RUSSIA'S DEVELOPMENT PATH

MAIN PRINCIPLES HAVE BEEN IDENTIFIED, BUT PROGRESS IS SLOW

Drifting or planning? One of the criticisms levied at Russia is that it remains far too dependent on and, therefore, vulnerable to earnings from commodities. Critics say the government has either been far too complacent about the need to reform the economy or has been regularly distracted from efforts to do so. This view has and continues to affect how both portfolio and strategic investors view Russia's risk and opportunity, and it is one of the main reasons why foreign investment flows have remained at a low level.

Russia is regularly criticized as a petro-state not having a realistic long-term development plan

Following the experiences of other countries. But the evidence is that, even from the early days of Vladimir Putin's presidency, there existed at least a broad outline of a long-term development plan (see below for description) to transform the economy from its dependency on natural resources to one with a better range of drivers, where the risk of the sort of boom-to-bust cycle experienced recently is substantially reduced. In critical areas, the development plan for Russia differs very little from those of other nations, which have successfully transformed their economies. Examples such as Chile and Malaysia come to mind. In each case, it also took about twenty to twenty-five years to end up with a restructured economy.

Investors remain sceptical. For investors, the slow progress and frequent distractions of the past nine years has naturally instilled a sense of caution, if not scepticism, that any plan beyond day-to-day crisis management really exists. A common view is that Russia is nothing more than a boom-to-bust-to boom economy, depending on where oil trades. This view holds that the lack of qualified officials in the civil service and the near-ingrained level of corruption coupled with weak institutions, make anything else unrealistic. For those prepared to look beyond the headlines and to leave the baggage of the Soviet-era aside, there is ample evidence to support the view that Russia is following a slow but determined path to economic, and social, diversity.

Many investors view Russia as not much more than a boom-to-bust commodities economy

Moving ahead to the next phase. The Medvedev presidency represents a significant change to this development plan. The long, and often frustrating, preparation phase of the previous eight years is over. There are clearer investment guidelines; however, after events such as Sakhalin-2, it will take time and several successful foreign-domestic partnerships in the strategic sectors to prove this. The economic crisis that began very early on in Medvedev's presidency has inevitably led to a delay in moving ahead with some of the initiatives that were outlined in the president's campaign. But, barring a major political upheaval or a dramatic collapse of the global economy, this program still remains the blue print for the next phase of development over the next five to ten years.

However, the plan's spending phase opens up some very clear investment opportunities

Long-term investment opportunities exist. In the coming years, the main investment opportunities for both strategic and portfolio investors will exist in industries receiving direct state support, both financial and regulatory, as well as in industries representing the move towards the diversification of Russia's economy.

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September 2009

RUSSIA'S DEVELOPMENT PATH

Decade of Change

Russia Vital Statistics

	1999	2007	2010E*
GDP, $ bln	196	1,289	1,576
GDP Growth, % YoY	6.4	8.1	4.2
Federal Budget Surplus, % of GDP	(1.1)	5.4	0.0
Oil/Gas Export earnings, $ bln	40	250	250
Trade Balance, $ bln	36	154	66
Current A/C, $ bln	26	77	35
Foreign Reserves, $ bln	13	476	452
Stabilisation Fund, $ bln	0	160	**
Foreign Debt, $ bln	144	49	61
Year-end RUB/$ rate	27.0	24.6	33.3
Inflation, % YoY	36.5	11.9	9.8
Average monthly income, $	51	554	**
Real disposable income, %	(12.4)	13.0	**
Unemployment rate, %	9.6	6.0	**
Retail sales growth, % YoY	(5.8)	15.2	6.6
Population, mln	145.9	142.0	140.2
GDP per capita, $	1,343	9,077	11,241

