operations have substantially dampened the key performance indicators of crude producers, leaving no incentive for incremental output. This limits the ability of Russian oil companies to unlock their latent upside that boasts huge reserves compared to their western peers. Against this backdrop, the capitalization growth potential of oil producers does not exceed 15% in 2008, according to our estimates.

- The outlook is brighter in the gas industry, where much lower taxes and a guaranteed hike in domestic prices enable gas companies to improve their financial performance. This factor, however, has already been priced into the stock valuations of Gazprom and Novatek, the only listed concerns, whose upside potential can be estimated in the range of 10-20%.

- Taking into account the fact that the O&G sector accounts for around 53% of benchmark RTS, it goes without saying that expectations for its growth are modest. We believe the banking and metals sector with heavy weightings in the index (18% and 15%) could also generate 15-30% returns for investors on the back of a more low-key environment on the steel market in 2008 and heightened liquidity deterioration risks due to a possible extension of the US mortgage lending crisis.

SECOND-TIER STOCKS: THE MAIN THING IS TO HONE IN ON THE RIGHT SECTORS AND COMPANIES

We maintain that second-tier and greenfield stocks still offer excellent investment opportunities that could easily outperform the RTS Index. And while the core concepts we're betting on next year are not brand new, this in no way undermines their validity as upbeat investment options:

- Completion of the key stages of utility sector reform.

- Focus on the industries that are expected to move up in line with favorable global trends.

- An investment boom.

- Sectors that have remained on the sidelines and trade cheaply.

While sticking to this basic strategy, we would like to highlight the following sectors of the national economy that look most attractive in 2008:

- **Utilities**. 2008 will see UES's final reorganization slated for July1. As a result, the industry's most liquid blue chip will be delisted. However, three new blue chips will replace it. Altogether, they can offset this loss. They are HydroWGC (to be listed in Q108), UES FGC and IDGC Holding (Q308). Each segment, including generation, trunk grids, distribution grids and sales, will undergo important and interesting developments which will allow investors to capitalize on them.

- **Coal and iron ore output**. In 2008 raw iron ore and coal prices are expected to spike and steel prices should rise at a slower pace than feedstock prices. Under these circumstances, we view as the most appealing investment instruments mining stocks, including raw iron ore producers (GOKs), coal makers and metal giants with strong vertical integration. Our top picks in the segment are **Korshunovsky GOK, Karelsky Okatysh** and **Belon, Severstal** and **Evraz Group**.

- **Chemicals.** We project favorable conditions on the mineral fertilizer market at least to remain in place. Mineral fertilizer prices doubled in 2007. In December 2007 stock valuations hit fresh record highs. We expect the consolidation of chemical holdings to gain momentum in 2008 and investors will see a number of IPOs in the segment (**Akron, Uralkhim, Silvinit** and possibly **Uralkaly and Eurochem**). These developments will lend support to investor interest in chemical stocks. Given the price levels at which foreign mineral fertilizer producers currently trade, Russian chemical companies will place shares at prices higher than now, using the market valuations of their foreign peers as a benchmark. We see **Ammophos, Silvinit, Metafrax** and **Kuibyshevazot** as holding the strongest upside potential.

- **The Bashkir fuel and energy complex**. We would like to point to enterprises of the Bashkir fuel and energy complex (**the Ufa Refinery, the Novoufimsky Refinery, Ufaneftekhim** and **Bashkirnefteprodukt**) where an ownership shakeup could act as a growth driver. Furthermore, investors are advised to include in their portfolios Bashkirnefteprodukt shares which have been trading extremely cheap compared to industry peers and the market as a whole, with EV/EBITDA 07 of 2.5 and P/E of 3.0 as of year-end 2007.

- **Gas distribution companies (regional gas distributors)**. In our opinion, the segment of regional gas distributors, which are undervalued by about 50% compared to foreign peers, looks very attractive and cheap to enter. Within this sector, gas transportation tariffs have been rising at a steady 15% a year and gas flow at a moderate rate of 2.5% a year. Furthermore, most regional distributors price an investment surcharge into their tariffs, which beefs up revenues and ultimately translates into higher fixed assets. All of the above factors tend to bolster the financial performance of these companies. The main risk associated with investing in the stocks of these enterprises is their low liquidity. Considering the liquidity aspect, according to our estimates, shares of **Kostromaoblgaz, Nizhegorodoblgaz** and **Orenburgoblgaz** held the most robust upside as of late 2007. Other alluring investment targets are **Voronezhoblgaz, Bryanskoblgaz** and **Smolenskoblgaz**.

