

Russia in the spotlight

Edition Q1 2013

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Feature article

Development update: financial market infrastructure

An important potential support for Russian local stocks this year is the reform of the country's financial infrastructure. This development should not only eventually eliminate the price discount between local stocks and depository receipts (DRs), but also help boost liquidity through the repatriation of trading volumes from foreign bourses. Many steps are being taken in this process, the key one being the launch late last year of the central securities depository (CSD) after the merger of the Russian MICEX and RTS exchanges in late 2011.

Below we look at recent developments.

Completed: Launch of the CSD

The CSD was launched in November 2012 after a central depository license was awarded to the national depository centre (NSD). The CSD finalised the opening of registrar accounts for all securities by the end of March 2013 and since 1 April has been operating as the exclusive clearing house and settlement facility for all stock trades in Russia, including OTC. This centralised infrastructure, protected by a central depository law, should over time substantially reduce costs, transaction terms and risks for investors, particularly as the new law protects investor property rights regarding securities along international standards.

Euroclear opened accounts with the CSD on 7 February, and will be allowed to open accounts for local equities from July 2014. Currently, it can only settle rouble-denominated government debt (OFZ).

Domestic depositories operating in Russia have been able to open nominee accounts since November 2012. This change benefitting the subsidiaries of foreign banks such as Citigroup, Deutsche Bank and JP Morgan Chase. International CSDs and international custodians will only gain access to the CSD from July 2014.

The lack of Euroclear accounts for equities is not a major impediment for global investors. As mentioned, local custodians, including domestic branches of international companies, can already hold Russian securities at the CSD.

In process: T+2 settlement

In a major development, the Moscow Exchange finally started selective T+2 settlement on 25 March this year, offering the 15 most liquid stocks and all government bonds to be settled by either T+2 or T+0 for a period of three months. From 1 July, T+0 will no longer be available for these securities. All remaining stocks listed on the Moscow Exchange will eventually migrate to the new system by January 2014.

Prior to T+2, trades had been settled using T+0, with prepayment and pre-delivery of shares via broker intermediaries. This was an arrangement that unsettled some large offshore institutional investors, who did not want the risk of trading local shares without a central depository. Over the past year, the exchange has adjusted its systems to accommodate the new settlement regime and it expects all market members to have done the same by July 2013. Trading in T+2 requires only partial collateral to be deposited at the moment of a trade. It also lowers the costs for market participants and results in greater flexibility for local and international investors.



It is likely that the impact of these developments will be felt from 2014, after a broader introduction of T+2 settlement. In our opinion, it should have a particularly positive impact on the small and mid cap stocks that are not available on offshore exchanges.

Moscow Exchange: IPO and rebranding

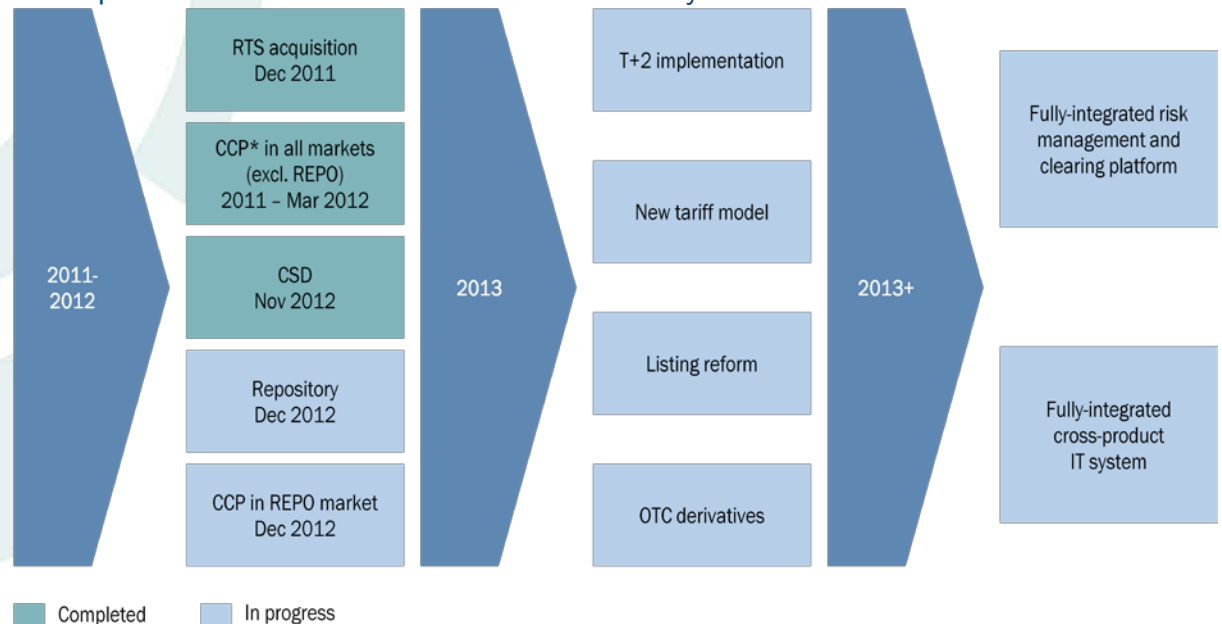
The Moscow Exchange Group's IPO in February placed USD 498 million of shares on its own platform, making it the largest IPO in Russia since 2007. Although the offering was twice oversubscribed, it was still priced at the lower end of the proposed range of RUB 55-63 per share. The company is currently valued at about USD 4 billion, with a free-float of around 30%. The largest participants in the IPO were the Vneshekonombank-owned Russian Direct Investment Fund and the China Investment Corporation. In March, the shares of the group were included in the MICEX index with a 0.61% weighting.

