Strategy 2013. Be selective

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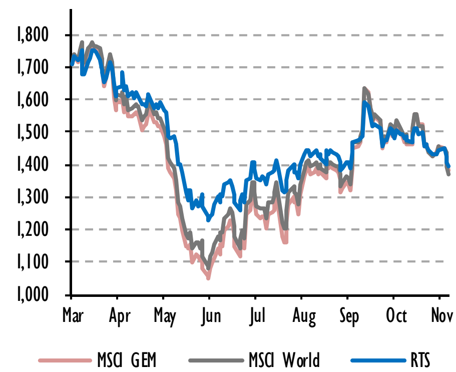
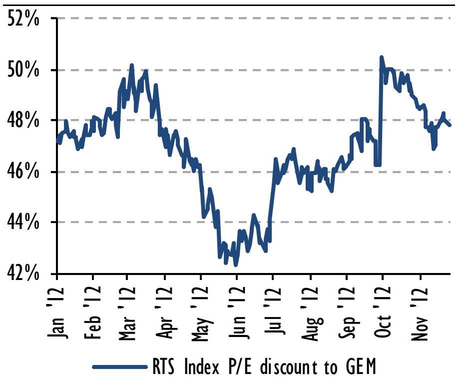
Strategy 2013: Be selective

MSCI GEM, MSCI Word and RTS Index YTD



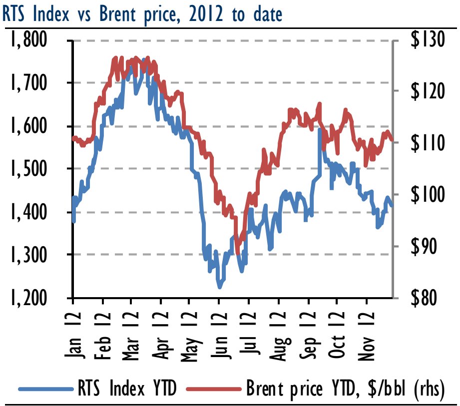
Source: Bloomberg, Gazprombank estimates

RTS Index P/E discount vs MSCI GEM



Source: Bloomberg, Gazprombank estimates

RTS Index vs Brent price, 2012 to date



Source: Bloomberg, RTS-MICEX, Gazprombank estimates

Top picks

Sector	Stock
O&G (blue chips)	Transneft prefs, SurgutNG prefs
O & G (2 tier)	Tatneft prefs, Bashneft prefs, EDC, NKNC
M & M	Evraz, Norilsk Nickel, NordGold
Banking	VTB, Vozrozhdenie Bank
Consumer	Dixy Group, Magnit
Utilities	E.ON Russia, MRSK Center & Volga, MRSK Center
Transport	NCSP
Fertilizers	Phosagro, Acron

Source: Gazprombank estimates

Our outlook on the Russian equity market for 2013 is broadly neutral, with only modest fundamental upside. Although the market trades at a significant discount to other EMs, we calculate an expected return for the RTS Index in 2013 of 18%. That said, while the prospects for the broader market appear limited, we suggest focusing on select names, particularly high-yielding dividend plays and primarily in the oil and gas and telecoms sectors. To a greater extent than in previous years, investors in Russian equities need to be selective, with the focus next year likely shifting to yield as the global search for an optimal mix of risk and return predominates.

- Unlike last year, we are neutral on the oil and gas sector in 2013, with the exception of certain dividend plays (Transneft prefs, SurgutNG prefs, Bashneft prefs and Tatneft prefs). We also favorably view second-tiers EDC and NKNC. In metals and mining, we favor the gold sector (Nord Gold), are cautiously optimistic on base metals (Norilsk Nickel) and are neutral on ferrous metals, though we highlight Evraz on its excellent exposure to rails and rebars and excessively low valuation. In the banking sector, we choose VTB as our top pick over Sberbank, while Vozrozhdenie Bank appears the most exciting growth story. Phosagro, one the top performers in the market last year, remains our top pick in fertilizers, with Acron also in focus. In the transport sector, we see the best value in NCSP, while in consumer and retail our top recommendations include Dixy and Magnit. We remain cautious overall on the utilities sector due to lingering regulatory uncertainty, though we see material potential in E.ON Russia, MRSK Center & Volga, and MRSK Center.
- One of the key tasks for Russia equity investors as they head into 2013 is to gauge how the perception of Russia's investment case will react to external events and conditions. While the domestic story remains in place, the perception of how the market will likely react to developments in foreign markets will likely continue to dominate sentiment next year.
- One broader question is whether Russia will remain vulnerable to external shocks and continue to be seen by many as a cyclical, high-beta play on events in other markets. Such investors remain skeptical about country-specific factors and have traditionally allocated to Russia based purely on the global economic cycle. They also still see Russia as a quintessentially high-beta market and, despite some encouraging developments in terms of market infrastructure, remain convinced that it is unlikely to behave any differently now than it did four years ago.
- Those who believe otherwise will likely argue that in an era of open-ended QE and stagnant growth in developed economies, investors are likely to devote an increasing share of their global allocations to markets that offer attractive returns at an acceptable level of risk. While Russia has always traded at a discount to EMs largely based on risk perception and structural vulnerabilities, the current discount seems excessive. Hence, the expectation among this group is for Russian equity performance to rebound in 2013 from what has been a frustrating 2012.
- We tend to agree with the first group while remaining fully cognizant of arguments made by the second. In general, we believe the Russian equity market in 2013 will increasingly benefit from the trend toward investment in tangible "hard" assets, while also remaining vulnerable to speculative fund flows, country-specific concerns and the vagaries of global risk aversion. Meanwhile, stock-specific stories, particularly involving dividends and primary placements, will continue to drive many investment decisions, with structural reform playing a secondary but increasingly visible role. In a very real sense, these factors represent the necessary growing pains – acute though temporary – that the Russian market must experience if it is to fulfill its intended role as a conduit for capital flows and shareholder return.

Contents

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Strategy 2013: Be selective

Investment summary

Our outlook on the Russian equity market for 2013 is broadly neutral, with only modest fundamental upside. Although the market trades at a significant discount to other EMs, we calculate an expected return for the RTS Index in 2013 of 18%. That said, while the prospects for the broader market appear limited, we suggest focusing on select names, particularly high-yielding dividend plays and primarily in the oil and gas and telecoms sectors. To a greater extent than in previous years, investors in Russian equities need to be selective, with the focus next year likely shifting to yield as the global search for an optimal mix of risk and return predominates.

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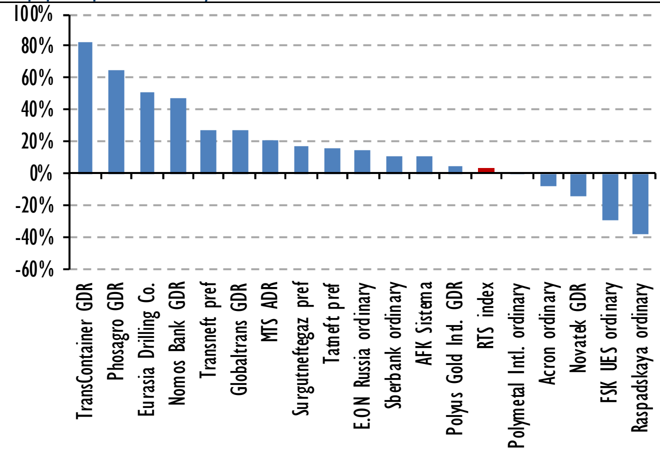
2012 top picks review

Looking back at 2012, we are proud to note that the vast majority (nearly three quarters) of our top picks worked extremely well, comfortably outpacing the average market performance (+1%). Four of our top picks managed to exceed the "grandmaster threshold" of 40% YTD growth in dollar terms (TransContainer, Phosagro, Eurasia Drilling Co. and Nomos Bank) despite last year's uneasy and flat market.

Industry-wise (we took the dollar performance of MICEX sector indexes as a comparative benchmark), our ideas generally performed much more convincingly as well. All of our sector top picks (including loss-making utilities) outpaced corresponding sector performances (by twofold at least).

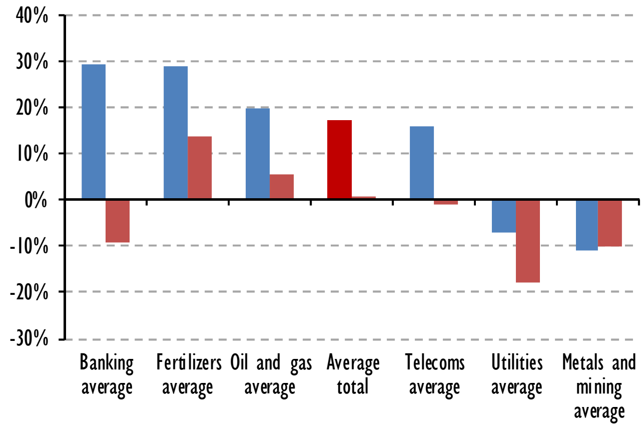
We also note our top industry pick for 2012 – oil and gas – managed to comfortably outperform the market despite its large weight, while our oil and gas top picks delivered three times as much return as the sector on average.

Top picks performance by stock in 2012



Source: Bloomberg, Gazprombank estimates

Top picks performance by sector in 2012



Source: Bloomberg, Gazprombank estimates

Top picks for 2013

Our top stock picks for 2013 (see table below) reflect our view that investors must be particularly selective and not adopt a top-down, sector-based view. In general, we see ongoing uncertainty regarding specific catalysts that are capable of unlocking sector-wide upside (e.g. in utilities) and thus a bottom-up approach seems warranted.

Sector	Stock
Oil and gas (blue chip)	Transneft prefs, SurgutNG prefs
Oil and gas (second tier)	Tatneft prefs, Bashneft prefs, EDC, NKNC
Metals and mining	Evraz, Norilsk Nickel, NordGold
Banking	VTB, Vozrozhdenie Bank
Consumer	Dixy Group, Magnit
Utilities	E.ON Russia, MRSK Center & Volga, MRSK Center
Transport	NCSP
Fertilizers	Phosagro, Acron

Source: Gazprombank estimates

RTS Index expected return

Based on our use of a DCF model (Grinold-Kroner), our expected return for the RTS Index is 18%. This calculation, however, should be viewed purely as a fundamental indicator of value in the equity market based on historical performance and forward expectations, and is independent of the outcome of three potentially game-changing scenarios that we mention later in this report.

Grinold-Kroner model. To calculate our expected return for the RTS Index, we use the Grinold-Kroner model, which is a DCF approach that takes the Gordon growth model and adds variables adjusting for stock issuance and changes in market P/E. We believe it makes sense to use Grinold-Kroner instead of a simple Gordon growth model during times of large-scale equity issuance, such as we anticipate for Russia in 2013 in the form of privatization sales and IPOs. In the past, significant equity issuance has tended to dampen performance on the Russian market as investors focus on primary issuance while deferring secondary trading activity.

We also like the Grinold-Kroner model because it explicitly captures the market's repricing return, or change in expected P/E. Russia's 2013E P/E (Bloomberg consensus) shows a change of only 2.6%, from 2012 (5.30 to 5.16), compared with nearly 12.4% for GEM (11.48 to 10.06), reflecting a reluctance among investors to pay a premium for Russian earnings growth relative to other opportunities in the GEM space.

The following chart shows a decomposition of Grinold-Kroner to help illustrate the expected sources of Russian market growth in 2013.

Grinold-Kroner model

Expected return on equity market = Div1 /P0 + i + g - Δ S + Δ P/E
E(r) = 4.1 + 7.0 + 9.0 - 4.8 + 2.6 = 17.9%
Div1/P0 = market dividend yield
i + g = expected nominal growth = inflation rate + real growth rate in earnings
i = 7.0 (GPB estimate), g = 9.0% (IMF estimate)
-Δ S = repurchase yield = change in % of shares outstanding
Δ P/E = 2013E repricing return = (5.30-5.16)/5.30 = 2.6%
Δ S calculation
Russia MCap ($735 bln) * free float (28%) = $206 bln
Planned privatization receipts in 2013 = $8.4-11.5 bln
8.4/206 = 4.07%
11.5/206 = 5.58%
Average = .83%

Source: "The Equity Risk Premium" by Richard Grinold and Kenneth Kroner, Bloomberg, IMF, Russian government, Gazprombank estimates

Note that we have only included state privatizations (totaling up to $11.5 bln) in the repurchase yield factor, which in the case of share issues represents a cash outflow for investors and thus reduces the expected return on the market. Any additional private-sector IPOs or SPOs would increase this cash outflow and result in an even lower return. It is believed that large share issuances (in particular by Sberbank and MegaFon) contributed to the extended period of sluggish market performance in the last several months of 2012.

Major risks to our outlook

While we calculate an expected return for the RTS Index of 18%, an assessment of the market's prospects may ultimately hinge on scenario-based considerations. In particular, we briefly look at three key scenarios, the outcomes of which could relegate our fundamental assessment to secondary importance. These are 1) fiscal contraction in the US – the so-called 'fiscal cliff'; 2) structural change in the Eurozone and/or significant economic deterioration in China; and 3) the outbreak of a deeper and broader conflict in the Middle East. We note that revision of the expected return based on these scenarios is not necessarily one-sided, i.e. progress toward resolution of one or more of these issues could act as a trigger for a lower ERP for the Russian market and subsequent multiples expansion.

The following are brief looks at our three key scenarios:

US fiscal cliff

- Fiscal cliff implies three scenarios for Russian GDP growth in 2013. We estimate Russia's long-term GDP growth rate at 3.8-4.0% (our official forecast for 2012 is 3.5%), but may review our estimates based on the outcome of three scenarios involving the ongoing fiscal cliff negotiations between the White House and Congress.
- First scenario (let's make a deal). Our first, most likely scenario involves the reaching of a compromise deal to address the fiscal cliff, either prior to or soon after the January 1 legislative deadline, that involves a mix of relatively moderate tax increases and spending cuts. This deal would prevent a US recession but nonetheless result in a minor shock to the global economy. Russian GDP growth would come in at 3.1%, down 0.7-0.9 pps from our baseline GDP growth estimate.
- Second scenario (kick the can). Our second, less likely scenario is a classic 'kick the can' decision by which the main fiscal and taxation issues are delayed until mid-2013 with the aim of striking a more comprehensive deal at some point. In this case, the US economy would absorb a moderate shock but recession would be avoided, while the effects on the global economy would be limited but still tangible. Russian GDP growth would come in at a slightly better 3.5%, down 0.3-0.5 pps from our baseline GDP growth estimate. It should be noted that the market is currently pricing in such an outcome.
- Third scenario (over the cliff). According to our third and least likely scenario, the fiscal cliff is not avoided and not swiftly followed by tax cuts to restore the status quo ante. Political deadlock ensues and the economy bears the full brunt of fiscal contraction. Forecasts for US and global GDP growth are slashed, precipitating a plunge in stock markets and corporate earnings estimates. In this worst case, we would consider cutting our Russian GDP growth forecast for 2013 all the way down to 1.6%.

Based on media coverage of the negotiations, the chances that our first and most likely scenario involving a bi-partisan deal will occur seem encouraging. That said, market sentiment, both in Russia and globally, will remain vulnerable to signs that the talks have hit a roadblock and that a deal may not be forthcoming before the January 1 deadline.

China and the EU

- China: With China's Communist Party leadership transition having taken place during November's first plenary session of the 18th National Party Congress, investors will now turn their attention to the second session in February devoted to the selection of new government leadership and, most importantly for the market, the third session next October devoted to economic issues. Topics for discussion will include how to deal with the increasing demands of the middle class, as well as how best to shield the low-income segments of the population from food price shocks and imported inflation. It goes without saying that the ability of the new Chinese leadership to address the country's significant structural challenges while maintaining a high rate of growth will go a long way toward determining longer-term global demand for a range of raw materials and commodities, with clear implications for Russia's investment case.

  Over the coming year, China's willingness to engage in QE – whether independently or in coordination with the US, EU, Japan and other major developed markets – will be watched closely by those seeking to gauge the level of risk sentiment. Portfolio investment in Russia has been and will continue to be directly impacted by such sentiment.

- Eurozone: The risk of an economic and/or financial collapse in the Eurozone – whether through the exit of a euro member or a default on sovereign obligations – has been a major fear among global investors for the past two years and Russia investors in particular given that Europe is Russia's largest trading partner and 40% of Russia foreign reserves are held in euros. Moreover, EU member Cyprus is Russia's largest source of FDI in the form of repatriated Russian wealth held in Cypriot financial institutions. Reflecting these key linkages between Russia and the Eurozone economy and currency, the RTS Index has shown a correlation of 0.70 with the EUR/USD exchange rate this year (for further details, see the section on correlations).

We see potential trigger events in the Eurozone as being largely connected to politics, in particular the stability of the Greek government and the German elections in September-October. In the case of Greece, the risk is that the current coalition government collapses and is replaced by a hard-line nationalist administration that threatens default, exiting the Eurozone and reintroducing the drachma. In Germany, the risk involves a delay in any serious and inclusive effort to resolve the EU debt crisis owing to the governing parties' desire to placate anti-bailout sentiment. While the issues involved in the EU debt crisis are of course exceedingly complex and not solely related to these two countries, it appears that the markets will continue to bounce back and forth between risk perception (and misperception) pending some trigger event – whether to the upside or downside.

Significant escalation of war in the Middle East

- A third area of worry and uncertainty for Russia investors in 2013 is the possibility of significant escalation and/or expansion of conflict in the Middle East. Among other potential scenarios, this could take the form of an attack on Iran's suspected nuclear facilities or through more serious proxy fighting in Syria, Israel and/or Lebanon that draws in one or more major external powers.

  For the Russian market, the main direct threat centers on hostilities in the Persian Gulf that lead to significant supply disruption. Such a blockage of deliveries could at least temporarily send the oil price surging to new all-time highs and precipitate a spike in Russian oil and gas stocks. That said, such a spike could also be short-lived as the market adjusts expectations to take account of the potentially devastating blow to global demand. Although investors have few opportunities in Russia to play on the theme of heightened military spending, it should be noted that historically the outbreak of war has typically been seen as supportive for equity markets globally.

Secondary risks to our market outlook

In addition to these major risk scenarios, we see other risks that could have a direct bearing on whether our RTS expected return is reached in 2013.

- Global risk appetite. Global risk appetite was the defining factor for the Russian stock market in 2012 and will remain so as we head into 2013. Russia remains firmly in the group of countries categorized by foreign investors as risky and as such will continue to be vulnerable to external capital flows driven purely by risk perception. The relative absence of long-term domestic money means that this vulnerability will persist until structural changes are introduced to the local market infrastructure. The recent passage of changes to the pension system reducing the share of accumulated savings from 6% to 2% has been seen as discouraging the development of a long-term domestic investment base.

- Economy: The relative health of Russia's economy has traditionally been one of the strongest points in its investment case. Among other things, the country has the fourth-largest FX reserves in the world more than covering total external debt, a budget surplus, sizable sovereign wealth funds and a steadily expanding middle class. While all of these factors are certainly impressive and Russia finds itself in much better shape than other countries, it appears that the country's economic growth may not be as robust as once commonly thought. It has been showing signs of slowing of late (GDP growth of just 2.9% YoY in 3Q12, industrial production) accompanied by slightly higher than expected inflation, an ongoing structural reliance on extractive resource revenues, and an unsustainable boom in consumer lending. Thus, the perception of Russia's investment case may start reflecting this relative economic slowdown over the coming year.

- Thin local investor base. One structural problem that has long plagued the Russian equity market is the lack of a long-term domestic investor base. This lack of natural buyers of the Russian market means that risk appetite among foreign investors, particularly as measured by portfolio fund flows, has a disproportionate impact on local market dynamics. In developed markets, mutual funds that manage pension savings act as a source of long-term portfolio investment, whereas in Russia the mutual fund industry has access to only a tiny amount of overall pension savings.

  The news flow on this front has been decidedly mixed. The government in November decided to reduce the defined pension contribution rate from 6% to 2% starting in January 2014, a measure aimed at covering the pension funding gap, which in 2012 totaled nearly $32 bln (around 1.8% of GDP). Although the move was initially scheduled to take effect in 2013 and the delay until 2014 is thus positive (leaving time for new proposals to be made regarding the establishment of a voluntary defined contribution system), the reduction itself has been seen as negative from the standpoint of pension reform.

- ETFs. While the remarkable rise of exchange-traded funds (ETFs) in recent years has eased the process of investing in Russian stocks for a whole new class of foreign investors (particularly those who seek to reduce transaction costs, or are otherwise prohibited from trading in local-listed securities), it has also tended to skew investment flows into the top five or six largest blue chips. ETFs have also tended to grab the lion's share of new money flows into Russia-dedicated funds, often accounting for three quarters or more of all fresh money on a weekly basis. This has effectively diverted a large amount of money that otherwise might have been directed to traditional mutual funds targeting the local market.

  Although the success of ETFs has arguably been among the factors contributing to greater liberalization and development of the local market infrastructure, as they have raised the level of competition for fund flows, their ease of trading also tends to heighten volatility during turbulent periods.

- IPOs and SPOs. Primary and secondary market offerings are something of a double-edged sword for Russia investors. One the one hand, such investors have traditionally sought greater exposure to high-quality Russian companies, but this has often come at a cost. Not only have many Russian IPOs been loss-making for participants, but primary equity issuance has also tended to weigh on overall secondary market performance, at least in the short to medium term. This effect was palpable in 2012, which saw a total of $12.7 bln in equity issuance (IPOs, SPOs and strategic shareholder stake sales), the largest amount since 2007 ($32.7 bln). We believe that the market dynamic in 2013 may also be impacted by the weight of primary issuance, which is one reason why we chose to employ the Grinold-Kroner valuation model.

The Russian government has set for itself the goal of raising around $24 bln by 2016 from the sale of stakes in state companies. The amount planned to be raised in 2013 ranges from $8.4-11.5 bln. This includes the following stakes:

IPOs in 2012

Company	Date	Placement	Volume, $ mln
RusPetro	January	IPO	$266
MD Medical	October	IPO	$408
MegaFon	November	IPO	$1,700
Total IPOs			**$2,374**

SPOs and strategic shareholder stake sales in 2012

Mail.ru Group	March/September	Strategic stake sale	$530
Highland Gold Mining	April	Strategic stake sale	$130
Polyus Gold*	May	SPO	$636
Globaltrans	July/October	SPO	$720
Sberbank	September	Strategic stake sale	$5,200
M.Video	September	Strategic stake sale	$146
Uralkali**	November	Strategic stake sale	$3,000
Total SPOs and strategic stake sales			**$10,362**

* sale of 7.5% of treasury shares
** estimated value of convertible bond issue

Privatization program, 2013-16

	Market value*	State holding	Stake to be sold
VTB	$17,671	85.5%	85.5%
Rosneft	$74,710	85.5%	85.5%
Sovcomflot	n/a	100.0%	100.0%
ALROSA	$6,000	50.9%	50.9%
Aeroflot	$1,534	51.2%	51.2%
Federal Grid Company	$8,566	79.1%	29.1%
InterRAO UES	$8,651	66.0%	41.0%
RusHydro	$9,008	57.9%	32.9%
Russian Railways	n/a	100.0%	24.9%
Transneft	$2,046	–	25.0%
Total	**$128,186**	–	–

* as of November 25 close, $ mln

Source: Russian government, Gazprombank estimates

Financial market reform

The notion of reform in Russia predates the establishment of the country's financial market itself. Although change has always been slow in coming and many investors have grown weary of disappointment, next year may end up ranking among the most significant in terms of restructuring the local market architecture. Several concrete measures are ongoing or on the verge of being introduced, and taken together may create a critical mass capable of reshaping the investor base.

- Central Depository: If the government's goal of turning Moscow into an international financial center is to be achieved, the Russian market needs greater capacity and flexibility to handle foreign investment in equities and bonds. To date, efforts have largely focused on the establishment of a Central Depository, which will allow local custodians or international central depositories to hold stocks on behalf of their international client base in nominee accounts. The Federal Service for Financial Markets in November granted the Central Depository a license to operate, which clears the way for its launch on January 1, 2013. Although international central depositories will be able to open accounts with the Central Depository only in July 2014, Russian domestic depositories – including the subsidiaries of major global banks – will be able to open accounts as soon as next year. The introduction of T+n trading, aimed to replace the problematic DVP (delivery versus payment) schemes that currently dominate local trading, is seen as another major step to bring local trading into line with foreign practice.

- Clearstream/Euroclear: The introduction of international clearing systems Clearstream and Euroclear from January 1, 2013 is another tangible example of the government's efforts to reform the market architecture. In particular, the presence of these two systems will create the potential for a significant increase in fund flows, initially to OFZs but eventually equities as well after July 2014. It will also broaden the investor base to new entrants while removing obstacles for current investors to expand their holdings. Presumably, a portion of this fresh money could flow into equities as soon as next year assuming a degree of portfolio rebalancing or other factors that could affect the relative attractiveness of equities versus bonds (such as rising yields).

- Payout ratios and dividends. One of the prominent themes among global investors in 2012 was a search for high-quality stocks with attractive dividend yields to augment the squeezed return on their fixed income portfolios. This theme was aided in part by the government's renewed push for state companies to pay out 25% of net income, seen by many as a method of boosting budget revenues. Payout ratios in Russia have traditionally been well below the average GEM level of 35%, but progress was made in 2012: the payout ratio in the Russian market rose from 13.3 in April to as high as 22.4 in November, up 68% and reducing the discount to 36%. Any further increase in the frequency and size of dividend payments could start to bolster the perception of Russia as a destination for value investors. In turn, this might help reduce the P/E discount of the Russian market from the current extreme level of around 50% to a more reasonable 20-30%. Meanwhile, the MICEX dividend yield for 2012 has risen as high as 3.8%, compared with 2.9% for MSCI GEM for a discount of nearly 30% – around the highest level in a decade.

We examine the issue of dividends as a key investment theme for Russian equities in more detail later in this report.

- WTO entry/Jackson-Vanik: Russia's entry to the WTO, an event more than 19 years in the making, has hardly any short-term effects on the Russian market. Longer-term, however, there are a great many benefits related to WTO entry, especially for domestic companies. Improved competitiveness and cheaper access to imported machinery for capital-intensive companies, as well as better prices for consumers through cheaper imported goods, are just a few of the benefits to flow through the Russian economy in the years ahead. The November removal by the US Congress of trade restrictions related to the Jackson-Vanik amendment was aimed at bringing the US into line with WTO obligations related to Russia and is both a practical and symbolic step towards Russia's greater integration into the global economy.

- IFRS reporting. Prime Minister Dmitri Medvedev recently called upon the Finance Ministry to continue working towards the widespread adoption by Russian companies of IFRS reporting. While the adoption of IFRS is not a new theme for Russia's investment case, as many of the large-cap investable companies already report to IFRS, it is still in relatively rare use among small-cap companies. In general, greater use of IFRS should be seen as positive trend from the standpoint of corporate transparency and the prospects for primary market issuance and a broadening of the market.

Removal of DR restrictions

Conditional in part on the launch of a Central Depository, the Federal Financial Markets Service (FFMS) has proposed to lift restrictions on converting local shares of non-strategic companies into DRs if 100% of the shares are placed locally. The measure, like others before, is intended to stimulate primary placements on the local market – of Russia's IPOs in 2012, only one (Megafon) had Russian jurisdiction. Currently, no more than 25% of the overall number of shares can be placed in the form of GDRs, and in case of a new placement at least 50% must be placed locally. However, the timing of this move is hazy and previous initiatives to remove the restrictions have lost momentum. In principle, the removal of DR restrictions would create the opportunity to play on a narrowing of local/DR spreads, especially in names where current spreads are historically wide (>20%).

Creation of a National Depository and the introduction of Euroclear should in theory be followed by the cancellation of conversion limits, leading to growth in Russian local shares that trade with discounts to DRs.

The following are our thoughts on why think playing on a tightening of discounts is not a good idea at this time.

- Creation of a National Depository and the introduction of Euroclear are necessary but not sufficient for discounts to disappear. Conversion limits must be removed, and we note this is a separate issue. The issue is not as important for the market as the National Depository and Euroclear, so it may be decided later and perhaps postponed until after 2013.
- Conversion limits are set by FFMS order No. 09-21 of June 10, 2009, with additions (not approved yet). Although the common conversion limit is proposed at 100%, there are still two exceptions left. A 25% limit is set for companies that have a strategic interest for Russian national security and a 5% limit is set for companies that hold a license for a strategic resource field.
- We must also keep in mind the Federal Law "On Foreign Investments in Strategic Entities" No. 57 of April 29, 2008. Under this law, all deals involving foreign investors or groups of investors acquiring more than 10% of a Russian entity holding a license for a strategic resource field are subject to additional governmental approval. This law needs to be changed as well.
- Currently we observe significant discounts of locals to DRs in NOVATEK, Tatneft, Magnit, Sistema, MTS, Pharmstandard and LSR Group. NOVATEK and Tatneft hold licenses for strategic resource fields, so the conversion limit may not be withdrawn at all. MTS is an entity with a strategic interest for Russian national security. Sistema, although formally a financial holding, controls MTS and Bashneft, both of which are of strategic interest. This leaves us with Magnit, Pharmstandard and LSR Group. The last two have average traded volumes in locals below $50,000 per day. Magnit's average traded volume is decent at about $4 mln, so we conclude that it is the only stock in which an investor can potentially materially play on possible cancellation of conversion limits.
- Mind the time gap. In theory, the National Depository may be introduced at the beginning of 2013, with real operations starting in mid-2013 – end 2013, so we now have at least 12 months left. The cost of capital in rubles would eat away a major part of the discount if you play on it now.

All in all, there are three major reasons not to play on discounts: conversion limits may not be fully removed, the timing may be too long, and the cost of capital may be too high.

Also, we need to remember that the National Depository and Euroclear will matter for stocks other than the ones mentioned above. We should not forget local shares that are not listed on foreign markets at all, but surely would be interesting for international funds. This group includes Transneft prefs, which are more liquid than any locals trading with a discount.

The National Depository and Euroclear would also open the ruble-denominated debt market for foreigners and could absorb an amount of cash (approximately RUB 7 trln, or $230 bln) larger than any estimate of the free-float market cap of Russian local equities.

Dividends

High dividend-yielding stocks in Russia have become more liquid, and the government's decision mandating a 25% dividend payout ratio will support blue-chip yields. We update our view on Russian equities that share excellent earnings with shareholders and pick a number of companies that may provide investors with dividend yields of about 5% and higher.

The oil and gas industry remains our top pick for dividend hunters – whatever you choose, you will likely get a decent dividend. Telcos also provide investors with a choice of dividend payers, and we note several top picks in other sectors (particularly Bank Saint Petersburg, which tops our list with an estimated yield of 21.2%).

Russian dividend payers in 2013E.

	Ticker		Currency	DPS	Price	Yield	Record date
Bank St-Petersburg	BSPBP RX	Banking	USD	0.4	1.9	21.2%	Mar 13
Nizhnekamskneftekhim pref	NKNCP RX	Petrochemistry	RUB	3.0	24.6	12.2%	Apr 13
Nizhnekamskneftekhim ord	NKNC RX	Petrochemistry	RUB	3.0	29.4	10.2%	Apr 13
SurgutNG pref	SNGSP RX	Oil and Gas	RUB	1.5	19.7	7.6%	May 13
Bashneft pref	BANEP RX	Oil and Gas	RUB	100.0	1328.5	7.5%	May 13
Tatneft pref	TATNP RX	Oil and Gas	RUB	7.5	104.3	7.2%	May 13
Vimpelcom	VIP US	Telecoms	USD	0.8	10.6	7.6%	Jun 13
Phosagro	PHOS LI	Chemicals	RUB	90.0	1284.8	7.0%	Apr 13
MTS common	MTSS RX	Telecoms	RUB	14.5	231.6	6.3%	May 13
Norilsk Nickel*	GMKN RX	Metals & Mining	USD	153.4	9.01	6.0%	May 13
Gazprom neft	SIBN RX	Oil and Gas	RUB	8.3	140.9	5.9%	Apr 13
Gazprom	GAZP RX	Oil and Gas	RUB	8.0	138.8	5.8%	May 13
MTS ADR	MBT US	Telecoms	USD	0.9	17.4	5.3%	May 13
Bashneft ord	BANE RX	Oil and Gas	RUB	100.0	1739.9	5.7%	May 13
Rostelecom pref	RTKMP RX	Telecoms	RUB	4.8	84.5	5.6%	May 13
Transneft pref	TRNFP RX	Oil and Gas	RUB	2500.0	65409.0	3.8%	May 13
Lukoil	LKOH RX	Oil and Gas	RUB	87.0	1939.3	4.5%	Apr 13
Rosneft	ROSN RX	Oil and Gas	RUB	7.7	244.6	3.1%	Apr 13

* Reportedly, the dividends mignt be even higher

Source: companies, Gazprombank estimates

Oil & gas: the usual suspects, plus state companies, minus TNK-BP

On the back of good YTD performance of the oil price, we expect oil companies to continue reporting excellent financial results for 2012. The usual bunch of second-tier dividend payers this year will be supplemented by state-run companies, which will pay at least 25% of their RAS net income. We note that in 2012, most Russian oil and gas blue chips may offer at least a 4% dividend yield.

- Transneft prefs. We think that Transneft may finally change its very conservative dividend practice and substantially increase dividends as soon as the publication of results for 2012. Paying around 1.5% of IFRS net income, the company represents a striking contrast with other large state-controlled companies in the sector. The government has approved a resolution requiring state-controlled companies to pay no less than 25% of net income as dividends, without specifying whether net income should be based on RAS or IFRS, or include part of the net income of subsidiaries if taken under RAS. A preliminary decision on increasing Transneft's dividends may have already been taken at a meeting in the Economics Ministry devoted to dividends of state-run energy companies. The most likely scenario for dividend policy changes may involve a switch to paying dividends on the base of 25% of RAS net income of the head company, increased by 25% of subsidiaries' net income. We expect the company to pay RUB 2,500 per preferred share based on the 2012 results, which may provide an attractive 3.8% dividend yield. The key risk is no changes to dividend policy in 2013.
- Gazprom. We expect Gazprom to continue its policy of paying 25% of RAS net income, which may translate into dividends of RUB 8.0 per share and a 5.8%

dividend yield. During the presentation of its 2Q12 financial results, Gazprom management announced plans to transition to the payment of 25% of net income as dividends from 2014, which may translate into dividends of RUB 11.3 per share for 2013, on our estimates.

- Rosneft. We expect Rosneft to expand its new dividend policy for 2012 as well, after paying extra dividends for 2011. The company may distribute RUB 7.7 in dividends per share for 2012, yielding 3.1%.
- Lukoil started to pay interim dividends this year, and thus the annual 2012 dividend would account for 2H12 only, but keep in mind you may get a 1H13 payout ahead of end 2013. We estimate the total yield at 4.5%.
- TNK-BP Holding. We highlight TNK-BP Holding as one of the best dividend payers in the past. On the one hand, we note the possibility that the company will pay high dividends for 2012. But at the same time, it is probably the most risky dividend play this year, given changes in the shareholder structure.
- Others. One should also remember the usual dividend plays, including Surgutneftegas prefs (7.6% yield), Tatneft prefs (7.2% yield) and Bashneft prefs (7.5%).

Telecoms: traditionally a good sector to look for hefty dividends

Telecoms are well known for their high dividends, and 2012 will be no exception. We see VimpelCom shares as offering the highest dividend yield (7.6%) at current prices. The company aims to pay out at least $0.80 per share in annual dividends for the period 2011-13, which we assume as our base scenario for the 2012 dividend amount. After the Federal Antimonopoly Service (FAS) recently withdrew its claim on Telenor, we do not see any legal obstacles to payment of the final dividend tranche ($0.35/share) relating to VimpelCom's 2011 results or the 2012 dividend payment going forward.

We conservatively project a dividend in 2012 of $0.9 per MTS ADR and RUB 14.5 per common share, which equals a total payment of RUB 30 bln and implies solid 5.3% and 6.3% yields to the current price. Following the recent publication of strong IFRS results for 3Q12, MTS raised its dividend forecast for 2012-14 to RUB 38 bln annually on average vs. RUB 30 bln over the 2009-11 period.

Utilities: Mosenergosbyt (13.7% yield)

The recent change in regulation of supply companies raised questions about the sustainability of high dividend yields in this segment, which was previously considered a cash cow. However, we still see a significant dividend yield in Mosenergosbyt. Based on its 9m12 RAS results, we would expect a DPS of RUB 0.06, yielding 14%.

State-owned companies (Federal Grid Company, MRSK Holding, RusHydro and InterRAO) are poised to increase dividends after the government's initiative to oblige them to pay out at least 25% of net income. However, we would not expect to see a dramatic rise in dividend yields in 2013 for utilities, which are overburdened with capex obligations and still rely on direct cash injections from the federal budget.

Metals & mining: one story has gone, another is possible

Mechel preferred shares were considered a dividend story at the beginning of 2012, a view once shared by us and the market. However, we no longer consider them to be a dividend play in the short run, as the group recently posted huge negative write-downs in 2Q12 resulting in a net loss of $823 mln, leaving no hope for a sizable dividend on preferred shares for 2012.

Norilsk Nickel's major shareholders are in the process of discussing a peace agreement that assumes, among other terms, a higher dividend payout ratio (currently 20-25%). Assuming an increase to 50% (the most probable level, in our view) and based on our forecasts, the respective dividend yield could be at least 6% (or, reportedly, even higher).

Banking: Bank Saint-Petersburg prefs (25% yield)

Bank Saint-Petersburg convertible prefs (25% dividend yield) look extremely attractive, offering by far the highest yield among Russian names. That said, we note one significant drawback: it was recently rumored that the dividend payment could be threatened in case the bank ends 2012 with an RAS net loss. We do not consider this our base scenario, as 10M12 RAS net income is comfortable at around RUB 1 bln, and still believe the probability of payment is sufficiently high. That said, certain care should definitely be taken with this story.

Chemicals: Phosagro appears to bring a good yield of 7%

Phosagro's dividend policy stipulates dividend payments in the range of 20-40% of net income. Nonetheless, we assume a 45% dividend payout in 2012, given that the company already distributed 49% of net income to shareholders in 2011 and 44% in 1H12. We estimate that the company may pay RUB 90 per share for 2012, yielding 7%.

Petrochemicals: Nizhnekamskneftekhim (10.4% ords, 13% prefs)

Nizhnekamskneftekhim has historically paid out 30% of RAS net income, and in 9M12 this figure rose 34% YoY to RUB 14.9 bln. We conservatively estimate just 15% YoY growth for the full year, which still translates to decent dividends of RUB 3 on both ordinary and preferred shares, yielding 10.2% and 12.2%, respectively.

Market relative valuation

When discussing relative value, global and EMEA investors ask why they should choose Russia from among other GEM and BRIC countries. It is not sufficient to simply argue that Russia is cheap; this fact is widely acknowledged. Rather, Russia's investment case must somehow find a catalyst to unlock this value. Based strictly on P/E, the Russian market trades at a level of just 5.2 for 2013E. This compares with 10.1 for MSCI GEM, marking a huge discount of nearly 48% to GEM peers and placing it among the cheapest emerging markets.

RTS P/E as a percentage of BRIC P/E

Source: Bloomberg, Gazprombank estimates

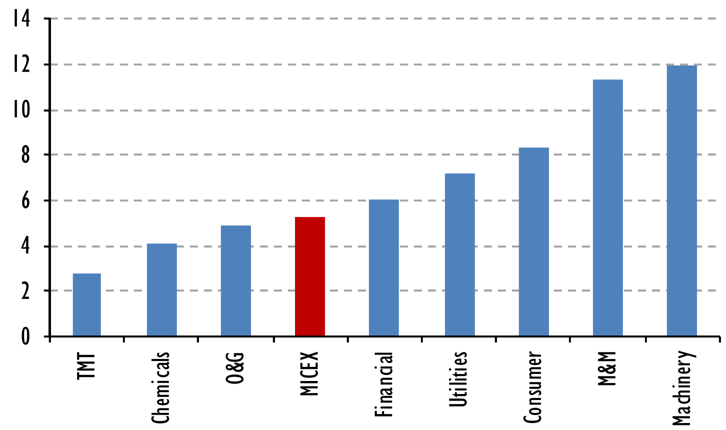
Notably, the headline P/E figure for Russia masks the fact that investors are willing to pay more for exposure to Russia's non-oil and gas story, particularly in the consumer (8.3x) and metals and mining (11.3x) sectors. In terms of return on equity, Russia comes in at 16.2% for 2013E, versus 19.1% for GEM for a 15% discount.

One might argue that due to the cyclical nature of Russia's earnings a large discount is warranted. This argument gains credence when one considers that massive monetary stimulus appears to have 'hijacked' the business cycle, leaving investors to wonder exactly where Russia stands currently. Is the country in the early stages of a global rebound, or merely on the verge of what may be another plunge, such as occurred in 2008-09?

Sector relative valuation

A relative valuation breakdown by sector displays a well-known picture. Three sectors are trading below the market average (2012E P/E of 5.3x), with five sectors trading above. Such skew is generally explained by the large share of the oil and gas sector (P/E12E of 4.8x) in the MICEX Index (nearly 53%), which keeps its valuation fairly low. That said, even excluding the oil and gas sector, the Russian market remains fairly cheap (5.7x P/E12E) with healthy discounts to EM peers.

Russian market P/E: sector breakdown



Source: Bloomberg, Gaz[prombank estimates

Correlations: Examining the correlations between Russia and global markets can provide clues about the degree to which the country's equity performance is a derivative of global market risk sentiment. The table below tracks the correlation of the RTS Index versus select indexes and currencies YTD and during the four main periods of quantitative easing by the US Federal Reserve.

Correlations of RTS Index with US Federal Reserve QE

	QE1 Nov 25, 2008 Mar 31, 2010	QE2 Nov 3, 2010 June 30, 2011	Operation Twist Sep 21, 2011 June 20, 2012	QE3 Sep 14, 2012 to date	2012 YTD
RTS-Brent	0.89	0.83	0.84	0.43	0.88
RTS-MSCI EM	0.86	0.76	0.75	0.73	0.76
RTS-S&P 500	0.93	0.81	0.60	0.88	0.32
RTS-EUR/USD	0.70	0.38	0.20	-0.66	0.70
RTS-USD/EUR	-0.47	-0.75	-0.30	-0.63	-0.80
RTS-VIX	-0.86	-0.14	-0.53	-0.81	-0.44

Source: Bloomberg, Gazprombank estimates

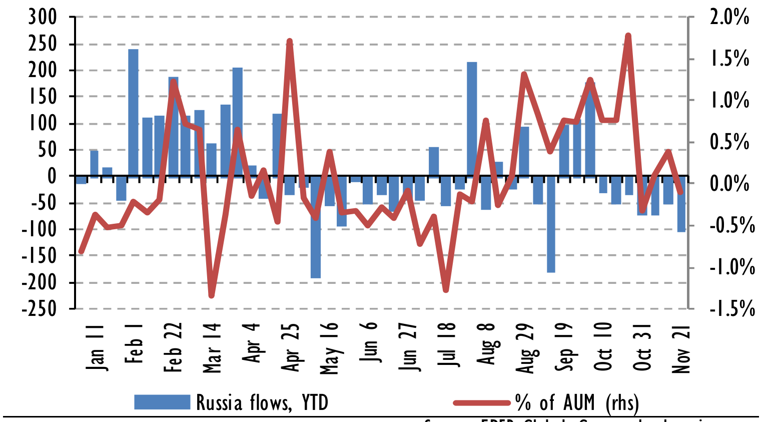
During QE1, we find that Russia was strongly correlated with MSCI EM (0.86) and Brent (0.89) – the main factors that traditionally shape sentiment toward the country. The even stronger correlation (0.93) with the S&P 500 during this period simply reflects the overall recovery in the US market and the global rebound off the 2008-09 recession lows. With the exception of Brent, all the other correlations have weakened as additional Fed programs were announced, suggesting that country-specific played the predominant role and that Russia has yet to benefit from the liquidity created by major central banks.

The YTD correlation that stands out is that between the RTS Index and the EUR/USD exchange rate – a barometer of risk-on sentiment toward Russia when the euro strengthens. The reason for this is that Russia is seen as particularly vulnerable to potential contagion from Europe, its largest trading partner. In the past, the correlation between the RTS and the Brent price has been much stronger, but this relationship has weakened this year. It appears that the oil price level above which the Russian budget is fulfilled is the level at which the correlation tends to weaken, i.e. a high oil price is a necessary but not sufficient condition for market performance. Anything higher than this 'sufficiency level' is deemed a threat to global economic growth and hence a negative for Russia, despite the nominal gains to the federal budget.