Source: State agencies

** URALSIB estimates*

*** the latest numbers for end July '09 are:*

stabilisation fund $190 bln

average monthly income is $590

real disposable income declined 5.4% YoY

unemployment rate is 8.3%

retail sales declined 8.2% YoY

Russia in 2009 is a different world compared to Russia in 1999

IMPORTANT DECISIONS

One step at a time. Vladimir Putin always made it clear that he did not support any major new initiatives to push reforms or big new spending programs until the problems inherited from the previous era were "fixed". This was partly because of fear over a loss of state control over such initiatives, but also because of a pragmatic recognition that the country's civil service and institutions are ill equipped to carry out too many tasks simultaneously. It will take a generation change for that condition to improve. That is why Putin's presidency spent so long in what can best be described as the "preparation" phase before handing over to an "investment" phase under Dmitry Medvedev's presidency.

The next phase of the development plan was not well supported by fiscal and budgetary decisions in 2008 …

Fiscal and budget decisions yet to be made. However, this new phase of the development plan was not adequately supported by practical fiscal and budgetary measures in 2008. It is not unfair to say that there was far too much complacency in the idea that the oil wealth would continue to grow and meet all of the states needs. That illusion was blown away in the second half of 2008. The government is now engaged in a wide-ranging debate on what exactly its fiscal, monetary and budgetary priorities should be, and how these should be reflected in practical measures to advance the goals of the development plan.

Time is running out. Decisions taken, or avoided, by the government in the current debate over what should be the country's key fiscal, monetary and budgetary priorities for the next three years, will have a significant impact on shaping the investment case for both strategic and portfolio investors over that time period and further on. The country has reached yet another important crossroad, and the direction chosen will either lead to real support for the reform and investment agenda or instead maintain the status quo of a cyclical boom-and-bust economy and a tough investment climate.

… but those decisions must now be taken – and that will lead to a much clearer investment picture

Hoping for a better investment climate. For the equity market, a favorable outcome to the planning process could lead to an improved investment case for stocks in processing industries, key infrastructure (i.e. cargo transportation and electricity generation) and those companies that benefit from spending in fabrication and materials.

TRANSITION PERIOD

Crisis provides opportunity for change. This is the third time in 20 years that Russia has reached such an important crossroad and, coincidentally, it is yet again the penultimate year of the decade. The backdrop is also similar: a big drop in oil revenues that lead to an economic crisis. In 1989 that combination was at least a major contributory factor in the demise of the Soviet Union. In 1999, it marked the end of the period of chaos and of the power of the oligarchs. In 2009, it is hoped that decisions taken this summer will mark the end of the powerful state sector and the start of the period of reform and investment. Nobody can expect Russia to make any sort of big leap forward. Instead, what is hoped is that 2009 will start the "drift" towards the goal of improving the investment climate and creating a genuinely diverse economy. Essentially, this is the end of phase one of the 20-year plan first announced by Vladimir Putin, and the start of phase two.

Yet again, Russia is at an important crossroads: it faced it in 1989 and in 1999, and ten years on, we are here again

LONG-TERM DEVELOPMENT PLAN

Key long-term goals have always been consistent. Since he became president, Vladimir Putin has always been very clear about his, and his government's view of how Russia should develop. He has framed this as a structured approach, with sequential priorities, that may take 20-25 years to fully achieve. Over the past ten years he has, in various speeches and comments, disclosed the key principles of that "master plan". Many commentators quickly dismiss the idea that there is any semblance of a "plan" in the way that Russia has developed over the past ten years. Instead, they take the abundance of examples of confusion, sudden direction changes, and apparent knee-jerk reactions to unfolding events as evidence that the government was little more than clinging onto the roller-coaster created by rising oil and gas wealth. But, while there can be little doubt that there has been little detailed planning and many distractions, there is credible evidence to support the view that there has been, and remains, a broad outline of a plan and that the events of the past ten years, although regularly confusing and frustrating for investors, have kept to this general outline.