- **Automotive engineering**. In our opinion, the top picks in this sector are Russian truck manufacturers, precisely, **Gaz Group** and **Kamaz Group**. Higher demand for trucks, commercial vehicles and road-building machinery gives Russian manufacturers a competitive edge over foreign automakers in terms of price and quality, as shown by a tenfold y-o-y increase in their sales in 2007. Even though the stocks of the companies more than doubled in value in 2007, we nevertheless believe that their upside is far from exhausted.

- **Timber industry.** In our view, stocks from this sector are likely to perform the same way those of the mineral fertilizer segment did in late 2007, i.e. the spark will ignite. Portfolio investors turned their attention towards the Russian timber industry after Russian Timber Group announced it would be going public on the AIM. RTG expected to raise $250 mn in proceeds, but its IPO plans fell through. The company cited the bad timing of the offering which coincided with the global credit crunch that left stock markets in turmoil as the reason for canceling the IPO. Investors seem to have lost interest in Russian timber companies, at least for the time being. We believe that a major offering (and it is entirely within the realm of possibility that RTG will make another attempt to go public) will become an upside driver for listed Russian timber producer in 2008. In our view, the most attractive investment targets in the industry are **Solombalsk Pulp** and **Paper Mill, Kommunar Paper Mill** and **Terneyles**.

- **Infrastructure construction and production of construction materials (cement)** will remain among the most appealing sectors and in 2008 sector players will continue to ramp up their volumes and financial performance. For example, road construction, which currently takes up some 2.2% of GDP vs. required 4%. In 2008 the road construction budget is planned to be raised from Rb 250 bn (about $10 bn) to Rb 330 bn (about $13 bn) year on year. Moving forward, we expect to see major upside in road construction stocks in 2008, and advise investors to keep a close eye on **Bamtonnelstroy, Khanty-Mansiyskdorstroy** and **Mosinzhspetsstroy**. Cement producers, in particular **Volskcement, Novoroscement** and **Iskitimcement**, are also expected to post strong FY07 financials on the back of a record spike in cement prices in 2007 due to hefty demand. The main investment hurdles facing these issuers relate to their low liquidity.

- **Developers.** In 2008, Russian developers will likely benefit from an uptrend in market prices and be able to eliminate the discount between their market cap and the value of their project portfolios which arose in the second half of 2007. In our opinion, this discount came about as a result of the meltdown in the US mortgage lending sector which triggered a global financial crisis. As a result, western investors have chosen to avoid buying into companies involved in the real estate business, especially on emerging markets, since they are viewed as high-risk investments. The situation on the Russian development market became even more complicated in light of the fact that most of the companies in this sector are listed on overseas trading platforms, where such a pessimistic mood has been especially pronounced. That said, the domestic real estate market is, in fact, more appealing than it could be based on fundamentals. We view **RGI, Sistema Hals** and **Open investments** as the most attractive investment vehicles in this sector.

Antanta Capital
investment bank

19, building 1, Lyalin per., Moscow, Russia, 105062
Phone: +7 (495) 775-51-00, +7 (495) 783-96-26 Fax: +7 (495) 783-96-27
www.antanta-capital.com

PIO GLOBAL
Asset Management

5, Gazetny per., Moscow, Russia, 125993,
Phone: +7 (495) 960-29-03, 960-29-60, Fax: +7 (495) 960-29-05, 974-30-45
www.pioglobal.com

Eugeny Kogan
CEO
Phone: +7 (495) 775-51-00

Galina Karyakina
Executive Director
Phone: +7 (495) 775-51-00

Nikolai Kulikov
Deputy CEO
Phone: +7 (495) 775-51-00

Ilya Razbash
Head of PR Department
Phone: +7 (495) 775-51-00
razbashi@antcm.ru

Alexey Oschepkov
Head of Marketing Department
Phone: +7 (495) 775-51-00
oschepkoval@antcm.ru

Valery Ivanov
Head of Sales (PIOGLOBAL)
Phone: +7 (495) 960-29-03
vivanov@pioglobal.ru