Fund flows

Portfolio fund flows have traditionally served as a leading indicator of global investor sentiment toward Russia, and this trend has been readily apparent in 2012. While Russia-dedicated funds saw significant inflows in 1Q12, helping to underpin the market's more than 20% rise, the reversal of flows in 2Q12 presaged the market's downturn. Since then, the trend has been volatile and event-driven, particularly prior to the US Federal Reserve's September meeting announcing its QE3 program. The trend in 4Q12 has once again turned lower, reflecting in part renewed concerns about the US Fiscal Cliff as well as uncertainty about the outcome of the US elections. Year to date, Russia-dedicated funds have taken in a total of $636 mln in new money, or 4.8% of overall assets under management.

Russia fund flows, YTD, $ mln

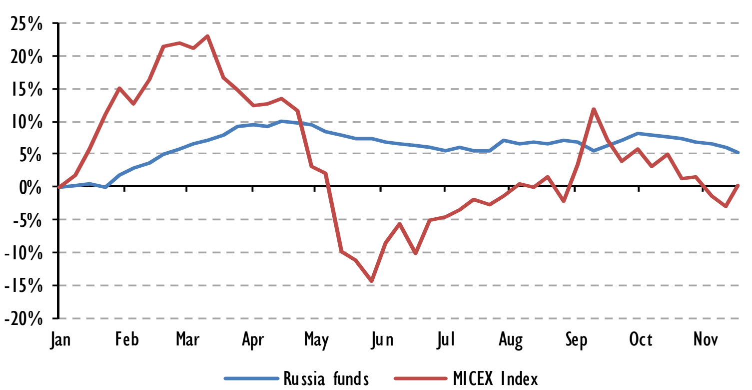


Source: EPFR Global, Gazprombank estimates

The distribution of flows last year also indicated a shift in the category of investor targeting Russia. The main story last year in terms of Russia's flow structure was the emergence of ETFs as the favored vehicle for foreign portfolio investment. More than 83% of all money directed to Russia-dedicated funds YTD has come through ETFs, with retail funds effectively relegated to the sidelines. To a certain degree, this shrinking of the local investor base reflects the scaling-back and even cease of activity by a few prominent institutions, but it also indicates the increasing liquidity premium among foreign investors, which has overshadowed the relative drawbacks of ETFs (narrow focus and relative volatility).

Regarding the correlation of fund flows and index performance in the BRIC category this past year, it appears that the inflow or outflow of money into country-dedicated funds does not really correlate with index performance – with the exception of Russia. Inflows to Russia funds peaked in February-March, when the MICEX Index reached YTD highs, while the reversal of flows in 2Q12 foreshadowed the market's downturn. Then, over the past six weeks since the Fed's announcement of QE3, a period that included uncertainty about the US elections and the Fiscal Cliff, MICEX performance has been on a slow downtrend – broadly in line with EPFR flows.

Russia fund flows YTD vs MICEX Index

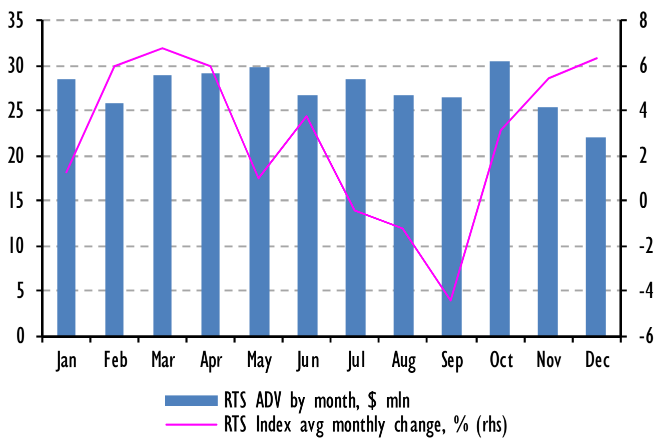


Source: EPFR Global, Gazprombank estimates

Seasonality – playing the averages

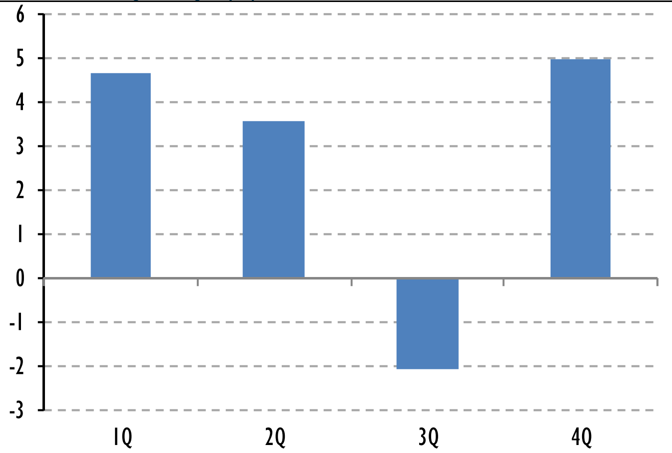
We conclude our 2013 equity market outlook by taking a brief look at the seasonality of the Russian market. Our analysis, which is based on the 17-year history of the RTS Index, suggests that trimming portfolios in the May-June period seems warranted considering that 3Q (-2.0% on average) is the worst quarter of the year for the RTS Index. September is the toughest month of the year (-4.4%), but it may also be the best time to position portfolios for a year-end rally, as the Russian market rises 3.1% on average in October, followed by November (+5.5%) and December (+6.3%). January's average return of just 1.3% suggests that most of a New Year's rally actually occurs before the new year arrives, while February (+5.9%), March (+6.6%) and April (+6.0%) are the three strongest consecutive months for the market, capping a cycle of strength.

RTS volumes and performance by month



Source: RTS-MICEX, Gazprombank estimates

RTS Index average change by quarter, %



Source: RTS-MICEX, Gazprombank estimates

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Russia 2013: "Perestroika" growth model

GDP growth to slow to 3.1% YoY in 2013, or 0.4 pps less than we expected for 2012. At the same time, against the backdrop of recession in Europe and the IMF's forecast of 1.5% YoY growth on average for developed countries, the 3.1% figure does not look too bad. Relative to Brazil, Mexico and South Africa, the growth rate of the Russian economy is at about the same level, but 2.0-2.6 times behind that of India and China. There is nothing dramatic in the decline of Russia's GDP growth; rather the economy is in a "perestroika" (restructuring) mode of growth: the role of consumption, now the main driver, will decrease, while the contribution of investment to GDP will increase.

Investment in fixed capital to accelerate to 7.5-8.0% YoY (versus 6.5-7.0% YoY in 2012) via expansion of corporate lending (from 10.0% to 15.0% YoY), and an increase in state spending on transport infrastructure (by 10.5% YoY) and the military industry (by 13.0% YoY).

Inflationary risks to recede to the background, replaced by risks related to economic growth. Inflation will remain close to 6.0-6.3% due to rapid growth in tariffs for paid services (7.0-15.0% per year). Helping to counterbalance these tariffs, monetary factors of inflation will have a dampening effect: a further slowing of growth in the monetary base (by 9.8% YoY in 2013 vs. 12.2% in 2011) will help stabilize base inflation, indirectly managed by the Central Bank, at a level of 5.5% YoY.

Ruble to enter a period of long-term devaluation. A decline in the average annual Urals price to $107.4/bbl will lead to stagnation in growth of exports of fuel and energy products at a level of 0.5-0.8% YoY. The current account balance will decline 2.2 pps to 2.8% of GDP. Alongside a reduced presence of the CBR on the domestic currency market, this will lead to an increase of the average annual USD/RUB rate to RUB 31.5 (vs. RUB 31.2 in 2012). Intra-year volatility of the ruble will increase. Strengthening of the ruble is possible at the beginning of the year (a rise in the USD/RUB rate to 30.0-30.5) due to an inflow of capital following the full launch of the Euroclear and Clearstream systems.

There will still be no excess liquidity. Banks in 2013 will continue to increase their obligations to the CBR by around RUB 0.8-1.0 trln. This will be facilitated by a number of innovations from the regulator: the introduction of three-year auctions, a shift to floating rates on refinancing operations for more than one month, and a possible expansion of the collateral base. The supply of money by VEB for placement in bank deposits will contract and be largely redirected toward infrastructure projects.

CBR monetary policy to reverse in favor of economic growth. Stabilization of inflation at a level of 6.0-6.3% YoY and slowing of growth in the real sector will lead to a 25 bps lowering of key CBR rates. Volatility of money market rates will decline, and spreads between long and short rates will be squeezed.

Key macroeconomic indicators

Medium-term forecast of Russian economic indicators

	2011	2012E	2013E	2014E	2015E	2016E	2017E
GDP growth, physical volumes, % YoY	4.3	3.5	3.1	3.0	3.2	3.2	3.3
Consumer inflation (CPI), % YoY	6.1	6.5	6.3	6.0	5.7	5.5	5.5
Producer inflation (PPI), % YoY	1.,0	8.5	8.3	7.8	7.5	7.0	6.8
Bi-currency basket, average over period, RUB	34.5	35.4	35.5	35.6	37.6	38.7	40.0
Exchange rate, average over period, RUB/USD	29.4	31.2	31.5	32.0	32.5	32.8	33.3
Urals price, average over period, $/bbl	109.3	110.0	107.4	106.5	108.6	110.8	113.0
Deficit/surplus of Federal Budget, % of GDP	0.7	0.1	-0.1	-0.2	0.0	0.1	0.4
CBR refinancing rate, end period, %	8.00	8.25	8.00	7.75	7.75	7.50	7.50
MosPrime rate (3m), end period, %	7.22	7.50	7.30	7.20	7.20	6.80	6.80

Source: State Statistics Service, CBR, Finance Ministry, Gazprombank

Estimate of macroeconomic indicators of Russia and leading EM countries, 2011-12

	Russia* (BBB/Baa1/BBB)		Brazil (BBB/Baa2/BBB)		Mexico (BBB/Baa1/BBB)		Turkey (BB/Ba1/BB+)		South Africa (BBB+/Baa1/BBB+)	
	2011	2012E	2011	2012E	2011	2012E	2011	2012E	2011	2012E
GDP growth, % YoY	4.3	3.5	2.8	1.5	3.9	3.8	8.5	2.9	3.2	2.5
Inflation, % YoY	6.1	6.8	6.6	5.3	3.4	4.2	6.5	9.0	5.0	5.5
Unemployment rate (EAP), %	6.6	5.5	6.0	5.6	5.2	4.9	9.8	9.5	2.0	24.9
Budget surplus (deficit), % of GDP	0.5	0.1	-2.3	-2.5	-2.3	-2.4	-1.4	-2.0	-4.4	-4.9
CBR refinancing rate	8.0	8.3	11.0	7.3	4.5	4.5	5.8	5.8	5.5	5.0
Growth in RUB vs USD, %	-5.2%	5.1%	-12.7%	-8.0%	-13.0%	7.6%	-22.7%	4.8%	-22.0%	-6.3%
External debt, $ bln**	545.2	597.7	404.1	417.7	285.4	314.0	306.7	323.5	111.5	119.0
Government debt, % of GDP***	8.3		54.2		35.4		40.0		38.6	
Current account balance, % of GDP	5.3	5.0	-2.1	-2.3	-0.8	-0.7	-9.9	-7.5	-3.6	-5.5
International reserves (gold and foreign currency), $ bln**	498.6	526.8	352.0	377.8	142.5	162.4	110.6	124.9	48.9	50.7
Import coverage of gold and foreign currency reserves, months***	14.0		14.0		5.0		4.0		5.0	

* Gazprombank estimates of unemployment for Russia, Bloomberg consensus estimates for other countries

** actual data for the prior accounting period

*** Gazprombank estimate

Source: World Bank, Bloomberg, Data Stream Thomson Reuters, CBR, Gazprombank

GDP: slowing for the sake of future growth

- Economy to enter a trajectory of low growth rates. The structure of its factors will remain unchanged for around another 10 years. GDP in 2013 will slow to 3.1% YoY vs. 3.5% expected for 2012.
- Consumption to remain a key factor for economic growth (contributing 70% to GDP), although its growth will be 0.5-1.0 pps less than in 2012.
- Growth of investment in fixed capital to total around 7.5-8.0% YoY, driven by growth in corporate lending (to 15.0% YoY) as well as an increase in state spending on infrastructure (to 10.5%) and the military-industrial complex (to 13.0% YoY).

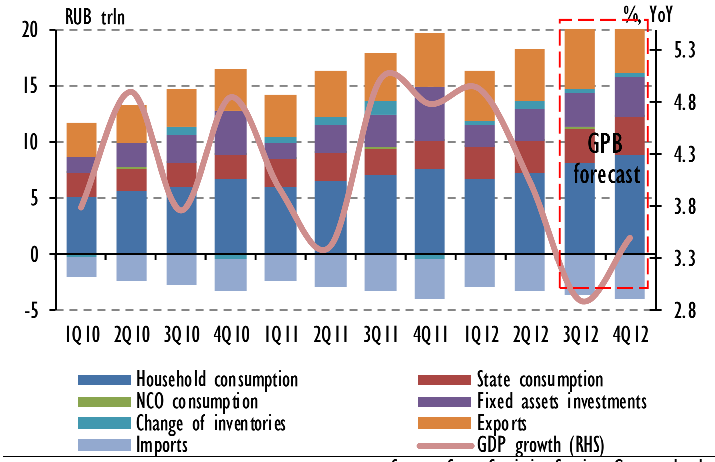
Rebalancing growth: path to increased investment

There will no longer be fast economic growth based on acceleration of investment in fixed capital. In our view, Russia will see GDP growth of 3.1% YoY in 2013 given a lack of external shocks such as those that occurred in 2008. Moreover, given the weak figures for industrial production and investment in fixed capital in 2H12, we reduce our estimate of GDP growth in 2012 to 3.5% YoY.

The structure of growth drivers will remain unchanged due to the high share of consumption (70%) and the inflexible manufacturing structure of the economy and investment. The transition to an "investment" model of growth, announced by the Ministry for Economic Development, may last up to 10 years. In order to develop this conception, the government has set forth the task of increasing the volume of investment in fixed capital to 25% of GDP by 2015 and 27% by 2018. Today this figure is around 20%, which is characteristic of the past six years.

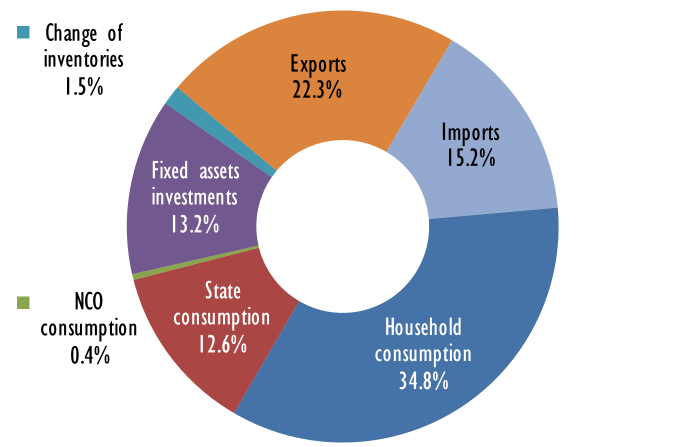
In order for growth of investment to outpace Russia's overall GDP dynamic, a structural rebalancing of growth factors must occur. In practical terms, this means that in order to achieve a 27% share of investment in GDP by 2018 (as the government desires) and support an overall rate of growth in physical volumes of GDP close to 4.0% YoY, investment in fixed capital must grow 7.0-7.5% per year (with an average deflator of 7.0%).

Dynamic of GDP and separate components by use, 2000-12



Source: State Statistics Service, Gazprombank

Structure of GDP by use, 1H12



Source: State Statistics Service, Gazprombank

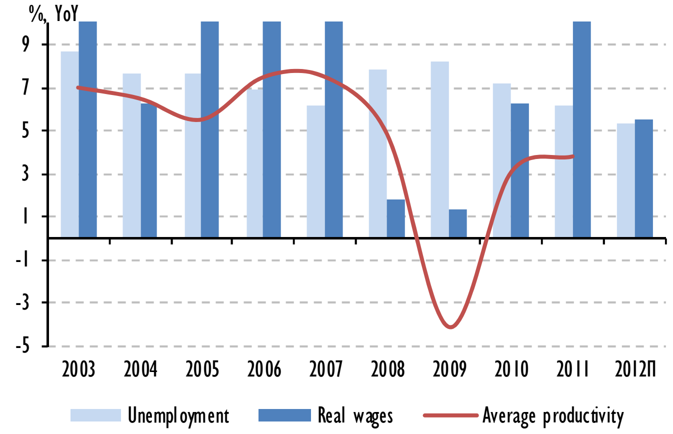
We do not expect any reversal points in the GDP dynamic in 2013, but simply a continuation of the overall declining tendency in quarterly growth noticed this year: GDP growth in 3Q12 totaled 3.8% YoY, practically reaching its potential long-term level (4.0% YoY), while the quarterly rate corrected for seasonality fell sharply (from 1.6% QoQ in 4Q11 to 0.1% in 2Q12).

Given that in 2013 there will be no "extra" percentage points of GDP gifted by the government to consumers as part of electoral campaigns, support for slowing growth (and not accelerating) will require a larger volume of investment than in previous years. We also expect the average annual Urals price to "gravitate" to \$107.4/bbl (vs. our forecast of \$110.0/bbl for 2012), which will prevent a correction of the situation from the standpoint of net exports.

That said, depletion of growth in 2013 will also have positive structural consequences. In particular, it will become necessary to balance the long-standing disproportions in the Russian economy between labor productivity, growth in real wages and unemployment.

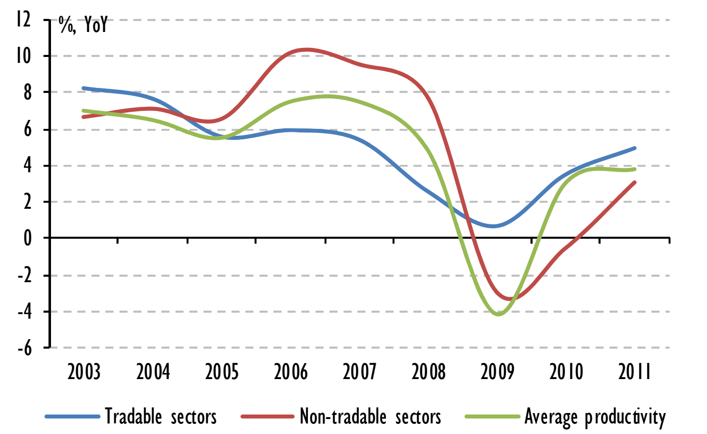
Deterioration in the external economic environment will require growth of productivity in export-oriented sectors of the economy (mainly in the fuel and energy complex and metallurgy), primarily through the release of surplus labor. In the services sector (financial business, operations with real estate, etc) correction of the imbalances will occur at the expense of a decline in real wages.

Labor productivity, real wages vs unemployment, 2003-12



Source: State Statistics Service

Labor productivity in export-oriented and "domestic" sectors of the economy

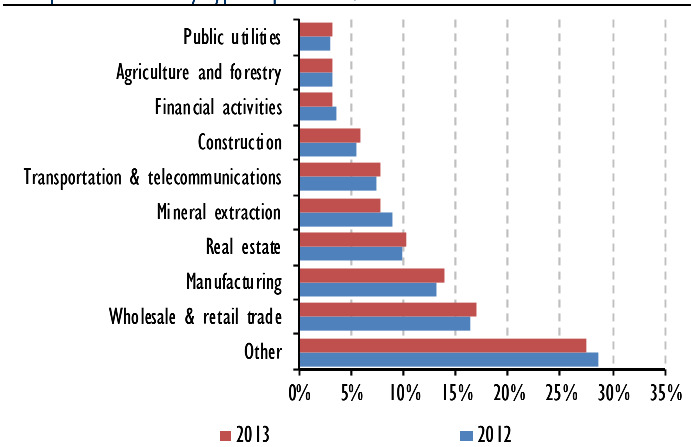


Source: State Statistics Service, Gazprombank

Another positive aspect of the slowing of growth is a long-term decline of inflation (to a level of 5.5-6.0% over the next five years), which could potentially become a driver of the economy in "non-tradable" sectors oriented to the domestic market. The contribution of this segment to GDP growth rose to 3.6 pps of 4.5 pps in 1H12 (vs. 1.9 pps of 3.9 pps in 1H11).

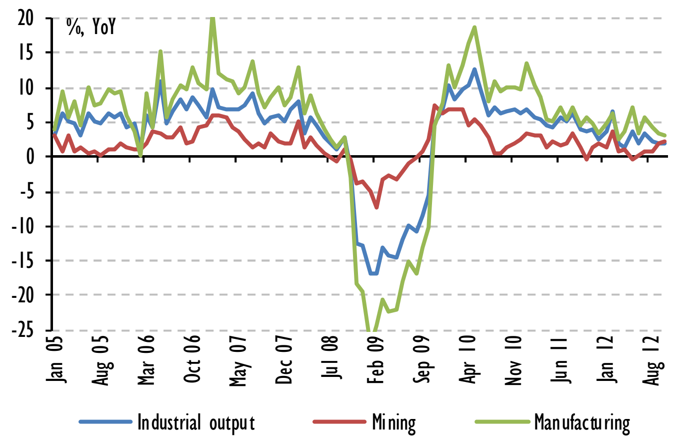
The nature of economic growth in the coming years will be different with respect to its greater resilience to external shocks compared with pre-crisis years. This is due to the increased share of sectors oriented to the domestic market in the structure of GDP, a decrease of the oil and gas deficit in the federal budget from 10.7% of GDP in 2012 to 8.3% in 2015, a further reduction of the presence of the CBR on the currency market, and an improved structure of external debt (growth in the share of long-term obligations).

Components of GDP by type of production, forecast for 2012-12



Source: State Statistics Service, Gazprombank

Industrial production in extractive and manufacturing sectors, 2005-12

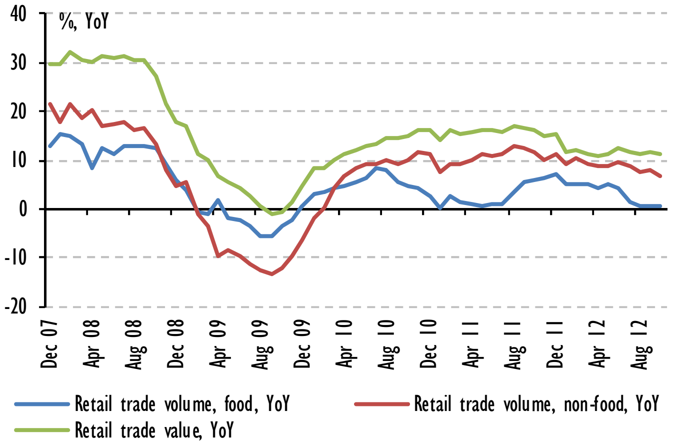


Source: State Statistics Service, Gazprombank

Consumption to slow, and along with it GDP growth

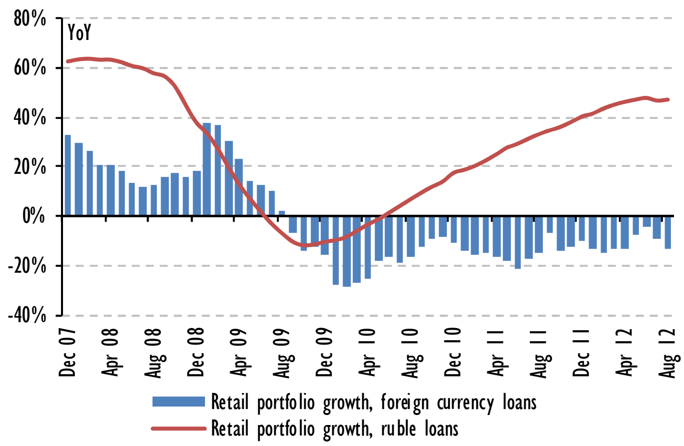
The dynamic of aggregate consumption in 2013 (3.5-3.8%) will be more modest than the figure for this year (4.8% YoY in 2Q12, 4.3% YoY for 2012), mainly due to stabilization of growth in real public disposable income at close to 3.5-4.0% (vs. around 5.5% in 2012) and increased savings (from 12% in 2012 to 15% 2013), due to higher average rates on public deposits. Contraction of the rate of growth in retail lending in 2013 to 20% YoY (vs. 35% in 2012) will have less of an impact on household consumption, as the latter is only 7.0-8.0% financed by bank loans (data for 2012).

Value and physical volumes of retail trade turnover, 2007-12



Source: State Statistics Service, Gazprombank

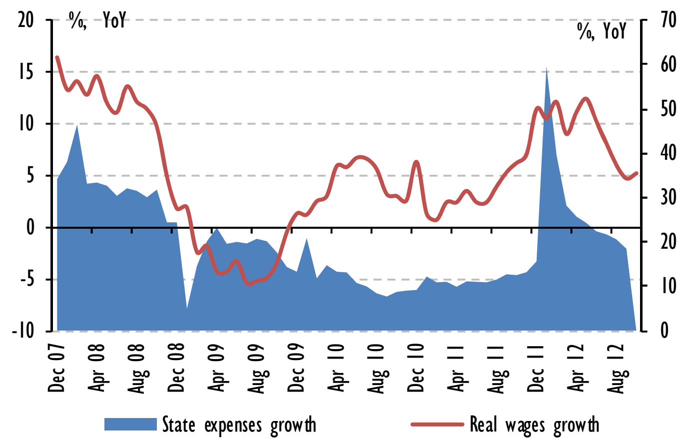
Bank loans to individuals, 2007-12



Source: CBR, Gazprombank

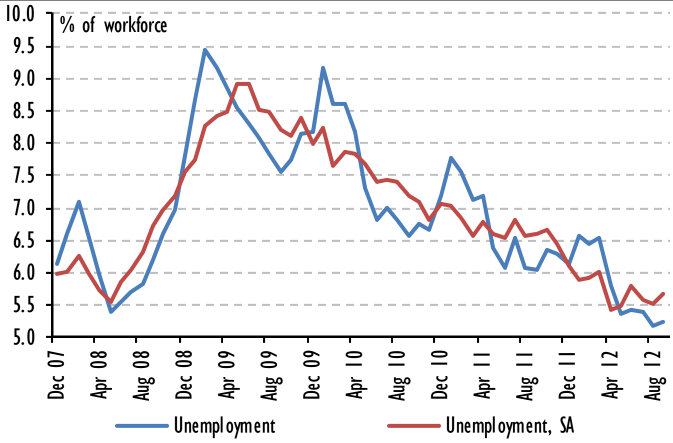
Preservation of the model of economic growth and the end of the period of post-crisis recovery determine the dynamic of retail trade turnover at the level of growth in real disposable income in 2013 (4.0% YoY) and subsequent years (3.5-4.0% YoY). In previous years, growth of retail trade outpaced income (by 1.8 pps in 2011 and 0.6 pps in 2012).

Government expenditures and real wages, 2007-12



Source: State Statistics Service, Gazprombank

Unemployment as a % of economic activity of the population (EAP), 2007-12



Source: CBR, Gazprombank

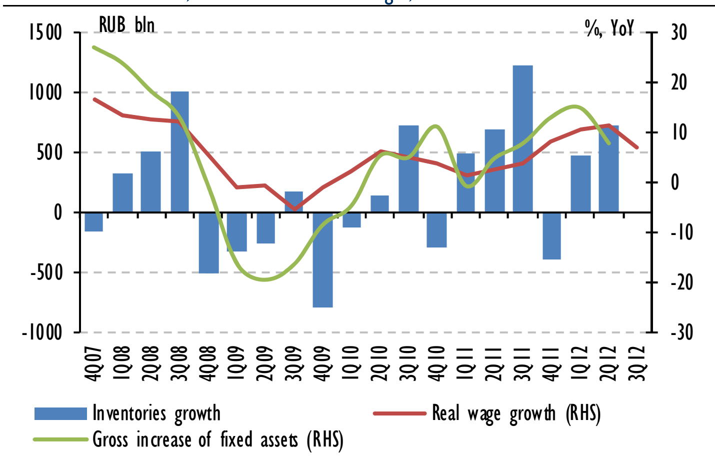
Actual government consumption is decreasing: the budget surplus over the past two years is no longer an indicator of firmness and stability, but instead is acting as a brake on the Russian economy. State expenditures in 2013 will rise 3.3% YoY to R13.4 trln, marking the lowest level of growth in eight years. Accordingly, the state budget will make little contribution to growth in aggregate consumption next year.

Investment pause will end, but this will not aid GDP growth

The end of the cycle of inventory accumulation, stabilization of wages, and industrial capacity utilization at close to the maximum level (70-73% in extractive industries and 63-65% in manufacturing segments – practically at the level of pre-crisis years) are all signs of transition to a stage of accumulation of fixed capital investment. We expect the latter to grow 7.5-8.0% YoY (vs. 6.5-7.0% YoY in 2012) due to heightened investment activity among quazi-sovereign companies as well as recovery of foreign capital inflows.

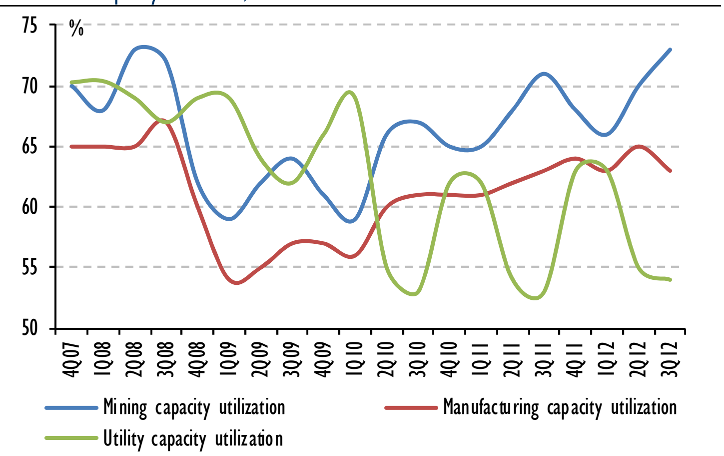
From the standpoint of the relationship of investment among sectors, we see a relative decline in the share of extractive export sectors due to contraction of global demand. The federal budget already contains outlays for the reconstruction of oil refineries and an overall reduction of government capex in the fuel and energy industry (by 52.2% YoY, or R24.1 bln in 2013). The share of manufacturing (excluding oil and gas refining) may increase as a result of activation of the military-industrial complex.

Growth of inventories, investment and real wages, 2007-12



Source: State Statistics Service

Industrial capacity utilization, 2007-12

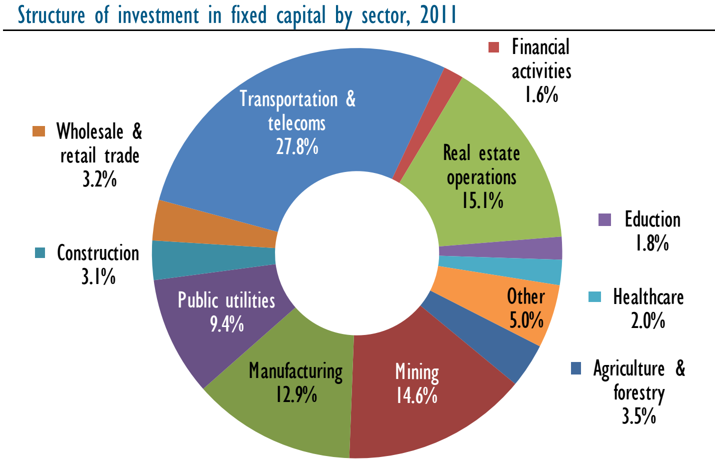


Source: State Statistics Service

We anticipate growth of investment activity in 2013 in the following sectors:

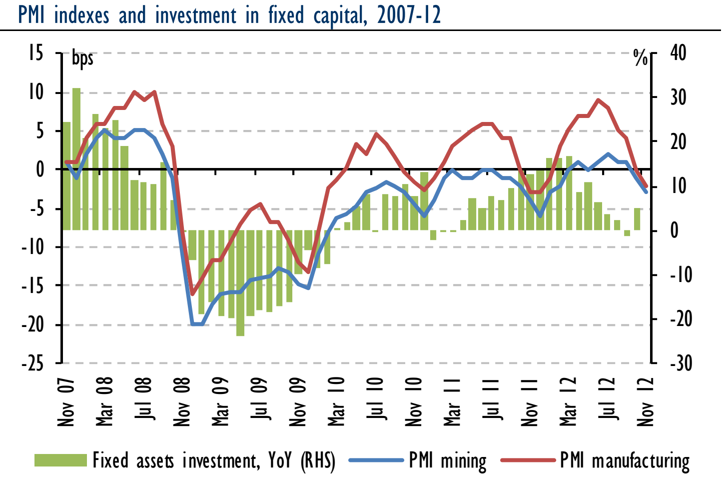
- transport infrastructure. In this segment the volume of investment over the next three years will total RUB 1.4-2.0 trln, including around RUB 800-860 bln from non-budgetary sources.
- machine-building and hi-tech production. For these areas, the Ministry for Economic Development promises by end 2012 to elaborate a comprehensive program of active industrial policy and segment applications (for the space program as well as aviation, ship and instrument building). The driver of development of the machine-building industry may be expansion of state military orders. To remind, a total of around RUB 20.7 trln will be directed toward military spending until 2020.

Structure of investment in fixed capital by sector, 2011



Source: State Statistics Service

PMI indexes and investment in fixed capital, 2007-12



Source: State Statistics Service

According to the State Statistics Service, as of 9M12 the Russian economy attracted a total of $114.5 bln in foreign investment, or 14.4% less than in 9M11. Most of this decline was due to "other investment" (trade and commercial credits), which fell 17.2% to $100.6 bln. Direct foreign investment (FDI) rose 4.6% YoY to $12.3 bln, while portfolio investment grew 1.9 times to $1.6 bln: equities attracted $1.5 bln (up 3.7 times) while bonds took $115.0 mln (down 17.3%). In 2013, we forecast acceleration of FDI to 7.0% YoY and an overall increase of foreign investment to 3.0-4.0%, thanks to improved institutional mechanisms for attracting investors.

The government has announced the following institutional transformations in the interest of improving the investment climate:

- harmonization of customs procedures in accordance with WTO regulations, minimization of indirect contact of participants in external economic activity with customs as a result of widespread use of electronic declarations;
- simplification of procedures in the areas of construction, business organization, reception of state services, as well as the elimination of a range of approval documentation, licenses, certificates, etc.
- recapitalization of state-guaranteed funds in order to promote the growth of "modernization loans" and develop small and medium-sized businesses.

Alongside liberalization of the domestic financial market for non-residents (via full introduction of the Euroclear and Clearstream systems), the expected improvement of the investment climate will lead to a slowing of the net outflow of private capital to $50-60 bln. If in addition the CBR fulfills the parameters of its monetary policy in 2013 (i.e. allows banks to increase gross lending to RUB 3.6 trln (base variant) versus a current RUB 2.6 trln), the real sector could receive an additional RUB 1.0 trln from the banking sector and raise the volume of investment to RUB 14.0 trln.

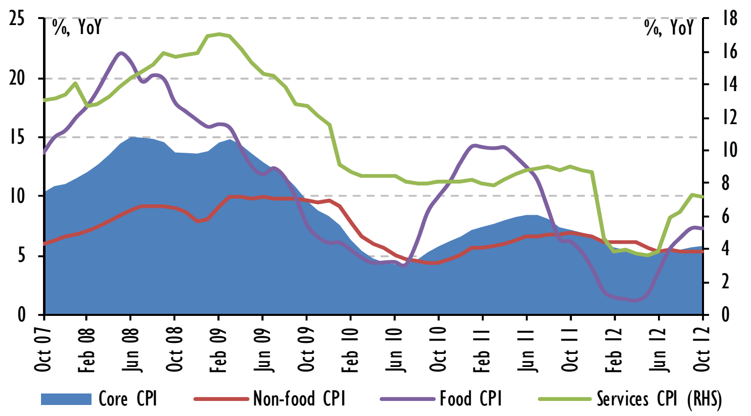
Inflationary risks to recede

- The CBR's raising of key rates by 25 bps on September 14 is bearing fruit: the annual rate of growth in the money supply in October slowed to 14.8% YoY (vs. 16.7% YoY in September and 19.7% YoY in October) and, as a result, inflation in November stabilized at 6.4-6.5% YoY. We forecast CPI in 2013 at a level of 6.3%.
- "Tariff inflation" over the next three years will be above the CBR's targeted rate of inflation (5.0-6.0%), while growth in tariffs for paid services of natural monopolies will remain at 7.0-15.0%, which will contribute about 3.0-3.5 pps to CPI for the entire year.
- Food inflation will not be a particular area of concern until March 2013, while thereafter a short-term seasonal spike is possible due to depletion of seasonal grain inventories and growth in global wheat prices. However, in 2H13 one can expect a decline in food prices, as the agricultural harvest in 2013 should be 20-30% better than in 2012.

The CBR's decision to hike key rates in September of this year is bearing fruit: following a spike of inflation in September (to 6.6% YoY) and mid-October (to 6.9% YoY), the regulator managed to stabilize CPI at 6.5% YoY at end November. We believe that in 2013, in conditions of "compressed" and uneven distribution of liquidity, inflationary risks will recede and annual CPI will reach 6.0-6.3% (versus our expectation of 6.5% YoY for 2012).

Monetary factors had a heightened impact on prices: annual growth in the monetary supply slowed to 14.8% in October vs. 16.7% in September. Given that the CBR has the greatest influence on base CPI (5.8% YoY as of November 1, or 0.3 pps above the targeted level), in order to fully curb growth in consumer prices the regulator will have to achieve stabilization of base inflation, which will very likely occur as soon as November.

Inflation (CPI), monetary base and money supply, 2003-12



Source: State Statistics Service, Gazprombank

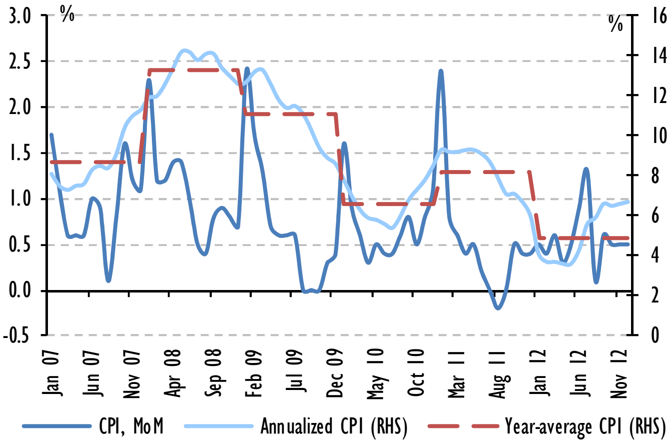
Non-monetary factors will have an ambiguous impact on inflation. On the one hand, growth in tariffs for services of natural monopolies in 2013 will range from 7.0% to 15.0%, which overall corresponds to the level of 2012 and will contribute about 3.0-3.5 pp to inflation. On the other hand, stagnation of growth in consumption at a level of 3.5-3.8% YoY will remove excess pressure on prices from aggregate demand.

Indexation of tariffs for services of natural monopolies, 2012-15

	2012 (estimate)	2013	Forecast 2014	2015
Electricity for all categories of final consumption (indexation in July)	3.5-6.0	12.0-13.5	10.5-12.5	11.0-13.0
for consumers, excluding individuals	3.6-6.0	12.0-14.0	10.0-12.0	10.8-12.5
regulated tariffs of grid companies	6.0	10.0-11.0	9.5-10.0	9.0-10.0
regulated tariffs for the population	3.0	9.1-10.6	12.0-15.0	12.0-15.0
Heat (indexation in June, September)	5.1-6.5	10.5-12.2	10.9-11.0	10.8-11.0
Natural gas (wholesale prices)	7.5	15.0	15.0	14.6-15.0
for consumers, excluding individuals	7.1	15.0	15.0	14.5-15.0
for the population (indexation in July)	10.4	15.0	15.0	15.0
Railway cargo turnover (indexation in January)	6.0	7.0	5.0	5.5
Railway PAX turnover (indexation in January)	10.0	10.0	10.0	10.0

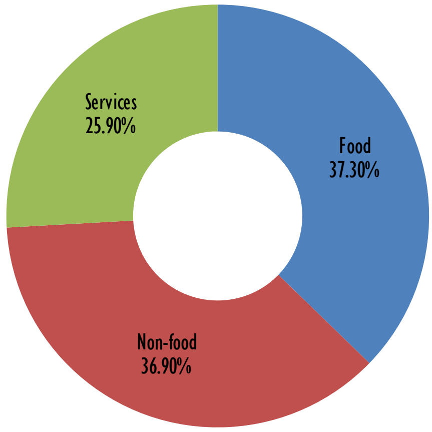
Source: Economics Ministry

Dynamic of average annual inflation, 2007-12



Source: State Statistics Service, Gazprombank

Structure of CPI index in 2012



Source: CBR, Gazprombank

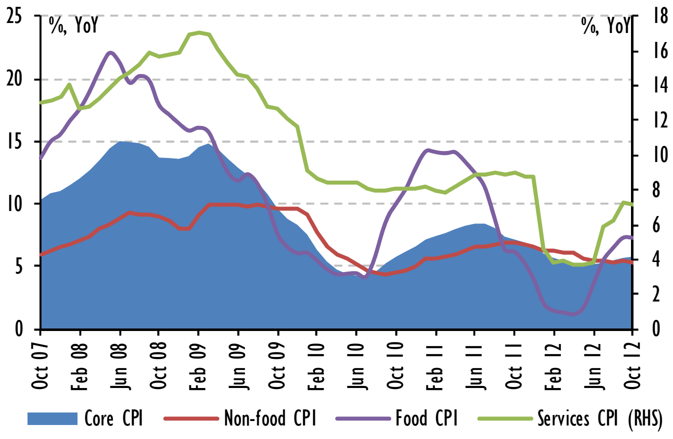
Food inflation, which played a deciding role in prices exceeding the CBR's target level in 2012 (5.5-6.0%), will now exert heightened pressure on the overall price level, but only in 1H13. Based on the opinions of experts from the Russian Grain Union, we believe that in March of next year there could be a short-term spike in prices for flour, bread and bread products due to seasonal depletion of grain stocks and a rise in global wheat prices.

The Russian Grain Union and the government expect the situation to change dramatically following the start of the agricultural harvest season, the indicators of which in 2013 should be 20-30% higher compared with 2012, including due to an increase in acreage an improvement of the technological base of agricultural producers. As a result, a decline in food prices is possible in 2H13.

Non-food inflation will face downward pressure from imported goods. According to the Finance Ministry, in accordance with WTO obligations, the average decline in rates of imported customs duties will total around 2.09 pps (from 9.33% in 2012 to 7.24% in 2013), and including VAT payments the overall effect on imports will be even stronger.

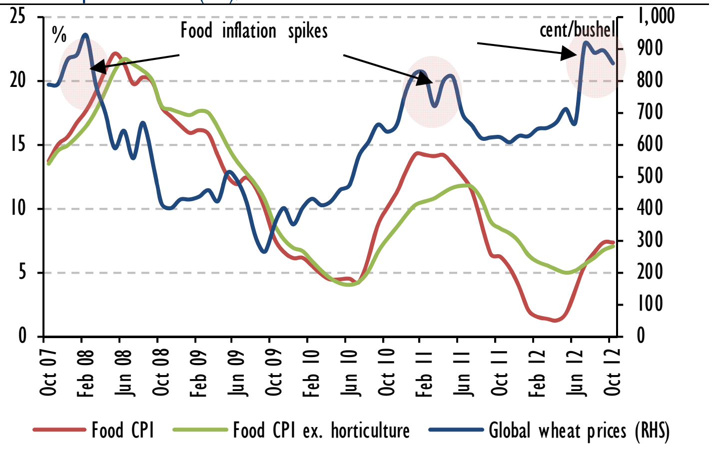
The "WTO factor" will have the greatest impact on non-food goods. In practical terms, a structural decline in non-food inflation has already occurred: whereas in July-August it was at a level of 0.6-0.7%, by November it had slowed to 0.4%. This is also shown by a comparison of the average growth in prices for non-food goods in the nine months to the May devaluation (0.6%) and the November index (0.4%).