Despite frequent distractions, there is clear evidence of consistency in the development plan's key goals

MAIN PARAMETERS OF THE DEVELOPMENT PLAN

Several key objectives have been made clear. The main long-term economic goals of the development plan have always been clear enough. They include:

1. To create greater diversification in the economy and to reduce budgetary dependency on revenue from natural resources;
2. To remove the cyclical nature of economic growth and foster a sustainable growth model;
3. To internationalize the economy by helping Russian companies take a bigger role in global trade and to form trade partnerships;
4. To boost the role of small- and medium-sized enterprises in the economy;
5. To improve the distribution of wealth in the country; to reduce the number of people living at or below the poverty line; and to raise the percentage of people classified as middle-class.

Key long-term goals set out for the country

Working principles also disclosed. During his years as president, Vladimir Putin also disclosed several key principles of the government's vision for the economy. Many of these were likened to the Chinese model, a fact mentioned by Putin during his first official visit to Beijing in his first term as president. Included in these key principles are:

Broken down into practical steps

1. The state should not spend money helping to create new industries, improving infrastructure or modernizing the economy until the "problems" inherited from the Yeltsin era were fixed. That included restructuring deals in the so called strategic sectors that he considered not in Russia's favor;
2. During the economic revival, the state should be the dominant power and only after the economic objectives have been achieved should greater political diversity be encouraged;
3. All key decisions about strategic development should be approved by the state;
4. The process of moving forward in the 20-25 year development plan should be done with objectives set sequentially and with new steps taken only when preceding objectives have been achieved;
5. Putin believes that only a small number of objectives should be pursued at any time. That is partly because of paranoia that vested interests are always ready to take advantage of a loss of state control. It is also a more pragmatic reflection of the fact that the government does not have the support of an experienced bureaucracy and simply cannot deal with too many issues at the one time.

Only one step at a time for pragmatic reasons

One objective at a time. In practical terms, the evidence thus far is that the time period for achieving these key objectives, or milestones, in the long-term plan is closely aligned with the duration of each presidential term, i.e. four years up to now, but perhaps six years after the next election. This compartmentalized approach of linking goals with identified time periods, remains a key feature of the approach to planning and is evident in how the government deals with many issues.

CHRONOLOGY TO DATE

From preparation to implementation. The start of the Medvedev presidency also marked the start of the next major phase of the development plan. The problem thus far has been that neither the declared goals nor the new president's program for government have been supported with the fiscal and monetary changes to actually help make this happen, which is what will hopefully result from the government's review of spending and policy priorities. This phase can best be described as the implementation, or spending, phase. The first phase – during Putin's presidency – can best be described as the preparation phase. The chronology may look something like this:

Putin's first term was all about establishing Kremlin control

2000-04

1. Putting the Kremlin back at the top of the power pyramid. Neutralizing the influence of opposition parties, the oligarchs, NGOs, etc;
2. Closing or severely restricting the routes that were used for tax evasion and moving money easily out of the country;
3. The main economic initiative was tax reform, i.e. to end tax evasion and control money flows; this provided a major boost to the depressed economy. The government also started to channel a large portion of the increasing oil wealth to the population via increased state employee wages, higher pensions, support for regions, and higher social spending generally.

The second term was about the so-called strategic industries

2004-08

1. The focus shifted to the strategic industries. The government formally identified what it considers to be countries' most important industries and activities, and formulated legislation to govern the ownership structure of each. New "rules of the game" for foreign strategic investors;
2. The major economic initiative was to build up the country's financial reserves and to pay down sovereign external debt;
3. Meanwhile, the process of continually trickling the oil wealth down via the budget continued.

THE CURRENT PROGRAM

A clearer path to go forward. President Medvedev's program for government is, in reality, the next phase of a long development plan first set out by his predecessor. The president set out his agenda for development, in great detail, under the umbrella of the so-called "four I" agenda. These are:

Medvedev inherited the fiscal and structural platform

1. The development of Institutions;
2. Improvement in the country's physical, social, and financial Infrastructure;
3. To help foster Innovation in the economy, especially in new industries;
4. To boost state-funded Investment and to attract higher levels of foreign investment.

