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As anticipated, 2006 was an active year for equity issuance by Russian firms, and 2007 is expected to be even bigger, with an estimated total of US\$31.6bn in issuance next year from an estimated US\$20.1bn in 2006.

Russian firms are being prompted to issue equity, both in the form of initial public offerings (IPOs) and secondary issues, in order to raise capital for development, fund overseas acquisitions and, by listing abroad, hedge against rising domestic political risk in the run-up to the 2007-08 election season. The state has also needed to raise funds so as to finance its increasing control of key "strategic" sectors of the economy, notably energy.

**Issuance in 2007 will be dominated by the banking sector**, with both Russia's largest bank, state-owned Sberbank, and its second-largest, Vneshtorgbank (VTB is also state-owned), having plans to raise equity. Precise details of volumes and timing have yet to be decided, although the Ministry for Economic Development and Trade recently stated that Sberbank could issue around US\$7.6bn, mostly on the domestic market, while VTB aims to make an IPO of up to 25% of its stock in a dual Moscow-London listing.

**The metals sector is expected to be another big issuer in 2007**, with steel firm Severstal and aluminum major Rusal both having announced plans. Renaissance Capital is penciling in as much as US\$5bn in metals listings in 2007. The ongoing restructuring of state-owned electricity monopoly Unified Energy Systems (UES) should also result in a number of IPOs by newly created generation firms going forward.

**By comparison, the oil and gas sector, which dominated 2006 issuance on the back of state-owned Rosneft's US\$10.4bn London listing, looks set to play a smaller role in 2007. Indeed, one of the most interesting aspects of issues in recent years - and planned issues over the coming period - is the increasing diversification of sectors that are getting involved, including non-strategic sectors believed to be largely outside the Kremlin's sphere of interest.** For example, next year could see debut issues by the IT, chemicals and transport sectors, and increased issuance by the pharmaceuticals, and retail & consumer goods sectors. All of which goes to show that Russia is no longer simply an oil and gas story, as booming growth has opened up opportunities in an increasing number of sectors, especially those related to buoyant consumer demand.

The possibility of a diversification of part of the Oil Stabilisation Fund into higher yielding credits, the potential for the Russian regions to access the international capital markets, and now the Russian Duma has voted to enact further banking sector reforms. Under the new legislation – which still needs presidential and upper house approval – foreign and domestic investors will be put on an equal footing in share transactions. The removal of the need for foreigners to buy "blessed" shares (that is, the stock



which has been approved by the central bank for sale to non-residents), will make this equity sector more liquid and appealing to investors. The requirement to inform regulators once a 1% stake has been built in a bank will remain for all investors, as will the need to seek permission for a holding of more than 20%. This will help to bring investment in Russian stocks into line with international norms, and make them attractive to a more broadly-based group of investors, while at the same time make strategic holdings more appealing. **Russia is a key frontier in the battle of the big European banks for greater market share in growth markets.** Already, countries such as Slovakia, Slovenia and Croatia have seen their banking industries almost entirely swallowed up by foreign groups, and the scope to buy institutions in the Western Balkans and CE-3 is diminishing. While the potential for organic growth in all of these markets is still considerable, acquisitions remain a key way of building market share rapidly. **With 13% of the banking sector foreign-owned and only 51 of the 1,359 licensed credit institutions being externally held in Russia there is certainly room for consolidation in the industry,** perhaps led by European groups. The benefits to Russia of greater involvement by Western groups include better capitalization of the sector, as well as the transfer of risk management, technological and procedural know-how.

In 2006 the Russian Ruble exceeded its pre-1998 default levels in real effective exchange rate terms, and **it is the point of view of PYTHEAS that the nominal exchange rate is in a medium-term uptrend.** It could hit RUB25.00/EUR as early as late 2007. The currency is still riding the tide of a strong global economy, and a confluence of bullish domestic factors. Indeed, inflows into the Russian economy from abroad could have been as much as US\$40bn in 2006 – with a strong showing on the cards for 2007 too – while global commodity prices are going to remain high, even if not stellar. Spot Urals crude prices, even at the drastically reduced US\$49.95/bbl (down from US\$73.06/bbl in August 2006) are still around levels seen in 2005. Major support comes in around US\$44.00/bbl for Urals.

**Despite the headlines surrounding the frequent oil and gas supply outages to countries in the near abroad, it is clear that the Russian macroeconomic story is not solely about the energy sector.** The local debt markets are fully liberalized, the stock market is still soaring, and it looks likely that it will become increasingly easy to buy ruble denominated assets going forward. Euroclear, the clearing and settlements group, is looking to offer settlement in rubles to its clients, possibly from February onwards.

As the 36th currency available for settlement in the system, this will make it easier for foreign investors to trade ruble-denominated bond issues, and underpin the trend of increasing liquidity across the board in Russian financial markets. This will help to add additional stability to both the currency and the wider economy. The country's second largest (and soon to be part-privatized) bank, Vneshtorgbank, and state-owned railway company, Russian Railways, have both previously suggested that greater ease of trading rubles would make it easier for them to finance their borrowing requirements in rubles rather than dollars. Given that total external debt came in at US\$287.4bn at the end of H106 (the latest available figures) despite government debt buybacks, reining in the growth of foreign-currency denominated borrowing would certainly be beneficial. **Although denominating debt in ruble would still result in**



**inflows from abroad it would reduce the currency risk involved for Russian corporates, and the economy in general.**

**While bullish the ruble in nominal terms, PYTHEAS is very much aware of the Russian government's ongoing predicament over inflation. CPI remains stubbornly high, and continues to exceed the initial very ambitious inflation targets.** At the end of December the Ministry of Economy published new forecasts of 7.0% in 2008 (up from 6.0%) and 6.8% in 2009 (against 5.5% previously). These numbers still appear to be too optimistic, especially with the election cycle heating up. As a result, the potential for increased social and infrastructure spending to fuel additional price pressures stays in place. The corollary of this is a forecasted end-year CPI at 8.8% y-o-y in 2007 and 8.5% y-o-y in 2008 which, combined with ruble strength will result in significant real effective exchange rate appreciation. As such, it is expected to see the debate continue in Russia over the country's currency policy. The critics of the strong ruble will continue to be led by exporters in the non-oil sector, which have been hit fairly hard by currency gains in recent years. However, a stable-to-strong ruble over the five-year forecast period will result in the appreciation – together with more moderate commodity prices – which is needed in order to bring down price inflation towards more sustainable levels.

**Opinion:** PYTHEAS is increasingly optimistic on the potential for the financial sector to boom. PYTHEAS also remains bullish on the Russian ruble, and it is PYTHEAS view that it is heading towards RUB25.00/US\$, with the risks weighted to the upside. The speed of ruble appreciation will be a key question for the non-oil economy, and the government. Ongoing moves to cap ruble gains are likely over the coming years, but it is expected that some local currency strength will be tolerated in order to rein in still robust price pressures. Against this backdrop PYTHEAS expects the ruble to become an increasingly important global currency, and it is encouraging that Euroclear is looking towards providing settlement in rubles.