Base inflation and components of CPI, 2007-12



Source: State Statistics Service, Gazprombank

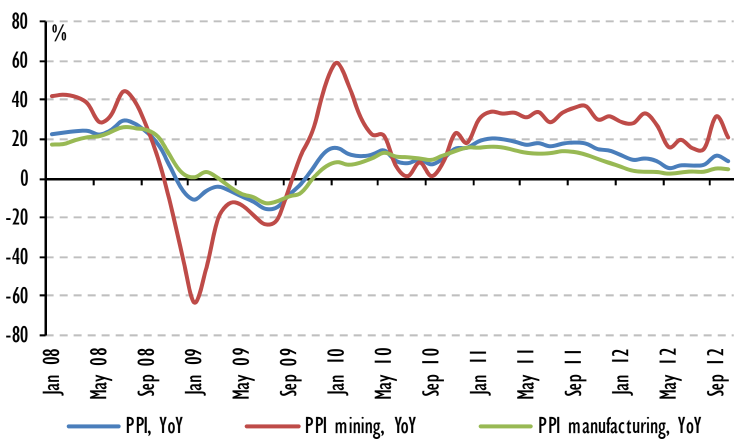
Producer price inflation (PPI), 2007-12



Source: CBR, Gazprombank

Manufacturing inflation will decline to 8.3% YoY in 2013 (vs. our expectation for 2012 of 8.5% YoY for 2012), which corresponds with our average annual oil price forecast (Urals at $107.4/bbl and Brent at $109/bbl in 2013). Weak growth in the global economy will lead to a fall in prices for other raw material goods with importance for Russian exports, which in turn will likely limit growth in wholesale prices for production of extractive industries.

Producer price inflation (PPI), 2008-12



Source: State Statistics Service, Gazprombank

Budget 2013: sufficient margin of safety at Urals above $85/bbl

- The new budget was formed with consideration for budget rules, as a result of which revenues are planned at a lower (0.3% YoY) level than in 2012, while growth in expenditures does not exceed 3.3% YoY. The structure of expenditures is dominated by items for defense and social needs.
- The deficit in 2013 will total RUB 521.4 bln, or 0.8% of GDP, while net placement of OFZs totals RUB 448.6 bln (vs. RUB 709.8 bln in 2012), of which RUB 373.0 bln will be absorbed by the Reserve Fund, i.e. this money will not flow into the banking system.
- The non-oil and gas deficit will contract by 0.8 pps of GDP to RUB 6.4 trln, while the breakeven Urals price will fall by $11.1 to $105.1/bbl.
- Given a negative scenario for development of the external economic situation, money from the Reserve Fund (RUB 1.9 trln) will be sufficient to cover the budget deficit if the average annual Urals price does not fall below $85/bbl.

Formation of the budget for 2013-15 took place on the basis of new budget rules elaborated by the Finance Ministry. Accordingly, the forecast Urals price contained in the budget's base turned out to be rather low at $97.0/bbl. Our base forecast is $10.4 higher, and thus we believe that the real deficit will total 0.2% of GDP.

The accounting amount of revenues in 2013 totals RUB 12.87 trln (-0.3% YoY), or 19.3% of GDP, including oil and gas revenues at a level of RUB 5.95 trln, or 8.9% of GDP (in 2012, oil and gas revenues are planned at 10.5% of GDP).

The practical dependence of budget revenues on oil prices will remain high. In our view, a $1 decline in the average annual Urals price leads to a RUB 70-75 bln loss in oil and gas revenues. Stress testing shows that if average annual Urals prices in 2013-15 correspond with the average Urals price for 2005-12 (i.e. $90.5/bbl), revenues will decrease each year by 0.7-0.8% of GDP. In this case, the government will have an interest in devaluing the ruble to a level of RUB 33.0-33.5/$ in order to recover the ruble equivalent of revenues.

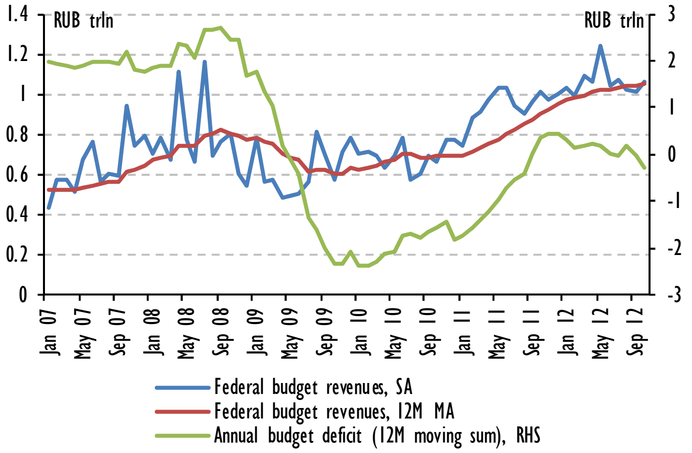
Spending in 2013 to total RUB 13.39 trln (+3.3% YoY) or 20.1% of GDP. The budget is characteristically oriented to the social sphere (RUB 4.3 trln or 31.8% of all expenditures), spending on which is comparable with expenditures for defense, security and law enforcement activities (RUB 4.2 trln, or 31.3% of all spending). Most of the spending in the social sphere (RUB 2.9 trln, or 21.6% of all expenditures) is represented by transfers to the Russian Pension Fund.

Main parameters of the federal budget for 2013-15

		2011	2012	2013	2014	2015
REVENUES	RUB trln	11.37	12.92	12.87	14.06	15.62
	% of GDP	20.8	21.1	19.3	19.0	18.8
Oil and gas revenues	RUB trln	5.64	6.41	5.93	6.28	6.93
	% of GDP	10.30	10.5	8.9	8.5	8.4
Non-oil and gas revenues	RUB trln	5.72	6.50	6.94	7.78	8.68
	% of GDP	10.50	10.6	10.4	10.5	10.5
EXPENDITURES	RUB trln	10.94	12.96	13.39	14.21	15.63
	% of GDP	20.0	21.2	20.1	19.2	18.8
DEFICIT (-), SURPLUS (+)	RUB trln	0.43	-0.04	-0.52	-0.14	-0.01
	% of GDP	0.79	-0.07	-0.78	-0.19	-0.01
Non-oil and gas surplus/deficit	RUB trln	-5.21	-6.45	-6.45	-6.42	-6.94
	% of GDP	-9.5	-10.5	-9.7	-8.7	-8.4
Transfers to the Reserve Fund	RUB trln	0.04	0.83	0.37	0.6	0.82
	% of GDP	0.07	1.36	0.56	0.81	0.99
Breakeven oil price for the budget, $/bbl	$/bbl	118.3	116.2	105.1	103.2	104.2

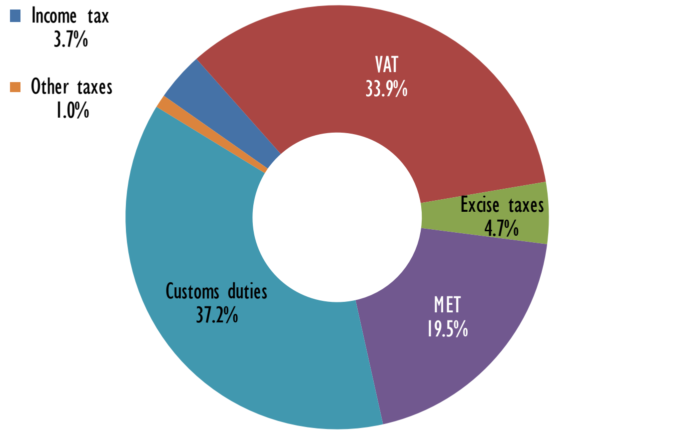
Source: Finance Ministry, Gazprombank estimates

Revenues and deficit of the federal budget, 2007-12



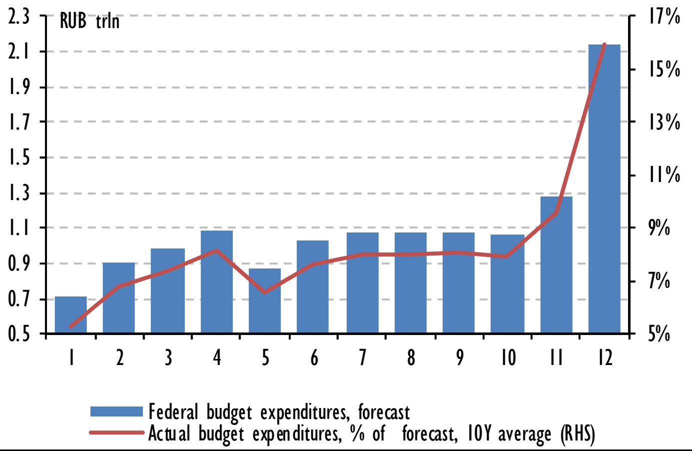
Source: Finance Ministry, Gazprombank estimates

Structure of tax revenues of the federal budget in 2013



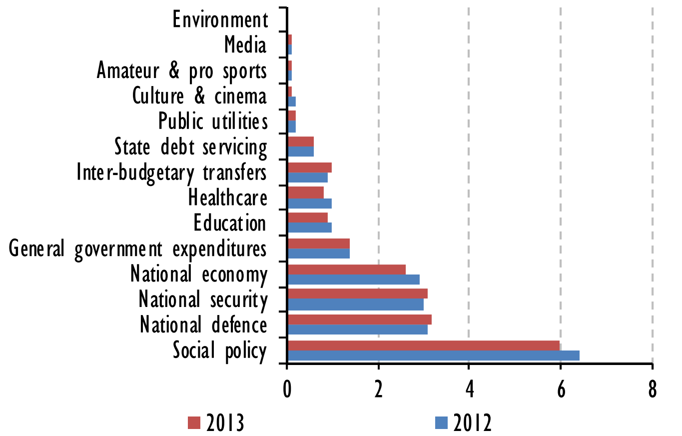
Source: Finance Ministry

Forecast cash execution of budget expenditures for 2013 (by month)



Source: Finance Ministry, Gazprombank estimates

Federal budget expenditures by item (% of GDP), forecast for 2012-13

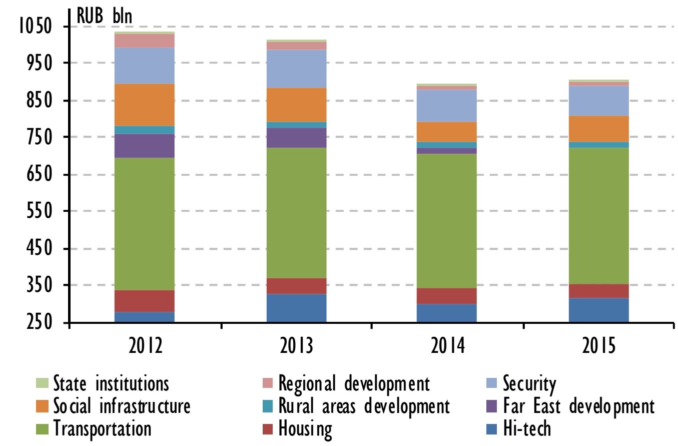


Source: Finance Ministry

The volume of budget appropriations to the item "National Economy" will decline 3% from the 2012 level (to RUB 1.7 trln), which is one of the factors behind the slowing of economic growth. Within this item, one notes significant growth in spending on roads (by 14.8% to RUB 450.1 bln) in the form of subsidies to the state company Avtodor as part of the Federal Target Plan "Development of the transportation system" and appropriations for major repair and maintenance of roads. We also note the increase in financing for the item "Research and use of outer space", by 38.5% YoY to RUB 47.2 bln – here the main amount of spending will be directed to activities of the Federal Space Program and the Federal Target Plan to develop the GLONASS system.

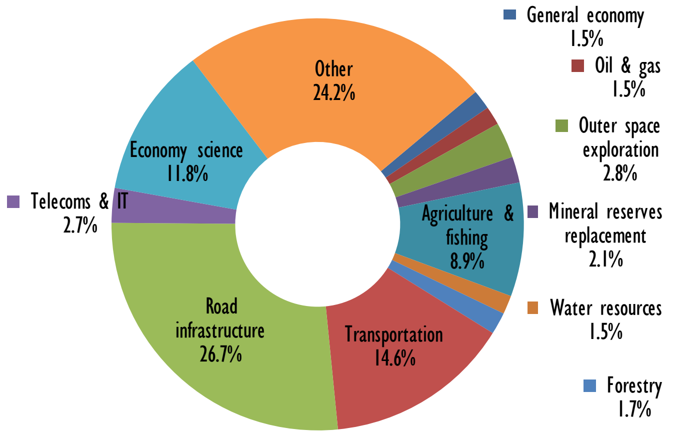
In addition, it is planned to subsidize interest rates on loans to industrial enterprises attracted for the purposes of modernization and technical upgrade. The government hopes that through this program the interest rate could be reduced to 7.0-9.0%, which would allow the attraction of additional loan resources totaling up to RUB 680 bln.

Distribution of budget revenues according to federal target program, 2012-15



Source: Finance Ministry

Distribution of revenues by item "national economy" in 2013



Source: Finance Ministry

The budget will be balanced in 2013 at a Urals price of $105.1 /bbl, or $11.1 less than in 2012. A sensitivity analysis shows that in case of maintenance of the current Urals price ($110/bbl) the budget surplus will reach RUB 0.5 trln, or 0.8% of GDP.

Given a negative scenario for development of the external environment, there is enough money in the Reserve Fund to cover the budget deficit on the condition that the average annual Urals price does not fall below $85/bbl.

Sensitivity of the federal budget deficit to changes in the Urals price

Urals price, $/bbl	110	105	100	95	90	85	80	75	70
GDP, RUB trln	68.5	67.0	66.0	65.4	65.0	64.8	64.0	63.2	62.1
Oil and gas revenues, RUB trln	6.7	6.5	6.2	6.0	5.8	5.5	5.3	5.0	4.8
Budget deficit, RUB trln	0.5	0.0	-0.2	-0.5	-1.2	-1.8	-2.4	-3.0	-3.7
Budget deficit, % of GDP	0.8%	0.0%	-0.4%	-0.8%	-1.8%	-2.8%	-3.8%	-4.8%	-5.9%

Source: Finance Ministry

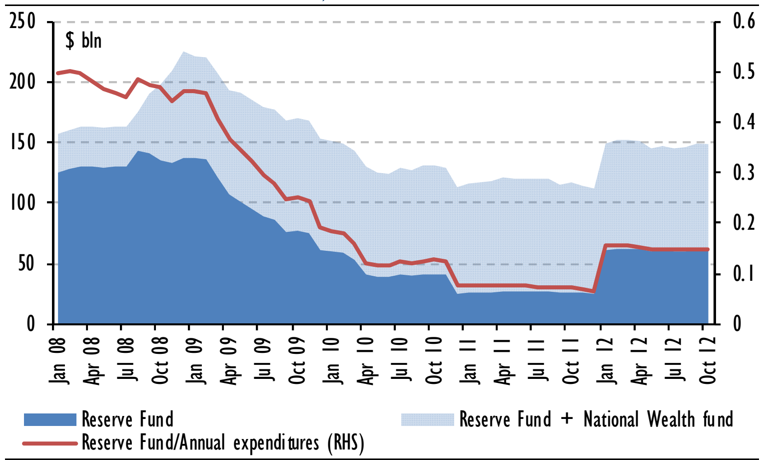
The accounting amount of the budget deficit in 2013 totals RUB 521.4 bln (0.8% of GDP) vs. RUB 42.7 bln expected for 2012. In the context of the money market, cash execution of the federal budget will act as a source for withdrawal of liquidity. Budget expenditures will be distributed more unevenly (in favor of December) than in 2012 (the "electoral overhang" part of spending at the beginning of the year). Accordingly, throughout most of the year the budget will be in surplus, while a real deficit is possible only in November-December.

In 2013, pressure from the budget deficit on the domestic debt market will be significantly less than in 2012. This is due to the near 37% YoY decline in the volume of net OFZ placements and 11.0% YoY rise in spending to service government and municipal debt.

The borrowing program on external and domestic markets calls for an increase in government debt in volumes that significantly exceed the size of the deficit. From the standpoint of the money market, increasing government debt in the interests of replenishing the Reserve Fund will serve to compress liquidity in the banking sector and sterilize monetary issuance. Such a situation occurred in 2011 and will repeat in 2012-15. In order to compensate for the sterilization effect, the CBR will have to increase its refinancing in a volume equal to growth of the Reserve Fund.

Regarding budget deficit indicators contained in Law No. 371-FZ (previous budget version), some rather serious changes were made. Earlier it was suggested that net OFZ placements would total RUB 1.2 trln in 2013. This figure has now been reduced to RUB 449.0 bln (down RUB 503.3 bln relative to 371-FZ), while the Reserve Fund will absorb RUB 373.4 bln.

Reserve Fund and National Wealth Fund, 2008-12



Source: Bloomberg

The overall volume of OFZ placements in 2013 will total RUB 1.2 trln, with redemptions at a level of RUB 764.6 bln. On the external market, the Finance Ministry plans to borrow RUB 235.6 bln (redemptions of external debt total RUB 77.7 bln). Given that spending on the item "Servicing of government and municipal debt" equal RUB 425.3 bln, one can conclude that OFZ placements in 2013 will not exert pressure on the domestic debt market.

Sources of financing of the federal budget deficit in 2013-15, RUB bln

		2012	2013	2014	2015	2013/2012	2015/2012
TOTAL SOURCES	RUB bln	135.1	521.4	143.6	10.8	285.9%	-92.0%
	% of GDP	0.2	0.8	0.2	0.0		
Government borrowing	RUB bln	836.9	606.5	563.4	414.4	-27.5%	-50.5%
	% of GDP	1.4	0.9	0.8	0.5		
Attraction	RUB bln	1,519.9	1,448.8	1,079.3	1,356.4	-4.7%	-10.8%
	% of GDP	2.5	2.2	1.5	1.6		
domestic	RUB bln	1,310.2	1,213.2	842.2	1,114.8	-7.4%	-14.9%
	% of GDP	2.1	1.8	1.1	1.3		
external	RUB bln	209.7	235.6	237.1	241.6	12.4%	15.2%
	% of GDP	0.34	0.35	0.32	0.29		
Redemption	RUB bln	-683.0	-842.0	-515.9	-942.0	23.3%	37.9%
	% of GDP	-1.1	-1.3	-0.7	-1.1		
domestic	RUB bln	-600.4	-764.6	-443.7	-808.3	27.3%	34.6%
	% of GDP	-0.98	-1.15	-0.60	-0.97		
external	RUB bln	-82.6	-77.7	-72.3	-133.7	-5.9%	61.9%
	% of GDP	-0.1	-0.1	-0.1	-0.2		
Balance of domestic placements	RUB bln	709.8	448.6	398.5	306.5	-36.8%	-56.8%
	% of GDP	1.16	0.67	0.54	0.37		
Balance of external placements	RUB bln	209.6	235.5	237.0	241.4	12.4%	15.2%
	% of GDP	0.34	0.35	0.32	0.29		
Privatization	RUB bln	300.0	427.7	330.8	595.1	42.6%	98.4%
	% of GDP	0.5	0.6	0.4	0.7		
Other sources	RUB bln	-1,001.8	-512.8	-750.6	-998.7	-48.8%	-0.3%
	% of GDP	-1.6	-0.8	-1.0	-1.2		

Source: Finance Ministry, Gazprombank estimates

Among the other sources of financing the government budget deficit, the most important is privatization. Based on the government's plans (confirmed by Government Order No 2102-r of November 27, 2010), revenues from privatization in 2011-13 are estimated at RUB 1.0 trln. According to the federal budget law, it is planned to attract RUB 427.7 bln in 2013. In October, Economics Minister Andrey Belousov noted that a total of RUB 260-270 bln might be raised from the eight largest deals (vs. RUB 223 bln in 2012), including Sovcomflot, VTB, ALROSA, Rosneft (up to a 6% stake), Arkhangelsk Trawl Fleet, TGK-5, Sibir Airlines and Mosenergostroi.

Ruble on a devaluation course, rates on a declining path

- Russia's currency will become more volatile in 2013, while the CBR's reduced presence on the market and the rapid "devouring" of the current account (in five years we anticipate a deficit) will exert significant downward pressure on the ruble (average annual rate of RUB 31.5/$).
- The net outflow of capital from the private sector will decline in 2013 to $50-60 bln. At the start of the year, we expect an inflow of foreign capital following the full start of the Euroclear and Clearstream systems, while in 1Q12 the USD/RUB rate may decline to RUB 30.0-30.5/$.
- The CBR will shift to a policy of declining interest rates due to stabilization of inflation and heightened risks related to economic growth. The CBR in 2013 will increase its long-term refinancing through new three-year funding instruments. The cost of "long money" may decline following a transfer to floating rates.

"Perestroika" of the payment balance: negatives outweigh the positives

The tendencies occurring in the structure of Russia's balance of payments, alongside a weakened presence of the CBR on the currency market, form a mechanism for long-term devaluation of the ruble. In 2013, we estimate the average annual Urals price at a level of $107.4/bbl and corresponding growth in the USD/RUB rate to RUB 31.5/$, which is below our previous official forecast for 2012 (RUB 31.8/$ – for details see our report of July 27 entitled "Russian Economy in 2H12: Safe Haven-2. Reboot"). However, in light of the events that took place in the global economy in September, we adjust our estimate for 2012 to RUB 31.2/$ (down RUB 0.5). Intra-year volatility in the ruble rate is strengthening. For example, the ruble rate may strengthen at the start of the year (a decline to RUB 30.0-30.5/$) due to an inflow of capital following the full start of the Euroclear and Clearstream systems.

The balance of payments in 2013 will experience the influence of two conflicting tendencies: contraction of the current account balance to $60 bln (or $37 bln less than in 2012) and slowing of the net outflow of private capital to $50-60 bln (vs. $70.4 bln in 2012). Clearly, the negative impact of the first tendency is stronger than the second, which is explained by the need to weaken the ruble amid the current monetary policy.

The main factors compressing the current account balance are the following:

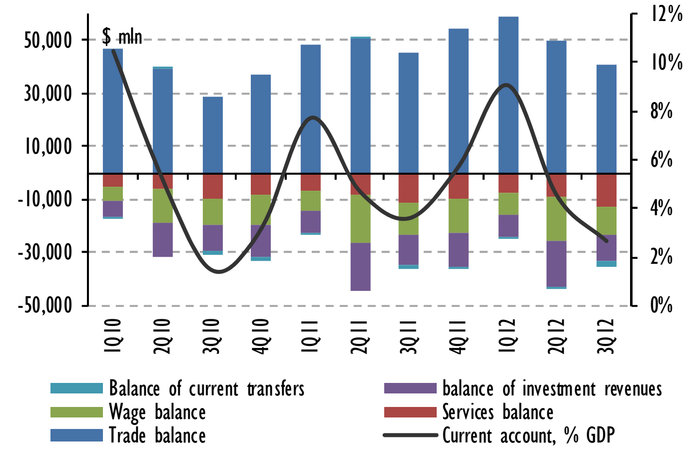
- Slowing of the rate of growth in global trade as a result of deterioration of fundamental macroeconomic indicators of Russia's leading trade partners. In particular, the European Commission expects Eurozone GDP to contract 0.4% YoY in 2012, while growth in 2013 is forecast to expand just 0.1%. For the EU as a whole, its estimate also does not inspire optimism (down 0.3% YoY in 2012 and up 0.4% in 2013).
- A weakening of the euro against the dollar due to a "flight to quality" stemming from rising concern about the prospects for the Eurozone economy. As a result, demand for Russia's main export goods will suffer.

The conjunction of these factors will lead to contraction of the trade balance to $180 bln, or 7.6% of GDP vs. 8.9% in 2012. The dynamic will be rather modest in exports, which are set to rise 2.5-3.0% in nominal terms (to $550-560 bln), including exports of fuel and energy products – by around 0.8% (to $370 bln).

In terms of imports, we see more dependable growth in physical and value volumes (due to the WTO factor as well as faster growth of domestic versus external demand) of around 12% YoY to $380 bln. The structure of imports will not undergo significant change, with the exception of a notable increase in imports of autos, equipment and transport materials (the share of which reached 51.6% in 9M12 versus 49.5% for the same period in 2011). There may be an increase of the investment component in the structure of imports due to the end of the "investment pause" in the economy.

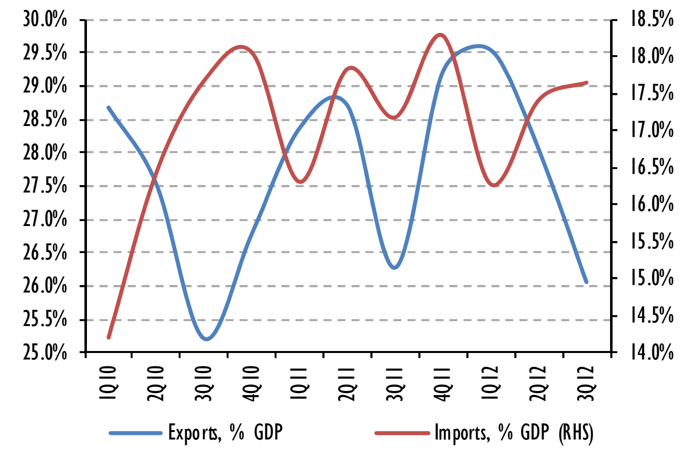
The possibility of import substitution is widening, but only closer to year end, when the cycle of renewing the main funds is launched. There are currently natural limitations to import substitution – capacity utilization in manufacturing has reached its pre-crisis level (63-65%).

Current account, 2010-12



Source: CBR, Gazprombank

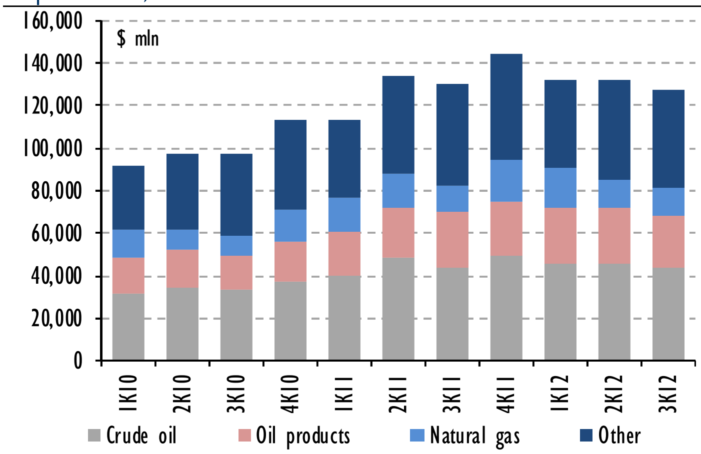
Export and import of goods as a share of GDP, 2010-12



Source: State Statistics Service

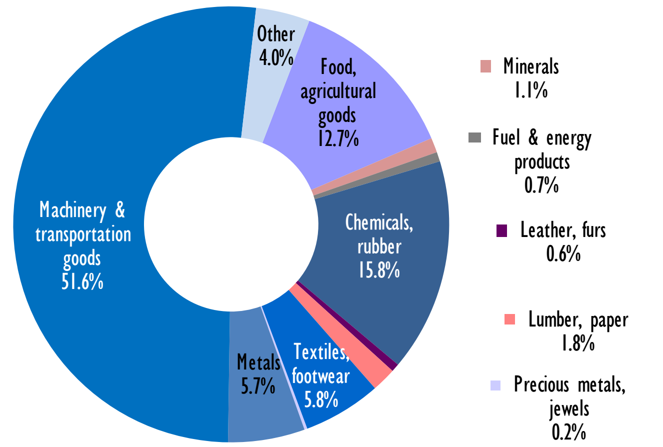
We estimate that the deficit of investment revenues in 2012 (-$50.5 bln) will be 7.5 times greater than 10 years ago (-$6.8 bln), which is occurring amid a large-scale outflow of capital. In practical terms, this means that the largest share of private capital flowing abroad is being used for foreign consumption and not investment. Over the past year, the deepening of the deficit of investment revenues has stopped, but we believe than in 2013 this tendency will change as a result of faster growth of external debt (which rose 13.2% YoY in 9M12) compared with an increase in the trade surplus (by 4.5% YoY in 9M12).

Export structure, 2010-12



Source: CBR

Export structure of imports from non-CIS countries in 9M12



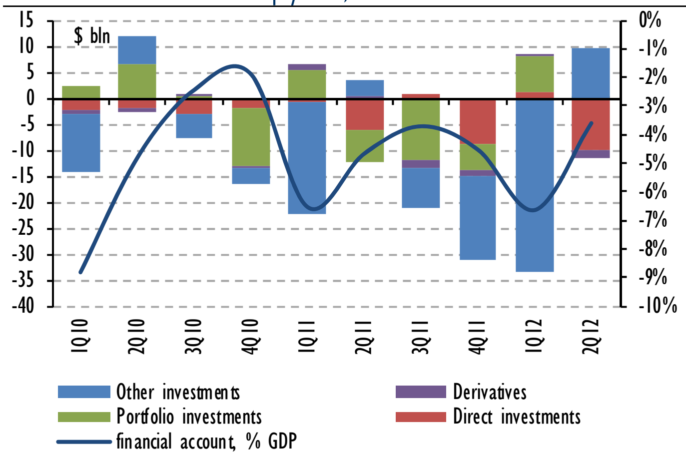
Source: Federal Tariff Service

To sum up, these tendencies are causing the current account to be "eaten away", which is indirectly being expressed in growth of oil prices, which ensures the current account's non-deficit status (unlike the analogous indicator of the federal budget). Whereas in 2006 this level in terms of Brent totaled $60/bbl, in 2012 it could rise to $85/bbl.

The main factor for improvement in the capital and financial account is liberalization of the domestic financial market for non-residents via the full functioning of the Euroclear and Clearstream systems. To be sure, Russia is not threatened with a net inflow of capital from the private sector or a surplus "capital" account in 2013, as we do not expect an overheating of the economy. We believe that the net outflow of capital from the private sector will shrink in the new year to $50-60 bln (vs. $70.4 bln for 2012).

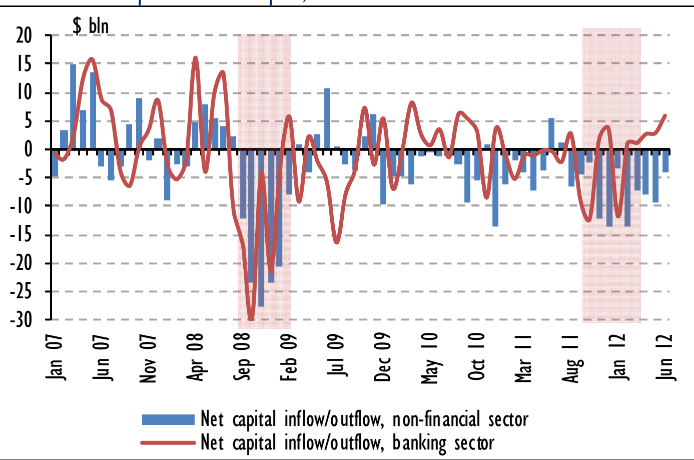
Even if liberalization of the government debt market increases the volume of foreign investment in this sphere to $15-20 bln (vs. $6.6 bln as of October 1, 2012), this will only result in a slower weakening of the average annual ruble rate (and not structural strengthening). Based on a Urals price of around $107/bbl, risks are much higher in terms of reduction of the trade surplus and, accordingly, the entire current account (by $37 bln to $60 bln).

Financial account of balance of payments, 2010-12



Source: CBR

Net outflow of private sector capital, 2007-12



Source: CBR

CBR's currency policy: laissez-faire

In September, First Deputy CBR Chairman Alexey Ulyukaev announced that the floating corridor for the bi-currency basket (RUB 31.65-38.65) would be removed by 2015, while the requirement to protect the bounds of the corridor would unequivocally remain in 2013. Thus, we believe that in 2013 the ruble will not experience any shocks greater than those experienced in 2012.

To remind, in its draft monetary policy for 2010, the CBR announced the transition to a policy of inflation targeting and rejected management of the exchange rate. Since then, the degree of the regulator's presence on the domestic currency market has declined significantly. The aggregate volume of CBR operations in dollars on the domestic currency market for 10M12 was 52% below the level of 1M11 and 63% below the level of 10M10.

CBR interventions on the domestic currency market, $ bln (EUR bln)

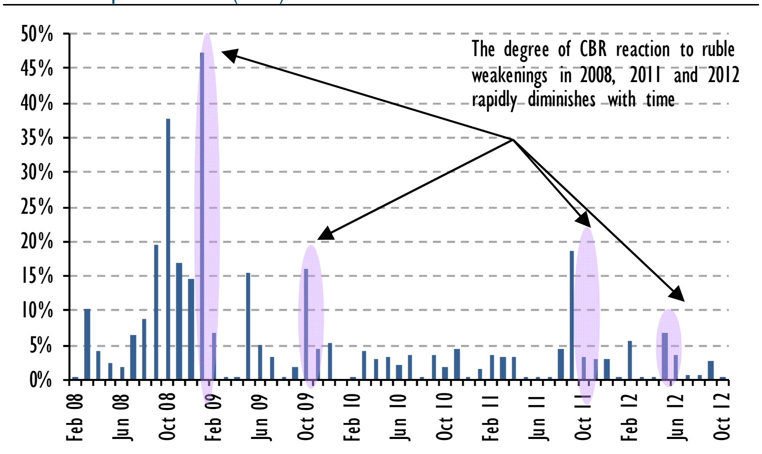
	10M10	2010	10M11	2011	10M12	10M12/10M11	10M12/10M10
Volume of operations with USD	46.0	51.5	35.6	38.7	17.1	-52.0%	-62.8%
Balance of operations with USD	37.2	31.7	11.9	8.7	7.1	-40.3%	-80.9%
purchases, total	41.6	41.6	23.7	23.7	12.1	-48.9%	-70.9%
including targeted	13.9	13.9	18.9	18.9	11.3	-40.2%	-18.7%
sales, total	4.4	9.9	11.8	15.0	5.0	-57.6%	13.6%
including targeted	3.3	6.6	4.9	8.0	4.7	-4.1%	42.4%
Volume of operations with EUR	3.9	4.7	5.1	5.4	1.3	-74.5%	-66.7%
Balance of operations with EUR	2.7	1.9	2.9	2.6	0.5	-82.8%	-81.5%
purchases, total	3.3	3.3	4.0	4.0	0.9	-77.5%	-72.7%
including targeted	1.6	1.6	3.1	3.1	0.8	-74.2%	-50.0%
sales, total	0.6	1.4	1.1	1.4	0.4	-63.6%	-33.3%
including targeted	0.5	1.0	0.6	0.9	0.4	-33.3%	-20.0%

Source: CBR, Gazprombank estimates

The fact that the balance of operations involving purchase and sale of foreign currency in 2010-11 and 10M12 remained positive indicates that the regulator is more actively preventing strengthening of the ruble than promoting its weakening. It is clear that this imperative of currency policy will remain in 2013 as well.

This point is confirmed by the dynamics of our revised gauge of forex market pressure (EMPR), which has shown less pronounced swings during the recent ruble devaluation. This reflects the change in the CBR priorities in choosing the forex regime. Importantly, this situation is likely to persist in 2013.

Forex market pressure index (EMPR)*



Source: Bloomberg

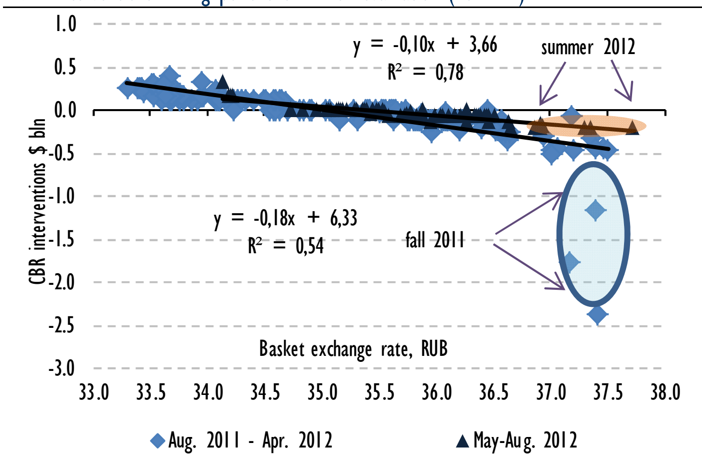
* the revised EMPR gauge uses the relation M2/International reserves to measure the degree of pressure from domestic money supply on capital outflows (and, hence, the possibility of speculative attacks on ruble:

$$EMPR_t = \frac{\left|\frac{\Delta e_t}{e_{t-1}}\right|}{\left|\frac{\Delta e_t}{e_{t-1}}\right| + \left|\frac{\overline{M2}_{t-1}}{\Delta R_t}\right|}$$

Where e_t - exchange rate; $\overline{M2}_t$ - 12M moving average of money supply,; ΔR_t - increase of international reserves.

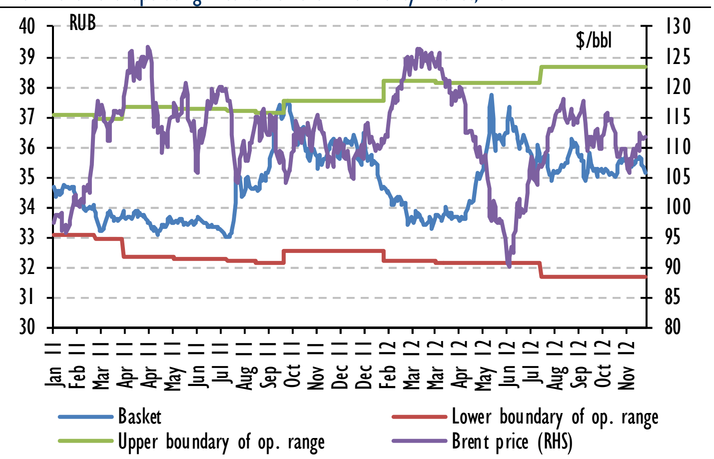
We expect the CBR to heighten its presence on the currency market only in cases when currency factors generate inflationary risks (e.g. as occurred at end May – early June of this year). In this case, the USD/RUB rate should cross a level of RUB 33.0/$.

CBR interventions during periods of ruble devaluation (2011-12)



Source: CBR, Gazprombank

Bounds of the operating interval of the bi-currency basket, 2011-12



Source: Data Stream Thomson Reuters, CBR

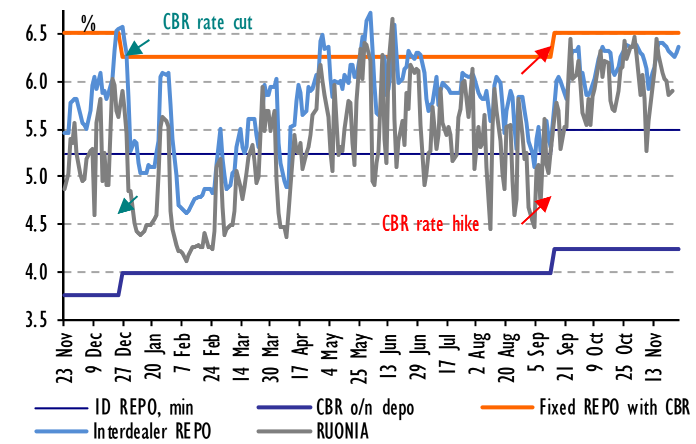
Interest rates: will there be any gifts from the CBR?

The CBR's raising of key rates in September helped decrease inflation to an acceptable level (6.4-6.5% YoY as of November 20, vs. the expected figure for 2012 of 6.8%). Moreover, for the first time in recent years, the Central Bank noted the heightening of risks related to economic growth. Such a statement was made to a journalist by First Deputy CBR Chairman Ulyukaev, who noted that the balance had tilted in favor of risks to economic growth, though they were not serious enough to warrant particular actions.

Given that in 2013 Russia awaits a slowing of the main driver of growth and a rather conservative budget policy, we would consider a 25 bps lowering of key CBR rates in 2013 as entirely logical. Certainly, inflationary risks cannot be written off, and we believe that rates will be lowered just once in the new year.

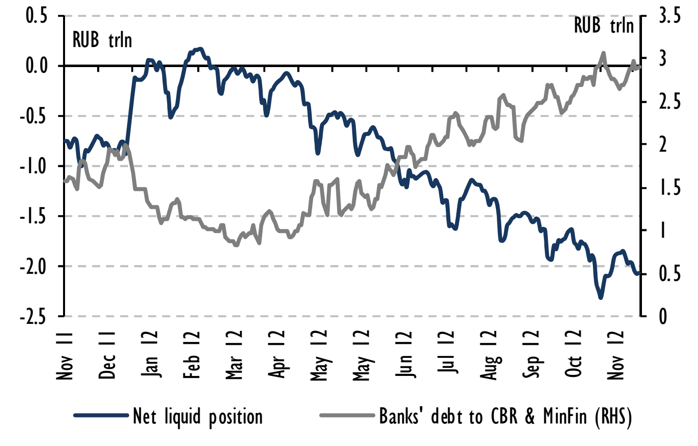
Thus, we believe that a decline in money market rates would be structural in character. We see the average annual level of 1d inter-dealer repo rates at close to 5.65% (vs. 5.78% in 2012). The asymmetry of the decline in key CBR and inter-dealer repo rates is explained by the ongoing unequal distribution of liquidity in the banking system. In practical terms, this mechanism has already exhibited itself: since the last tightening of interest rate policy (on September 14), the average level of rates rose by more than 50 bps (from 5.66% between January 1 and September 13 to 6.18% between September 14 and November 22).

CBR interest rates, RUONIA and inter-dealer repo, 2011-12



Source: State Statistics Service

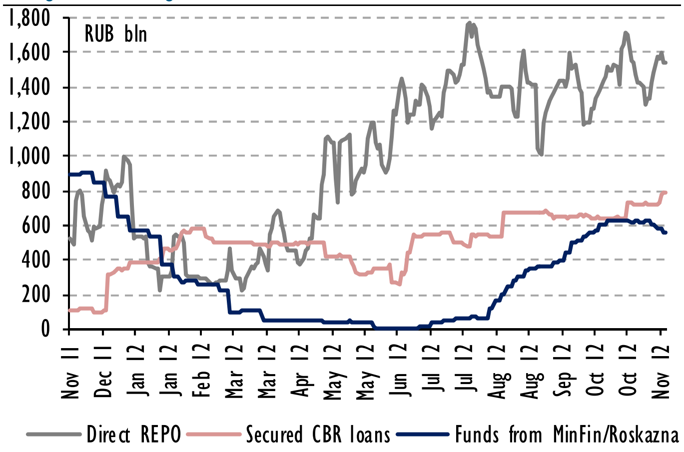
Net liquidation of positions and banks' obligations to the CBR and Finance Ministry/Federal Treasury, 2011-12



Source: State Statistics Service

The CBR is expected to introduce a number of innovations in 2013 aimed at expanding volumes and access by banks to refinancing. In particular, Deputy CBR Chairman Sergey Shvetsov announced that next year the regulator will shift to floating rates on refinancing instruments with a term of more than one month (repo, collateralized credits, currency swaps). Two main variants are being considered for the role of indicative rates: RUONIA and repo auction rates.

Banks' obligations to the government, 2011-12



Source: State Statistics Service

An important element of the refinancing system will be long-term CBR loans (term of three years). The introduction of such instruments will require a revision of current legislation that limits the term of CBR operations to one year. In case of a positive resolution of this problem, we would expect heightened interest from the largest banks implementing large-scale projects in the area of the national economy.

Banks' debt to the CBR as of November 30 stood at RUB 2.67 trln, of which RUB 1.89 trln involves repo operations and RUB 778.4 bln the most expensive collateralized loans related to non-market assets and sureties. According to Deputy Director of the CBR's Department of Financial Stability Sergey Moiseev, the regulator may be prepared to increase the refinancing of banks to RUB 4.0 trln in 2013. At the same time, according to the Central Bank's monetary program, it is planned to increase gross lending to banks to RUB 3.8 trln (vs. RUB 3.0 trln expected at end 2012).

As of October 1, the volume of paper posted to the CBR in the form of collateral on direct market repo operations totals RUB 1.46 trln, including RUB 1.39 trln in the form of bonds. Banks can potentially attract another RUB 2.43 trln based on current collateral. In other words, as of end 3Q12 the collateral base was only 37.6% utilized, which is a positive signal with regard to a possible future increase in banks' obligations to the CBR.

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Select ideas in oil, pressure on gas

Investment summary

Last year we called for the oil and gas sector to outperform the market, but not this year. In 2012, we chose the oil and gas sector to be the only outperformer in the Russian market, but our view has changed for 2013. We expect a slight YoY decrease in the oil price to $109/bbl, do not expect gradual changes in oil sector taxation, and still see the gas market – in both Russia and globally – as under pressure from oversupply. Therefore, we do not call for an overweight in oil and gas in 2013, but still see significant upside in select names.

- We see a strong investment case in Transneft preferred shares, while among oil sector blue chips we prefer Lukoil.
- We would still be buyers in the preferred shares of most Russian oils – Surgutneftegas, Bashneft and Tatneft.
- We continue to like Eurasia Drilling Company (EDC) the most among the OFS companies.
- In the second tier, we highlight Nizhnekamskneftekhim (NKNC) as one of the most undervalued stocks in Russia.

We would be NEUTRAL on the sector as a whole.

We see pressure on Gazprom and independent gas companies from increased competition on the part of independent gas producers, the uncertain demand outlook, risks of gas oversupply in Russia by 2014-16, and risks of delays in achieving equal profitability with exports. This may be partly counterbalanced by MET tax breaks for Eastern Siberia and Far East projects. We also expect a substantial increase in capex by Russian oil companies, stemming from the need to efficiently maintain brownfield production volumes, develop greenfields and complete a large-scale refining modernization project by 2015-17.