Practical measures. In practical terms, he further elaborated the agenda as being:

1. Overcoming legal nihilism;
2. Reducing bureaucratic barriers to business;
3. Using tax mechanisms to encourage innovation and investment in human capital;
4. Building a strong and independent financial system;
5. Helping to establish the ruble as a reserve currency;
6. Modernizing transport and energy infrastructure;
7. Building a new telecoms platform for the country;
8. Forming the foundation of a national innovation system;
9. Carrying out a social development program.

His "phase" is all about investment and pushing long overdue reforms

Not much so far. In reality, one year into his term, the Medvedev phase has not made much progress, due partly to the economic crisis but also because it was not matched with fiscal and budgetary measures.

THREE SCENARIOS

Sub-dividing priorities. In February 2008, Economics Minister Elvira Nabiullina set out the three possible scenarios facing Russia. She said that the country had two main choices: essentially do nothing and hope for higher oil, or advance the long-term plan.

Scenario 1: Inertia

Do nothing and hope. Under this scenario, there would be no changes to either institutions or to the structure of the economy. The country would fail to exploit the competitive advantages that it has, and would largely remain static other than the experiencing the sequential boom-bust-boom cycles. The economy would remain dependent on the natural resource industries. Under this scenario, long-term growth would average about 3.5%, or about half the rate required to double the size of the economy.

Scenario 1, rejected, is basically to do nothing. That would have delivered no more than 3.5% annual growth

Scenario 2: Transition

Making more from existing activities. The minister said that, realistically, the country would have to adopt scenario 2 for several years before it could move ahead to the goals of scenario 3. The main objectives of this scenario would be to move up the value chain in processing industries, and to improve basic infrastructure. During this phase, the economy would remain dependent on natural-resource revenues and would be vulnerable to changes in the global economy, but that would be lessening. The forecast average growth rate under this scenario would be between 5.0% and 5.5% annually, she said.

Scenario 2 can deliver 5.0%-5.5% annual growth by moving up the value chain in raw materials

Scenario 3: Innovation-led growth

Investing in technology and people. This is basically the main part of President Medvedev's program. It simply reflects the practical acknowledgement that before the country can push ahead with investment in new industries and achieve growth from them, the main improvements in scenario 2 – i.e. infrastructure upgrades – have to be achieved. Under scenario 3, the projected long-term average annual growth rate is 6.5%, close to the annual 7.2% rate that would be required to double the size of the economy every 10 years.

Scenario 3, the main plan, is forecast to raise growth to an average of 6.5% per annum

NEXT PHASE

Sticking with the step-by-step approach

Sub-dividing priorities. In early 2008, the economics minister spelled out what the president's program might actually look like in practical steps. She split the program into two parts, with the first part being a necessary precondition before the latter goals might be achieved. Pursuing the first set of objectives is essentially what we hope to see being given practical support when this policy and budget review process is over. The priorities for the 2008-12 presidential term may, therefore, be as follows.

Upgrade, expand, move up the value chain. The immediate priority was originally stated to be, and probably remains, to concentrate on improving critical parts of the industrial and economic infrastructure and extracting more value from areas in which Russia already has some competitive advantage:

1. Improving key infrastructure:
   - Electricity supply and distribution;
   - Railroad improvement and expansion;
   - Upgrades to key airports and seaports;
   - Oil & gas pipeline expansion;
   - Telecommunication upgrades.
2. Extracting more value from existing industries, especially those in natural resources. Essentially, this means building processing industries and moving up the value chain so that the country will eventually have a better mix of raw material and product exports. This means:
   - Refineries;
   - Petrochemical plants;
   - LNG;
   - Smelters;
   - Furniture and paper mills;
   - Etc, etc, etc.
3. Agriculture is also a priority target. Russia currently has 20 mln hectares of arable land lying idle, according to the Agriculture Ministry, and the efficiency of the industry overall is only about half that of the European average.
4. Financial service investment to help create a more viable domestic pool of domestic capital and, especially, a local pension-fund industry.