SALES & TRADING DEPARTMENT +7 (495) 783-44-44

Aslan Khalishkhov
Director
aslan@antcm.ru

Alexander Antipov
Deputy Director
aantipov@antcm.ru

Roman Gudkov
Head of Trading Department
rgudkov@antcm.ru

Vladimir Morozov
Manager of Sales Department
morozovv@antcm.ru

Vladelina Popsueva
Manager of Sales Department
popsuevav@antcm.ru

Olga Molchanova
Manager of Sales Department
molchanovao@antcm.ru

Anton Makarov
Head of Sales Department
amakarov@antcm.ru

Olga Vakulova
Manager of Sales Department
vakulovao@antcm.ru

Kirill Silvestrov
Manager of Sales Department
silvestrovc@antcm.ru

Artem Ananyan
Manager of Sales Department
ananyanar@antcm.ru

Alexander Dudnikov
Manager of Regional Sales
doudnikoval@antcm.ru

Sergey Drozdov
Manager of Sales Department
drozdovs@antcm.ru

Dmitry Shatskiy
Manager of Sales Department
shatskiyd@antcm.ru

Giovanni Castignani
Manager of Sales Department
castignani@antcm.ru

Roman Osipov
Manager of Sales Department
osipovr@antcm.ru

RESEARCH DEPARTMENT +7 (495) 775-51-00

Georgy Ivanin
Head of Research
Chemicals, Petrochemicals
ivaning@antcm.ru

Dmitry Terekhov
Senior Analyst
Power Utilities
terekhovd@antcm.ru

Maxim Osadchyi
Senior Analyst
Bank sector
osadchyim@antcm.ru

Eugeny Ryabkov
Analyst
Metals
ryabkove@antcm.ru

Timur Khayrullin
Senior Analyst
Oil & Gas
khayrullint@antcm.ru

Fedor Kornachev
Analyst
kornachyovf@antcm.ru

Vladimir Popov
Deputy Head of Research
Metals
popovv@antcm.ru

Andrey Verholancev
Senior Analyst
Consumer
verholancevan@antcm.ru

Anna Krylova
Senior Analyst
Telecommunications
akrilova@antcm.ru

Alexander Potavin
Head of Research
Markets
potavinal@antcm.ru

Eugeny Tyapkin
Analyst
Markets
tyapkine@antcm.ru

Stanislav Savinov
Analyst
Markets
savinovs@antcm.ru

DESIGN AND INTERNET PROJECTS DEPARTMENT +7 (495) 775-51-00

Andrew Shapovalenko
Head of Department
shapovalenkoa@antcm.ru

Michail Podmogov
Web programmer
podmogovm@antcm.ru

Mariya Gavrina
Editor
gavrinam@antcm.ru

Anna Bodrenkova
Designer
bodrenkovaa@antcm.ru

TRANSLATION DEPARTMENT

Stephen Frauzel
Head of Department
frauzels@antcm.ru

Alexander Kateshov
Translator

Alla Peklich
Translator

Shaun Haskins
Translator

Irina Gareeva
Translator

INVESTMENT BANKING DEPARTMENT +7 (495) 981-15-85

Sergey Petrov
Managing Director
petrovs@antcm.ru

Irina Olishevskaya
Personal Assistant
perfilevai@antcm.ru

CORPORATE FINANCE

David Davtian
Vice President
davtiand@antcm.ru

Alexander Chernov
Senior Associate
chernoval@antcm.ru

Vyacheslav Kotov
Senior Analyst
kotovv@antcm.ru

Roman Ulasevich
Analyst
ulasevichr@antcm.ru

Tatyana Smirnova
Analyst Assistant
smirnovat@antcm.ru

Yaroslav Samoylov
Corporate Lawyer
SamoylovY@antcm.ru

Yurij Korolev
Deputy Director
KorolevYu@antcm.ru

Eldaniz Shikhlinsky
Associate
shikhlinskye@antcm.ru

Veronika Ukader
Senior Analyst
ukaderv@antcm.ru

Eugeny Belov
Analyst
belove@antcm.ru

Aleksandr Galaganov
Analyst Assistant
GalaganovAl@antcm.ru

Ruslan Sattarov
Deputy Director
SattarovR@antcm.ru

Tatyana Starikova
Associate
starikovat@antcm.ru

FIXED INCOME

Alexander Baburin
Director
baburinal@antcm.ru

Alexander Loskutnikov
Deputy Director
loskutnikoval@antcm.ru

Aleksander Khlopetsky
Senior Associate
khlopetskya@antcm.ru

Ekaterina Kuznetsova
Associate
peredelskayae@antcm.ru

Dmitry Monastyrshin
Financial Analyst
monastyrshind@antcm.ru

STRATEGIC CONSULTING

Denis Borisenko
Head of Department
borisenkod@antcm.ru

Natalya Sycheva
Consultant
sychevan@antcm.ru

Licenses for professional securities market operators issued by Russian Federal Financial Markets Service to Antanta Capital:
1. Brokerage operations: license # 177-09002-100000 issued on March 21, 2006;
2. Dealer operations: license # 177-09008-010000 issued on March 21, 2006;
3. Depositary operations: license # 177-09017-000100 issued on March 21, 2006;
4. Securities management operations: license # 177-09013-001000 issued on March 21, 2006