Our calls worked perfectly in 2012. We note that five of our top picks for 2012 outperformed the market. In USD terms, EDC (+38.5% YTD), Bashneft prefs (+29.2%), Transneft prefs (+37.2%), Surgut prefs (+24.5%) and Tatneft prefs (+23.2%) outperformed both the MICEX (+4.3%) and MICEX Oil and Gas (+9.3%) indexes (also recalculated in USD terms). We also recall our average Brent oil price forecast for 2012 of $106/bbl, which has been just 5% below the actual average price YTD.

We see Brent at $109/bbl in 2013. We expect oil prices to stay close to current levels in 2013. We slightly increase our Brent price forecast in 2013 to $109/bbl from $108/bbl, up 2% YoY. Our Brent forecast is $109/bbl, which is 2% below the YTD average for 2012. We leave our longer-term forecasts unchanged and estimate the mid-cycle price at $110/bbl in real terms. In our view, the oil price trajectory in 2013 will be determined by recovery in demand led by China, major Asia-Pacific and Latin American countries, further liquidity injections from the Fed and other monetary authorities of OECD countries, the risk of war in the Persian Gulf, and growth of inflationary expectations in the US.

Oil or gas? We prefer oil stocks, but advise to be selective. Although showing excellent fundamentals, we see gas stocks as under pressure because of negative global sentiment, weak demand growth in Europe, a substantial increase in competition and the risk of deceleration of tariff growth on the domestic market after 2015. Potentially the key driver in the oil sector may be a package of new tax breaks for greenfields. The situation in the oil sector looks more balanced. However, with a slight decline in the oil price we do not expect a broad-based sector re-rating. In this environment, we focus our attention on growth stories with reasonable valuation (EDC) and turnaround stories (Transneft, Lukoil, Nizhnekamskneftekhim). In particular, we highlight the preferred shares of Russian oil as an asset class.

Consistent progress with tax reform in the oil sector. Such reform includes the introduction of additional tax breaks (including export duty tax breaks) for greenfield projects in East Siberia, the Far East, West Siberia and Timano-Pechora (north of the Polar Circle), large-scale tax breaks for offshore Arctic projects, and approval of tax breaks for tight oil. In 2013, we may see the first pilot projects on revenue-based taxation. The positive trend is likely to be partly counterbalanced by an additional increase of excise tax indexation in excess of that scheduled for 2012-14, published in the Tax Code.

Preferred shares remain the core of our portfolio. In 2013, we would stay in Russian oil prefs. While remaining a decent dividend play, most of them have additional drivers. Transneft prefs will continue to be driven by expectations of larger dividends and progress with the state privatization program. Surgutneftegas prefs will remain a high-yielding stock with a probable positive effect from the company's IFRS report, expected to be released for the first time in a decade. Bashneft prefs provide the same dividends and liquidity as ordinaries do but have a 23% discount to ords and the potential to be converted into common shares in the medium term. To recap, Tatneft prefs are one of the main beneficiaries of high crude prices through decent dividends. In the prefs universe, the only stock we would stay away from is TNK-BP Holding based on dividend uncertainty.

Increase of dividends by state-controlled companies, higher popularity of interim dividends. In 2013, Rosneft will pay 25% of IFRS net income for the first time in a single tranche. Lukoil and likely Gazprom Neft will start paying interim dividends. Gazprom has announced plans to transition to the payment of 25% IFRS net income by 2014. We may also see a substantial increase in dividends by Transneft, which currently pays only around 1% of IFRS net income.

Preparation for privatization. The government's privatization program envisages the privatization of up to a 25% stake in Rosneft and reduction of the government share in Transneft's capital to 75%+1 share. The privatization of the first 6% stake in Rosneft may take place already in 2013, but it remains unclear whether it will be limited to the sale of 5.66% of Rosneft shares from the government's stake to BP as part of the Rosneft/TNK-BP transaction, or complemented with the placement of another 6% in the form of an SPO.

New wave of SPOs in Russia's oil and gas sector. Potential candidates for holding SPOs in Russia's oil and gas sector for 2013-14 include Rosneft (up to 10-15% in 2014-15), Bashneft (10-12% in late 2013 – early 2014), Gazprom Neft (12-15% in 2014-16), Lukoil (up to 11.3% in 2014-16) and Transneft (IPO of 5% of common shares in 2014-16).

Our top picks:

- We see a strong investment case in Transneft preferred shares, while among the oil sector blue chips we prefer Lukoil.
- We would still be buyers of most Russian oil preferred shares – Surgutneftegas, Bashneft and Tatneft.
- We continue to like Eurasia Drilling Company (EDC) the most among the OFS companies.
- In second tier, we highlight Nizhnekamskneftekhim (NKNC) as one of the most undervalued stocks in Russia.

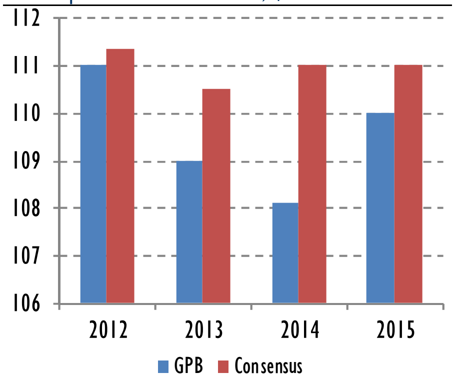
We would be NEUTRAL on the sector as a whole.

Oil price – relative stability for further 12 months

We expect oil prices to stay close to current levels in 2013. Our Brent oil price forecast is $109/bbl, which is 2% below the YTD average price for 2012.

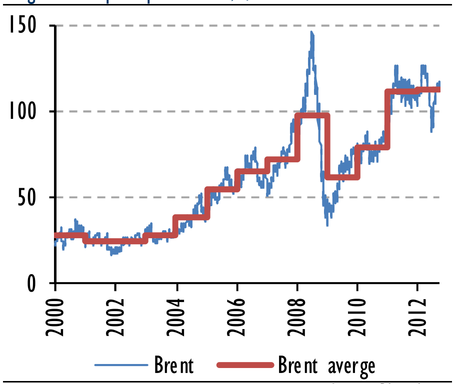
In these conditions, we believe that investment strategy in the sector must be based on careful stock selection.

GPB oil price forecast vs. consensus, $/bbl



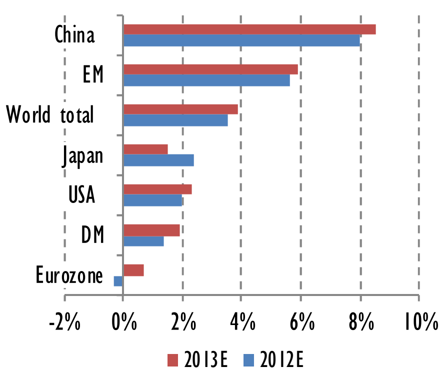
Source: Bloomberg, Gazprombank estimates

Long-term oil price performance, $/bbl



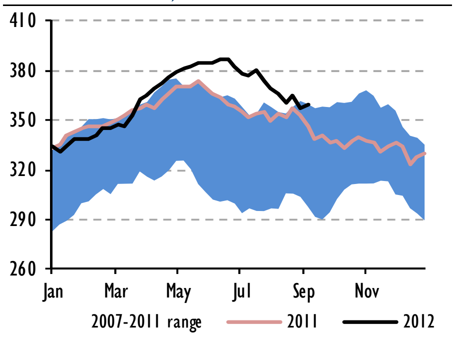
Source: Bloomberg

Global GDP growth forecast



Source: IMF

US crude oil inventories, mln bbl



Source: US Department of Energy

Oil price forecast

We expect oil price to average at $109/bbl in 2013, supported by monetary stimulus by the US Federal Reserve and other OECD central banks. We leave our longer-term oil price forecasts unchanged and estimate the mid-cycle oil price at $110/bbl in real terms.

New Brent price forecast, $/bbl

	2013	2014	Mid cycle oil price level (in real terms)
New forecast	109	108	110
Previous forecast	108	110	110
% difference	0.9%	-2.0%	0.0%

Source: Bloomberg, Gazprombank estimates

Our previous forecast of the average Brent price in 2012 ($106/bbl), made in December 2011, differs by only 6% from the YTD price performance, which we believe is a fairly good result.

Key drivers:

- risk of a military conflict in the Persian Gulf;
- further liquidity injections from central banks of OECD countries;
- sustainable increase in demand on the back of economic growth led by China, major Asia-Pacific countries and Latin America;
- growth of inflationary expectations in the US.

Key risks:

- higher risk aversion on the global market amid European debt problems;
- deceleration of economic growth in China, disappointing statistics;
- partial release of the US strategic petroleum reserve.

Large-scale liquidity injections provide additional support to oil prices

Being the vital commodity for the world economy, oil also remains one of the most liquid financial assets and its price is highly sensitive to major trends on global financial markets.

We expect that the QE3 program announced by the US Federal Reserve in September, as well as monetary stimulus from the ECB and the liberal monetary policies of other OECD central banks, will provide support to oil prices.

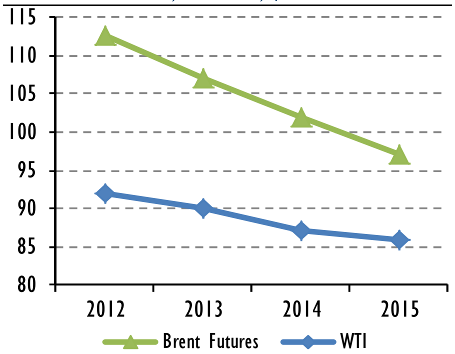
Oil demand to grow by 0.9 mbpd in 2013

We expect crude oil demand to grow by 1.0 mbpd in 2012 and show further growth by 0.9 mbpd in 2013, driven by higher oil consumption in China, the Asia-Pacific region and other emerging markets. Despite concerns about economic deceleration, China should remain the key engine of crude oil demand growth in 2013. The demand in China is expected to increase 3.8% in 2013, followed by developing countries in Asia and Latin America, where oil demand may rise 1.8-2.3%. European oil demand is set to decline 1.8%.

"Military premium" to stay in 2013

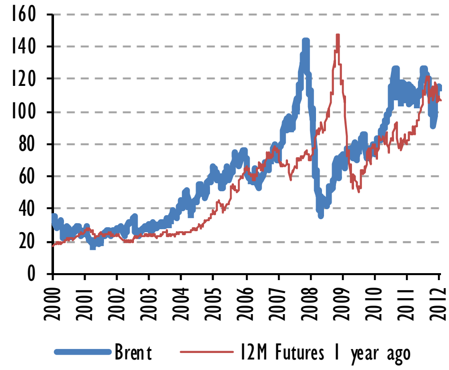
Destabilization of the situation in the Middle East, the revolution in Egypt, the large-scale military operations and civil war in Libya, and the conflict in Syria have all raised concern about a possible spillover of instability to other Arab countries, including such key oil producers as Saudi Arabia.

Brent and futures curve, 2012-2015, $/bbl



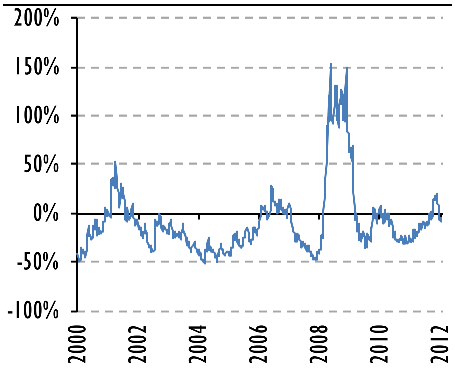
Source: Bloomberg

Futures have rarely been good oil price predictors Comparison of Brent price and price predicted by 12M futures 1 year ago, $/bbl



Source: Bloomberg, Gazprombank estimates

Futures have rarely been good oil price predictors Comparison of Brent price and price predicted by 12M futures 1 year ago, % difference



Source: Bloomberg, Gazprombank estimates

Over the past six months, we have witnessed substantial escalation of tension surrounding the Iranian nuclear issue. The most important development over the period was the embargo on Iranian oil exports. Tehran's threats to close oil exports through the Straight of Hormuz in case of a foreign attack represent substantial risk to the security of supply.

We expect the elevated level of risks brought about by instability in the Persian Gulf to likely remain on the table into 2013.

Risk of inventory release from strategic petroleum reserves

The elevated risk of supply disruptions from the Persian Gulf and the record-high inventories of crude oil in the US may motivate Washington to release part of inventories (over 400 mln bbl) from its strategic petroleum reserve. This may exert substantial short-term pressure on oil prices.

OPEC to intervene only in case of substantial price decline

The next OPEC meeting is scheduled for December 12. Despite the substantial criticism over the weakening role of OPEC, the cartel remains one of the most influential forces on the market. The current price level looks comfortable for OPEC and we expect it to intervene only in case of a substantial price correction.

Forecast for 2013 up 1% to $109/bbl, longer term-forecasts intact

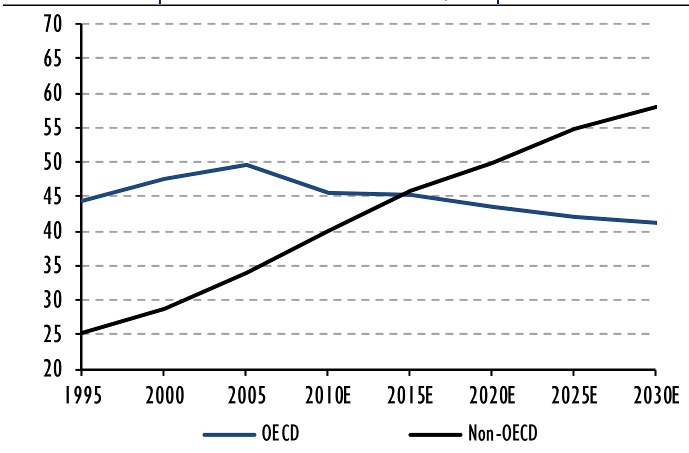
We increase our Brent price forecast for 2013 by 1% to $109/bbl on expectations of stimulatory monetary policy by the Fed and central banks of other OECD countries. We leave our longer-term oil price forecasts unchanged. We estimate the mid-cycle oil price level at $110/bbl in real terms.

Comparisons with consensus and current futures prices

Our forecasts for 2013 are 0.7% below the Bloomberg consensus and 1.6% above crude futures. For 2014, we are 1.6% under consensus and 5.4% above crude futures. Futures prices are pointing to a significant decline in the oil price in 2015 to $98/bbl.

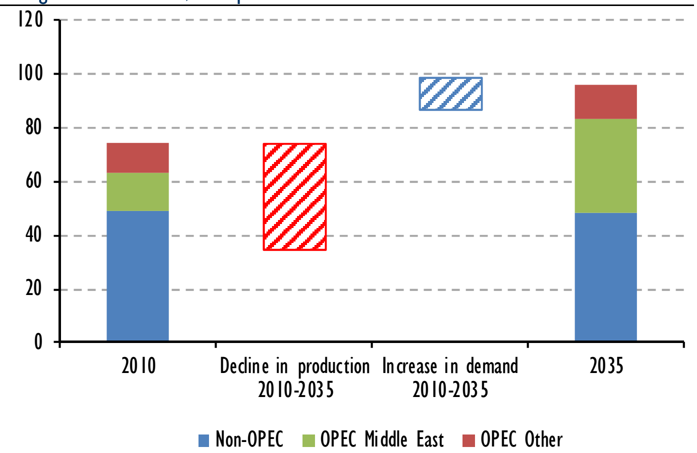
The experience of the past 10 years shows that futures have rarely been good predictors of actual oil price levels. For example, in 2009, oil prices indicated in 2008 by crude futures differed by more than 80% from the actual price levels.

Global oil consumption OECD and non-OECD countries, mmbpd



Source: BP Statistical Review of the World Energy, OPEC, Gazprombank estimates

Long-term oil demand, mmbpd



Source: EIA, Gazprombank estimates

Oil supply and demand in 2011-13, mmbpd

Global oil demand	2011	1Q12	Q12	3Q12E	4Q12E	2012E	2013E
North America	23.6	23.4	23.3	23.7	23.5	23.5	23.6
Western Europe	14.3	13.9	13.8	14.5	14.1	14.1	13.7
OECD Pacific	7.9	8.5	7.2	7.9	8.4	8.0	8.1
Total OECD	**45.8**	**45.7**	**44.4**	**46.1**	**46.0**	**45.5**	**45.4**
Other Asia	10.4	10.6	10.8	10.6	10.9	10.7	10.9
Latin America	6.4	6.3	6.5	6.7	6.6	6.5	6.7
Middle East	7.5	7.5	7.5	8.0	7.7	7.7	7.8
Africa	3.4	3.5	3.4	3.3	3.5	3.4	3.3
FSU	4.2	4.3	4.1	4.5	4.5	4.4	4.5
Other Europe	0.7	0.7	0.7	0.7	0.7	0.7	0.7
China	9.4	9.4	10.0	9.8	10.0	9.8	10.3
Total other	**41.9**	**42.2**	**43.0**	**43.5**	**43.9**	**43.1**	**44.2**
Total world	**87.7**	**88.0**	**87.3**	**89.6**	**89.9**	**88.7**	**89.6**
Global oil supply	**2011**	**1Q12**	**2Q12**	**3Q12E**	**4Q12E**	**2012E**	**2013E**
North America	15.5	15.8	15.8	15.8	15.9	15.8	16.6
Western Europe	4.1	4.1	3.9	3.9	4.0	4.0	3.8
OECD Pacific	**0.5**	0.5	0.6	0.6	0.5	0.5	0.5
Total OECD	**20.1**	**20.4**	**20.3**	**20.3**	**20.5**	**20.3**	**20.9**
Other Asia	3.6	3.7	3.7	3.7	3.7	3.7	3.7
Latin America	4.7	5.0	5.0	5.0	5.1	5.0	5.0
Middle East	1.7	1.5	1.6	1.6	1.6	1.6	1.7
Africa	2.6	2.4	2.5	2.6	2.6	2.5	2.5
FSU	13.3	13.4	13.3	13.4	13.4	13.4	13.5
Other Europe	0.1	0.1	0.2	0.2	0.2	0.1	0.2
China	4.1	4.1	4.1	4.2	4.3	4.2	4.3
Total other	**30.2**	**30.2**	**30.3**	**30.5**	**30.7**	**30.4**	**30.8**
Total Non-OPEC	**52.3**	**52.7**	**52.7**	**53.0**	**53.4**	**52.9**	**51.7**
Processing gains	**2.1**	**2.1**	**2.1**	**2.2**	**2.2**	**2.2**	**2.2**
OPEC	**35.4**	**35.1**	**34.6**	**36.5**	**36.4**	**35.7**	**35.9**
Change in inventories	0.1	0.2	0.0	0.1	0.2	-0.1	-0.2
Total world	**87.7**	**88.0**	**87.3**	**89.6**	**89.9**	**88.7**	**89.6**

Source: OPEC, IEA, Gazprombank estimates

Gas price forecast for 2013

Russia

Regulated gas tariffs in Russia are set to increase by 15% from July 1, 2013, bringing the same rates of effective annual price increase over 2012. The regulated prices will set the stage for the average realization prices of independent gas producers on the domestic market. We expect the average wholesale prices for industrial consumers to reach $110 per '000 cubic meters in 2013. Prices for final consumers are further increased by VAT, the cost of gas transportation via distribution networks, and commissions charged by supply companies, which add $25-35/bbl to wholesale prices.

CIS prices

Gas export prices to CIS countries are set by Gazprom on an individual basis. We expect the average realization price to be close to the current level, rising by up to 10% on the back of gas price indexation for Belarus from the current level of $165.5 per '000 cubic meters. The average price level will largely depend on the level of gas prices for Ukraine – the largest CIS market.

Europe

The situation on the European market will be determined by the competition of gas suppliers on the back of still-weak demand. Prices on different markets will substantially depend on the level of competition between gas suppliers on different markets. Gazprom has substantially adjusted the terms of long-term contracts for the key market of Western Europe, where the level of competition with LNG is especially strong. We expect gas prices on the markets of East European countries to show substantial 15-25% premiums to West European markets.

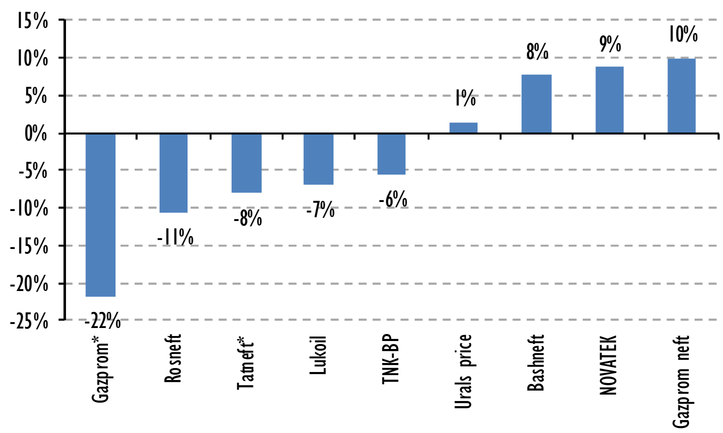
Oil-linked prices. We expect Gazprom's average realization price in Europe in 2013 to be in the range of $370-390 per '000 cubic meters.

Spot NBP prices. We see NBP prices in Europe remaining strong on the back of demand recovery and increased use of gas in electricity generation in Asian countries. We expect average NBP prices in 2013 to total $330-360/bbl, implying only a modest 10-12% discount to Gazprom's prices.

Taxation changes. Focus on greenfields, offshore resources. Looking for long-term decisions

To remind, a new taxation system was introduced to the Russian oil industry in 2012, the so-called "60-66-90" plan. We estimate that the system has generally benefited the industry, bringing a net $1.5 bln to the Russian oil sector, mainly crude exporters. However, the profit dynamics show the opposite – two companies with the smallest part of revenues coming from crude oil exports showed the best 9M12 EBITDA dynamics in the sector.

9M12 EBITDA dynamics, YoY

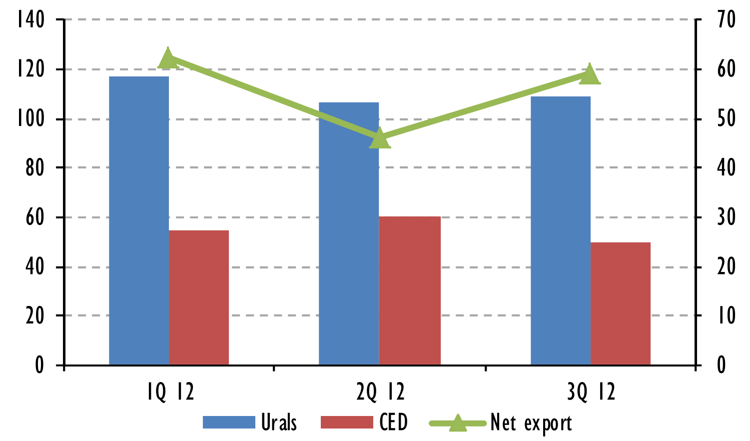


* - 6M12 EBITDA dynamics

Source: companies, Gazprombank estimates

The reason for this disparity relates to the ongoing "tax scissors", i.e. the time lag between changes in the crude price and respective changes in MET and CED rates. That said, the negative lag in 2Q12 over 1Q12 was up to $20/bbl, while in 3Q12 the situation reversed.

9M12 Urals and CED dynamics



Source: Gazprombank estimates

At the same time, in 2013 we expect significant changes in taxation of offshore fields, greenfields and tight oil. The following are possible topics in 2013:

- More tax holidays for offshore production. Main beneficiary – Rosneft.
- More tax holidays for tight and bitumen oil. Main beneficiaries – Lukoil, Tatneft.
- EPT introduction for new oil fields. Main beneficiaries – Rosneft, TNK-BP, Gazprom Neft.
- Gas MET differentiation. Long-term gas MET formula, tax breaks for gas greenfields. Main beneficiary – Gazprom.

Without any prejudice to the importance of these measures, we note that the majority of these discussions would involve the post-2015 period, though they could potentially have an immediate effect on share price dynamics. We do not anticipate changes to the Russian taxation system capable of affecting more than 5% of the country's oil and gas sector EBITDA.

As to the brownfields taxation in 2013, we see only the new gas MET rates being implemented, with a minor increase in excise taxes. At the same time, we do not expect 2013 to be a year of large-scale change in oil industry taxation, barring a collapse in the oil price. We do think that over the next three years the main part of oil revenues will be taxed via export duties and MET, with no real EPT (excess profit tax implementation) on onshore fields. The central event in sector taxation may be the introduction of a package of tax breaks for greenfields and the approval of a special tax regime for offshore projects.

We also note that new taxation initiatives are usually discussed and decided in the second half of the year, when the following year's state budget is discussed. We have a pretty optimistic budget outlook and thus would not expect any urgent discussions next year. The Russian government would rather focus on pension reform than large-scale innovations regarding Russian oil and gas taxation.

A new wave of industry consolidation?

One of the laws of modern economics is that size indeed matters, and economies of scale are important in the oil and gas business as well. Rosneft may become the world's second-largest listed oil and gas company (after Gazprom) following its acquisition of TNK-BP, and will account for some 23% of total Russian crude oil production. Does this likely represent a new trend? We do not think so. The Rosneft/TNK-BP deal was a unique one-off, in our view, for two main reasons.

- Capital markets will not allow another major acquisition over the next 12 months, in our view.
- There are not many acquisitions targets. While TNK-BP, with its old conflicting shareholder structure, was a likely deal candidate, we currently see very limited opportunities for another major merger.

Rather, we would anticipate the opposite trend – private or public offerings of stakes by major shareholders. First of all, in 2013-15 we still expect progress with the government's privatization program, which already involves Transneft and Rosneft. Second, the market has been awaiting a number of IPOs for years, with Bashneft, Lukoil (on Asian exchanges) and Gazprom neft being the most discussed names.

The government privatization program envisages the privatization of up to a 25% stake in Rosneft and reduction of the government's interest in Transneft's capital to 75%+1 share. The privatization of the first 6% stake in Rosneft may take place already in 2013 as partial sale of the government stake to BP in the framework of the Rosneft/TNK-BP transaction.

Top picks

- Transneft prefs. Wy still like Transneft story despite the substantial outperformance of the market in 2012. The key factors for the investment case of Transneft prefs remain expectations of a substantial increase of dividends and partial privatization of the government's stake on the back of very attractive valuations. The government consistently requires state-controlled companies to substantially increase dividends. Rosneft has already revised its dividend policy following a direct request from President Putin and already pays out 25% of IFRS net income as dividends, while Gazprom, which currently pays 25% of RAS net income, has announced plans to switch to a 25% dividend payment from 2014. On the back of the examples of Rosneft and Gazprom and the government's requirement of at least 25% payout, we believe that Transneft will not be able to continue paying only 1.4% of IFRS net income for long. We see good chances that the company will switch to a transition model of paying out 25% of RAS unconsolidated net income and 6.25% of RAS net income of its subsidiaries as soon as in 2013. In the long run (3-5 years) the company may switch to the payment of 25% of IFRS net income as dividends. Transneft remains the cheapest stock in the oil and gas sector, valued at a 2013E P/E of 2.6 and 2013E EV/EBITDA of 2.2, implying respective 46.1% and 35% discounts to Russian oils. The discounts to international pipeline companies reach 82.4% on 2013E EV/EBITDA and 87.5% on 2013E P/E. Currently, the target price of $2,388 per one preferred share already leaves quite modest 13.5% upside potential. However, an announcement of a substantial dividend increase would open the way for further stock re-rating.
- Lukoil. In 2012, Lukoil stabilized oil production, approved a clear and ambitious 10-year strategy, announced a $2.5 bln share buyback program and interim dividends. We note the shift in management focus to an increase in company efficiency across the board and achieving a higher valuation for the company. Potential drivers for the stock include the start of the buyback program, a consistent increase in dividends for 2012, consideration of cancellation of part of the treasury stake, and the approval of additional tax breaks for Caspian fields. Notably, Lukoil's top management are consistently buying the stock. The company remains the cheapest Russian blue chip in the oil sector, trading with healthy discounts of 17.7% to Russian peers on 2013E EV/EBITDA and 11.7% on 2013E P/E. We anticipate a gradual turnaround of investor sentiment toward the company.
- Surgutneftegas prefs. Brokers have historically liked Surgutneftegas preferred stock more than ordinaries, for a number of reasons including almost no difference in having the voting rights, much better dividends, the same rights on the company's assets, etc. However, the spread is still a factor and remains large, though in 2012 it has been smaller than average. We think there are three main reasons for this.

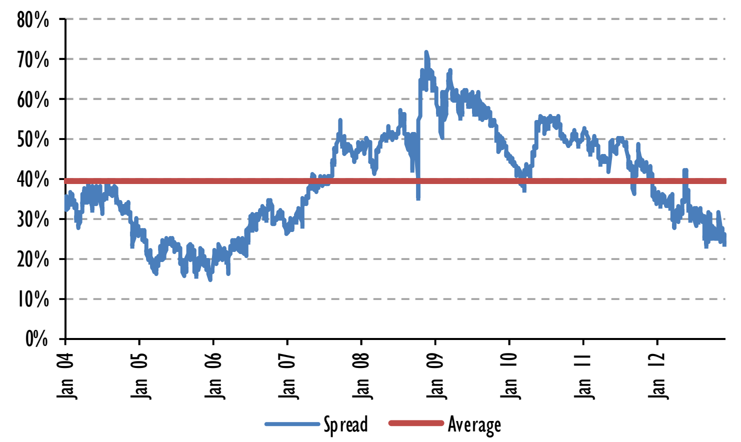
1) *Liquidity.* The simple fact that ordinary shares are eligible for the company's liquid DR program and preferred shares are not helps explain the large difference in average traded volume, weights in indexes and, respectively, the discount.

2) *Merger risk.* In case of hypothetical acquisitions by Surgutneftegas, preferred shareholders are not subject to an obligatory buyback offer. That says it all – in case of merger risk, the market plays the ords.

3) *Relative performance play.* Albeit a different class of shares, they are still company shares and thus in the long run one should not expect differing performance.

To sum up, we also like the preferred shares more, as we do not expect the company to engage in near-term merger activity. In our view, better dividend yields represent an additional potential driver.

Surgutneftegas historical discount between ordinary and preferred shares, %



Source: company, Gazprombank estimates

- Bashneft prefs. Since our initiation report in September 2012, where we recommended to shift the focus from the company's ordinary shares to prefs, the latter's discount has narrowed from 31% to 23.6%. However, we still believe that Bashneft prefs are the best way to play the Bashneft story. Bashneft is a high-quality oil story that offers investors the rare combination of a high degree of interest alignment between core and minority shareholders, attractive growth and free cash flow profiles, and fair profit-sharing with minorities. However, Bashneft common shares are no longer cheap, trading with premiums of 38% to Russian oils on P/E and 15.5% on EV/EBITDA, which motivates investors to look at cheaper entry points. We note that Bashneft preferred shares are entitled to the same level of dividends, have the same liquidity as commons, and provide a higher dividend yield on the results for 2012, which may exceed 7.5% vs. 5.7% on commons. Bashneft management has indicated that the company may consider the conversion of preferred shares into commons in the future. In these conditions, the premium of more than 40% for voting rights looks exaggerated. Our target price of $60 leaves 40.3% upside potential.

- Tatneft prefs. Tatneft has historically been one of the top dividend plays in the Russian oil and gas industry. The company has historically paid out 30% of its RAS net profit, providing an attractive dividend yield for shareholders. In terms of dividend payout, 2012 should be no exception, though the dynamics involving the share price (Tatneft hit historical highs in 2012) and RAS net profit (up just 17% YoY in 9M12) have likely decreased yields for the company. We estimate the dividend yield on Tatneft ordinary shares at just 4%, below the levels that the more-liquid Gazprom, Rosneft and Lukoil will provide for 2012. At the same time, Tatneft preferred shares still trade at a discount to common shares of some 40-45%, and thus the yield on prefs is still attractive at 7.5-8.0%. We also note the decent liquidity, essentially the same voting rights, and the speculative possibility of conversion in the future. We would stay in Tatneft preferred shares.

- Eurasia Drilling Company (EDC). Back in 2011, we bet on EDC as one of the active consolidators of the Russian drilling market and one of the main indirect beneficiaries of the "60-66-90" scheme. Our expectations were fully met – after consolidating Schlumberger assets, EDC has increased its Russian onshore drilling market share to 27%. The company's 9M12 EBITDA was up an impressive 38% YoY, the best dynamic in Russian oil and gas. That's not the end of the story, we suppose. During its Capital Markets Day presentation, the company revealed an extremely optimistic three-year plan, according to which revenues and EBITDA in 2015 could be some 25% above the market consensus, reaching $5.2 bln and $1.5 bln, respectively.

  We also expect EDC to double its offshore capacity by 2015 to four jack-up rigs. Offshore revenues comprise only 7% of the company's total revenues but almost 20% of total EBITDA, and thus we could see the 2016 EBITDA margin hit 30%.

  We see three main drivers for EDC:

1) *Double-digit growth of the Russian drilling market.* Drilling is still the only essential service for supporting brownfield output and developing greenfields.
2) *Offshore expansion.* Offshore is a highly profitable segment with an EBITDA margin of more than 50% for some contracts. Moreover, EDC is probably the only available Russian offshore play.
3) S*cale effect.* EDC is already the number one independent driller in Russia and has excellent bargaining power, sometimes being the only driller available in certain regions.

   We also note the company's delivery track record – it has always outperformed its own guidance. This leads us to believe that a realistic target for 2015 revenues could be at least $5.5 bln, making the current 2015 consensus way too conservative and EDC shares more attractive.

- Nizhnekamskneftekhim (NKNC). NKNC is a true winner from the "60-66-90" scheme. In 2011 and 2012, the market environment turned extremely positive for NKNC. About 50% of the company's revenues and 60% of EBITDA come from rubber sales, the prices of which set a positive trend on the back of a severe shortage of natural rubber in 2009-10. On the cost side, about 50% of NKNC's feedstock is naphtha, which began to be taxed with a 90% export duty in June 2011. According to the company, it buys naphtha at export netback prices, which means that at least 10 pps of the company's EBITDA increase in 2011, supported in 2012, were contributed by the decline in the domestic naphtha price.

  NKNC, like other companies in Tatarstan, has historically paid out 30% of its RAS net income, which provides attractive dividend yields of about 7-10% for commons and 10-13% for prefs. The company intends to keep the payout ratio at 30% of RAS net income. We believe that the payout ratio will not change over the next few years. We estimate that NKNC may pay RUB 3.0 on both preferred and ordinary shares for 2012, yielding 10% and 13%, respectively.

  We highlight NKNC's excellent growth potential. According to the company, it plans $3.5 bln of capex in 2012-17 to expand production capacity. Annual capex will peak at $1.2 bln in 2014-15 and, as a result, the company will increase its capacity by more than 120% by 2017, which could almost triple revenues and EBITDA by 2018.

  NKNC is currently trading extremely cheaply on multiples – 2012 EV/EBITDA is below 2.0x, which is even cheaper than Gazprom. The discount to international petrochemical majors is more than 50%.

  The only and the main problem is liquidity – the company's low free-float and MICEX-only listing prevent many investors from taking a look at the stock. Nevertheless, we highlight NKNC as one of our best ideas in the second tier.

Valuation table

Company name	Trading currency	Country	Closing price, trading currency	Closing price, $	Market cap, mln $	Share price performance 1D	5D	1M	3M	12M	YTD	EV/EBITDA 2012E	2013E	2014E	P/E 2012E	2013E	2014E
RTS Oil and Gas	USD	Russia	197.4	197.4	n/a	1%	1%	1%	6%	0%	10%	n/a	n/a	n/a	n/a	n/a	n/a
MICEX Oil and Gas	RUB	Russia	3,139.3	101.9	n/a	0%	1%	-1%	1%	0%	5%	n/a	n/a	n/a	n/a	n/a	n/a
RTS	USD	Russia	1,437.5	1,437.5	n/a	0%	1%	0%	2%	-7%	4%	n/a	n/a	n/a	n/a	n/a	n/a
MICEX	RUB	Russia	1,407.2	45.7	n/a	0%	0%	-2%	-2%	-7%	0%	n/a	n/a	n/a	n/a	n/a	n/a
Dow Jones	USD	USA	13,025.6	13,025.6	n/a	0%	0%	-1%	0%	8%	7%	n/a	n/a	n/a	n/a	n/a	n/a
BOVESPA	BRL	Brazil	57,474.6	26,854.2	n/a	-1%	0%	-2%	0%	-1%	1%	n/a	n/a	n/a	n/a	n/a	n/a
MSCI EMF	USD	Global	1,007.0	1,007.0	n/a	0%	1%	0%	6%	5%	10%	n/a	n/a	n/a	n/a	n/a	n/a
Oil and gas																	
Brent	USD	Global	111.4	n/a	n/a	-1%	0%	5%	-4%	1%	4%	n/a	n/a	n/a	n/a	n/a	n/a
WTI	USD	USA	88.9	n/a	n/a	1%	1%	4%	-6%	-11%	-10%	n/a	n/a	n/a	n/a	n/a	n/a
Urals	USD	Global	109.8	n/a	n/a	1%	0%	2%	-2%	-1%	4%	n/a	n/a	n/a	n/a	n/a	n/a
Natural gas USA (Henry Hub, 1M futures)	USD	USA	127.8	n/a	n/a	2%	-3%	2%	29%	1%	21%	n/a	n/a	n/a	n/a	n/a	n/a
Natural gas UK (NBP, 1M futures)	USD	Great Britain	380.0	n/a	n/a	1%	0%	1%	18%	17%	30%	n/a	n/a	n/a	n/a	n/a	n/a
Russian oils																	
Alliance Oil Company (SEK)	SEK	Russia	52.6	7.9	1,357.0	0%	-1%	3%	3%	-35%	-33%	4.4	3.8	3.2	4.2	3.5	2.7
Bashneft*	RUB	Russia	1,739.9	56.4	10,310.7	0%	-1%	-4%	11%	18%	33%	3.7	3.8	3.8	6.8	6.6	6.0
Gazprom neft*	RUB	Russia	140.9	4.6	21,664.7	0%	1%	-8%	-3%	1%	-2%	3.3	3.2	3.1	4.3	4.3	4.0
Lukoil	RUB	Russia	1,939.3	62.9	46,759.3	0%	1%	2%	10%	13%	20%	2.8	2.7	2.5	4.3	4.2	4.1
Rosneft	RUB	Russia	244.6	7.9	84,069.7	0%	2%	1%	32%	9%	21%	4.8	4.5	4.5	4.4	4.4	4.5
SurgutNG*	RUB	Russia	26.2	0.9	35,301.0	0%	2%	-4%	-2%	-13%	9%	2.2	2.4	2.5	5.8	6.0	7.0
Tatneft*	RUB	Russia	197.4	6.4	14,448.7	0%	-1%	2%	6%	18%	34%	3.5	3.3	3.6	5.7	5.5	6.1
TNK-BP Holding*	RUB	Russia	60.6	2.0	30,155.6	0%	5%	-5%	-26%	-26%	-23%	2.6	2.7	2.8	3.5	3.7	3.9
Average												**3.4**	**3.3**	**3.3**	**4.9**	**4.8**	**4.8**
Russian gas																	
Gazprom	RUB	Russia	138.8	4.5	103,307.2	0%	-1%	-3%	-8%	-24%	-15%	2.6	2.6	2.6	2.7	2.8	3.0
NOVATEK	RUB	Russia	331.7	10.8	32,663.1	0%	1%	7%	-5%	-21%	-9%	11.0	8.9	7.6	14.2	11.2	9.3
Average												**6.8**	**5.7**	**5.1**	**8.5**	**7.0**	**6.2**
Russian pipelines																	
Transneft (pref)	RUB	Russia	65,409.0	2,121.5	15,066.3	0%	5%	6%	30%	31%	38%	2.3	2.2	2.2	2.7	2.6	2.6
Russian oil and gas average																	
International pipeline companies																	
Enbridge	CAD	Canada	40.2	40.5	32,382.2	0%	2%	1%	4%	15%	9%	16.5	13.1	11.4	25.4	22.1	18.8
TransCanada	CAD	Canada	46.0	46.3	32,639.0	1%	2%	2%	3%	9%	7%	12.9	11.4	10.5	23.5	19.4	17.5
Average												**14.7**	**12.3**	**10.9**	**24.5**	**20.7**	**18.2**
Emerging market oils																	
PetroChina (Hong Kong Stock Exchange)	HKD	China	10.3	1.3	248,927.5	-1%	2%	-1%	11%	3%	7%	6.0	5.4	5.0	12.0	10.7	9.7
PetroChina (Shanghai Stock Exchange)	CNY	China	8.5	1.4	248,927.5	0%	0%	-3%	-2%	-10%	-12%	6.0	5.4	5.5	13.4	11.4	12.9
Petroleo Brasileiro SA	USD	Brazil	17.6	17.6	116,028.4	-3%	-3%	-15%	-15%	-30%	-24%	6.9	5.8	5.8	9.1	6.8	7.0
Average												**6.3**	**5.5**	**5.4**	**11.5**	**9.6**	**9.8**
Developed market majors																	
BP	USD	Global	41.8	41.8	132,651.6	1%	0%	-3%	0%	-2%	-2%	4.3	4.0	3.7	7.5	7.0	6.4
Chevron	USD	Global	105.7	105.7	206,854.5	0%	1%	-5%	-5%	4%	-2%	3.9	4.0	3.9	8.5	8.7	8.6
ConocoPhillips	USD	Global	56.9	56.9	69,119.2	0%	0%	-3%	1%	4%	3%	3.8	3.9	3.6	9.4	9.7	9.0
ExxonMobil	USD	Global	88.1	88.1	401,860.5	0%	-1%	-4%	1%	10%	3%	4.8	5.3	5.0	11.0	11.4	11.3
Repsol YPF	EUR	Global	16.3	21.2	26,692.1	-2%	-1%	6%	15%	-29%	-30%	5.1	5.0	4.7	10.4	9.6	8.7
Royal Dutch Shell	GBp	Global	2,089.5	33.5	215,648.3	0%	0%	-5%	-4%	-3%	-8%	4.0	3.9	3.8	8.2	7.7	7.5
Total	EUR	Global	38.5	50.1	118,592.2	0%	0%	-1%	0%	-3%	-2%	3.1	3.1	3.0	7.4	7.5	7.2
Average												**4.2**	**4.2**	**3.9**	**8.9**	**8.8**	**8.4**
Russian oilfield services companies																	
Eurasia Drilling Co.	USD	Russia	32.6	32.6	4,777.0	-3%	-4%	-8%	8%	14%	42%	5.4	4.7	4.2	12.6	10.9	9.8
Integra	USD	Russia	0.5	0.5	81.9	0%	0%	-14%	-61%	-79%	-75%	7.7	4.8	4.7	neg.	10.3	4.8
C.A.T.Oil (in Euros)	EUR	Russia	6.5	8.4	411.4	5%	11%	16%	15%	36%	44%	3.9	3.3	3.0	16.9	11.7	9.5
Average Russian OFS												**5.6**	**4.3**	**4.0**	**14.8**	**11.0**	**8.0**
Preferred shares**																	
Bashneft	RUB	Russia	1,328.5	43.1	1,296.6	0%	2%	6%	14%	13%	29%	0.9	0.9	0.9	1.6	1.6	1.4
SurgutNG	RUB	Russia	19.7	0.6	4,933.6	0%	2%	2%	-1%	16%	25%	0.5	0.6	0.6	1.4	1.5	1.7
Tatneft	RUB	Russia	104.3	3.4	498.9	0%	2%	3%	10%	7%	23%	3.5	3.3	3.6	0.2	0.2	0.2
TNK-BP Holding	RUB	Russia	47.2	1.5	688.5	0%	6%	-12%	-33%	-37%	-31%	2.4	2.3	2.6	0.1	0.1	0.1
Transneft	RUB	Russia	65,409.0	2,121.5	3,298.7	0%	5%	6%	30%	31%	38%	2.3	2.2	2.2	2.7	2.6	2.6
Average						0%	0%	0%	0%	0%	0%	1.9	1.9	2.0	1.2	1.2	1.2

Source: Bloomberg, Gazprombank estimates

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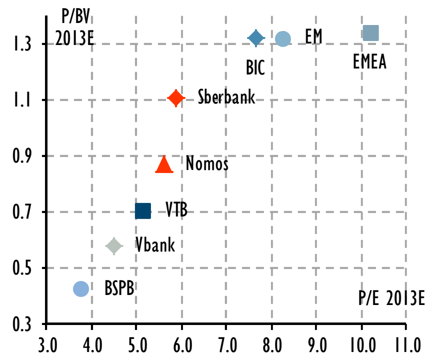
VTB			O/W
Ticker			VTBR RX
Free float			25%
Share price, RUB			0.052
12M TP, RUB			0.081
Upside			56%
	2011	2012E	2013E
ROE, %	15.4	13.5	14.7
ROA, %	1.6	1.3	1.5
EPS, RUB	0.9	0.8	1.0
BVPS, RUB	5.8	6.5	7.4
P/BV	0.9	0.8	0.7
TP/B	1.4	1.3	1.1
P/E	6.1	6.3	5.1
TP/E	9.5	9.8	8.0

Vbank			O/W
Ticker			VZRZ RZ
Free float			25%
Share price, RUB			564
12M TP, RUB			861
Upside			53%
	2011	2012E	2013E
ROE, %	9.03	11.27	13.80
ROA, %	0.91	1.15	1.44
EPS, RUB	67.01	92.67	128.70
BVPS, RUB	737.21	824.65	946.22
P/BV	0.74	0.66	0.57
TP/BV	1.14	1.02	0.89
P/E	8.54	6.18	4.45
TP/E	13.25	9.58	6.90

Sberbank			O/W
Ticker			SBER RX
Free float			50%
Share price, RUB			91.4
12M, RUB			138.5
Upside			52%
	2011	2012E	2013E
ROE, %	28.1	24.2	20.5
ROA, %	3.2	2.8	2.4
EPS, RUB	14.6	15.7	15.9
BVPS, RUB	56.0	68.9	81.4
P/BV	1.6	1.3	1.1
TP/BV	2.5	2.0	1.7
P/E	6.5	6.0	5.9
TP/E	9.9	9.1	9.0

P/BV 2013E and P/E 2013E relative valuation by region



Source: Bloomberg, Gazprombank estimates

So the last shall be first…

Investment summary

- VTB and Vozrozhdenie Bank (Vbank) are our bets for 2013. We recommend to focus on VTB (which lagged behind the market in 2012), as we expect the story to provide the best mix of price and opportunity ratios in 2013. Among the key drivers we should mention the announcement of a new three-year strategy, mark-to-market risk reduction, a strong focus on retail and transaction banking, as well as M&A cost synergy kicking in. We single out Vbank as the most exciting growth story left on the market, with an EPS CAGR forecast for 2011-14 at a whopping 35%. We like Vbank for its robust business model, strong focus on NIM maintenance and reduction of cost pressures (as well as the available tools to do so).
- Sberbank. We believe Sberbank still has decent upside, but that it also faces a lack of clear drivers, which could prevent it from becoming the growth leader. We still like Sberbank from a fundamental standpoint, but believe it is likely to take a breather in 2013 after its outstanding performance of 2011-12. We believe that its already high net income base alongside cost pressures and expected NIM shrinkage will weigh on earnings dynamics.
- Macro view. Our macro view presumes a tight but healthy environment for banks in 2013. We do expect consumption to slow down in 2013, but this will likely be offset by higher capex, in particular infrastructure investments. GDP growth is expected to decline moderately (to 3.1%), while the ruble is anticipated to enter a long but shallow depreciation phase (for further details, see the macroeconomic section of our report).
- Russian banking sector: confident look into 2013 despite obvious challenges. On the allocation side, we expect slower loan growth in the retail sector (reflecting high interest rates and the prudent steps by the CBR to curb overheating expansion in the consumer segment), as well as a modest recovery in the corporate sector. On the funding side, we expect growth in both corporate and retail deposits to slow, while the role of the CBR should even strengthen, as it will provide longer-term funding to banks along with extending the collateral list and employing a floating rate. We anticipate that margins will be under moderate pressure in 2013. That said, the overall outlook remains stable, we believe. Both financial stability (capital adequacy, provisions, liquidity) and the cash generating power of banks are expected to be reliable.
- Relative valuation shows extended discounts to peers. According to relative valuation, the Russian banking sector is valued at discounts of 25-68% on P/BV 2013E and 28-52% on P/E 2013E to EM peers. With competitive KPIs, Russian banks look favorable on a peer comparison, though country risks still weigh on investor sentiment. We believe VTB has the best mix of price and opportunity.