Concentrating on process industries and infrastructure

INVESTMENT OPPORTUNITIES

Risk clarity helps valuations. Despite the value of the stock market rising by more than any of the world's major markets over the past eight years, both portfolio and strategic investors have frequently been frustrated. This is partly due to delays in moving forward with promised reforms, etc, and also because of the occurrence of events such as Sakhalin-2. But, while it is something of a cliché to say that the "rules of the game" have now changed and become clearer, the fact is that since the strategic industries legislation was signed into law in early May 2008, this is the reality. Clearer rules do not reduce risk, as such, but they do make it easier to understand the risks and to price them into valuations.

Investors have been put off by lack of clarity in the "rules" - that is now changing with clearer "rules"

Some sector themes. Assuming that the current government review of spending and policy priorities does lend practical support to the priorities identified for this next phase of development, there are a number of ways for investors to participate. Amongst the options for listed companies are:

Steel: The steel companies and those that supply them, and especially those that supply rails for railway expansion and upgrades. The only caveat during this crisis period is the risk that the government may impose certain unofficial price caps on materials supplied to large infrastructure projects. Evraz, Novolipetsk, and Magnitogorsk are amongst the well-positioned companies;

Materials: Materials suppliers, such as LSR Group, will benefit from an increase in infrastructure spending;

Recent events have shown just how urgent is the need to start rebuilding major parts of the nation's infrastructure

Electricity: The electricity sector has been one of the worst-performing in the stock market over the past year due to fears over future tariff growth and capex commitments. Given that improvement in the electricity sector is a critical part of the development plan – a point starkly driven home with the accident at RusHydro's plant in Siberia in mid-August – the current uncertainties are unlikely to last, and the industry will have to get state financial support sooner rather than later. The electricity generators represent a strong theme, and the distribution companies will also become much more profitable when the economy improves and allows for both better prices and connection growth;

Machinery: Companies such as Power Machines, which is dominant in the electricity turbine sector, will have the opportunity to benefit from increased state, and company, spending to improve infrastructure and to promote growth in new industries. Conglomerate AFK Sistema is another way to gain broad coverage exposure, as it has interests in telecommunications, aviation, oil refineries, and technology companies, etc.

Portfolio and strategic investors can benefit from these themes

Pipes: Gazprom is to spend close to $30 bln annually on capital projects, as it develops major new projects such as gas deposits in the Yamal Peninsula and Russia's Far East. Transneft is also expected to extend and upgrade its export and distribution network. This means that there will be sustained long-term demand for pipes, especially for the sort of large-diameter pipes that companies such as TMK now supply.

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Transport: Transport infrastructure is one of the key areas for investment, according to the president's development plan. This should benefit the railway system in particular, as well as companies that are linked to it; these include container company Global Trans and Novorossiisk Sea Port. The aviation sector, via the United Aircraft Corporation and subsidiaries of AFK Sistema plus the shipping sector, including Far East Shipping Compnay;

Warehousing: The country's stock of industrial warehousing will have to be upgraded and expanded; Raven Russia is well placed to benefit from this;

Agriculture: Razgulay is the best-placed of the stocks available to investors. Otherwise, it is via private equity funds;

Banks: As a proxy for the country "theme" and general economic expansion. This economic crisis has also strongly reinforced the need for reform of the financial sector and the development of new products such as savings.

Stocks like Sberbank are proxies for what happens across the entire economy

APPROACH TO STRATEGIC INDUSTRIES

Setting the rules. During Vladimir Putin's second term as president, the government developed its approach to the so-called strategic industries, covering both how the state will assist these industries in growing and the new "rules" for foreign investor ownership in companies in these industries. Investors first heard about this approach when Siemens applied for permission to acquire majority control of Power Machines, a company that controls 80% of the country's turbine market. This application was passed to the Federal Antimonopoly Agency, where it remained for almost a year. During this period, the government developed its approach to industries that it viewed as strategically important to the economy.