Market 2012 look back: nice shot with top picks

Overall, 2012 was not a bad year for banking stocks. The GPB Banking Index is up 5% YTD versus 0% for the MICEX Index and 16% for MSCI World Finance (in ruble terms).

Stock performance has been fairly flamboyant, driven by company-specific events to a much greater extent than in 2011. We are proud to note that our top picks for 2012 (Nomos Bank, up 39% YTD and Sberbank, up 8% YTD) were by far the fastest-growing stories among local banking names. Vbank largely held its own with a 4% YTD increase, but could have added more given its intra-year performance. VTB (-12% YTD) and Bank Saint-Petersburg (-24% YTD) fell victim to less than stellar interim financials released during the year.

Nomos Bank was the absolute winner in 2012, capitalizing on low valuation and healthy results, which showed a good fundamental pace of growth and resilience to market volatility. That said, the year-end has presented a surprise, as Otkrytie is set to buy out 100% of Nomos Bank shares ahead of a big merger and subsequent IPO with a two to three-year horizon.

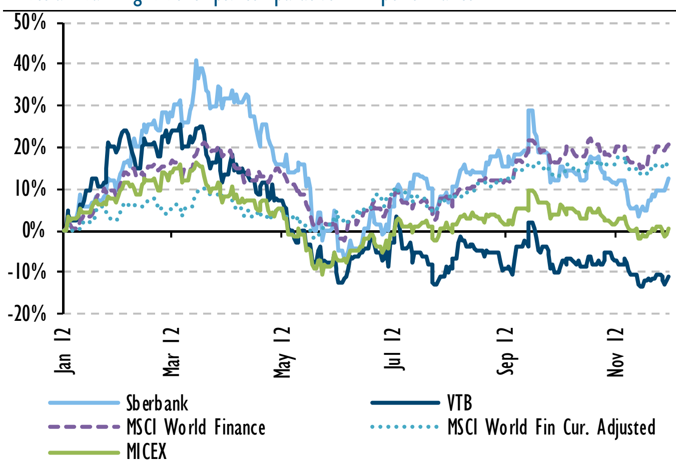
Sberbank stock stood out by virtue of its hot streak in retail loans, the landmark acquisition of Denizbank and – last but not least – the successful blitzkrieg SPO and subsequent increase of its weight in MSCI indices.

Vbank should be given credit for its great start to the year (strong NIM, cost control) and spike of investor interest, but the complicated market situation coupled with the low liquidity of the stock prevented it from delivering stronger performance.

VTB's positive start to the year rapidly faded after the bank released its results for 1Q12, which showed dramatic deterioration on the core income line (NIM decline, stumbling growth), followed by losses on non-core trading items in 2Q12 and an unofficial downgrade of the previous net income forecast (RUB 100 bln).

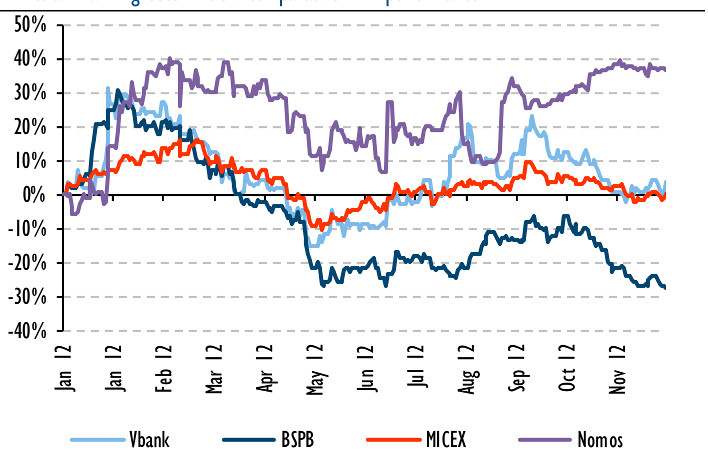
Bank Saint-Petersburg (BSPB) shares continue to disappoint investors amid numerous issues, including NIM erosion, loan quality deterioration, and below-market rates of growth in assets.

Russian banking blue chips: comparative YTD performance



Source: Bloomberg

Russian banking second tier: comparative YTD performance



Source: Bloomberg

Banking sector overview

2012

Last year was generally mixed for the Russian banking sector. We highlight outstanding growth in retail loans (up 30% YTD over 10M12) amid higher wages in state-owned organizations, record-low unemployment and crisis expectations among households. The opposite situation was observed in the corporate segment, where demand for credit resources was fairly unimpressive, as companies adhered to a conservative outlook about economic growth prospects. The deposit side was not the top performer despite more lucrative interest rates, as the propensity of households to save still leaves a lot to be desired.

The net interest margin was generally stable in 9M12 (4.8-4.9%, we estimate), as pressure from rising funding costs was offset by outpacing growth in the high-margin retail loan segment.

The bottom line can be attributed to the stronger part of 2012, as the banking sector's pre-tax net income in 10M12 (RUB 830 bln) practically equaled the total amount for 2011.

Trends on the quality side were generally favorable in 2012, especially in the retail segment. The dynamics of corporate NPLs were mixed, however, led by loans restructured and/or inherited from 2008-09.

2013

According to our updated banking macro model, we highlight our expectation of pronounced cooling in the retail loan segment (20% growth vs. 35% expected in 2012) amid rising rates, prudent steps by the CBR to curb growth in consumer loans, and general demand saturation (albeit the retail loans to GDP ratio of 12% remains one of the lowest among peers due to under-penetration of mortgage loans). Corporate loans, on the contrary, should see some pickup (up 12% YoY) after a fairly stale 2012 and on a better outlook for capital investment in the economy. Corporate and retail deposits are anticipated to deliver moderate performance (up 10-12% YoY) amid a low propensity to save, despite the inflation gear-down and positive real interest rates.

On the quality side, our base scenario calls for flat performance, as the natural decline in the NPL ratio amid loan growth is likely to be offset by episodic spikes of additional provisioning on old loans dating back to 2008-09, which we witnessed in 2012 for a number of banks.

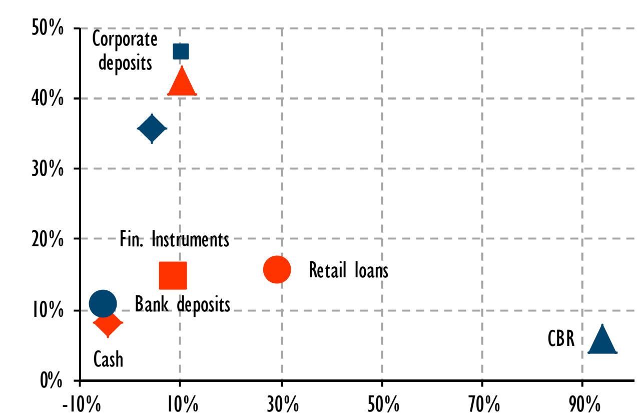
Overall, we view the market environment in 2013 as being fairly healthy and banks should prove sufficiently resilient. Despite some expected cooling, we see no major threats to banks on the allocation side under our base scenario, as demand is likely to be high in the retail segment and stable in the corporate segment. The funding side, however, remains fragile, as banks will likely still be counting on CBR support. The CBR's role in bank funding will not only remain important, we believe, but will also likely become even stronger amid planned diversification of the list of refinancing instruments, their increased longevity, and the introduction of a floating rate in 2012. The disposition of rates will not be favorable for banks, as we still believe that funding yields are likely to be more upward-sensitive than allocation yields. That said, we do not expect big shifts here either.

Russian banking sector parameters, RUB bln

	2008	2009	2010	2011	2012E	2013E	2014E	2015E	CAGR 04-08	CAGR 08-12	CAGR 12-15
Corporate loans	12,844	12,879	14,063	17,715	19,709	21,930	24,477	27,179	41%	11%	11%
Retail loans	4,017	3,574	4,085	5,551	7,529	9,109	10,755	12,613	68%	17%	19%
Due from other banks	2,501	2,726	2,921	3,276	3,673	4,049	3,709	4,069	66%	10%	3%
TOTAL LOANS (without banks)	16,861	16,453	18,148	23,266	27,238	31,039	35,232	39,792	45%	13%	13%
TOTAL ASSETS	28,022	29,430	33,805	41,628	47,131	52,632	58,596	65,099	38%	14%	11%
Corporate deposits (incl current accounts)	8,466	9,324	10,881	13,694	15,302	16,869	18,543	20,343	54%	16%	10%
Retail deposits	5,907	7,485	9,818	11,871	13,588	15,250	17,208	19,123	31%	23%	12%
TOTAL DEPOSITS	14,373	16,809	20,699	25,566	28,891	32,119	35,751	39,466	42%	19%	11%
TOTAL LIABILITIES	24,211	24,809	29,072	36,385	40,826	45,547	50,659	56,148		14%	11%
EQUITY CAPITAL	3,811	4,621	4,732	5,242	6,305	7,085	7,936	8,951	36%	13%	12%
Pre-tax total net income	409	205	573	848	980	1,080	1,130	1,260		Average 08-12	Average 12-15
Pre-tax ROE	12.6%	4.9%	12.3%	17.0%	17.0%	16.1%	15.0%	14.9%		12.7%	15.8%
Pre-tax ROA	1.7%	0.7%	1.8%	2.2%	2.2%	2.2%	2.0%	2.0%		1.7%	2.1%
Assets/GDP	68%	75%	75%	76%	77%	78%	79%	80%		74.3%	78.5%
Loans/GDP	41%	42%	40%	43%	45%	46%	48%	49%		42.1%	46.7%
Deposits/GDP	35%	43%	46%	47%	47%	48%	48%	49%		43.6%	47.9%
Loans/Deposits	1.17	0.98	0.88	0.91	0.94	0.97	0.99	1.01		1.0	1.0
Loand/Deposits (excl. current accounts)	1.74	1.43	1.27	1.32	1.36	1.40	1.42	1.45		1.4	1.4

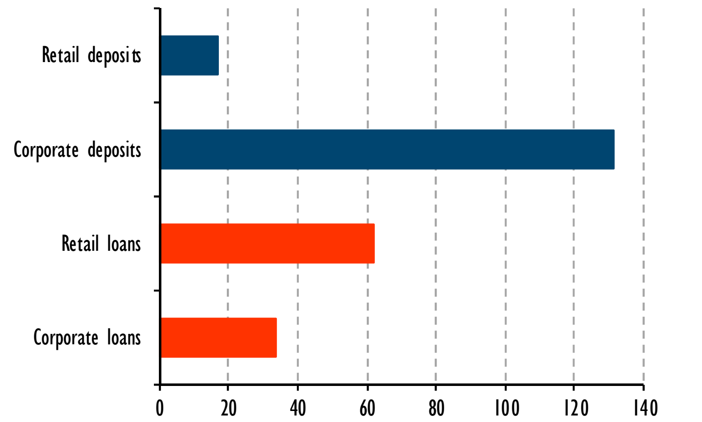
Source: CBR, Gazprombank estimates

Russian banking system: balance sheet items growth, 9M12 YTD



Source: CBR, Gazprombank estimates

Russian banking system: yields growth, 9M12 YTD



Source: CBR, Gazprombank estimates

Our top picks for 2013

We highlight VTB and Vbank as the most promising stories from both price and growth-driver standpoints.

VTB

While 2012 was not the best year for VTB, we look forward confidently to 2013, as the current price offers an attractive entry point to Russia's second-largest financial group, with many positive factors not yet priced in.

- Time to focus on value after M&A turmoil. The M&A period has largely been left behind, which minimizes the risk of unforeseen and questionable deals in the near future, allowing VTB to focus on value creation after the recent consolidation of TCB and BoM. We view 2013 as the right time to spur cross sales and increase the share of banking transactions.
- Efforts to lower the income volatility will not go unnoticed. Following the painful trading losses from the prop book in 2Q12, the management of VTB announced a new focus on risk reduction. Minimization of proprietary trading risk is a move in the right direction, as the mark-to-market volatility of non-core income has always been a risk rather than an opportunity in VTB's investment case.
- New strategy should not disappoint. Although VTB's new strategy has yet to be approved and will be considered by next year's Supervisory Board meeting, we praise the shift in VTB's focus from booming expansion to flatter but higher-quality growth (tapping more stable and traditional interest income, as well as commissions and client trading proceeds) alongside crystallization of profitability (i.e. developing cross sales, enhancing the decision-making process, widening the product line).
- The spread to Sberbank is the largest in three years. VTB's current discount to Sberbank on P/BV is currently the largest in three years, mainly reflecting the former's poor performance and the latter's hot streak over the last two years. As we believe that the comparison pendulum could swing in favor of VTB, this spread is likely to narrow as soon as 2013.
- Overhang threat is exaggerated. We do not consider the SPO planned for 2013 to be a big overhang threat, as after the recent Tier-1 capital increase (via perpetual eurobonds) VTB does not seem limited in capital. Most likely, any placement will be very selective and cautious to avoid pressure on the stock.

Vozrozhdenie Bank

Vbank is finishing 2012 in neutral territory following several noticeable spikes of investor interest. However, we still view the story as full of value at current prices. The biggest drawback seems to be the stock's liquidity, as low market volumes do not favor illiquid names without a clear-cut return story (dividends, buyback, etc). That said, last year saw Vbank (not to mention Nomos Bank) achieve healthier financials, comfortably outpacing the far more liquid VTB, which was dampened by internal issues.

- Greater retail exposure. The share of retail loans in Vbank's assets (14%) is three times the level of BSPB (5%). The bank's sizable retail exposure supports both the pace of balance sheet growth and margins.
- Better shape amid rising rates. The low dependence on wholesale debt markets alongside a decent franchise in the high-margin SME and retail segments creates solid protection for margins.
- Strong transaction banking. By virtue of its largest share of transaction business among traded peers, BSPB looks very strong from a cash-origination standpoint.
- Good room for increased efficiency. Vbank's share of low-yielding liquid assets (23% of total assets) is the largest among traded peers, which reflects the bank's defensive approach. This creates the opportunity for the bank to lift its profitability by redistributing assets and making their structure more natural.

- Cost optimization to further support the bottom line. The announced cost-optimization program aimed at drastically reducing the CIR and improving profitability ratios has already begun to bear fruit, and we believe Vbank has a lot more to do in this regard going forward.

Sberbank

Sberbank remains one of the hottest stories and the most obvious choice for anyone seeking to invest into the Russian banking system. Its free float and liquidity received an additional boost after the blitzkrieg SPO in September (followed by the subsequent positive rebalancing of MSCI index weights). Its NIM and ROE levels are still unattainable for virtually any local public peers. The current year has been remarkable for Sberbank considering its SPO, the Denizbank consolidation and skyrocketing retail lending. That said, we do not see Sberbank among the most appealing stories growth-wise in 2013, for the following reasons:

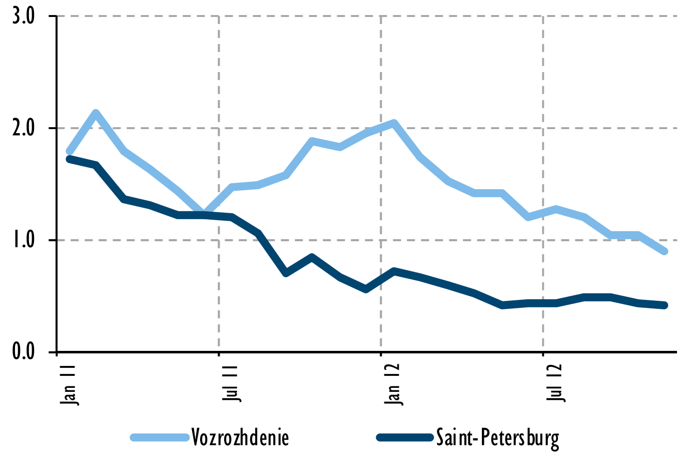
- High net income base coupled with cost pressures likely to weigh on bottom-line growth. In 2012, the YoY pace of growth in net income slowed dramatically. Next year will likely bring bigger challenges to Sberbank, as we anticipate slower growth rates for the high-margin retail segment alongside fast growth in costs (anticipated by Sberbank itself) and the consolidation of less-profitable East European businesses (VBI and Denizbank). The combination of these factors makes us rather cautious toward Sberbank's performance in 2013.
- Asset consolidation should take time. The consolidation of VBI and Denizbank, despite their relatively small share, could entail temporary growth in costs, which could exert even more pressure on Sberbank's already painful cost line.
- Steep price tag. On a multiple-based valuation, Sberbank is by far the most expensive local bank, which is definitely justified by its outstanding KPIs. In light of this and in the absence of clear drivers, should the stock's healthy fundamental upside persist we believe its price in 2013 will curb interest among investors and re-direct them toward cheaper and more interesting names.

Bank Saint-Petersburg (BSPB)

Pressured by a bunch of external and internal factors, BSPB has been an outsider for a second straight year. While we admit that a rebound after two horrendous years is likely and the current pricing is the cheapest among all local peers, we note the lack of fundamental drivers for BSPB and expect its stock performance to be unstable.

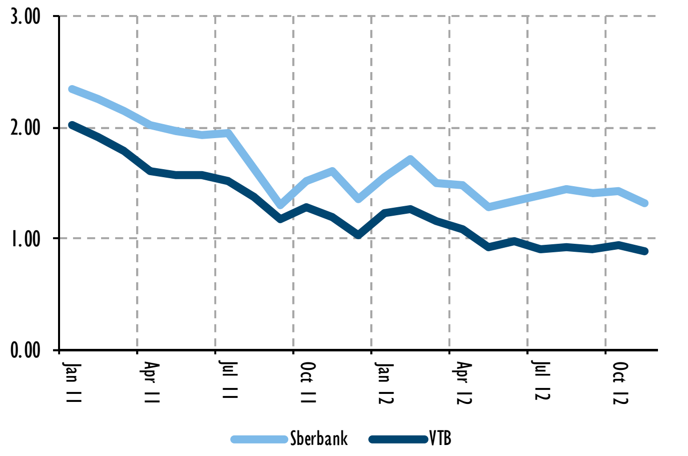
- Weak demand in the corporate segment. Corporate loans – the key focus for BSPB – are facing hard times currently, while BSPB, being a regional bank, has limited room to re-allocate resources, in our view.
- New strategy is more sensitive initially to higher costs than profits. BSPB's new strategy, while being a positive event, is prone to additional cost pressure in the medium term.
- Loan quality is at risk. We see relatively high risks of a further increase in NPLs in light of the recent heavy one-off LLP charges provoked by a large NPL, given the high regional concentration of the bank's loan portfolio.
- Weaker margin control amid rising rates environment. We view BSPB's tools to support NIM as limited due to the lack of flexibility on the allocation side and a more rate-sensitive funding structure.

Banking second tier: historical P/BV valuation



Source: Bloomberg, Gazprombank estimates

Banking blue chips: historical P/BV valuation



* used latest actual BV

Source: Bloomberg

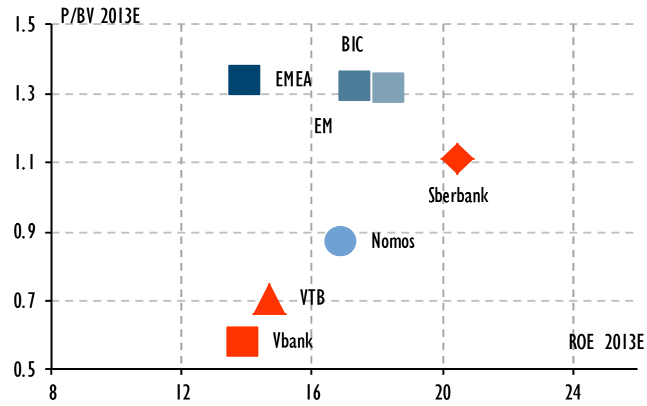
Relative valuation

From a relative valuation standpoint, we still favor local banks. On P/BV 2013E, our banks trade with heavy discounts (from 25% for Sberbank to 68% for BSPB) to the EM average (1.4x). Valuation on P/E 2013E draws a similar picture with a different mix of names: from 28% for BSPB to 52% for Vbank relative to the EM average (9.5x).

We note that basic KPIs are fairly competitive for local banks as compared to international peers, although the overall picture is mixed. In particular, an ROAE comparison shows that Sberbank (20.5%) and Nomos Bank (16.8%) outpace the competition (15.9% for the EM average), while VTB (14.7%), Vbank (13.8%) and BSPB (12.1%) lag behind (all figures are our estimates for 2013).

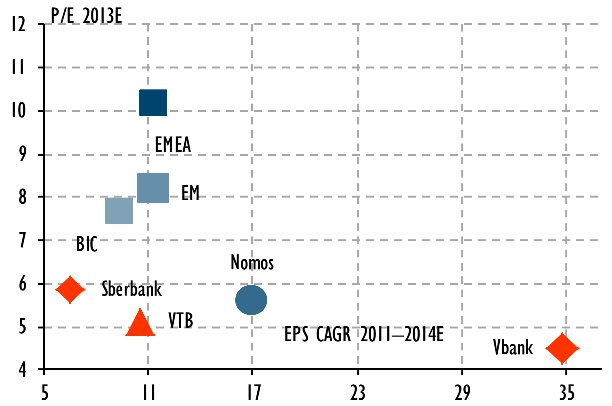
EPS CAGR 2011-2014E shows Vbank (34.8%) and Nomos Bank (16.9%) in a better light (EM average of 11.6%), while VTB (10.5%), BSPB (9.6%) and Sberbank (6.5%) look a bit worse here.

Relative valuation: P/BV 2013E, P/E 2013E



Source: Bloomberg, Gazprombank estimates

Relative valuation: P/E 2013E, EPS CAGR 2011-2014E



Source: Bloomberg

We believe the current discounts offer a decent investment opportunity overall, as the price/performance ratio seems generally favorable for Russian banks. However, KPIs do not look as favorable over the competition as a year ago because of our downbeat intra-year estimates.

That said, we believe that VTB has the best mix of valuation and opportunity, as healthy discounts come together with decent KPIs, while Sberbank looks relatively expensive. In the Vbank/BSPB pair, we again favor Vbank having an edge over the latter due to healthy EPS growth opportunities, which more than justifies its slightly higher valuation against BSPB.

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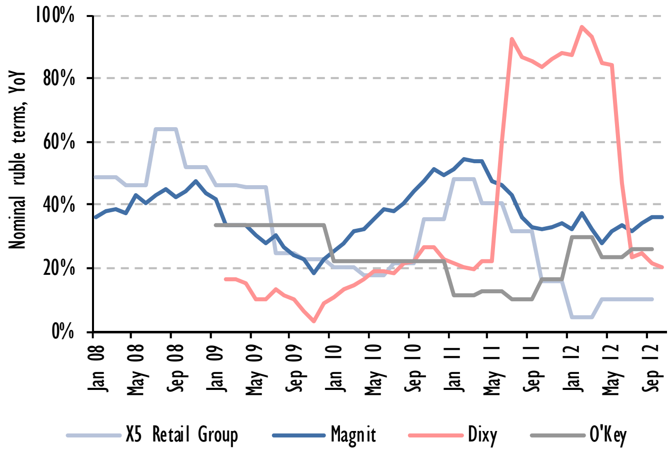
Structural investment case remains
Review of 2012

In 2012, we have seen continued growth in Russia's economy and parallel growth in private consumption. Supported by sustained consumer demand, many consumer businesses exhibited double-digit revenue growth, ahead of their developed and emerging market peers. Real wages grew 9.4% YoY (in 9M12), experiencing a tailwind from electionary cycle increases in pensions and public-sector salaries, while unemployment has trended down during the year, reaching 5.2% in September, the lowest level recorded in post-Soviet Russia. Moreover, consumer credit to Russian borrowers continued to expand throughout the year by over 50% YoY.

Leading companies in the Russian consumer, retail and agriculture sectors continued their expansion, gaining market share at the expense of smaller players. Still, many consumer markets remain highly fragmented, suggesting that Russia's consumer sector investment case – that of a structural story, where there are long-term opportunities for companies to demonstrate higher growth than international peers due to market fragmentation – remains strong.

Russian food retailers. In food retail, while total industry revenues rose 11.6% YoY in nominal ruble terms in 9M12, the four listed food retailers drove superior top-line growth (see chart below left), as they continued to consolidate the market via aggressive store rollouts and M&A, taking share from traditional formats (such as street markets), independent grocers and regional operators. We estimate that the top five food retailers had a combined market share of 16% in 2011 – a much lower level of industry consolidation compared with more developed markets where the top five players constitute 50% or more of the market.

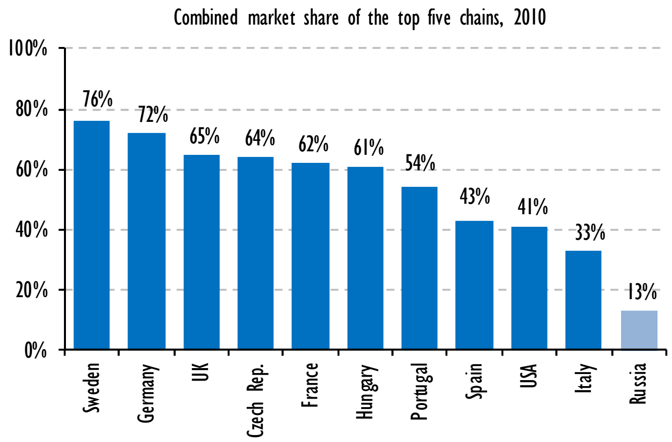
Russian food retailers monthly sales growth, January 2008 – October 2012



Note: Consolidated growth rates for X5 Retail Group and Dixy.

Source: Companies

Russian food retail offers significant consolidation potential



Source: Euromonitor

The combined EBITDA of the four Russian food retailers under our coverage for 1H12 rose 43% YoY in ruble terms (+34% YoY in dollar terms), making the sector – at least as far as the listed universe is concerned – one of the fastest-growing in Russia.

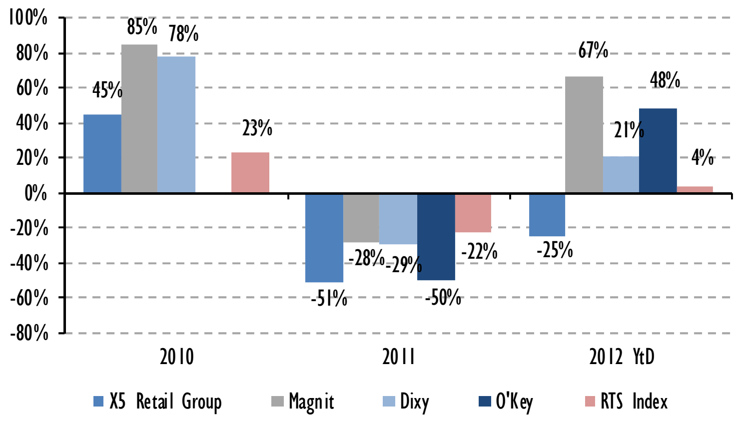
This was not least due to robust margin trends. The market has been fairly benign in 2012, in our opinion, allowing retailers to keep much of the sourcing and efficiency gains to themselves. Magnit demonstrated the strongest improvements in gross margins YoY in 1H12, up 3.0 pps, along with Dixy, up 2.7 pps. O'Key's gross margins increased 1.3 pps, while X5 Retail Group's gross margins were flat.

In 1H12, low food inflation (1.9% YoY) meant no downward correction in operating costs as a percentage of sales for Russian food retailers (with the exception of Magnit), even despite the decrease in insurance contributions, which we estimate shaved ~30 bps off retailers' opex. Magnit and O'Key were able to translate some of the gross margin gains to the EBITDA level, driving up EBITDA margins 3.3 pps YoY and 0.4 pps YoY, respectively, in 1H12. X5 Retail Group and Dixy, on the contrary, saw EBITDA margins contract (-0.1 pps and -0.5 pps, respectively), which in our view is mainly attributable to company-specific cost challenges, such as the integration of ~250 Victoria stores in Dixy's case, and falling LfL sales in the case of X5 Retail Group. For 2H12, we expect sales growth to exceed cost growth (except for Dixy, for which we expect the bulk of Victoria integration costs to fall in 2H12), helped by a pick-up in food inflation (from a trough of 1.2% YoY in April to 7.3% YoY by October), so margins should be healthy.

One thing that struck us in 2012 was the extent of X5 Retail Group's like-for-like underperformance. The company has gone from having the highest LfL sales growth among listed peers in 2Q09-1Q10 to the lowest during 3Q11-3Q12. Moreover, X5 Retail Group has witnessed negative LfLs over the past four quarters (since 4Q11), with all key formats contributing to weak numbers, but particularly hypermarkets, which suffered sharp traffic declines (of 7-9%). The high base could be part of the explanation, but we feel the problem is broader, as the company seems to be suffering from the impact of new competitors gaining market share (e.g., Azbuka Vkusa in Moscow) and of normalized/improving competitor performances (examples include O'Key and Lenta, both of which have strong presence in hypermarkets in the Saint Petersburg market). We believe it will take time for the company to regain traction on its LfL performance, likely requiring i.) improvements to both food and non-food ranges, and ii.) investments towards store renovations/remodels. However, some encouraging signs were visible lately (for example, LfL sales at hypermarkets improved to -5% in October from -16% in July).

Investors have taken this year's industry developments positively, with shares of Magnit and O'Key rising by 67% and 48%, respectively, and that of Dixy increasing 21%, all soundly beating the RTS Index (+4%). Struggling X5 Retail Group has been a laggard, its shares down 25% since the beginning of the year.

Russian food retailers have outperformed the RTS Index in 2012 YTD after underperforming in 2011



Note: Dollar-denominated performance. Source: Bloomberg

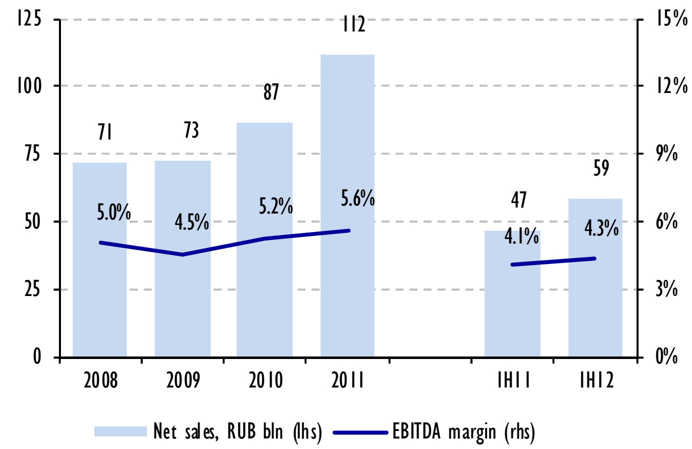
M.video. In consumer electronics, M.video continued to gain market share, having increased revenues by 23% YoY (in ruble terms) and opened a net 21 stores in 9M12. According to data from the company and real estate adviser RRG, M.video held the number one market position and a 24% share in terms of selling space among consumer electronics chains in the 100 largest Russian cities in 2011 (followed by Eldorado with 21% and Tekhnosila with 11%). Research firm GfK estimates the total Russian market for consumer electronics and home appliances grew by 21% YoY in rubles to RUB 1.18 trln (~$39 bln) in 2011 and 9% YoY to RUB 580 bln (~$18 bln) in 1H12, implying that M.video increased its market share from 11.2% in 2011 to 12.0% in 1H12.

M.video released 1H12 IFRS results in late August. Revenues were up 26% YoY in rubles to RUB 58.6 bln on a 16% increase in total floorspace and 16% LfL sales growth. This translated to a 32% YoY increase in EBITDA, improving the EBITDA margin 0.2 pps YoY to 4.3%. Net profit jumped 58% YoY to RUB 1.2 bln, with the net margin climbing 0.4 pps to 2.0%.

After the strong 1H12 results, M.video announced special dividends in the amount of RUB 30/common share, or a total of RUB 5.3 bln (~$171 mln). Based on the closing price on the cut-off date of October 23, this represents a 10.8% dividend yield, unprecedented in the Russian consumer sector. We have always viewed M.video's potential to grow earnings and pay respectable dividends in the long term as one of the attractions of its investment case. However, we did not expect dividends to grow materially before the company's heavy capex stage is over, i.e. until around 2018-20. During the conference call on August 29, CFO Christopher Parks said that M.video has enough cash to finance its capex program and does not see attractive acquisition opportunities. The payout, in our view, signals a turn to a less capital-intensive model, with slower expansion of the brick and mortar segment and more focus on online operations.

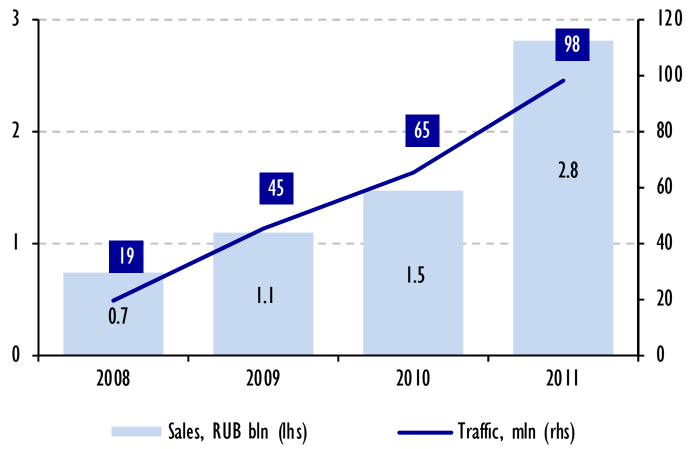
We note that 2012 was a year of tremendous expansion for M.video's online-retailing business, as the company launched online stores in 16 Russian cities, including St Petersburg, Novosibirsk, Yekaterinburg, Nizhny Novgorod and Samara. Prior to that, online shopping services were only available to customers in Moscow. Online sales accounted for a marginal 2.1% of the company's revenues in 2011, but the market is growing quickly (M.video's online sales increased 90% YoY in rubles last year), reflecting consumers' preference for time-saving and convenient shopping. With its new capabilities, we believe M.video is well prepared for a continued market boom.

M.video net sales and EBITDA margin, 2008-1H12



Source: M.video

M.video internet sales and traffic, 2008-11



Source: M.video

Cherkizovo. Cherkizovo Group also continued to demonstrate steady growth, reporting revenues up 16% YoY and EBITDA up 47% YoY in rubles in 1H12, driven primarily by increased volumes at the Penza and Bryansk clusters as well as M&A (acquisition of Mosselprom in May 2011). According to data from the respective industry associations, Cherkizovo had a 5.4% nationwide market share in both meat processing (#2 market position) and pork production (#3 market position) and a 10.1% share in poultry production (#2 market position) in 2011. Margins widened YoY in 1H12 (gross margin by 3.1 pps to 27.8%, EBITDA margin by 4.1 pps to 19.5%). In 2012 to date, the company's performance has translated into 12% growth in its London-traded GDRs.

Rosinter. Rosinter Restaurants continued to struggle, posting only 3.4% YoY sales growth in rubles in 9M12, which included a like-for-like sales decline of 1.6%, as the company seems to be losing customers to competition. We note that Rosinter has experienced consistent LfL traffic declines since May 2011. Obviously, in such an environment the company's profits could not escape unscathed. In 1H12, on revenues of RUB 5.19 bln (~$170 mln), Rosinter generated EBITDA including impairment and write-offs of RUB 214 mln (~$7 mln), implying a 4.1% margin, and a net loss of RUB 75 mln (~$2.5 mln). In an attempt to strengthen its business, the company hired Kevin Todd (over 20 years of industry experience with Britain's Bass/Mitchells & Butlers) as CEO, Ian Dunstall (16 years with Mitchells and Butlers) as marketing director, and Brian Johnston (19 years of experience with Burger King including a role as senior director of development in EMEA) as director of real estate and development. In September, the new management team unveiled a three-year strategy, which includes a focus on key brands, and investment in upgrading restaurants, including menus and infrastructure. However, it remains to be seen whether the strategy will work.

Protek. In the pharmaceutical industry, 2012 marked a notable turnaround in Protek's business. The company reported strong 1H12 results (sales growth of 20% YoY in rubles vs. 7% in 2011, EBITDA margin of 3.3% vs. 1.8% in 1H11), driven by the changes it made to the sales mix and as the price war between Russian drug distributors cooled down somewhat. However, pharmaceutical distribution (from which the company sourced 83% of its revenues in 2011) is highly consolidated in Russia, with the top five players controlling 64% market share (2011), meaning that further gains will likely be difficult to achieve. Since the beginning of the year, Protek shares have risen 47% in MICEX trading.

Razgulay. On the contrary, Razgulay shares dropped as much as 40% YTD in Moscow, currently trading near historical lows, as investors seem to be losing confidence in the company's ability to pay off its debt. We have not seen IFRS financials since 2010 and the company can provide no visibility on when audited financial statements will be published. For 2010, Razgulay reported revenues of RUB 23.8 bln (~$785 mln) and EBITDA of RUB 4.4 bln (~$144 mln). Net debt was RUB 25.3 bln (~$830 mln) as of December 31, 2010, implying net debt/LTM EBITDA of 5.8x. In August 2012, the company raised RUB 1.1 bln in a secondary public offering, selling 31.9 mln shares at RUB 35 a piece, nearly double the market price at the time. The shares were purchased by one of Razgulay's subsidiaries, to be later sold to Vnesheconombank, the company's main lender, we believe.

In the table below we have compared a number of public Russian companies from various consumer sectors across a range of metrics, such as market share, top-line growth, margins, etc. This, we think, should be helpful in evaluating each sector's appeal.

Side-by-side comparison of selected publicly-traded consumer companies, 2011

Sector	Food retail	Food retail	Food retail	Food retail	Consumer electronics retail	Meat	Pharmaceutical distribution/retail
Company	X5 Retail Group	Magnit	Dixy	O'Key	M.video	Cherkizovo	Protek
Company's market share	5.7%	4.2%	1.3% (consolidated) 1.5% (pro-forma)	1.2%	24%*	5.4% (processing) 10.1% (poultry) 5.4% (pork)	15.7% (distribution) 2.6% (retail)
Share of top player	5.7%	5.7%	5.7%	5.7%	24%*	5.9% (processing) 14.1% (poultry) 7.7% (pork)	17.0% (distribution) 2.6% (retail)
Share of top-5	16.0%	16.0%	16.0%	16.0%	69%*	22.4% (processing) 41.5% (poultry) 26.0% (pork)	64.0% (distribution) 9.9% (retail)
Sales, $ mln	15,455	11,423	3,486	3,173	3,814	1,473	3,647
Sales growth, ruble terms, YoY	33%	42%	59%	13%	29%	20%	7%
Gross margin	23.8%	24.3%	27.1%	22.8%	26.2%	25.1%	13.0%
EBITDA margin	7.3%	8.2%	6.3%	8.1%	5.6%	16.7%	3.0%
Net margin	2.0%	3.7%	1.1%	3.5%	3.0%	10.2%	1.8%
Net debt(YE11)/EBITDA(FY11), in ruble terms	3.1x	1.3x	2.9x / 2.4x**	1.2x	Net cash position of RUB 13.2 bln	3.2x	Net cash position of RUB 2.1 bln
Capex as % of EBITDA	78%	185%	335%	116%	57%	87%	82%

* market shares in consumer electronics retail are in terms of selling space among consumer electronics chains in the 100 largest Russian cities
** based on pro forma EBITDA

Source: Companies, State Statistics Service, DSM Group, Pharmexpert MRC, RRG, National Pork Association of Russia, Russian Poultry Association, Russian Meat Association, Gazprombank estimates

M&A activity

After a wave of M&A activity in the sector in 2010-11, which among others included acquisitions of Kopeyka by X5 Retail Group, of Wimm-Bill-Dann by PepsiCo, of Victoria by Dixy, and of Mosselprom by Cherkizovo, 2012 has been a very quiet year. We can only recall fairly minor acquisitions – those of Lekko and Bigpearl Trading Ltd by Pharmstandard worth a total of ~$80 mln. Also, AFK Sistema in November applied for and received permission from the Federal Antimonopoly Service to acquire Veropharm, Russia's No. 3 drug maker with a market capitalization of approximately $280 mln. During the year, X5 Retail Group was negotiating the acquisition of Holiday Classic (operating ~220 stores in Siberia) and O'Key was in talks to acquire Mindal (a regional retailer, operating eight supermarkets and one hypermarket in Tolyatti, Samara Region), but both deals fell apart. Dixy continued the integration of Victoria acquired in 2011. The year also saw a lingering government discussion about conditions for privatization of 100% in Arkhangelsk Trawler Fleet, which is now likely to take place in 2013. Russian Sea Group has shown interest in the asset.

Capital raising

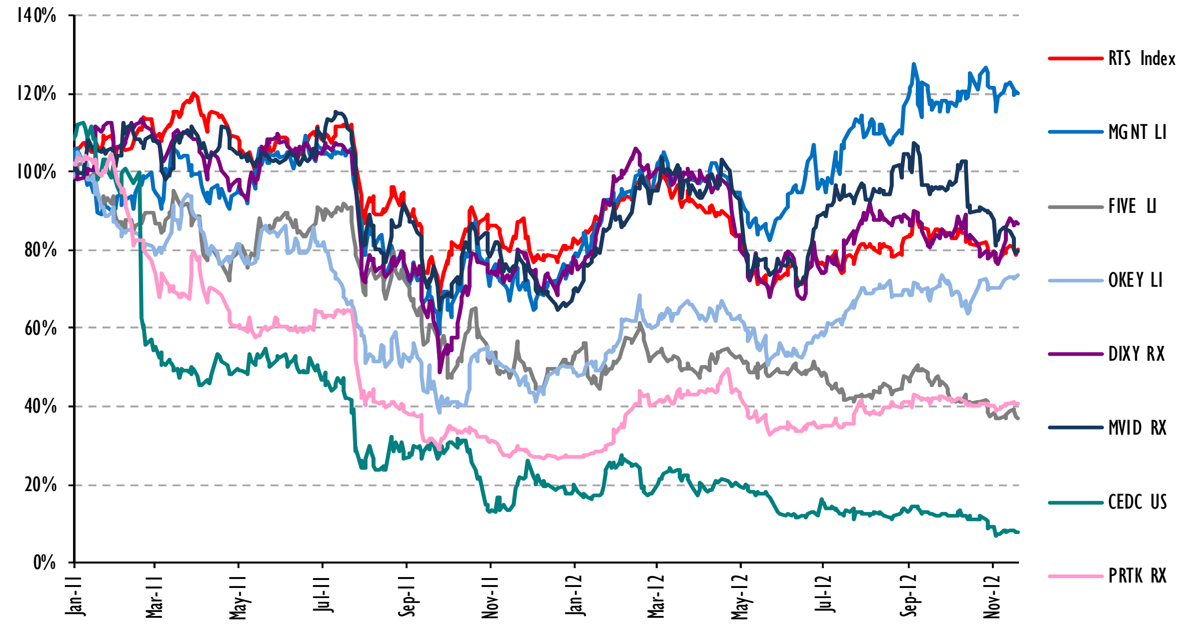
Against a backdrop of ongoing economic malaise, capital raising activity in 2012 has been limited.

- MD Medical Group braved the market and found investors. The private healthcare provider, specializing in women's and children's healthcare, raised $289 mln through an initial public offering in London in October. The deal valued the company's equity at $902 mln. For 2011, MD Medical Group, which operates a chain of two hospitals and eight outpatient clinics in Russia, posted revenues of $99 mln and EBITDA of $44 mln (44% margin). MD Medical Group plans to direct $150 mln in proceeds to fund expansion of its network.
- M.video's founding shareholders sold 10% of their stock for $146 mln in a secondary offering in September. The amount of freely traded stock as a result has grown by around one third to ~38%. Shares were sold at $8.12 each, a discount of approximately 11% to the closing price on the day before the announcement.

Recent stock performance

Since the beginning of 2011, only one stock – Magnit – is up, having returned 20%, while only two stocks – Magnit and Dixy (-14%) – have outperformed the RTS Index (-19%).

Comparative performance since the beginning of 2011

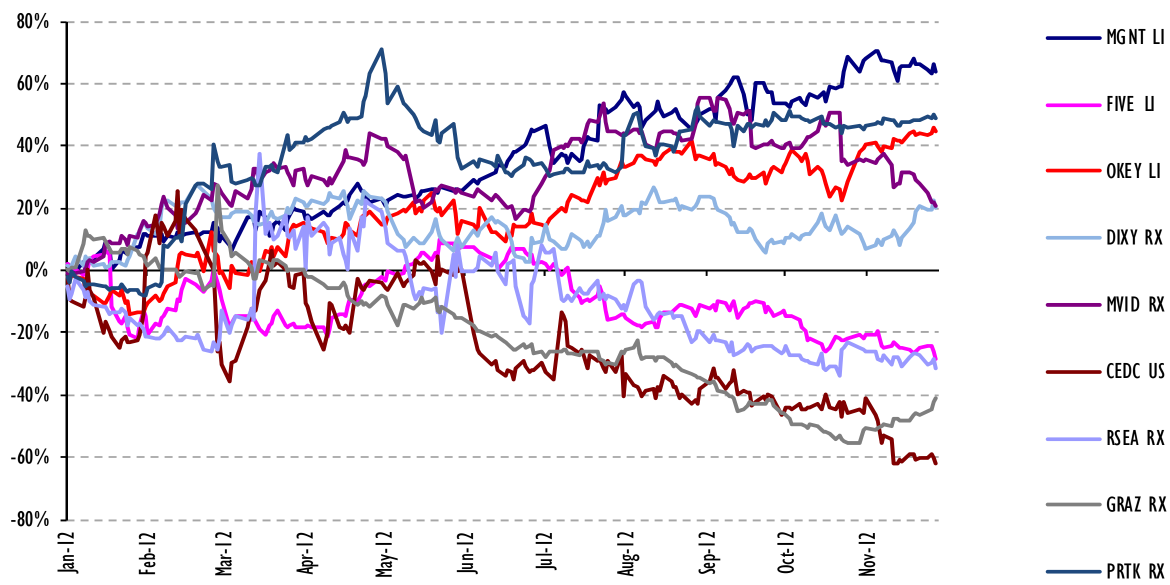


Notes: 1.) US dollar-denominated performance
2.) MGNT LI is Magnit, FIVE LI is X5 Retail Group, OKEY LI is O'Key, DIXY RX is Dixy, MVID RX is M.video, CEDC US is CEDC, and PRTK RX is Protek.

Source: Bloomberg

Year-to-date, the shares of Magnit (+67%), Protek (+53%) and O'Key (+48%) have outperformed the RTS Index (+4%), while the shares of CEDC (-61%), Razgulay (-37%) and Russian Sea Group (-30%) have underperformed significantly.

Year-to-date performance vs. RTS Index



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Source: Bloomberg

Outlook for 2013 (focus on food retailers)

Below is what we view as key factors/trends that will shape earnings in the sector in the coming year.

- Our economist expects Russian retail sales growth to slow to 4.0% YoY (real terms) in 2013, compared with 6.1% in 10M12. Highly fragmented industries such as food retail, pharmaceutical retail and meat production appear to be relatively protected against a slowdown due to the structural argument.
- In 2013, we expect food retailers to continue to ramp up new store growth rates. Dixy has already expressed a desire to accelerate openings next year, while Magnit sees openings roughly flat and X5 Retail Group has yet to issue guidance. Dixy targets at least 400 net openings per year in 2013-15 compared to 350+ planned for this year. Having opened as of November 16 only seven hypermarkets out of 14 planned for this year, O'Key looks likely to postpone several openings for 2013, which together with a total pipeline of 30 hypermarkets under development (as of end 3Q12) should make for a larger number of store openings next year versus this year. The company has not yet announced guidance for 2013. Magnit continues to invest aggressively in expansion, aiming to spend $1.6-1.8 bln next year to open a net 800-1,000 convenience stores, 55-60 hypermarkets (incl. Magnit Family stores) and 500 cosmetics stores.
- We expect margins to continue to flow from producers/suppliers to retailers, as the bargaining position of the latter continues to improve (due to their faster growth).
- We think food inflation could surprise on the upside in 1H13 due to the current high grain and oilseed prices. Particularly, as meat producers will pass on cost increases to consumers, and also as high feed costs encourage farmers to reduce livestock, meaning lower supply in the future.
- We see a risk to earnings forecasts in the industry in case X5 Retail Group decides to try to regain sales momentum by improving ranges and store presentation and then giving customers a reason to visit/reassess the business through strong promotions and brand advertising. Dixy and O'Key will be more affected in this scenario than Magnit due to their significant overlap with X5 Retail Group in the Moscow and Saint Petersburg markets.

We think M&A activity and regulatory changes may be among the biggest movers of stock prices in the sector.

- Two key M&A drivers are the pervasive consolidation of the sector and interest of international companies to expand into Russia. Under Russian law, an acquirer of more than 30%, 50% or 75% of shares in a listed company is required to make a tender offer for that company's remaining shares at a price not lower than that of the initial transaction, meaning that minority shareholders should benefit from premium M&A valuations. In Russian publicly traded universe, we identify Veropharm, M.video, O'Key, Synergy and Cherkizovo as more likely targets.
- Historically, the Russian government took a hands-off approach to the consumer sector, but this has changed in the past few years. Examples of recent activism include the retail law (limited retailers' market share to 25% per municipality/city or federal district, limited volume discounts to 10%, linked payable terms to product shelf life), price controls for the pharmaceutical industry (set price caps for pharmaceuticals on the essential drug list), anti-alcohol and anti-tobacco campaigns (set a minimum price on vodka, banned alcohol sales at night-time). The latest initiative bans selling beer (effective January 1, 2013) and tobacco (draft law was submitted to the State Duma) in kiosks and stores of less than 50 m2, which we believe should be marginally positive for food retail chains. New government involvement could have a pronounced impact on share prices – positive or negative.

Our top picks for 2013 are Dixy and Magnit.

Top picks

Dixy

Dixy remains our preferred Russian retail name. The stock looks cheap. At a 2012E EV/EBITDA of 7.0x and 2013E EV/EBITDA of 5.0x, valuations currently trail EM averages by 47% and 56%, respectively. But with improving organic trends, M&A-related advantages and accelerated store rollout, we think the market may change its view on the company. In particular, we highlight the following:

- Accelerated store opening pace. Dixy demonstrated a notable step-up in organic rollout in FY11. The company opened a net 245 convenience stores and three compact hypermarkets versus 109 convenience stores in FY10 (25.8% organic selling space growth versus 10.6% in FY10). For FY12, Dixy's management guides for 350+ convenience store openings (a net of 245 stores already added through 10M12) and for 2013-15 the company looks to accelerate expansion pace further to at least 400 openings per year.
- Improving LfL trends. Dixy's LfL performance no longer trails that of market leaders X5 Retail Group and Magnit. In fact, in 1H12 Dixy posted the highest LfL ticket growth (up 5%) of the four listed retailers, while at the same time seeing better traffic trends than competitors (with the exception of O'Key, performance at which was helped by a low-base effect due to the Ozerki hypermarket roof collapse in 1Q11).
- Better margins. Cost controls showed long-awaited signs of improvement in 2011, including a stabilization of shrinkage. As Victoria's margins are higher (7.7% standalone EBITDA margin in 2010 versus Dixy's 5.7%), the blended numbers should be even better. In 2012, Victoria integration costs have weighed on margins, but from 2013 we expect the full extent of improvement to become visible.
- Advantages extracted from Victoria integration. The benefits of the Victoria deal include increased purchasing power of the combined business, as well as lower marginal logistics, marketing and overhead costs.

Valuation and risks. Our target price for Dixy is a DCF-derived $17.20/share (11.2% WACC, 3.0% TGR), suggesting 55% upside potential to the current price. Key sector risks, in our view, include access to capital, weaker than expected consumption trends, ruble weakness and the threat of government intervention. Key company-specific risks, in our view, include failure to execute targeted expansion plans, an increasing scale differential with market leaders making it increasingly more difficult for Dixy to compete with them on price, and an inability to demonstrate further operational improvements.

Profit and loss statement, $ mln unless otherwise indicated

Year to December	2009	2010	2011	2012E	2013E	2014E	2015E
Net sales	1,710	2,115	3,482	4,629	5,930	7,308	8,775
Cost of goods sold	(1,252)	(1,606)	(2,538)	(3,352)	(4,290)	(5,295)	(6,367)
Gross profit	458	509	944	1,277	1,640	2,013	2,408
Operating costs	(417)	(454)	(826)	(1,117)	(1,386)	(1,680)	(2,012)
EBITDA	92	120	216	293	416	530	627
EBIT	41	56	118	159	254	333	396
Net interest	(26)	(23)	(44)	(65)	(61)	(41)	(15)
FX gain/(loss)	(6)	(3)	(0.6)	0	0	0	0
Earnings before tax	10	29	73	94	193	291	381
Tax	(13)	(20)	(36)	(45)	(90)	(133)	(170)
Net income	(4)	8	37	49	103	158	210
EPS ($ per share, adjusted)	(1.33)	0.10	0.35	0.39	0.82	1.27	1.69

Source: company data for 2009-11, Gazprombank estimates for 2012-15

Balance sheet, $ mln

As at December	2009	2010	2011	2012E	2013E	2014E	2015E
Cash & cash equivalents	44	52	74	76	189	231	354
Accounts receivable	46	50	81	114	146	180	216
Inventories	110	127	244	321	413	509	611
Other	38	42	69	69	69	69	69
Total current assets	239	272	468	580	817	989	1,250
PP&E	421	421	762	918	977	1,037	1,073
Other non-current assets	64	71	733	733	733	733	733
Total assets	724	763	1,963	2,230	2,527	2,759	3,056
Short term debt	194	102	354	290	213	50	65
Payables	210	237	494	546	708	872	1,047
Other	12	13	37	37	37	37	37
Total current liabilities	417	352	885	873	957	959	1,149
Long term debt	107	206	307	538	647	718	616
Other	9	8	44	44	44	44	44
Total non-current liabilities	116	214	351	581	691	762	660
Shareholders' equity	191	198	727	776	879	1,037	1,248
Total equity and liabilities	724	763	1,963	2,230	2,527	2,759	3,056

Source: company data for 2009-11, Gazprombank estimates for 2012-15

Cash flow statement, $ mln

Year to December	2009	2010	2011	2012E	2013E	2014E	2015E
EBT	10	29	73	94	193	291	381
Depreciation & amortization	51	64	98	134	162	197	231
Change in working capital	14	(6)	40	(57)	38	35	37
Other	(9)	(22)	(33)	(32)	(143)	(201)	(246)
Net cash from operating activities	65	65	178	139	250	322	402
Capex	(49)	(62)	(739)	(290)	(222)	(258)	(267)
Other	2	2	10	0	0	0	0
Free cash flow	18	6	(551)	(151)	29	64	135
Financing cash flow	(16)	3	578	153	84	(23)	(12)
Net change in cash	1	9	27	2	113	42	123

Source: company data for 2009-11, Gazprombank estimates for 2012-15

Magnit

The core elements of Magnit's investment case, in our view, include its regional focus, aggressive store rollout, margin expansion potential, low leverage and a commitment to logistics-supported growth.

- Regional focus. According to the company, as of end 1H12 it had a presence in 1,461 population centers across Russia, with around two thirds of its stores located in cities/towns with a population of less than 500,000, where the economics of food retailing are very different from those in big cities. Magnit has lower sales per square meter than peers, but its operating (in particular, wages and rents) and capital costs are also lower. In addition, benefits of regional/rural exposure include less intense competition. We view the company's wide geographic presence as a strong platform that should help it to continue rapid expansion. The regions where Magnit already operates offer the company significant room for profitable growth, as there are still many small population centers that lack modern retail formats and also due to reduced marginal logistics costs.
- Aggressive store rollout. Magnit consistently demonstrates industry-leading organic space expansion, with the number of stores opened continuing to rise each year. The company added 646, 827 and 1,254 stores in 2009, 2010 and 2011, respectively. This year, the company plans to open a net 1,550-1,555 stores (incl. 1,000 convenience stores, 50-55 hypermarkets (incl. Magnit Family stores) and 500 cosmetics stores) and for 2013 the management's preliminary guidance envisages 800-1,000 net convenience store openings, 55-60 new hypermarkets (incl. Magnit Family stores) and 500 cosmetics stores, with capex at $1.6-1.8 bln. Since Russian food retail is a structural growth story, we believe investors should favor companies that are the most aggressive in expanding their store base.
- Margin expansion potential. We think that in the medium term the company may demonstrate further margin improvements, driven by the following:
  1. a growing share of CoGS handled through the company's own distribution network (see below);
  2. better purchasing terms, as the company's growing scale enhances its bargaining position versus suppliers;
  3. private label becoming a larger proportion of total sales. Private label penetration increased from 11% of sales in 2006 to 14% in 2011, and we expect the company to continue to increase its offering of higher-margin private label products;
  4. Magnit replacing distributors in the supply chain with direct imports.
- Low leverage. Magnit's lower leverage compared to peers creates a funding advantage that we expect should allow the company to continue to out-expand competitors in 2013.
- Commitment to logistics-supported growth. The company's rapid rollout and low prices would not have been possible without investment in logistics infrastructure. Magnit currently has one of the most extensive distribution systems in Russia, including 16 distribution centers and a truck fleet numbering over 4,000 vehicles. At end 1H12, the share of CoGS handled through the company's DCs was 87% for convenience stores and 66% for hypermarkets, and the long-term target is to increase these shares to 90-92% and 80%, respectively. Interestingly, even though X5 Retail Group is the largest retailer in cities with the highest disposable incomes (Moscow and St Petersburg) and supermarkets account for some 20% of its revenues, Magnit generated notably higher margins than X5 Retail Group in 1H12 (9.9% versus 7.1%). We believe this outperformance is attributable in large part to Magnit's superior efficiency in logistics.

Valuation and risks. Our target price for Magnit is a DCF-derived $43.68/GDR (8.2% WACC, 3.0% TGR), suggesting 24% upside to the current price. Key sector risks include access to capital, weaker than expected consumption trends, ruble weakness and the threat of government intervention. Key company-specific risks, in our view, include execution risk around the aggressive hypermarket rollout and the fact that the business model is untested in highly competitive markets.

Profit and loss statement, $ mln unless otherwise indicated

Year to December	2009	2010	2011	2012E	2013E	2014E	2015E
Net sales	5,354	7,777	11,423	14,096	17,995	22,494	27,443
Cost of goods sold	(4,097)	(6,037)	(8,644)	(10,505)	(13,451)	(16,866)	(20,653)
Gross profit	1,257	1,740	2,779	3,592	4,544	5,628	6,789
Operating costs	(851)	(1,259)	(2,111)	(2,643)	(3,374)	(4,195)	(5,115)
EBITDA	509	632	939	1,322	1,663	2,051	2,445
EBIT	406	481	668	949	1,170	1,433	1,674
Net interest	(51)	(33)	(107)	(163)	(203)	(225)	(237)
Earnings before tax	355	449	561	786	967	1,208	1,437
Tax	(80)	(115)	(142)	(198)	(243)	(302)	(357)
Net income	275	334	419	588	724	906	1,080
EPS ($ per GDR, adjusted)	0.65	0.75	0.94	1.24	1.53	1.92	2.28

Source: company data for 2009-2011, Gazprombank estimates for 2012-2015

Balance sheet, $ mln

As at December	2009	2010	2011	2012E	2013E	2014E	2015E
Cash & cash equivalents	371	133	534	847	1,100	1,501	1,751
Accounts receivable	15	76	18	23	29	34	41
Inventories	415	660	905	1,258	1,559	1,948	2,377
Other	61	108	73	73	73	73	73
Total current assets	862	977	1,530	2,201	2,761	3,556	4,242
PP&E	1,638	2,651	3,816	4,864	6,106	7,237	8,270
Other non-current assets	29	61	100	100	100	100	100
Total assets	2,529	3,689	5,447	7,165	8,967	10,893	12,612
Short term debt	266	197	192	389	417	304	335
Payables	577	770	1,043	1,402	1,795	2,244	2,737
Other	80	123	215	215	215	215	215
Total current liabilities	924	1,090	1,450	2,006	2,427	2,763	3,288
Long term debt	153	810	1,424	2,001	2,659	3,343	3,457
Other	27	67	129	129	129	129	129
Total non-current liabilities	180	877	1,554	2,130	2,788	3,472	3,586
Shareholders' equity	1,425	1,723	2,441	3,029	3,752	4,658	5,738
Total equity and liabilities	2,529	3,689	5,447	7,165	8,967	10,893	12,612

Source: Company data for 2009-11, Gazprombank estimates for 2012-15

Cash flow statement, $ mln

Year to December	2009	2010	2011	2012E	2013E	2014E	2015E
EBT	355	449	561	786	967	1,208	1,437
Depreciation & amortization	103	150	272	374	493	619	771
Change in working capital	(8)	(88)	182	2	85	54	58
Other	(74)	(82)	(66)	(132)	(256)	(299)	(347)
Net cash from operating activities	376	429	949	1,029	1,289	1,582	1,919
Capex	(422)	(1,214)	(1,701)	(1,422)	(1,735)	(1,749)	(1,804)
Other	(26)	(16)	(13)	0	0	0	0
Free cash flow	(72)	(801)	(765)	(393)	(446)	(167)	115
Financing cash flow	339	565	1,150	700	698	567	134
Dividends paid	(18)	(32)	(35)	0	0	0	0
Net change in cash	256	(238)	402	313	253	401	250

Source: company data for 2009-11, Gazprombank estimates for 2012-15

Consumer stock valuations

Company name	Bloomberg ticker	Price, $	MCap	P/E		EV/EBITDA		EPS growth		EBITDA margin
		30/11/12	$ bln	2012E	2013E	2012E	2013E	2012E	2013E	2012E
Magnit	MGNT LI	35.28	16.7	28.4	23.0	13.4	10.7	40%	23%	9.4%
X5 Retail Group	FIVE LI	17.12	4.6	17.8	13.2	7.4	6.2	-14%	35%	7.2%
Dixy	DIXY RX	11.08	1.4	28.2	13.4	7.0	5.0	31%	109%	6.3%
O'Key	OKEY LI	10.16	2.7	21.7	19.2	10.6	8.7	14%	13%	7.9%
M.video	MVID RX	7.06	1.3	9.4	8.0	4.5	3.8	17%	17%	5.6%
Cherkizovo	CHE LI	12.27	0.8	4.1	4.2	5.0	4.8	37%	-4%	19.1%
Synergy	SYNG RX	14.79	0.4	7.3	6.3	5.5	4.9	-4%	16%	12.7%
CEDC	CEDC US	1.72	0.1	neg.	17.3	12.9	9.6	nm.	nm.	13.0%
Rusagro	AGRO LI	6.90	0.8	5.1	4.8	4.6	3.9	100%	6%	24.6%
Razgulay	GRAZ RX	0.47	0.1	3.4	2.0	6.0	5.6	406%	71%	16.5%
Russia - food retail			25.4	24.0	17.2	9.6	7.6	18%	45%	7.7%
Russia - food products				1.3	5.7	9.3	7.8	6.5	17%	6%
EM - food retail			129.2	25.9	21.6	13.3	11.3	43%	20%	6.5%
EM - consumer electronics retail				9.5	11.8	15.1	9.0	7.9	203%	4%
EM - food products			59.0	26.4	21.5	16.2	13.6	-3%	21%	15.4%

Source: Bloomberg, Gazprombank estimates

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Recovery from low base

Positive on gold, cautiously optimistic on recovery in base metals from lows, neutral on ferrous metals

Judging by supply/demand fundamentals and upside/downside risks in the Russian metals and mining sector, we are the most positive on gold for 2013. Our view is cautiously optimistic on base metals and we expect a significant rebound from particularly low levels for nickel. Copper should be well supported in the short term by relatively good fundamentals, but risks will grow toward end 2013 on a possible supply increase. In our view, steel prices will rise from current lows but will not surprise significantly on the upside due to the low capacity utilization rates globally and the weak bargaining power of steelmakers stemming from the industry's very low level of concentration. We predict a gradual increase in coking coal prices and consider the local coking coal market as especially weak based on excessive capacity at Raspadskaya and a high proportion of medium to low-quality coal in total mining output. We are neutral on steels/coal in general, as the industry remains relatively weak, but we also believe that prices have been bottoming out.

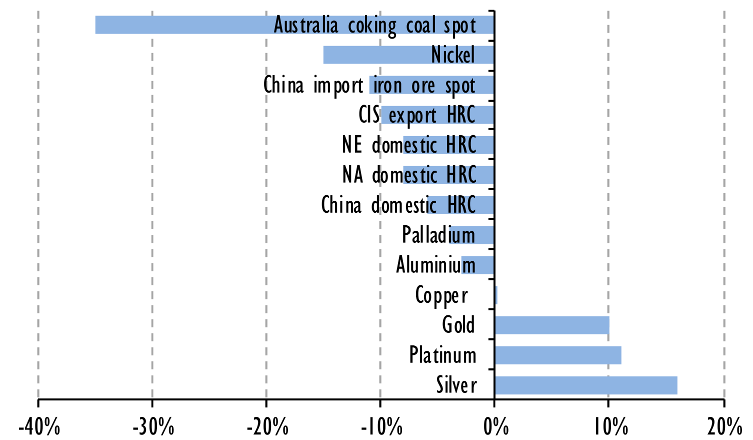
The global environment is uncertain in terms of both upside and downside risks, and the market should remain focused on high-beta metals and mining names.

Macro environment calls for selective investing

2012 was very unfavorable for metals and mining

The year 2012 was again challenging for the global metals and mining industry, as Europe continued to suffer from its debt crisis and Chinese economic growth slowed to a larger extent than anticipated by the market. These factors had a dramatic impact on demand for most metals. The industry was also under pressure from cost inflation, strikes and reduced output by a number of companies. The year was particularly bad for bulks, nickel and steels, while precious metals mostly benefited in this environment.

Global metals and bulk prices changes YTD



Source: Bloomberg, Gazprombank estimates

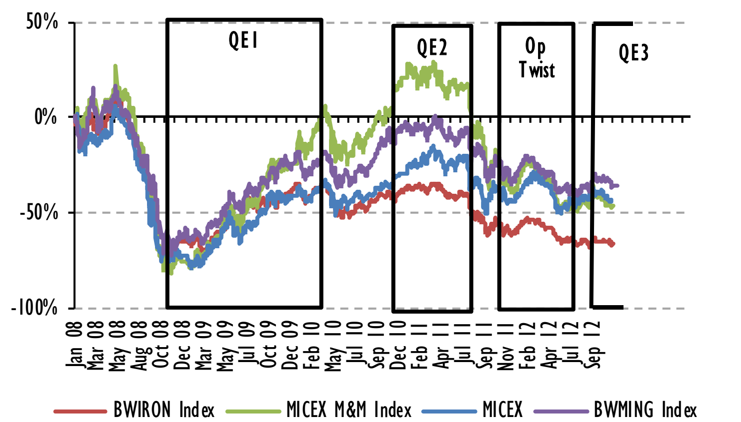
Global authorities undertook considerable stimulus measures toward end 2012; we expect to see the positive impact in 2013

In late 2012, global monetary authorities expanded the scale of their stimulus measures and we expect to see a positive impact in 2013, as government actions usually influence the economy with a certain time lag. In particular, we believe that China's GDP will continue to expand in 2013. We believe that metals and mining fundamentals will improve in 2013 on average, albeit from a low base.

After the launch of the US Federal Reserve's QE1 program, global metals and mining equities recovered rapidly from depressed crisis levels. The period of 2H11-2012 was challenging for the industry, despite the launch of QE2 in late 2010-

1H11. The second program was rather short-lived, however, while the global environment was impacted by sharp deterioration of the situation in Europe and the consequences of monetary tightening in China. With QE3 stimulus measures now in place, offsetting the tightening in China, we expect conditions in 2013 to improve for metals and mining equities. That said, we expect next year to remain challenging, which calls for a selective approach – investors should carefully choose sub-sectors and individual equities.

Global equity indexes in USD terms and stimulus programs



Source: Bloomberg, Gazprombank estimates

Metal prices will be mostly supported at current levels

Metal prices will in general be supported at current levels by (1) high production costs compared with current prices; (2) possible currency appreciation in a number of key metal-producing countries; (3) cost inflation; (4) downward adjustments of supply from high-cost producers; and (5) other interruptions (strikes, technical difficulties).

We expect recovery from a low base across the universe; the challenge for investors is that a recovery is often largely priced into equities

Based on the supply/demand balance, we expect to see a fundamental recovery in the metals and mining universe in 2013 from the low base of 2012. The challenge for investors is that a recovery is often largely priced into equities, while the real economy still needs to provide evidence.

Oversupply risks are high for many metals and bulks; prices might be capped

Oversupply risks are rather high in the industry, while demand is often anemic. In particular, we see high short-to-medium term oversupply risks for steels (globally, Russia continues to resist this trend due to its favorable cost position and relatively healthy local market) as well as nickel, copper (though not in 1H13), metallurgical and thermal coal, and iron ore. This situation will prevent significant price hikes in the near term on a YoY basis, something that the industry has experienced in the past.

This environment should make investors prefer:

- cost leaders (Russian metals and mining companies generally enjoy strong cost positions on the global cost curve);
- companies with healthy balance sheets;
- exposure to the relatively strong domestic market.

Industrial risks

We estimate industrial risks in 2013 as high, calling for elevated return requirements on global metals and mining equity investments.

Key risks

- Commodity prices represent a major risk, as their volatility was extremely high in 2012. We expect the volatility of metals and mining product prices to be above the historical level in 2013.
- The global macro environment is very uncertain and metals demand growth could be weaker than we forecast. Europe and China continue to be the most risk-exposed regions. In China, GDP growth may be slower than expected, while in the US, risks may be increasing due to the "fiscal cliff" issue.
- Global oversupply risks are high for a number of metals/bulk commodities.
- Russian metals and mining majors are large exporters in general, and ruble appreciation is a risk.
- Cost inflation could accelerate in Russia, negatively influencing companies' profitability.

Global steel and steelmaking materials industry

Steel demand is expected to grow 3.2% YoY in 2013

According to the Word Steel Association (WSA), global steel demand (apparent consumption of finished steel) may grow 3.2% YoY in 2013, compared to an estimated 2.1% YoY in 2012. Thus, the growth will improve but remain too weak to support the industry to a significant extent.

Run rate was 78% in November 2012; will remain low in 2013, capping prices

Global steel run rates were low in 2012, negatively influencing steel prices across all regions (78% in November 2012, with a similar 2012 average level YTD). We believe the global capacity utilization ratio is low enough to cap steel price hikes but unfortunately not at a level to expect a sizable price rebound (more supply discipline is needed in the industry). We do not expect significant structural improvements in the near future and believe that under current conditions global utilization rates will remain low in 2013. However, we believe the process of closing ineffective capacity in Europe will continue gradually in the medium term, providing some support.

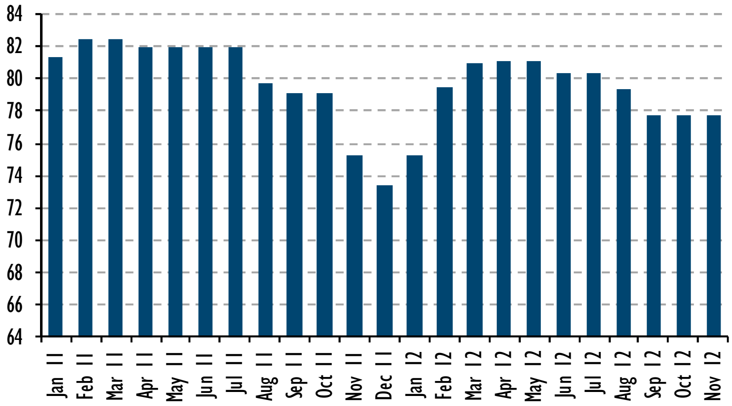
Steel stocks decreased globally from peaks and declined in China – a normal entry point for 2013

On a positive note, global stocks, which were very high in February 2012, normalized into the year end, while stocks in China even declined to below historical levels. This level of stocks is a natural entry point for 2013, we believe.

We believe global steel prices have bottomed, but steel equities are not cheap

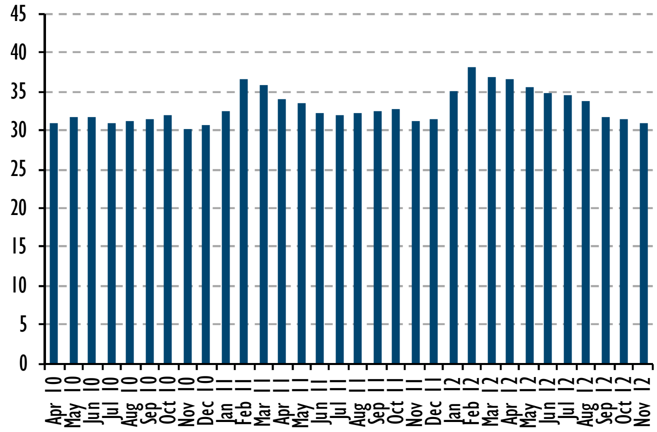
We believe that global steel prices have bottomed, a view shared by the management of NLMK and Severstal in November in their outlooks released alongside financial results for 3Q12. We see several key arguments for this: 1) as we noted, steel demand is expected to grow in 2013 compared to the extremely low level of 2012; (2) prices of steelmaking raw materials are rather close to costs, especially for coking coal; (3) BOF integrated steels in Europe made a loss at EUR 16/tonne in November 2012, and losses usually do not persist for a long period. Additionally, the average profit level is EUR 33/tonne YTD compared to EUR 36/tonne for 2011 and EUR 51/tonne for 2010. We assume that the profit per tonne will improve in 2013 from a low base.

Global steel capacity utilization rate



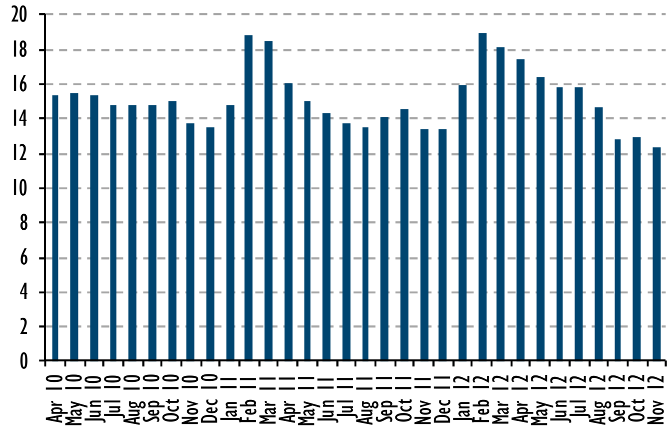
Source: Bloomberg, Gazprombank estimates

Global steel inventory, mln tonnes



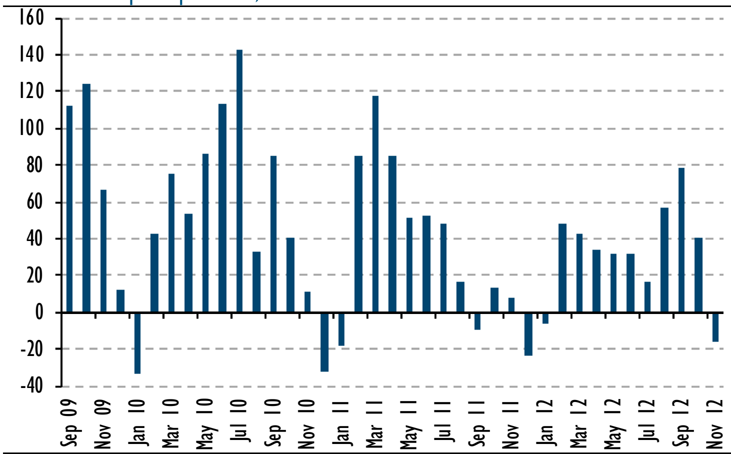
Source: Bloomberg, Gazprombank estimates

China steel inventories, mln tonnes



Source: Bloomberg, Gazprombank estimates

BOF EU steels profit per tonne, EUR/tonne



Source: Bloomberg, Gazprombank estimates

Steelmaking raw material prices

Iron ore and coking coal spot prices are 11% and 35% lower YTD

The year 2012 was marked by a dramatic slowing of demand worldwide and oversupply in both iron ore and coking coal markets. As a result, spot iron ore prices are down 11% YTD, while spot coking coal prices have plunged 35% YTD.

Iron ore prices rebounded strongly from 2012 lows

The iron ore price has rebounded a significant 40% from its September 2012 low of $86.6/tonne but is still 18% below the April 2012 high of $148.4/tonne. This rebound was related to an increase in Chinese iron ore imports.

Coking coal prices – no rebound yet

Coking coal spot prices remain close to their 2012 lows. Coking coal fundamentals were additionally impacted by the recovery of Australian miners from floods and increased exports to China from Mongolia (+6% YTD in 9M12).

We expect flat iron ore prices YoY and an 8% decrease YoY for coking coal prices

Iron ore supply growth may remain significant in 2013 compared with demand. We believe that the average iron ore price will remain at a low level at end 2012 and in 2013. New coking coal capacity will continue to come from Mozambique and Mongolia in 2013-14. Growth in the Japanese economy, which accounts for approximately 20% of seaborne imports of coking coal, continues to slow: the consensus expects 1.0% GDP growth in 2013 compared with 2.1% in 2012. Inventories are relatively low for both iron ore and coking coal, supporting prices. Costs are more supportive for coking coal, we believe, and we see very limited price downside from current levels. However, low-growth countries account for approximately 25% of seaborne demand for iron ore and 37% of demand for iron ore, and thus in terms of demand iron ore prices should be better supported (albeit with greater dependency on China).

In Russia, we see additional oversupply risks in the domestic coking coal market due to idled capacity restored after the accident at Raspadskaya. We forecast flat iron ore prices in 2013 on average and an 8% YoY decrease in coking coal prices (our forecasts assume flat iron ore prices from current levels and 26% recovery in coking coal prices from still very depressed spot levels).

Russian steel Industry

Domestic fundamentals will remain relatively supportive

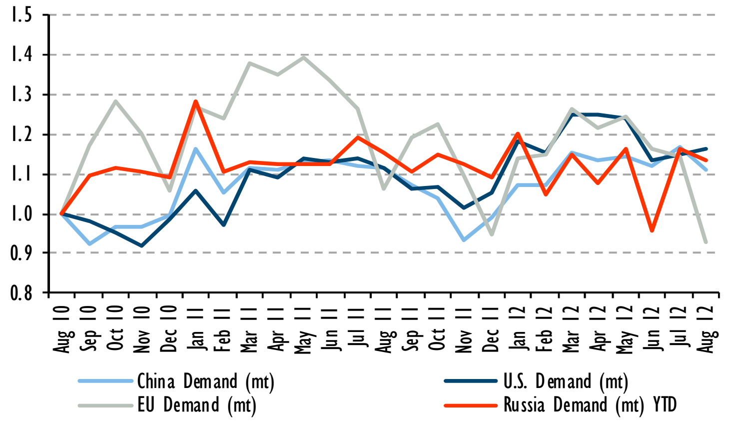
Crude steel growth will be moderate

We estimate that crude steel production in Russia will increase 3.7% YoY to 70.7 mln tonnes in 2012E. Such growth will mainly stem from NLMK thanks to new BOF capacity at the company's Lipetsk site. In 2013, we expect crude steel production in Russia to grow around 4%, in line with 2012. The increase will be driven primarily by the launch of new EAF capacity, in particular the new mini-mills of NLMK and Severstal and EVRAZ's production recovery following relatively extensive maintenance works in 2012. That said, we think capacity utilization rates for the new EAF projects will increase gradually in 2013, averting excessive pressure on the domestic market.

Local demand will outpace global

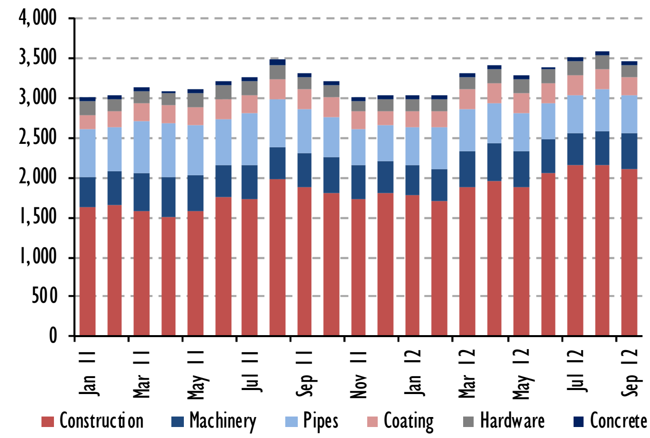
According to our calculations, steel demand will grow 6.7% YoY in Russia in 2012, driven mainly by construction (+17% YoY). Pipes-driven demand decreased 15% YoY in response to a very weak LDP market due to delays/downward adjustments of oil pipeline projects. As a result, the share of construction in total domestic apparent demand increased from 54% in 2011 to 59% in 2012. Our macro team forecasts GDP growth at 3.1% in 2013 in Russia compared with 3.8% in 2012, and based on this figure we expect domestic steel demand to slow to 5-6% YoY in 2013. However, local demand will outpace world steel demand (+3.2% YoY in 2013, according to the World Steel Association). Construction will remain the key driving force, while we expect a modest recovery of pipe demand as well (from a low base). Floor space per capita is still 52% below the EU level and 37% lower compared to Eastern Europe, while rather high oil prices continue to support demand. The relatively strong local steel market and low cost position globally will continue to support healthy capacity utilization rates of Russian steels in 2013.

Comparative demand pace, Russia and US demand were relatively strong



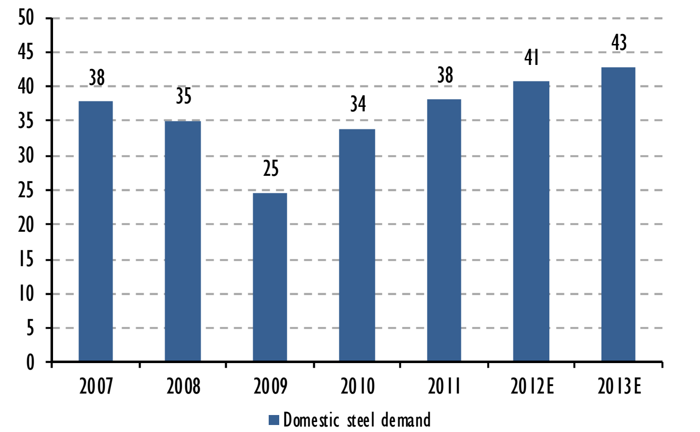
Source: Bloomberg, Gazprombank estimates

Domestic steel demand, monthly dynamics, '000 tonnes



Source: Metal Expert, Gazprombank

Domestic steel demand, annual statistics and forecasts, mln tonnes



Source: Metal Expert, Gazprombank

HRC export CIS steel price is expected at $589/tonne

The global slowdown was especially painful for steel/steelmaking industries in 2012. We estimate that the benchmark HRC CIS price decreased 16% YoY to $580/tonne due to weak global demand and the significant fall in prices of iron ore and coking coal. The dynamic was especially unfavorable for Russian steels, the vertical integration of which is relatively high on a global scale. Steel products exposed to a larger extent to construction, such as rebars and billets as well as HVA products, were rather resilient: prices were down 4.0-14.5% YoY. We forecast that the HRC export CIS price will increase 2% YoY in 2013E, which actually implies a sizable rebound from current levels. Domestic prices were resilient in 2012, and we believe they will remain relatively strong in 2013. Rebar prices were particularly strong, even in terms of local prices. We expect domestic rebar prices to remain stronger in 2013, benefiting our top pick EVRAZ. Closer to end 2013 – early 2014, local competition in the long sector could increase as a result of new capacity.

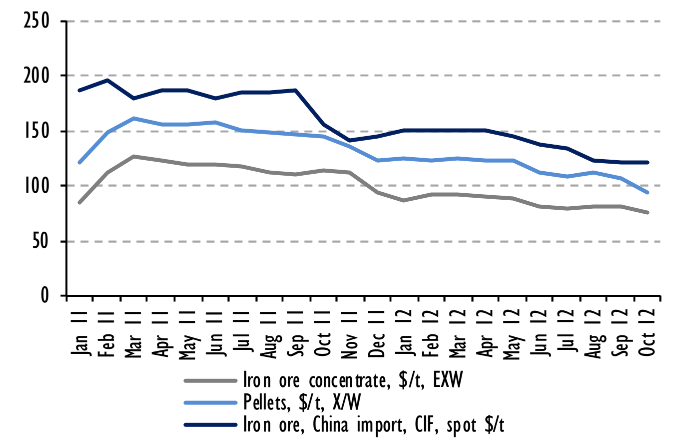
But even accounting for the rebound in steel prices, price levels will remain rather weak. Additionally, given the fragile global conditions, we believe Russian steels will continue to focus on cost optimization and strengthening their position on the local market in 2013. The local market was a real "sweet spot" for Russian steels in 2012 and will continue to support their margins in 2013, we believe.