Trying to invest in Russia's so-called strategic industries has been very frustrating

39 Industries. Sixteen industries were initially proposed for this list but, by the time the legislation was framed, the number had expanded to 39. The process of deciding what the investment rules, etc, should be for companies in these 39 industries formed an often lively debate in government, but eventually the Strategic Industries Bill was approved and signed into law as one of the last actions of the Putin presidency in early May 2008.

A long period of uncertainty. But, while investors have been very focused on the investment rules for companies in these industries – essentially no foreign investor can own more than either 24.9% or 49.9% depending on the sensitivity of the industry – the legislation also clears the way for more active development programs. No new investment was allowed or encouraged while the state was working on the legislation, and the picture remained very unclear. This was also a time when the state moved to bring some deals done in the 1990s in line with the "new rules", and this resulted in episodes such as the change of ownership structure of Sakhalin-2.

The legislation passed in May 2008 makes the picture much clearer and opens the way for increased investment flows

Better risk assessment. The May 2008 legislation clears up the investment guidelines and sets the stage for the long-awaited development of many of these industries. For international investors, this also means a lot less risk and clearer opportunities.

The Opel/Magna/Sberbank example. The current Opel/Magna deal provides a good example of how Russia would like to develop its strategic industries and, using them, to further develop the economy. The government – both President Dmitri Medvedev and Prime Minister Vladimir Putin – has consistently stated that the best way for Russia's strategic industries to improve is via relationships with established international peers; thus, the lack of management expertise and industry know-how could be mitigated. Russia tried several years ago to buy an equity stake in EADS to help the fledgling United Aircraft Corp; that effort was rejected by core EADS shareholders. The crisis in GM is therefore an opportunity that the Kremlin does not want to miss. A successful deal for Opel could smooth the way for many more strategic partnerships for Russia's large corporations. Sberbank's role is almost certainly only as an intermediary to acquire the holding for "Russia Inc", and the stake is likely to be passed on to an industry holding in the future.

Deals such as the proposed Opel JV could also help the economy to gain international exposure

SUCCESS/FAILURES TO DATE

Some progress, albeit slow. On the plus side:

- Russia is a much more stable country now than in the 1990s, and has a much greater sense of purpose. Confidence levels are high, and so too are people's expectations for the future;
- The economy has grown from a GDP value of $187 bln in 1999 to $1.7 bln last year. In per-capita terms, the growth has been from $1.3 per capita to $11,776 per capita;
- Incomes and disposable wealth have grown from an average of around $100/month to close to $600/month;
- The country's financial position has improved dramatically. In 1999, international reserves totalled $12.5 bln and sovereign external debt was $145 bln. Today, the figures are $400 bln in reserves and less than $40 bln of sovereign foreign debt
- Oil exports have been increased so that the country has a significant base of daily cash flow, even with fluctuating oil prices. In 1999, Russia exported approximately 2.5 mln bbl of crude and 250,000 bbl of refined product every day; today, the figures are approximately 5 mln bbl of crude plus over 2 mln bbl of refined product every day;
- Russia has regained a prominent place at the top table of geo-politics;
- Russia has at least a broad outline plan that it is following. Progress is frustratingly slow, but is continuing.

Russia today is very different from Russia 10 years ago

On the negative side:

- The economy is still very dependant on oil and gas exports for funding;
- Russia ranks amongst the most corrupt countries, and is cited as having a very poor business environment;
- The legacy of events such as YUKOS and Sakhalin-2 is that foreign investors remain suspicious of Russia. FDI remains at a very low level relative to other emerging markets;
- Demographics are bad. The population has fallen from 145.9 mln in 1999 to 141.1 mln today;
- The workforce is projected to fall by 10 mln to 69 mln between 2005 and 2015;
- There is only a very small pool of domestic capital in Russia – the pensions industry in particular is too small;
- The proportion of SMEs in the economy is far too small, at less than 20%. The wealth gap is over fifteen times, when it should be closer to five times for a developed economy.

However, while progress has been significant, difficult problems remain unsolved or have not yet even been addressed

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