Ferrous industry, key price assumptions, $/tonne

	2008	2009	2010	2011	2012E	2013E
Iron ore concentrate, domestic, EXW	78	37	78	112	84	84
YoY	34%	-53%	111%	43%	-25%	0%
Coking coal concentrate, EXW, standard mix	170	63	134	190	137	131
YoY	98%	-63%	113%	42%	-28%	-4%
Hard Coking coal, Australia	250	172	192	289	210	194
YoY	143%	-31%	12%	51%	-27%	-8%
HRC, export price, CIS	860	457	615	693	580	589
YoY	53%	-47%	35%	13%	-16%	2%

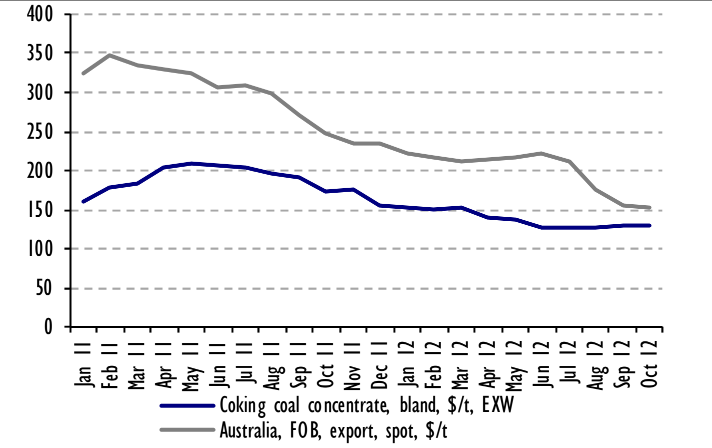
Source: Metal Expert, Gazprombank estimates

Iron ore prices



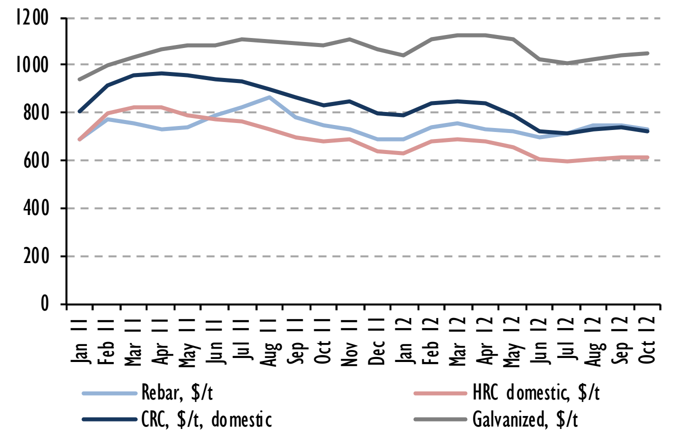
Source: Metal Expert, Gazprombank

Coking coal prices



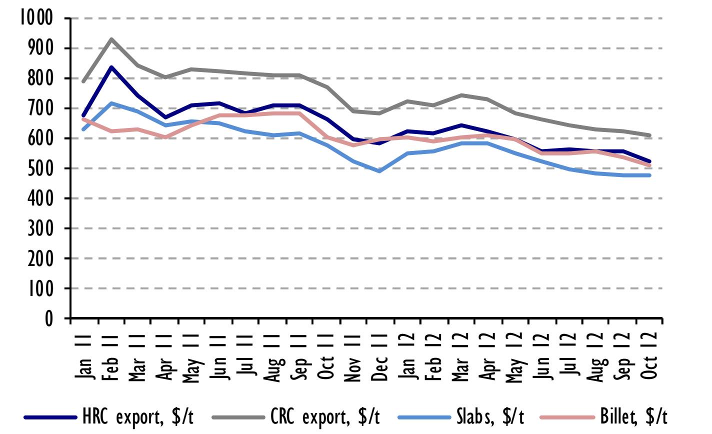
Source: Metal Expert, Gazprombank

Domestic steel prices



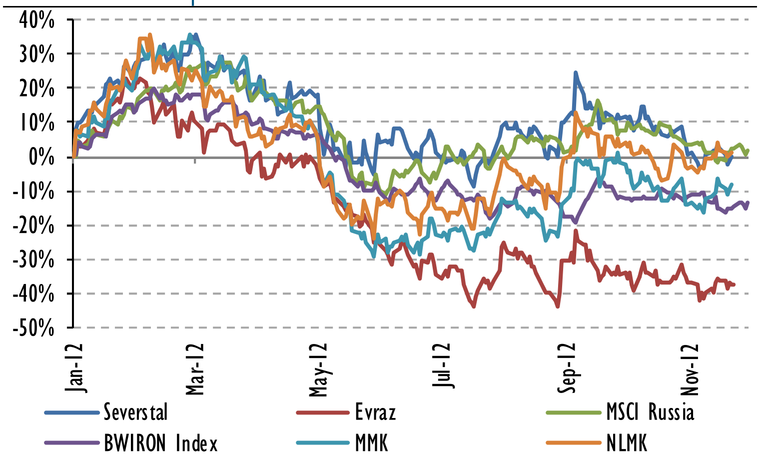
Source: Metal Expert, Gazprombank

Export steel prices



Source: Metal Expert, Gazprombank

Russian steels relative performance



Source: Bloomberg, Gazprombank estimates

Steel companies peer valuation

	EV/EBITDA			P/E		
	2011	2012E	2013E	2011E	2012E	2013E
Posco	5.6	7.4	6.7	8.2	10.9	9.5
Gerdau SA	7.4	9.0	7.3	12.2	15.7	12.6
Erdemir	5.6	9.4	7.1	8.1	14.3	9.5
Wuhan Steel	8.3	8.5	7.5	12.4	n/m	n/m
CSN (Companhia Siderurgica Nacional S.A.)	3.7	7.4	5.7	4.1	n/m	9.9
Dongkuk Steel	5.6	n/m	8.2	4.8	n/m	n/m
Tata Steel	4.6	6.6	6.4	5.0	6.8	13.8
Sail	4.5	7.5	7.0	5.2	8.9	10.2
Hyundai Steel	7.8	8.7	7.7	8.0	8.9	7.7
Average	**5.9**	**8.0**	**7.1**	**7.5**	**10.9**	**10.5**
Developed Markets						
Nucor Corp	8.0	9.5	6.9	17.8	25.1	13.8
US Steel Corp	6.7	6.3	5.2	n/m	28.2	12.7
Arcelor Mittal	5.1	7.5	6.3	7.2	n/m	15.1
Nippon Steel	7.8	10.0	n/m	17.4	n/m	n/m
Thyssen Krupp	4.0	7.5	6.3	8.9	n/m	n/m
SSAB	6.7	n/m	7.7	10.3	n/m	16.1
BlueScope Steel	9.6	n/m	5.4	n/m	n/m	n/m
Daido Steel	5.9	5.7	8.1	6.8	8.0	17.1
Hitachi Metals	5.5	5.0	5.6	13.0	10.1	10.5
JFE Holdings	2.9	8.0	9.4	10.2	n/m	24.9
Kobe Steel	4.8	6.2	9.4	4.8	n/m	n/m
Acerinox	8.3	n/m	8.2	19.5	n/m	18.1
Rautaruukki	7.7	n/m	7.5	11.4	n/m	24.1
Average	**6.4**	**7.3**	**7.2**	**11.6**	**17.9**	**16.9**
Russia						
Evraz	3.9	5.8	4.7	11.1	59.1	10.4
Severstal	4.0	5.9	5.6	6.2	11.1	10.2
MMK	5.1	5.8	5.2	n/m	n/m	20.7
NLMK	7.0	8.1	6.9	9.2	13.3	10.3
Average	**5.0**	**6.4**	**5.6**	**8.8**	**27.8**	**12.9**

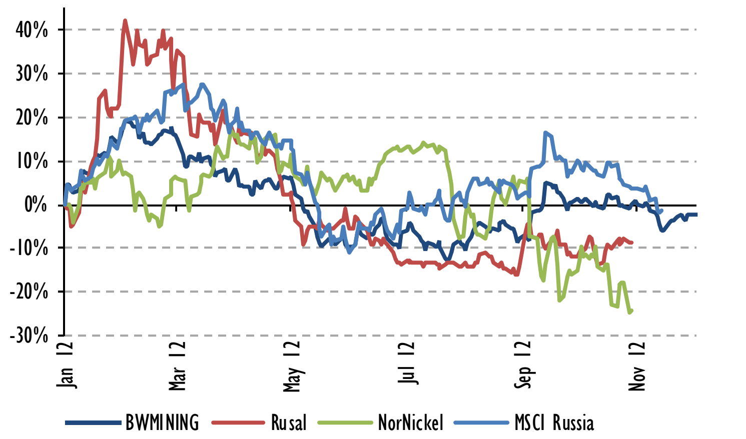
Source: Bloomberg, Gazprombank

Coal companies peer valuation

	EV/EBITDA			P/E		
	2011	2012E	2013E	2011	2012E	2013E
Emerging markets						
China Shenhua	5.8	5.6	5.2	9.7	9.2	8.7
China Coal Energ	6.4	6.6	5.9	8.7	10.0	9.5
Bumi Resources	3.8	5.1	5.0	3.4	40.4	11.4
Yanzhou Coal	6.5	9.4	8.8	7.4	11.8	13.0
Pingdingshan	4.6	5.6	6.0	7.9	13.1	14.0
Indo Tambangraya	5.5	5.8	6.2	9.5	9.8	11.1
Tambang Batubara	6.0	7.0	7.0	9.1	10.3	10.6
Banpu Pub Co Ltd	6.4	7.0	7.1	7.3	10.6	10.3
Hidili Ind Intl	7.2	9.4	8.3	4.9	11.4	8.5
New World Resources	2.6	5.3	5.0	5.3	68.4	51.4
Average EM	**5.5**	**6.7**	**6.5**	**7.3**	**19.5**	**14.9**
Developed Markets						
Peabody Energy	5.7	7.0	6.9	6.1	12.5	12.8
Consol Energy	5.6	8.9	7.7	10.7	30.8	23.6
Alpha Natural Re	3.4	6.0	8.0	4.6	nm	nm
Arch Coal Inc	5.8	7.6	8.6	7.5	nm	nm
Average DM	**5.1**	**7.4**	**7.8**	**7.2**	**21.6**	**18.2**
Average Global	**5.3**	**7.0**	**7.1**	**7.3**	**20.6**	**16.6**
Russian coal miners						
Raspadskaya	6.6	12.1	5.2	11.6	n/m	13.6
Mechel	5.0	7.4	7.0	22.6	n/m	n/m
Kuzbasskaya Toplivnaya Kompania	4.0	5.4	3.9	7.4	13.1	9.2
Average RM	**5.2**	**8.3**	**5.4**	**13.8**	**13.1**	**11.4**

Source: Bloomberg, Gazprombank estimates

Norilsk Nickel, Rusal: relative performance



Source: Bloomberg

Precious metals and PGMs

Debt problems in Europe and global economic slowdown will support gold; platinum and palladium offer solid upside

The fundamentals of the gold market will remain favorable in 2013, in our view. The announcement of QE3 was positive for gold, while fiscal and monetary factors will keep investment demand high. Additional support should be provided by the expected relatively poor performance of certain alternative investments. In 2012, the gold price has averaged \$1,690/oz and we expect it to grow to \$1,890/oz in 2013. The current market consensus estimates the average price at \$1,850 oz next year, or 4% higher than we expect.

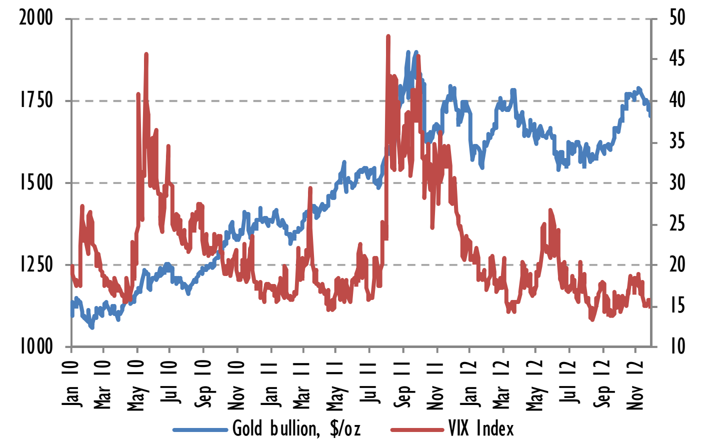
We anticipate a relatively small deficit of platinum in 2013 versus surpluses in 2011 and a balance in 2012E. On the contrary, the deficit in palladium has been significant in 2012, totaling 9% of demand. We forecast quite conservative 3.5% YoY growth in palladium supply, which will not be sufficient to eliminate the supply-demand gap and ensure a continuing imbalance in 2013. On the global market, the presence of Russia's state reserves will be limited. In 2012-13, we expect volumes of palladium sales to amount to only 200 koz, which is much lower than the level in 2011 (775 koz). Given demand from the automotive catalyst market, we forecast 5.3-5.6% YoY growth in platinum and palladium consumption, which should support prices. We expect palladium and platinum prices to grow 16% and 19% YoY to \$760/oz and \$1,828/oz in 2013, respectively.

Precious metals and PGM price

	2008	2009	2010	2011	2012E	2013E
Gold, USD/oz	**882**	**1,097**	**1,421**	**1,572**	**1,690**	**1,809**
change	*6%*	*24%*	*30%*	*11%*	*8%*	*7%*
Silver, USD/oz	**11.2**	**17**	**30.9**	**35.3**	**31.3**	**32.6**
change	*-24%*	*52%*	*82%*	*14%*	*-11%*	*4%*
Platinum, USD/oz	**1,578**	**1,205**	**1,610**	**1,722**	**1,570**	**1,828**
change	*21%*	*-24%*	*34%*	*7%*	*-9%*	*16%*
Palladium, USD/oz	**352**	**263**	**526**	**734**	**640**	**760**
change	*-1%*	*-25%*	*100%*	*40%*	*-13%*	*19%*

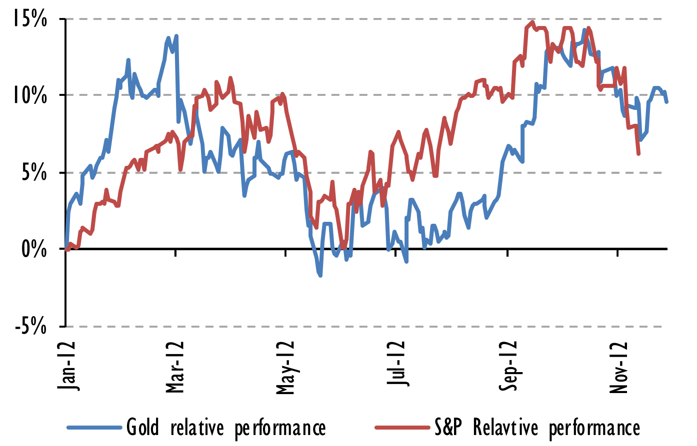
Source: Bloomberg, Gazprombank estimates

Gold vs VIX Index



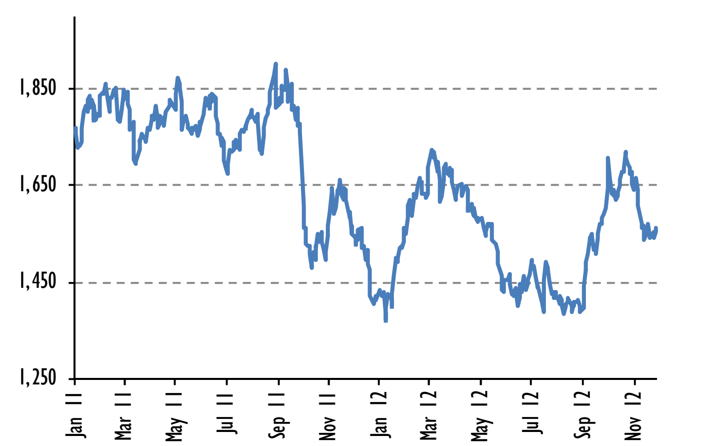
Source: Bloomberg

Relative performance of S&P vs. Gold



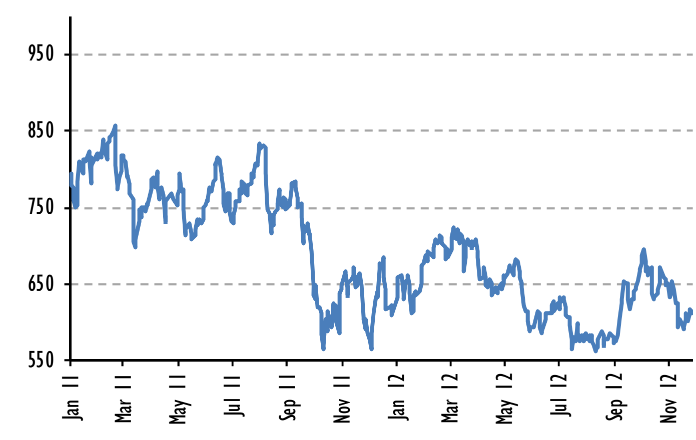
Source: Bloomberg

Platinum, $/oz



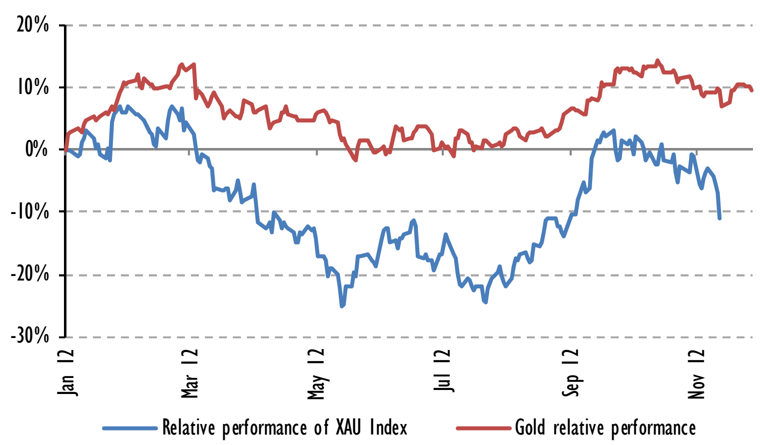
Source: Bloomberg

Palladium, $/oz



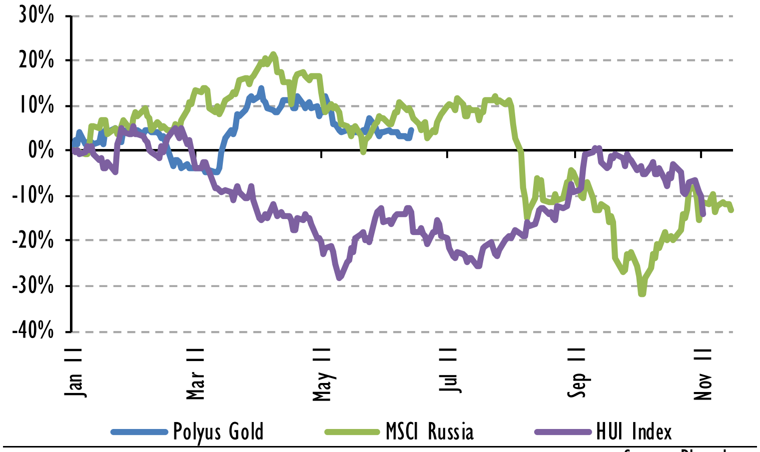
Source: Bloomberg

Relative performance of gold vs. XAU Index



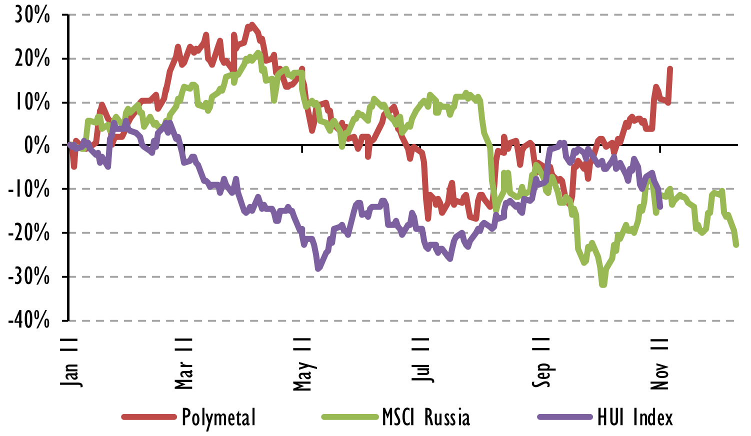
Source: Bloomberg

Relative performance of Polyus vs. MSCI Russia vs. HUI Index



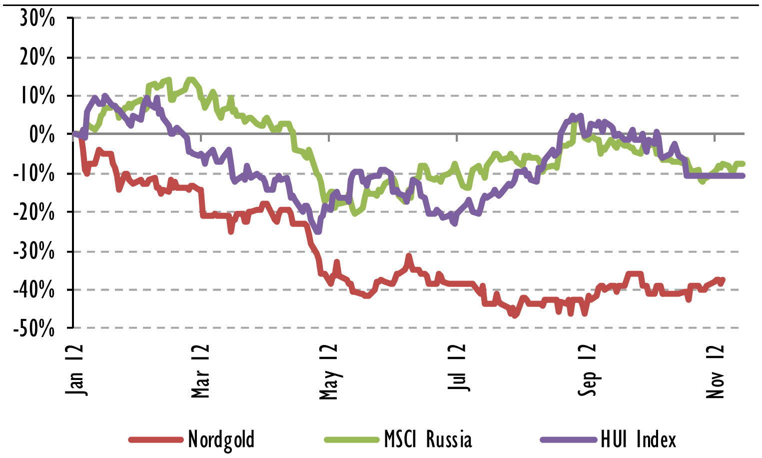
Source: Bloomberg

Relative performance of Polymetal vs. MSCI Russia vs. HUI Index



Source: Bloomberg

Relative performance of Nordgold vs. MSCI Russia vs. HUI Index



Source: Bloomberg

Comparative valuation: gold companies

	2011	2012E	2013E	2011	2012E	2013E
Global Senior Gold Miners						
Newmont	6.0	7.1	5.5	10.6	12.7	9.0
AngloGold	4.7	5.3	3.8	8.0	9.4	6.1
Barrick Gold	5.6	6.4	5.1	7.2	9.1	6.8
Goldcorp	9.9	10.6	7.3	18.0	19.1	13.2
Kinross	5.8	6.1	4.4	12.4	13.3	8.5
Newcrest	10.1	10.0	9.6	18.5	18.0	18.2
Average	**7.0**	**7.6**	**6.0**	**12.5**	**13.6**	**10.3**
Median	**5.9**	**6.8**	**5.3**	**11.5**	**13.0**	**8.8**
Global Mid-Cap Gold Miners						
Agnico-Eagle	12.4	12.0	10.2	27.6	26.7	22.0
Eldorado	16.4	16.5	11.2	30.8	31.0	19.9
Gold Fields	4.3	4.6	3.3	8.9	10.3	6.1
Harmony Gold	8.2	5.3	4.7	22.5	9.7	9.5
IAMGold	5.1	5.6	4.2	9.8	13.1	9.1
Randgold Resources	16.4	12.9	9.4	27.0	21.3	15.6
AURICO GOLD INC	9.4	13.4	8.8	17.8	18.5	13.0
Average	**10.3**	**10.0**	**7.4**	**20.6**	**18.7**	**13.6**
Median	**9.4**	**12.0**	**8.8**	**22.5**	**18.5**	**13.0**
CIS Gold Producers						
Centerra	3.4	7.6	2.3	5.7	31.0	3.8
Highland Gold Mining	2.2	2.1	1.6	4.4	4.3	3.5
Petropvalovsk	4.5	4.6	3.7	3.6	7.3	4.3
Polymetal	**11.5**	**8.2**	**6.3**	**16.1**	**12.0**	**8.6**
Polyus Gold	**9.0**	**6.3**	**5.5**	**13.3**	**7.5**	**6.6**
Nord Gold	**3.6**	**4.0**	**2.8**	**7.3**	**10.8**	**5.6**
Average	**5.7**	**5.5**	**3.7**	**8.4**	**12.1**	**5.4**
Median	**4.1**	**5.4**	**3.3**	**6.5**	**9.1**	**4.9**

Source: Bloomberg, Gazprombank estimates

Base metals

We are cautiously optimistic on base metals

We expect copper's short-term fundamentals to remain the strongest. Copper is a key beneficiary in the base metals universe from QE3 in terms of demand. Supply challenges will provide additional support to the metal in the short run. However, its relatively high price and increased supply in 2013 should cap any sizable price increase. We forecast the average copper price at $8,200/tonne in 2013, which is close to the average level for 2012.

The nickel price will continue to suffer from structural issues, but we expect it to grow from extremely depressed levels on slowly recovering demand from the stainless industry supported by the cost side. We forecast an 8% YoY increase to $18,850/tonne, though this is still 14% below the metal's 52-week high. Key risks relate to NPI producers decreasing their costs.

We forecast the average aluminum price at $1,999/tonne in 2013, flat YoY. Our forecast suggests limited growth from current depressed levels. Excess stocks will continue to weigh on the market.

Base metal prices

	2008	2009	2010	2011	2012E	2013E
Nickel, USD/t	**21,027**	**14,700**	**21,809**	**22,831**	**17,425**	**18,850**
change	*-43%*	*-30%*	*48%*	*5%*	*-24%*	*8%*
Copper, USD/t	**6,952**	**5,164**	**7,539**	**8,811**	**7,990**	**8,200**
change	*-3%*	*-26%*	*46%*	*17%*	*-9%*	*3%*
Aluminium, USD/t	**2,585**	**1,671**	**2,173**	**2,398**	**2,002**	**1,999**
change	*-2%*	*-35%*	*30%*	*10%*	*-17%*	*0%*

Source: Bloomberg, Gazprombank estimates

Nickel price, $/tonne

Source: Bloomberg

Aluminium price, $/tonne

Source: Bloomberg

Copper price, $/tonne

Source: Bloomberg

Comparative valuation: base metals and diversified companies

	EV/EBITDA 2011	2012E	2013E	P/E 2011	2012E	2013E
Diversified						
Vale	3.2	5.9	4.7	3.8	8.1	7.0
RIO Tinto	4.4	6.6	5.4	6.3	10.4	9.0
BHP Billeton	5.5	6.2	6.9	8.1	10.8	12.9
Xstrata	5.5	7.8	6.3	8.9	13.7	11.4
Anglo American	3.5	5.5	4.3	6.7	14.7	11.4
Teck Resources LTD	4.3	6.4	5.8	7.9	14.5	12.0
Average	**4.4**	**6.4**	**5.6**	**6.9**	**12.0**	**10.6**
Nickel Producers						
PT Internatonal Nickel Indonesia	3.7	8.7	6.2	5.6	15.7	11.3
Eramet	3.7	7.1	5.1	10.3	n/m	15.0
Aneka Tambang	3.7	6.0	5.3	5.9	10.6	10.3
Sherritt International	4.5	5.3	4.2	6.8	16.4	11.3
Norilsk Nickel	4.6	5.6	4.7	8.1	8.7	7.2
Average	**4.0**	**6.6**	**5.2**	**7.0**	**13.0**	**11.4**
Copper producers						
Vedanta	8.3	7.2	5.2	5.1	11.5	9.7
Antofagasta	5.7	5.6	5.5	16.6	15.0	13.5
Freeport-McMoran	4.0	5.7	4.1	8.1	12.0	8.3
Grupo Mexico	5.1	5.7	5.4	10.1	10.7	10.6
Southern Copper	8.2	8.6	8.3	13.2	14.3	13.9
Jiangxi Copper	7.3	9.7	9.3	9.1	12.1	11.7
First Quantum Minerals	7.5	7.3	5.9	17.0	13.6	13.1
Aurubis AG	5.4	4.2	5.1	11.7	8.5	10.3
Katanga Mining Ltd	4.3	9.2	1.8	7.6	n/m	4.2
Lundin Mining	7.1	7.7	5.8	13.6	15.2	10.2
OZ Minerals	2.7	4.3	4.4	7.1	13.5	15.1
Inmet Mining Corp	8.5	6.8	6.7	19.1	12.9	13.0
Kazakhmys	4.0	5.9	5.4	4.4	8.0	7.5
Average	**6.0**	**6.8**	**5.6**	**11.0**	**12.3**	**10.8**
Aluminum producers						
Alcoa	6.2	9.8	6.6	11.5	n/m	12.5
Chalco	14.1	n/m	19.3	n/m	n/m	n/m
Hindalco Industries	5.8	7.5	7.1	5.9	7.9	7.7
Yannan Aluminium	19.8	n/m	18.6	n/m	n/m	n/m
Norsk Hydro	4.6	10.3	6.9	12.3	n/m	21.9
Century Aluminum	6.5	15.1	6.6	n/m	n/m	n/m
RUSAL	7.9	11.8	8.5	5.1	19.1	9.2
Average	**9.3**	**10.9**	**10.5**	**8.7**	**13.5**	**12.8**

Source: Bloomberg, Gazprombank estimates

Russia's WTO accession

We see the next major effects on the Russian steel market as coming from Russia's accession to the WTO:

1. The EU's import quotas for Russia will no longer apply, which is positive. On the other hand, the quotas have not been utilized to the full extent in recent years (by just 80% in flat steel and 30% in long steel), while in the absence of quotas new measures might be implemented (although we estimate this risk as low).
2. The domestic market should rely on imported finished steel-containing goods to a higher extent. We believe that machinery is the most exposed segment in this regard, although it accounts for only 13% of total apparent demand in Russia and only a relatively small part of the sector might be affected.
3. Scrap export tariffs will decline in the medium term and domestic scrap prices could increase as a result.

That said, all negative factors will be softened by the gradual nature of changes during the transition period (until 2017). We see the accession as neutral to negative in the short run for Russian steels.

For nickel, copper and PGMs, the effect will be positive due to the switch from progressive duties on nickel and copper to fixed duties from 2013, as well as full cancellation of export duties after the transition period. We note, however, that at current low price levels the impact from the switch in 2013 should be neutral.

Top picks

EVRAZ

We believe that rebars and rails will remain relatively strong on the domestic steel market in 2013, especially in the first half, and EVRAZ represents the best exposure to these products. EVRAZ is scheduled to finish reconstruction of rail mills at ZSMK and NTMK in 4Q12 ($550 mln capex), which will improve performance of the rail division in the medium term. Additionally, EVRAZ will implement PCI (Pulverized Coal Injection) technology in 1H13, which will decrease BOF costs via 20% lower coke consumption and diminished natural gas volumes used in production. EVRAZ's North America foreign steel division, which is the key division outside Russia for EVRAZ, remains the strongest among foreign arms of Russian steels (its capacity utilization was a relatively high 90% in October 2012).

EVRAZ has agreed to increase its indirect stake in Raspadskaya from 41% to 82% by end 2012 (subject to approvals) with the premium estimated at just 15% to the market via a deal that was mostly non-cash in nature. We consider this deal as attractive for EVRAZ thanks to the high fundamental upside for Raspadskaya in the medium term. Raspadskaya has significant potential to increase production locked by the weak coking coal market, while we expect global economic recovery in the medium term and to a greater extent the long term. EVRAZ is the cheapest steel name in the Russian universe, and we believe the valuation is excessively low.

Norilsk Nickel

Norilsk Nickel provides attractive exposure to the underlying metals basket, albeit complicated by a conflict between major shareholders. The nickel price has increased 8% from its 52-week low of $15,190/tonne but is still far from its 52-week high of $21,850/tonne. We expect the nickel price to average $18,850/tonne in 2013.

The shareholder conflict is negative for Norilsk Nickel, but we believe it is priced in. Moreover, the key shareholders reportedly started negotiations on a new agreement at end October and are close to an agreement. We believe the agreement might result in at least a temporary peace. Moreover, in this case, dividends might grow significantly (to as much as 50% of the payout ratio for 2013, we estimate, effectively doubling the dividend yield).

Norilsk Nickel's unique global scale combined with its low valuation versus historical levels will keep investors focused on the stock amid bottom fishing. The company's financial leverage is low, with net debt/EBITDA 2013E of just 0.3x, while the EBITDA margin is impressive at 44.5%. We prefer Norilsk Nickel's metal basket over bulks and steels and thus believe the company wins on many relative scores.

NordGold

Nordgold's investment case is driven by production growth (14% CAGR in 2012E-2015E), favorable gold prices, turnaround at a number of assets and the launch of new projects in the near future. Additionally, NordGold's liquidity will increase significantly if High River Gold minority shareholders accept the swap offer. We estimate that free float could potentially double to 23%. In 2012, we expect production at 724 koz, which is in line with the company's guidance of 720-770 koz (the company is now predicting the lower end of that range) and 4% below the 2011 result (754 koz). In 2013, we forecast that production will amount to 846 koz, up 17% YoY. This growth will be driven by improvements at Lefa and Taparko plus the launch of Bissa (end 1H13) and Gross (middle to end 2H13).

The year 2012 was marked by a number of troubles at some of the company's mines, the most significant of which was a technical issue at Lefa at the beginning of the year, considerably slowing output in 1H12. All required work has been completed and new facilities were installed at Lefa over the course of 2012. We expect the results of these efforts to materialize by end 2012 – 1Q13, which would provide an additional driver for the stock and improve investment sentiment toward the company. Moreover, the measures at Lefa are expected to drive cash costs down from the elevated level of 9M12 (+41% YoY to $1,180/oz). Since Lefa accounts for 25% of total production, the cost deflation will have a noticeable impact on the company's average cash cost, which, in turn, will support EBITDA profitability. NordGold is expected to lower its 2013 guidance, but we believe this would not surprise the market (we also assume significantly lower production). We have a positive view on NordGold stock, which has been depressed since January 2012.

Weights of top picks

We assign different weights to our ideas: 15% to NordGold, and 42.5% to Evraz and Norilsk nickel each.

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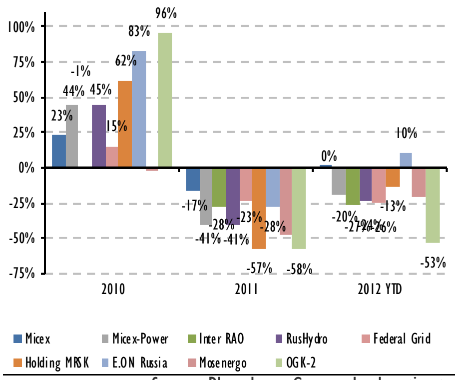
Another tough year ahead?

Investment summary

Russian electric utilities were under significant pressure in 2012 from regulatory tightening and slowing demand, with the MICEX-Power Index showing a 21% drop YTD compared with the headline MICEX Index's loss of just 1%. The biggest outperformers were TGKs, which rely to a great extent on the heat supply business, and electricity grid companies, which have suffered from the so-called RAB reload. Thus, our recommendation in last year's equity strategy outlook to be cautious on Russian electric utilities was warranted, we believe.

Russian utilities performance, 2010-2012 YTD



Source: Bloomberg, Gazprombank estimates

However, certain stocks demonstrated positive dynamics. The best-performing names in the generation sector were E.ON Russia (our top pick last year) and TGK-9 – both up 15% YTD. The highest returns among grid companies were shown by Kubanenergo (the share price of which has doubled YTD on the back of the buyout), Tomsk DC (+36% YTD) and MRSK Center & Volga (+18%).

We expect the major negative factors that pressured the utilities sector this year will persist in 2013, namely sluggish growth in demand for power and the tight regulatory environment. Due to the fundamental slowing of demand for power and the unfinished reform agenda, coupled with strong manual control, the utilities sector is not a growth story. We have a NEUTRAL/UNDERPERFORM view on electric utilities as a whole in 2013. Poor financial result dynamics in 2012 only confirm our view. However, there are a few exceptions – thermal gencos with the highest quality of generation assets and the best management practices, such as E.ON Russia and Enel OGK-5, as well as hydro generation (RusHydro, TGK-1, Irkutskenergo), even though they depend heavily on such an unpredictable factor as weather.

We also see another threat, which is associated with additional share placements becoming more frequent. Such actions allow companies to raise cash to finance obligatory investment projects, but for minority shareholders this frequently carries dilution risks. Moreover, in case of significant additions to charter capital, the placement price creates a kind of ceiling for the stock. This was the case for such names as Holding MRSK, RusHydro, and OGK-2. Next year, a number of other companies (mostly grids) will also place extra shares.

Additional share issues may also be used to structure M&A deals. In particular, the government plans to contribute the state's stake in Federal Grid Company (FGC) to the charter capital of Holding MRSK, while RusHydro is seeking a 40% stake in Irkutskenergo via share placement. Such schemes pose risks rather than bring direct benefits to minority shareholders. In fact, 2012 was marked by large M&A deals that significantly reshaped the industry. In particular, Inter RAO fully consolidated OGK-1, OGK-3, TGK-11, St. Petersburg Supply Co. and the generation assets of Bashkirenergo, while the government has launched the consolidation of FGC and Holding MRSK. On the other hand, the merger of the generation assets of Gazprom and Renova failed.

Our recommendations

In 2012, the overall downward trend on the markets and industry-specific negative factors led to a considerable decline of average daily turnover in most Russian electric utility stocks. Coupled with falling market capitalization and the fact that an entire range of companies halted stock exchange trading for various reasons (being acquired like OGK-1, OGK-3, TGK-11, reorganized like Bashkirenergo and Yenisei TGK, or delisted like a number of supply companies), this led to a significant shrinkage of the utilities universe. This suggests that investors now have fewer opportunities to invest their money in the sector.

Given the factors and the risks described above, we recommend that investors continue to exercise caution when considering investment in Russian electric utilities. We do not expect the sector to outperform the broad market in 2013, but some stocks look fairly protected and promise good returns. We still see material potential in E.ON Russia (EONR, TP of RUB 3,23, 37% upside). Among grid companies, we favor MRSK Center & Volga (MRKP, TP of RUB 0.25, 49% upside) and MRSK Center (MRKC, TP of RUB 0.75, 42% upside).

Another tough year ahead?

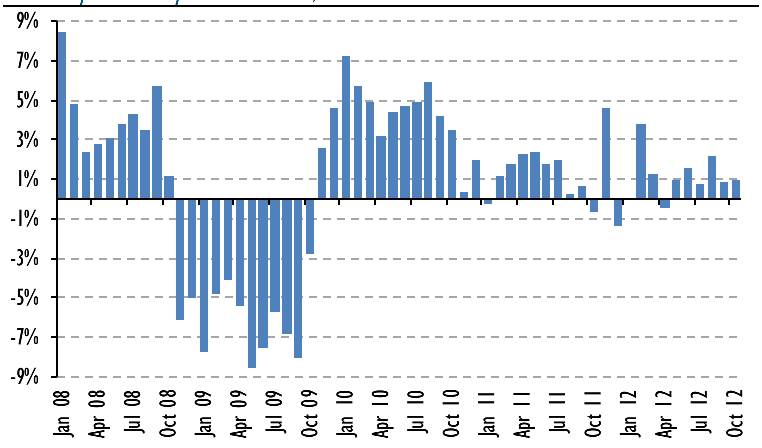
Regulatory tightening not over

The coming year promises to be as tough for electric utilities as 2012 has been. Even though four years have passed since the former monopoly RAO UES of Russia was reorganized, the industry is still experiencing ongoing transformation and the government maintains strong control over the companies. This has coincided with a slowing of demand for power. We do not console ourselves with hope that the extraordinary measures to curb growth in end electricity prices introduced in 2011-12 will be lifted. On the contrary, the fact that electricity bills for industrial consumers have already reached the levels of other countries and undermine the competitiveness of Russian exporters abroad, only supports expectations of further stiff regulatory conditions in the electric utilities sector.

Demand slowing

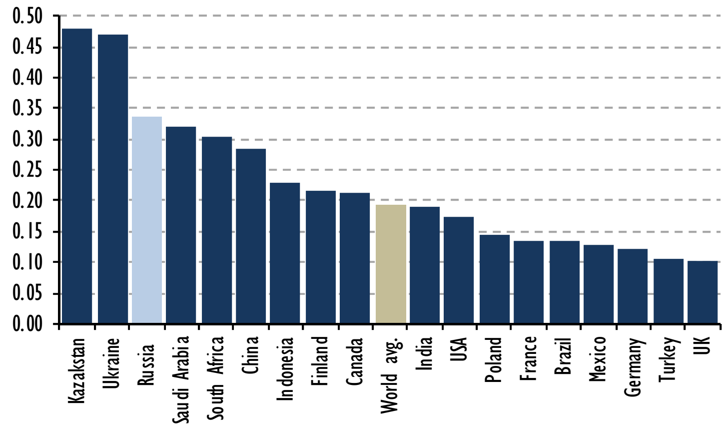
After the period of post-crisis recovery, electricity consumption dynamics in Russia have flattened out, with the average YoY growth rate falling to 1.2% for 10M12 and 1.1% in 2011 from an average of 2.2% over 2000-08. This occurred on the back of slowing industrial production in Russia and large-scale energy efficiency initiatives. The rapid growth of electricity prices is encouraging all types of consumers to save energy or – in the case of industries – to roll out their own sources of power. In the housing sector, implementation of power-saving technologies is being encouraged by special state programs in line with the recently adopted laws on power and heat saving. Large energy-intensive industrial enterprises have started to face risks of low competitiveness as domestic electricity prices for industries approach those in other countries. Nevertheless, given the prospects for further rapid appreciation of electricity, power-saving initiatives will only gain momentum, especially given the high energy intensity of Russia's GDP relative to developed countries and most emerging markets (excluding the CIS).

Electricity demand dynamics in Russia, % YoY



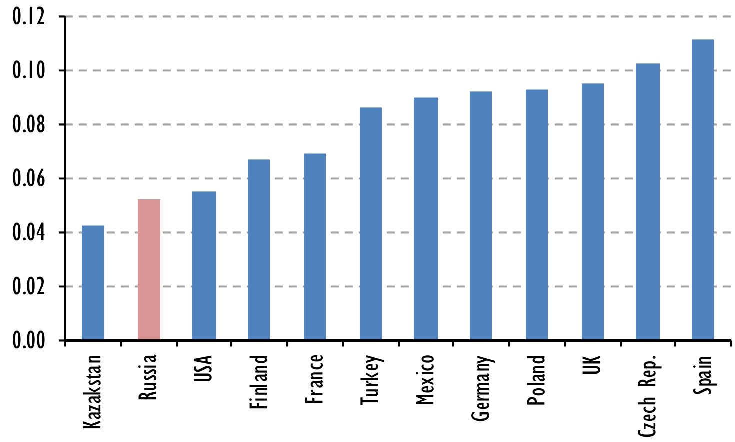
Source: Market Council

Russia lags in terms of GDP energy intensity, koe/$2005p



Source: Enerdata, Global Energy Statistical Yearbook 2011

Electricity prices for industrial consumers in Russia have reached global levels, EUR/kWh



Source: Eurostat, US Energy Information Administration

The official long-term economic projections are based on assumptions of moderate demand growth – by at least 2-3% a year. Given the obvious demand slowdown, these expectations may be overly optimistic and the extensive capex of generation companies is thus questionable.

Electricity demand dynamics are weak

Fortunately, the demand slowdown coincides with the state's pressure on companies aimed at containing electricity prices. The first half of 2012 saw negative dynamics in free electricity indices: in the first pricing zone, the decline amounted to 10.4% YoY, contributing to a 7.9% YoY decline in end power prices. In Siberia, however, the situation was the opposite, with the pricing index adding 20.9% YoY, but this is explained by the fact that Siberia's energy system is dominated by "cheap" hydro power plants, whose load suffered due to negative hydrological conditions. The accompanying rise in output from thermal power plants was the main culprit behind higher prices. End electricity prices in Siberia grew a mere 5.9% YoY.

The price dynamics in 2H12 were affected by gas price indexation. We remind that the tariffs will stay flat until the next adjustment scheduled for the beginning of 2H13.

Gencos may benefit from growing competition on the domestic gas market

The growing competition between Russian oil and gas majors on the domestic gas market gives generation companies a chance to benefit from switching to new suppliers, which offer better terms, including prices below the tariffs set by the Federal Tariff Service (FTS). The most vivid example is Inter RAO, which signed a 25-year contract for gas supply with Rosneft in November 2012, effective from

2016. According to the company, the discount to FTS tariffs will be roughly 10%. Apart from that, Inter RAO will enjoy less strict conditions regarding the take-or-pay rule. The contract envisages annual supplies of up to 35 bcm of gas to power plants of Inter RAO Group.

Although supplies under the contract will start only in 2016, such an agreement marks an important new trend in the electric utilities sector involving generation companies signing long-term contracts (providing more visibility) and independent suppliers being ready to provide discounts to the regulated price.

2013: major events to watch

Reform progress

We believe that investors should not rely on hopes that the regulatory tightening is over. In our view, the tightening cycle was not a one-off event, but rather represents a strategy addressing the issue of high inflation in Russia fueled by tariffs of monopolies – mainly gas and electricity. However, officials are calling for less pronounced government intervention and have set deadlines for resolving the industry's major issues, such as cross subsidization and last-mile agreements. We look forward to seeing some progress in the elimination of cross subsidization and the introduction of new regulatory principles for heat and power supply activities, relaxing the grip on electricity and capacity markets (with cancellation of price caps), etc. But most probably, 2013 will only see gradual progress in these aspects at best.

Capacity commissioning, CPAs

In 2012-13, generation companies will launch as much as 8.8 GW of new capacity under Capacity Provision Agreements (CPAs). The agreements have been designed to guarantee gencos a return on their investment in construction of generation units. So far, regulators have not revised them (as was the case with the RAB regulation in grids), but introduced only minor adjustments. Hence, given the very high competitiveness of new efficient units (mostly CCGTs) as compared to units launched at least 30 years ago, as well as high capacity rates, we expect capacity additions under CPAs to be one of the major factors behind gencos' investment attractiveness.

Inter RAO Group has scheduled the largest launches – 1.2 GW per year in 2012 and 2013, which will increase its current installed capacity by 7.4% (or 10.6% of the domestic capacity). E.ON Russia will add 800 MW at Beryozovskaya SDPP by end 2013, which will mark the end of its CPA program and increase its capacity by 8%.

The largest increases of installed capacity are expected at TGK-5 (+15.2%), which will launch its first units under CPAs by end 2013; and TGK-2 (+14.3%).

Capacity addition schedule under CPAs

Company	Capacity additions in 2012-2013, MW	Installed capacity growth	Total CPA portfolio	To be launched in 2014-2017, MW
Inter RAO Group	2,444	7.4%	5,178	1,466
EON Russia	850	8.2%	4,043	0
Mosenergo	702	5.7%	2,883	870
TGK-1	540	7.9%	1,650	100
TGK-5	375	15.2%	710	335
OGK-2	360	2.0%	4,496	2,916
TGK-2	320	14.3%	630	40
Volga TGK	240	3.8%	600	0
TGK-6	230	6.8%	690	560
Quadra	230	6.5%	1,100	338
TGK-9	165	5.0%	1,409	1,120

Source: Energy Ministry, Gazprombank

Similar to OGKs and TGKs, RusHydro has a mandatory investment program facilitated by certain guarantees regarding payback of invested capital. However, the terms of capacity provision agreements for RusHydro materially differ from those for thermal gencos. In particular, the payback period is set at 25 years as compared to 15 years for OGKs and TGKs, and the allowed return on investment is 10.5% versus 13.0%. Tariffs under the CPAs are to be based on the actual cost of construction. Probably a more important fact is that, contrary to thermal gencos, capacity tariffs for new hydro units under CPAs will be subject to annual adjustments to account for profits from the electricity market. TGKs and OGKs have room for outperformance of regulated rate of return, but RusHydro does not. The adjustment means that RusHydro will not be able to earn extra profits from the two pump-storage plants to be launched under the CPAs – Zagorskaya PSHPP-2 and Zelenchukskaya HPP-PSP.

Given the different regulatory approach toward hydro plants and the total volume of agreements with RusHydro (1.5 GW throughout 2011-2014, or under 5% of the company's total installed capacity), we do not regard CPAs to be as important for RusHydro as for thermal gencos, especially given that CPAs do not fully cover RusHydro's capex program.

RAB reloaded – new guidance

After a series of different steps to contain electricity prices, state regulators announced a reload of RAB implying an overall revision of the previously approved long-term tariffs for grids. The complete change of the rules ruined the brilliant investment story associated with introduction of the world's best tariff-setting practices in utilities and repelled investors from the stocks.

The reload resulted in 21 out of 65 MRSK branches being switched to tariff indexation. For the rest, regulators cut the initial asset base values, changed the rules regarding return on invested capital and introduced a 1-11% range for rates of return on "existing" invested capital instead of the previously unified rates. These measures allowed regulators to limit the tariff growth rates within the new regulatory period to just 10% per year, which complies with the price cap set earlier by the government. This illustrates the fact that the RAB reload was aimed at capping tariffs, which does not satisfy the proclaimed objectives of the guaranteed return regulation.

By November 1, the FTS had finalized the process of tariff revision with 44 of the total 65 branches receiving new long-term tariff plans based on RAB regulation. The rest have been switched to the long-term indexation method even though previously some of those subsidiaries were regulated under RAB (e.g. Tomsk DC, Tyumenenergo and most of the branches of MRSK Siberia). However, given the significant change in RAB regulatory rules and reapproved parameters, we believe the difference between the two tariff-setting approaches has been smoothed.

The reload complicates the RAB-based comparison of companies and makes the traditional EV/RAB multiple unreliable, especially when compared to foreign RAB-regulated peers. We think that investors should rely more on traditional multiples, such as P/E and EV/EBITDA, to value Russian grid companies. However, we estimated fair EV/RAB multiples for grid companies based on the balance between the cost of capital and the expected actual returns for 2012-13. But given the limited relevance, we did not incorporate the express-assessment results in our final valuation, providing them for guidance purposes only.

Privatization

Privatization is cited by the government as one of its priorities. After the big sale involving the former RAO UES of Russia and subsequent reconsolidation by state-controlled companies, 2013 may witness the beginning of another round of privatization, with grid companies probably being the key beneficiaries. The Russian government plans to carry out a wide-scale privatization before 2015 of electric utility companies, including FGC and other gridcos, RusHydro, Inter RAO and TGK-5.

Given the current unfavorable market conditions and the high degree of uncertainty in the electric utilities industry in Russia, this privatization seems unlikely to be held in 2013. We would only expect certain pilot projects in the distribution grids, which should support the stocks of MRSKs. To conduct privatizations, regulators need to settle the major regulatory issues and bottlenecks, such as long-term tariffs and cross-subsidization, thereby restoring investors' trust in the RAB story. We believe that preparations for the privatization of distribution grid companies should be a good catalyst for the sector as the whole in the longer term. However, there is currently no guidance on which companies may be sold to private investors. According to Energy Minister Alexander Novak, the decision on privatization of regional gridcos will be taken within a few months.

A peculiar issue in this regard is the role of Rosneftegaz, which has been entitled the right to act as the investor in electric utilities to be privatized before 2015. Rosneftegaz has proposed a plan to create a national grid giant on the base of FGC and Holding MRSK and to recapitalize RusHydro and Inter RAO. These plans do not look like privatization, given the fact that Rosneftegaz is 100% state-controlled. However, currently there is no consensus among officials regarding its role.

There is another issue why the prospects for privatization of major utility companies – FGC, RusHydro and Inter RAO – do not look as bright. In particular, one of the cornerstones is the high price benchmarks. The par value of FGC shares is RUB 0.5, or 2.5 times the market price. The price for the latest additional share placement by RusHydro was RUB 1.65, or 2.3 times the market level, while the same gauge for Inter RAO (RUB 0.0535) was 2.2 times the market. These benchmarks should be viewed as the lowest price for possible privatization; otherwise the government would sell the assets cheaper than it had bought them (through the additional share issues).

Dividends

In November 2012, the Russian government approved a resolution requiring companies with state participation to pay out at least 25% of net income as dividends. This initiative looks very beneficial for shareholders of state-owned utilities, such as FGC, RusHydro, Inter RAO and Holding MRSK with its subsidiaries, as these companies lack a track record of high dividend yields. However, the resolution does not directly state the basis for net income calculation – RAS or IFRS. This makes a great difference in the case of the state-owned utilities, especially Holding MRSK and Inter RAO. Moreover, the resolution provides for possible exclusions from the 25% rule, which can be granted through a specific government order. We believe this might be the case for certain utilities, especially Holding MRSK. To our mind, paying high dividends does not make much sense for a company that still relies heavily on direct capital injections from the federal budget to finance its huge capex needs.

Expected dividend yields of state-owned utilities based on the 25% rule

	2012E net income RAS	2012E net income IFRS	Expected DPS, RAS	Expected DPS, IFRS	Expected dividend yield, RAS*
RusHydro	0.019	2.6%	0.008	0.019	2.6%
Inter RAO	0.0004	1.4%	none	0.0004	1.4%
Federal Grid	0.003	1.7%	none	0.003	1.7%
Holding MRSK, ords	0.078	3.9%	none	0.078	3.9%
Holding MRSK, prefs	0.078	6.1%	0.070	0.078	6.1%

*based on expected dividends for 2012 and current share prices
Source: Gazprombank estimates

Overall, we believe that the 25% rule would not suddenly turn state-controlled utilities into bright dividend stories, but we would still expect positive dynamics in dividend yields, which should be welcomed by the markets. The situation may only change once the companies are past the period of high capital investment, which is not going to happen over the next few years. Some private utilities may deliver better dividend yields, we believe. In particular, we forecast the DPS of E.ON at RUB 0.1 in 2013, corresponding to a 4.1% yield based on the stock's current market price.

SPOs

Another reason for concern stems from the fact that the government still prefers to supply state-controlled utilities with funds to finance their capex not via tariffs, but through direct equity injections. A number of grid companies, including Holding MRSK and RusHydro, have scheduled large additional share placements to absorb cash from the federal budget. But this is not only an issue for state-owned companies – some private gencos have the same plans – for example OGK-2 controlled by Gazprom.

The large additional share placements not only carry dilution risks for minority shareholders, but may also create a price ceiling for the stocks, limiting their growth potential. This is the case with OGK-2, Holding MRSK and RusHydro. In 2013, we expect to see a number of other SPOs by companies aimed at raising cash to fulfill their investment obligations. In particular, Lenenergo, Kubanenergo and MRSK North Caucasus have already scheduled additional share placements. In this regard, the most successful companies generating sufficient cash flow to finance capex, such as E.ON Russia and Enel OGK-5, look more protected.

Russian generating companies valuation

Company	Ticker	Last price, RUB	YTD, %	Mcap. USD mln	P/E-12	P/E-13	EV/EBITDA-12	EV/EBITDA-13	EV/IC, $/kW
Generating companies									
OGK-2	OGKB	0.3530	674	7.2	6.5	5.1	4.5	96	0.3530
E.ON Russia	EONR	2.3600	4,791	8.0	7.7	4.7	4.7	495	2.3600
Enel OGK-5	OGKE	1.6700	1,902	7.8	7.2	5.2	4.9	314	1.6700
TGK-1	TGKA	0.0055	681	4.3	3.2	3.7	3.0	271	0.0055
TGK-2	TGKB	0.0022	105	neg.	neg.	6.8	7.3	295	0.0022
Mosenergo	MSNG	1.2905	1,652	6.2	5.7	1.7	1.8	113	1.2905
Quadra	TGKD	0.0039	249	2.6	2.9	2.2	2.3	144	0.0039
TGK-5	TGKE	0.0035	139	neg.	neg.	12.0	12.2	258	0.0035
TGK-6	TGKF	0.0150	897	neg.	neg.	20.5	28.2	362	0.0150
Volga TGK	VTGK	1.6293	1,574	9.3	6.0	5.0	3.8	259	1.6293
TGK-9	TGKI	0.0031	775	neg.	neg.	12.0	10.0	506	0.0031
Kuzbassenergo	KZBE	0.0150	247	15.4	12.2	4.4	3.7	217	0.0150
TGK-14	TGKN	0.0014	59	3.2	3.0	3.7	3.7	285	0.0014
Integrated utilities									
Inter RAO	IRAO	0.026	8,574	17.5	12.4	8.4	5.8	305	0.026
RusHydro	HYDR	0.736	7,012	8.0	6.4	5.1	4.2	494	0.736
Irkutskenergo	IRGZ	0.238	329	n/a	n/a	n/a	n/a	219	0.238
RAO ES of East	VRAO	16.085	2,469	6.2	n/a	3.6	n/a	224	16.085

Source: Reuters, Bloomberg, Gazprombank estimates

Russian electricity distribution and transmission companies valuation

Company	Ticker	Last price, RUB	YTD, %	Mcap. USD mln	EV/RAB-12	P/E-12	P/E-13
Federal Grid	FEES	0.2085	8,461	0.53	15.1	12.0	0.2085
Holding MRSK	MRKH	2.007	3,178	0.42	5.3	4.1	2.007
MOESK	MSRS	1.3778	2,161	0.54	5.0	4.7	1.3778
Lenenergo	LSNG	6.898	304	0.61	6.7	18.9	6.898
MRSK Center	MRKC	0.529	719	0.49	7.6	6.5	0.529
MRSK Center Volga	MRKP	0.1678	608	0.37	8.6	4.7	0.1678
MRSK North-West	MRKZ	0.0657	202	0.49	11.4	32.2	0.0657
MRSK Urals	MRKU	0.19	549	0.47	10.6	8.1	0.19
MRSK Siberia	MRKS	0.0833	256	n/a	neg.	31.7	0.0833
MRSK Volga	MRKV	0.4364	415	0.32	7.1	7.6	0.4364
MRSK South	MRKA	0.051	82	0.74	15.8	3.7	0.051
MRSK North Caucasus	MRKK	26.56	48	0.15	8.2	3.1	26.56
Kubanenergo	KUBE	148	464	0.90	neg.	neg.	148
Tomsk Distr. Co	TORS	0.4914	66	n/a	20.4	14.4	0.4914

Source: Reuters, Bloomberg, Gazprombank estimates

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Paradigm shift

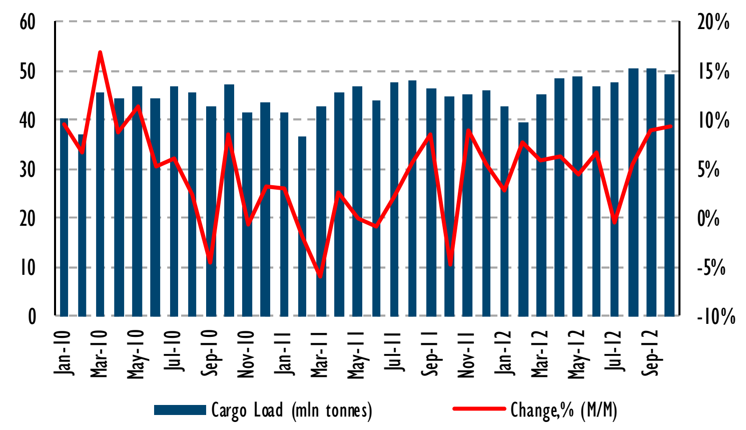
2012: a retrospective look

2012 turned out to be another successful year for domestic transportation industry with stevedores and rail operators securing solid increase in terms of volume while domestic air carriers demonstrating another double-digit growth for three years in a row now.

Stevedores

According to latest data available cargo turnover in Russian ports grew by 5.7% in January-October supported mostly by growing export of coal and ferrous metals, robust increase of container traffic and, finally, withdrawal of grain export ban. Given the modest 3.1% increase in oil and oil product transshipment, which comprises more than a half of total cargoes handled by stevedores, we view sector performance as quite strong.

Cargo loading volume at Russian ports, mln tonnes

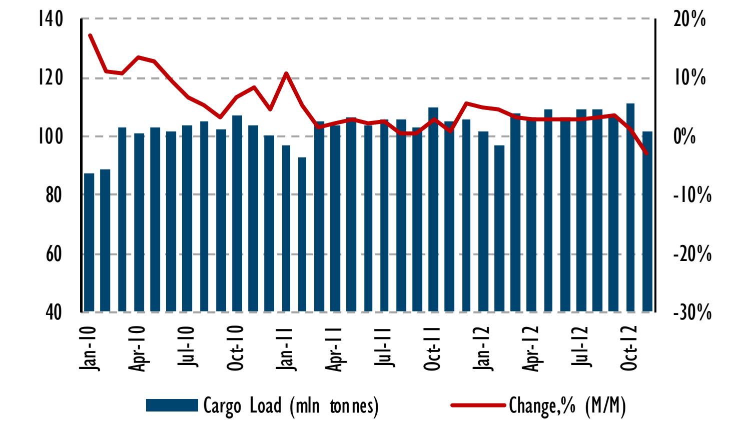


Source: ASOP

Rail

In the first ten months of 2012 cargo loading volume on Russian Railway's network grew by 3.2% in comparison with the last year's period – the slowest increase in volumes catered by domestic rail operators since the 2008/09 economic downturn. We believe that quite modest performance of rail transportation industry is explained by the infrastructure constraints that domestic rail operators are currently facing. Industry liberalization process started with the privatization of railcar market led to emergence of almost two thousands private railcar operators and to unproportional burden to the railway infrastructure. As such, we believe, the railway infrastructure currently operates close to full capacity, which limits the development rail transportation industry.

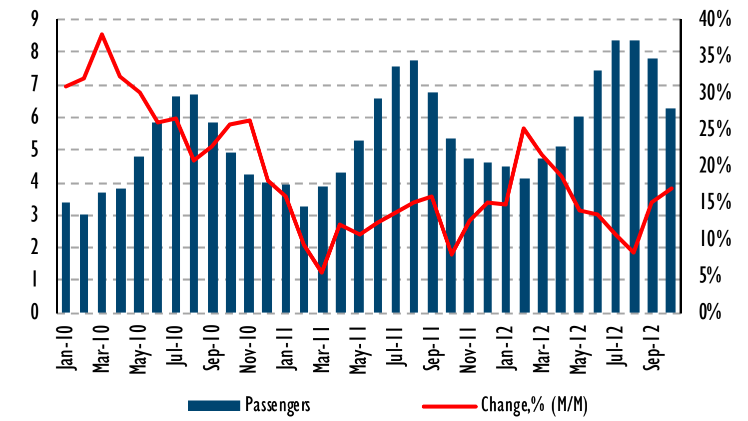
Cargo loading volume on Russian Railway's network, mln tonnes



Air

Air transportation industry continued to demonstrate remarkable performance with 17.4% increase in air traffic and 15.5% increase in passengers carries during January-October period pointing to another strong year for domestic air carriers. The increase in personal income, low saturation of air services across the country, absence of alternative means of transportation among selected regions and state subsidies to Far East destinations supported double-digit growth in demand for air transportation since the 2008/09 economic downturn.

Air traffic, mln pkm



Source: FAVT

The market didn't appreciate solid operating performance and improved financials of major domestic stevedores and air transportation companies which resulted in poor share price performance for the latter. Aeroflot's shares slid by 16% since the start of the year, NCSP stocks dropped almost by 10% YTD and Globalports shares are trading just under the last year closing price.

Contrary to air carriers and stevedores domestic rail operators were among top performance among domestic public names. Transcontainer, the largest rail container operator in Russia, demonstrated remarkable 73% YTD share price appreciation. Another leading private rail operator Globaltrans secured almost 22% increase since the start of the year. To remind: Globaltrans shares demonstrated almost 60% increase from the start of the year to the mid-September just before the second public placement that was negatively assessed by investment community. The company shares dropped almost 30% since in just over two months since the placement.

2013 Outlook

We expect that next year market focus to be shifted from rail to stevedores and to lesser extend to air transportation sector:

1) We forecast continuing slowdown in railway cargo volumes growth next year due to the weakening metallurgical cargo segment (constitutes approximately 40% of Globaltrans' transfers).

2) Intensifying competition in the sector as large financial holdings are entering the market through M&A. AFK Sistema paid almost twice Globaltrans' multiple for SG-Trans (an operator of chemicals and gas tanks) and bids for other targets most aggressively (25% state stake in Freight One), limiting acquisition opportunities for the more price-sensitive Globaltrans. Neftetmasservice recently acquired transportation subsidiary of Evraz. Summa is at the final stage of sealing the deal to acquire FESCO. Once the M&A stage in the industry is completed, the competition will move from the M&A space to competition for clients.

3) Liberalization of tariffs for Russian stevedores, which has been recently approved, is expected to increase stevedores' margins further. After the successful pilot-project with tariff liberalization at Big Port of Saint-Petersburg

the decision on liberalization of tariffs in other Russian ports has been taken in October 2012. Next year stevedoring operators will be able to set market tariffs for their services (but Federal Antimonopoly Service will continue to monitor the dynamics of the tariffs).

4) We forecast robust increase in dark oil products exports through Russian ports as they are expected to draw extra cargo volumes off from FSU ports, which are currently accounting for over 20% of Russian dark oil products handling.

5) As for domestic airlines, we see strong market backdrop for the industry to continue with double-digit growth in traffic and volumes at least in the medium-term. At the same time industry consolidation process is imminent. Over the last two year there were no new airlines entering the market while many small airlines (including two domestic discounters Skyexpress and Avianova) lost their operating licenses. Diminishing competition should improve pricing power for the remaining air carriers.

Top pick: NCSP

Why invest?

Since the announcement of the shareholder change back in September 2010, NCSP has underperformed the market delivering over a 40% loss to its shareholders while RTS index demonstrated a slight gain. With recently announced long-term development strategy and completed rotation of top-management team we believe the company now has clear view how to deliver sustainable growth and margin enhancement while renewed focus on investor relations and corporate governance should help to unlock the fundamental value of currently depressed stock.

We believe the market ignores NCPS's strong drivers. The company is a diversified stevedore with the core assets in major country's export gates: Novorossiysk, Primorsk and Baltiysk. NCSP controls almost 30% share of total Russian cargo turnover and transshipped 47% of Russian oil exports last year. The liberalization of stevedors' tariffs scheduled to take place next year should provide for significant flexibility of company's tariffs and improves margins. New iron ore capacities will allow competing with Ukrainian ports, and further expansion in the container segment will provide new growth opportunities while upcoming privatization of the government stake will decrease the uncertainty concerning the ownership structure.

NCSP's current valuation looks unfairly cheap compared to foreign peers. NCSP is currently valued at around 6.2 EV/EBITDA 2013 vs. 8.0 for EM peers and 9.7 for DM peers. This discount looks unjust to us as most company specific risk already priced in. In our view, the market overestimates the risks of excess oil capacities in Russia and uncertainties with NCSP's ownership structure.

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Focus on phosphates

2012 Retrospective

The global fertilizer market remained on a roller coaster-ride throughout 2012 with hardly any segments (nitrogen, phosphate and potash) experiencing stability in terms of volumes or prices.

Potash

We believe the potash market exhibited the highest volatility in terms of volumes. After the record growth and strong price levels throughout 2011, the potash industry witnessed a certain slowdown by the end of last year and at the start of 2012 following concern about a possible decline across agricultural commodities and deterioration in macroeconomic conditions as well accumulation of high inventories by some consuming regions. Potash demand started to recover only by the end of first quarter boosted by the start of the spring sowing season and the March contract settlement with China. Clarity regarding China established a price benchmark for the global spot potash market and encouraged buyers in other regions to step into the market more actively.

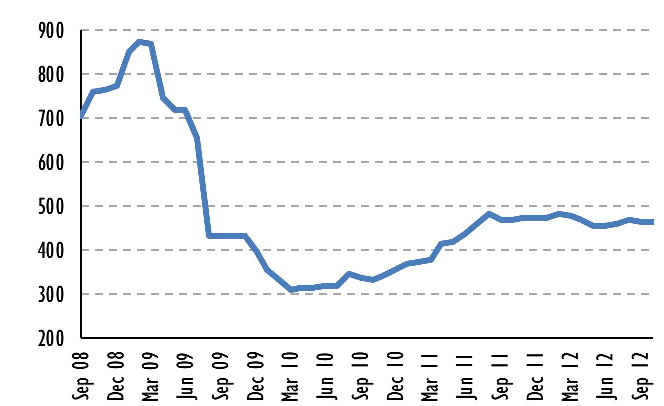
By mid-summer, almost all global consuming regions recovered to corresponding levels observed a year ago, as farmers increased fertilizer application in view of higher crop yields. However, market conditions started deteriorating again in 2H12 despite healthy crop yields and near-record high soft commodity prices. Limited market visibility due to the prevailing global macroeconomic uncertainty put additional pressure on buyers' sentiment in major consuming markets and kept inventories lean across much of the fertilizer supply chain.

The decline in MOP (mariate of potash) international sales observed in 3Q12 as well as uncertainties from ongoing negotiations for next-year deliveries with two leading global consumers (India and China) drove MOP (FOB Baltic Sea) contract prices to $464/tonne by end 3Q12 from $479/tonne at the start of the year.

In order to match declining demand, two leading global potash producers, PotashCorp and Uralkali, stepped out to readjust their production. In August, PotashCorp announced a month-long shutdown at its key producing assets Lanigan and Rocanville facilities, while Uralkali decreased its 4Q12 production guidance by 700 kt, thus lowering its 2012 forecast from 10.0 to 9.3 mln tonnes.

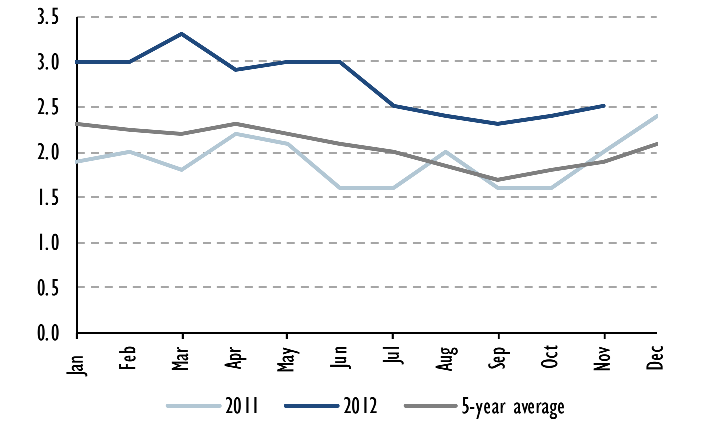
The global demand guidance was also reduced to reflect the weakening market environment in 2H12. If both global majors forecasted global shipments for 2012 in a range of 57-58 mln tonnes at the start of the year, the demand target has been reduced to 49-52 mln tonnes on uncertainties over long-term contracts with China and India.

MOP price performance ($/tonne)



Source: Fertecon, Ycharts

North American producers potash ending inventory (mln tonnes)



Source: TFI, PCS

Indian demand has been badly damaged by the revised subsidy system and consumers have been extremely slow in offtaking volumes under the 2011 contract. The latest Indian contract was extended several times throughout 2012 and now it is clear that shipments under the contracts could last until year end. Thus, the new contract is unlikely to be signed before the last one is fully excised.

The Chinese contract also expired in the wake of 2012, but buyers were in no hurry to sign up for new shipments given reasonable inventories, growing domestic production and deliveries via rail from Belarus. It is rumored that China and India are demanding a $70/tonne reduction from last year's contract prices ($470/tonne for China and $490/tonne for India), while Canpotex and BPC are holding out for the status quo.

Uncertainty over the long-term contract with major consumers also pushed down spot prices below their benchmark levels. Current spot prices are stuck 15-20% below the benchmarks and there are rumors that some producers have been selling batches even below these levels.

Undoubtedly, the potash story will remain centered on supply contract issues and production curtailments, and thus new term contracts with India and China should become major drivers for the whole industry, as they will establish a clear price benchmark for the spot markets, allow buyers to step out from the hand-to-mouth pattern and fill up inventories across the supply-demand chain. Nonetheless, in the best scenario, agreements could be reached no earlier than the start of 2013.

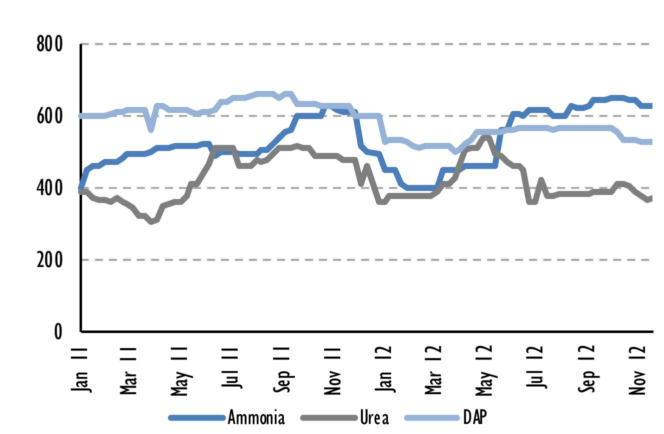
Phosphate

The global phosphate market exhibited the opposite trend, with softening demand at the start of the year and improving global consumption since the end of 1Q12. DAP (diammonium phosphate) prices touched their 2012 lows of $495/tonne (FOB, Tampa) in March 2012 and then bounced back to this year`s maximum of $580/tonne in mid-summer on resumed DAP imports from India in 2Q12 and growing demand from South America in 3Q12.

India imports all of its potash and buys about 90% of its phosphate from abroad. Indian fertilizer makers have substantially raised prices for DAP to record highs from April as global prices jumped, while the Indian rupee fell severely against the dollar. Also, the government slashed subsidies for DAP by 27.4% for the current financial year. As a result, Indian buyers turned their heads to more price-competitive import products.

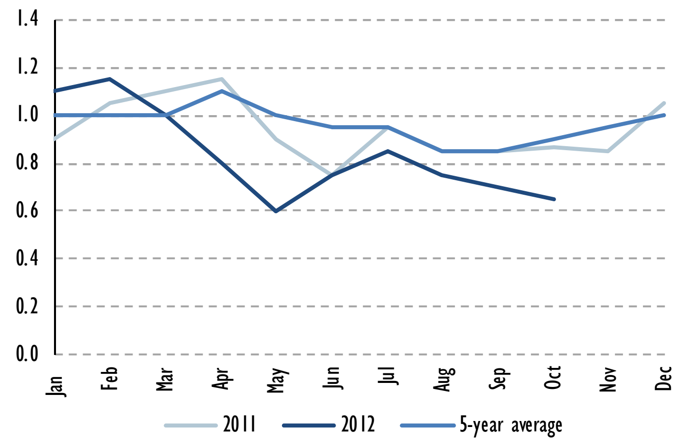
While the delayed Monsoon slightly held back demand from India in 3Q12, healthy demand for MAP/DAP products from South America (thanks to strong soybean pricing and expanding acreage under cultivation) pushed DAP prices from $559/tonne in 2Q12 to $567/tonne in 3Q12.

Fertilizer price performance ($/tonne)



Source: Bloomberg, Green market

US producers DAP/MAP ending inventory (mln tonnes)



Source: TFI, PCS

Ma'aden's capacity utilization rate remains close to 60% according to Fertecon weekly phosphate reports. With these volumes Ma`aden is fully committed until February 2013. The decrease in Indian demand is already counterbalanced by reduction in supply of phosphate-based fertilizers from China (-40% YoY in 9M12) as a result of a restrictive export tariff policy by the Chinese government. With no significant capacity additions expected to come on stream in the near term, we believe the global phosphate market has currently found its balance in terms of volumes and prices.

Nitrogen

Global nitrogen demand remained broadly stable in terms of volumes during 2012, while underlying fertilizers prices exhibited high volatility.

The combination of unusually mild weather and lean inventories across the supply chain provided much-welcomed support to nitrogen prices during 1Q12. The early start to the North American season carried prices throughout 2Q12 with demand outpacing supply due to capacity constraints and startup delays, thus keeping the nitrogen market balance tight. Prices responded accordingly, with prilled urea (FOB Yuzhny) rebounding from its December lows of $320/tonne to $391/tonne in 1Q12, skyrocketing further to an average of $473/tonne in 2Q12 and reaching its 2012 high of $530/tonne in May. However, priller urea prices averaged $382/tonne in 3Q12, mostly due to the opening of the Chinese export window, which applied steady pressure on pricing.

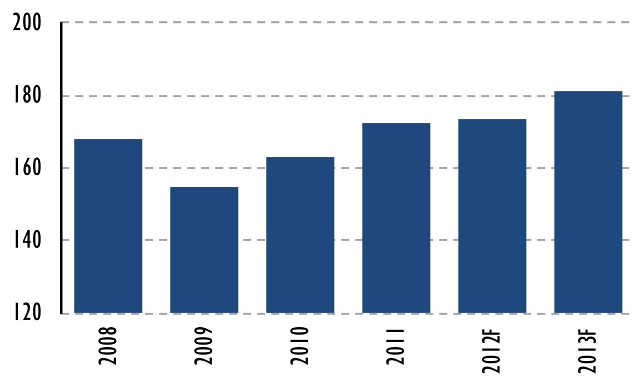
Ammonium nitrate prices mainly matched the dynamics of urea prices throughout 2012, while the ammonia price trend exhibited a transverse dynamic (especially in 3Q12), which is very rare for the industry. Prices for ammonia in the third quarter showed a significant increase due to growing demand and limited supply. In particular, the ammonia market has been supported by gas restrictions in Trinidad as well as less net ammonia available from new projects than expected. During 3Q12, the ammonia price level rose by $50/tonne, reaching $650/tonne (FOB, Yuzhny) by end September.

Nitrogen prices have been relatively stable and largely balanced in recent months, as recent strong demand from India and the US has offset new capacity in Qatar and higher Chinese export supplies during the low export tax window this year. We believe the fundamentals for nitrogen demand moving into 2013 should remain positive.

2013 outlook

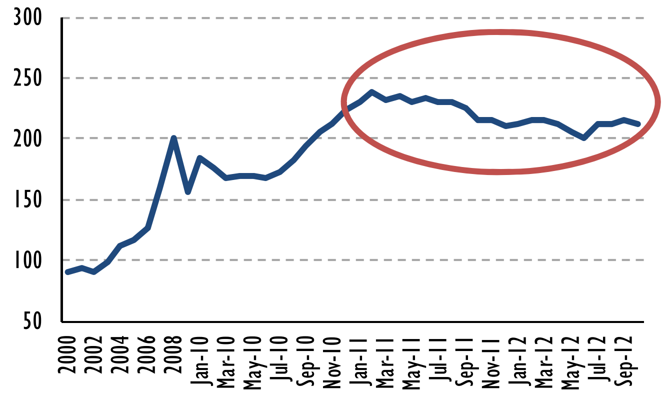
After a severe decline during the 2008-09 economic crisis, global fertilizer consumption rebounded sharply in 2010 and 2011, with growth rates of 5% and 6%, respectively. In 2011, global fertilizer consumption reached 172.2 mln tonnes (in nutrients), outpacing the 167.9 mln tonnes consumed in 2008.

Global fertilizer consumption (mln tonnes)



Source: IFA, GPB

FAO food price index



Source: FAO

The IFA expects global demand to reach 177.0 mln tonnes in 2012 (Fertilizer outlook 2012-2016, IFA, May 2013) and 181.4 mln tonnes in 2013, which represents growth rates of 2.8% and 2.5%, respectively. Given the severe decline in fertilizer imports this year from India, which remains the world's second-largest consumer and largest importer of total fertilizer consumption, we believe the IFA's outlook for 2012 is modestly optimistic. We would expect global consumption to reach 173.5 mln tonnes in 2012, which represents less than a 1% increase over 2011.

Throughout 2012 we experienced an interesting dichotomy, when crop nutrient prices diverged from the crop price trend despite certain shutdowns and delays in new projects, which definitely pressured the supply side. Major crops were hovering close to their historic highs since the start of the year, but farmers walked off from increasing fertilizer application, keeping fertilizer inventories at very low levels (hand-to-mouth buying pattern).

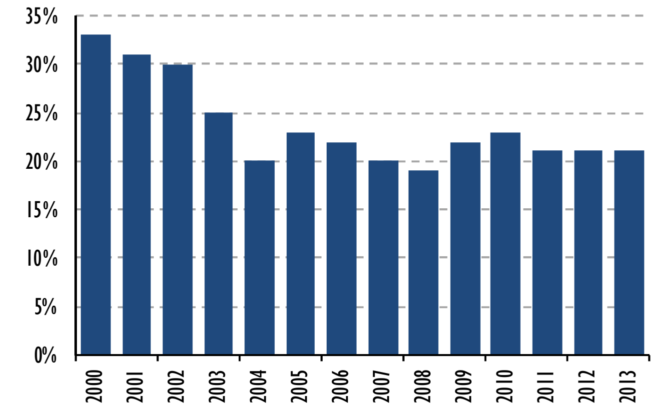
Cautious buyers' sentiment prevailed throughout the year on fears of a global economic slowdown and the possibility that the high crop price trend would not last long. The hand-to-mouth buying pattern prevailed in 2012 and we see it rolling over into 1Q13 despite strong economic incentives for farmers to increase crop production and yields by applying more fertilizers.

At the same time, we argue that the "crops-fertilizers dichotomy" will not last long, and envisage robust growth in fertilizer demand and prices at least in 2Q13 due to several factors:

1) Farmers are not experiencing liquidity constraints as in 2008-09, and therefore remain able to invest in increasing crop output.
2) Soft commodity stocks-to-use ratios remain at very low levels compared to historic averages, while at the same time major crops (corn and soybean) have already surpassed their previous historical peaks in 2008.
3) Grain production problems affected by this year's drought in the world's most important growing regions are expected to result in global grain ending stocks being drawn down to their lowest levels since 2007-08.

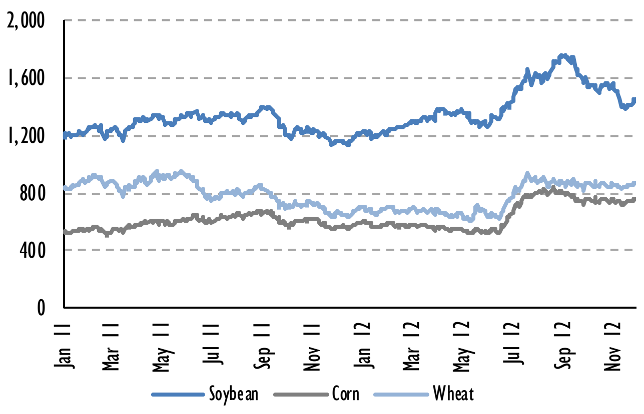
Current crop nutrient prices are very attractive relative to corresponding crop prices and farmers' budgets. A combination of reduced seed supply, high crop prices and improved genetic offerings should further support higher seed demand. Without question, global macroeconomic uncertainty will remain a consideration, but increasing demand combined with reduced pipeline inventories should support producer shipments and drive nutrient prices up.

Global cereal srock-to-use ratio



Source: IFA

Soft commodity price performance ($/5,000 bushels)



Source: Bloomberg

Our 2013 crop nutrient forecast corresponds with IFA projections at 181 mln tonnes, which would represent all-time record high fertilizer consumption globally. At the same time, we believe the performance of different segments will vary.

We see the strongest market backdrop for phosphate fertilizers. The IFA expects phosphoric acid and phosphate fertilizer capacity to expand 20% by 2015, but global phosphate demand is projected to grow at a similar pace, thus fully absorbing the projected incremental supply.

This year's drought in the world's most important growing regions will definitely promote larger phosphate-based fertilizer application next year, as phosphate plays a key role in adequate root development and the photosynthesis process while helping plants to resist drought.

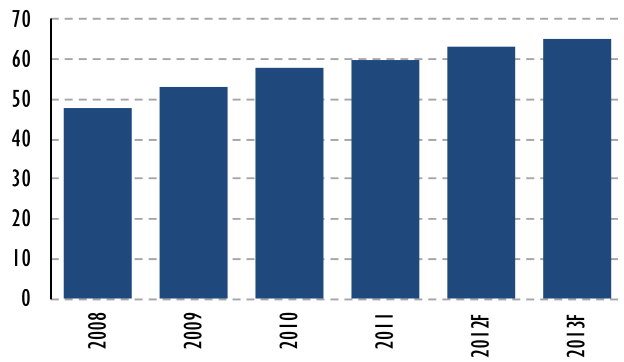
Some governments were also trying to promote balanced nutrient application for sustained agricultural growth. For instance, the Indian government did not implement the Nutrient Based Subsidy (NBS is the latest subsidy formula that gives a subsidy on fertilizers not according to products, but nutrients in the fertilizers) for urea, but NBS for P and K has already been in force since 2010. Thus, we witnessed strong demand for NPK throughout 2012 and a revival of demand for DAP in 2Q12 from India. Given the changing global application habits involving substitution of straight nitrogen fertilizers (urea, ammonium nitrate) for complex fertilizers, we would project robust global demand for NPK and a modest increase in DAP demand next year.

As such, we forecast the DAP price to average $530-550/tonne next year, while the NPK price should average $480-500/tonne.

Global nitrogen capacity is projected to expand 17-25% compared with 2011 according to the IFA, leading to potential surpluses by 2015. Nonetheless, we see next year's straight nitrogen fertilizers prices at levels achieved in 4Q12 ($420-440 for urea, $320-330 for ammonium nitrate), as nitrogen demand is far less volatile than demand for other nutrients due to the need to apply nitrogen fertilizers on a regular basis without affecting crop yields. Nitrogen promotes protein formation and determines a plant's growth, vigor and color, and thus its timely and regular application is crucial for crop yields.

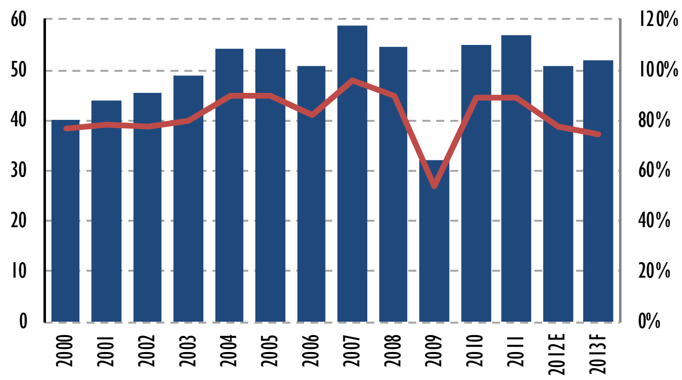
Potash applications could be skipped in one year without significantly affecting next year's yields. Potash improves a plant's durability and resistance to disease, weeds, parasites and cold weather. Thus, P is crucial over the long term.

Global phosphate (DAP, MAP, TSP) shipments, mln tonnes



Source: Fertecon, Mosaic

Global potash sales (mln tonnes), utilization rate



Source: Fertecon, Uralkali, PCS

According to the IFA, world potash capacity may increase 42%, while demand should only expand by 14% by 2015. Although most potash greenfield projects suffer from delays, slowing down the emergence of massive surpluses in the short to medium term, most global potash majors are already operating below an 80% utilization level, meaning that next year's potash story will remain centered on supply contract issues and the ability of global majors to maintain a "price-over-volume" policy.

New term contracts with India and China will also be crucial for the industry, as they provide a price benchmark for the spot market and better visibility for the demand-supply balance, filling up inventories across the supply chain. Nonetheless, the current situation in the potash market remains gloomy:

1) North American producers' ending inventory level remains modestly above the historic average;

2) Spot prices are stuck 15-20% below the benchmarks and there are rumors that some producers have been selling batches below even these levels.

We believe the best-case scenario for global majors would be to reach agreements with China and India on previous contract terms (or even at a slight discount). As such, we forecast next year's potash prices to stay at levels achieved in 2012.

Top pick: Phosagro

Why invest?

Phosagro is positioned at the lower end of the phosphate rock and finished fertilizer (DAP, MAP, NPK) global production cost curve. The group can produce diammonium phosphate (DAP) at roughly a 25% lower cost than Brazil and 60% less than India (both regions being the key global consumers) thanks to its high-quality rock supplies, favorable logistics and efficient production cycle. As a result, the company enjoys above-average mid-cycle margins.

The excess supply of phosphate rock concentrate provides Phosagro with such important benefits as a diversified product mix and sales flexibility. The group can either use the maximum possible amount of phosphate rock to produce fertilizers, when prices of fertilizers are high relative to phosphate rock prices, or sell more phosphate rock externally and accordingly reduce the amount of fertilizers produced by the group when fertilizer prices are low relative to phosphate rock prices.

Flexible production lines allow the company to easily switch between MAP/DAP and NPK to promptly react to the evolving market environment and demand conditions. The company is able to change its product mix virtually in 1-2 days depending on demand and pricing conditions. The company greatly benefited from stable demand for DAP during the 2008-09 downturn (supported by growing purchases from India), while demand for other types of fertilizers plunged sharply. The situation turned upside down in 2012 as global demand drifted from DAP to NPK fertilizers. The company promptly readjusted its production facilities at end 2011 to enjoy stable global demand for NPK.

We see the strongest driver for the company next year in upcoming liberalization of the domestic apatite concentrate market. Currently, changes in the domestic price for phosphate rock are directly regulated by the Federal Antimonopoly Service (FAS). Certain price caps are usually announced twice a year to keep fertilizer inflation under control during the sowing season. As a result of direct regulation, the domestic realization price of apatite concentrate is more than half the level of the export netback. Following successful deregulation of the domestic potash market, the Russian government is aiming for apatite market liberalization starting next year. We estimate that deregulation of the domestic apatite concentrate market could bring Phosagro more than $150 mln in EBITDA and sales as soon as next year.

Also in focus: Acron

Why invest?

Given the pace of new greenfield projects that Acron is currently developing, we see the company turning into one of the few truly vertically integrated fertilizer producers already in 2016 with the launch of the Talitsky potash project. The company recently attracted state-run VEB and other big-name banks to the Talitsky project's equity and debt financing, which should jump-start the project's realization.

In 2012, the company managed to launch the Oleniy Ruchei apatite project and started to produce apatite concentrate for its own needs. Next year, Oleniy Ruchei's production will cover Acron's own needs, while the company should start exporting the excess apatite concentrate production in 2014.

The company's attractiveness is also supported by deep discounts on relative valuation metrics to major foreign peers.

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