Index reform

The MICEX and RTS exchanges had historically run separate indices with numerous differences. The MICEX index comprised 30 stocks, was calculated in roubles, and covered 75% of the overall equity market capitalisation. The RTS index was denominated in USD, had 50 stocks and covered 85% of the market capitalisation. The merger of the two exchanges called for unification in terms of the equity universe and the calculation of the indices.

On 18 December 2012, the composition and calculation methodology of MICEX and RTS indices were synchronised to form the MICEX 50 index. Today, both indices include 50 stocks and the only remaining significant difference is the currency in which they are denominated. The next step will be to launch the Moscow Exchange index, which is to become the main Russian stock index. It will pick up the historical quotations of both the MICEX and RTS indices for its rouble and USD quotes and will include the top-50 stocks and DRs by market capitalisation. Stocks will be selected from the broad market basket of the top-100 securities by capitalisation, free-float and liquidity.

Development of financial market infrastructure: key milestones



* Central Clearing Counterparty

Source: Credit Suisse, Moscow Exchange, April 2013



Changes in oil and gas taxation

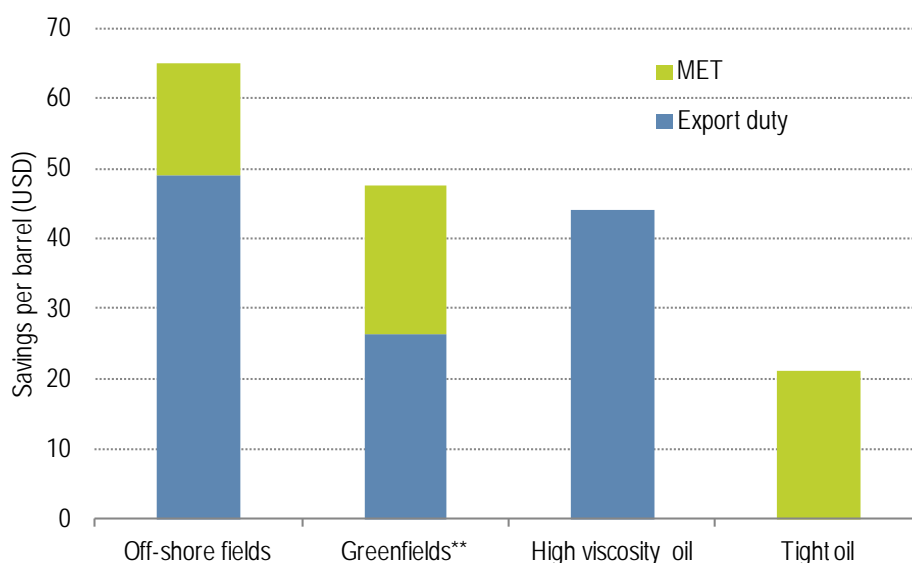
A new oil tax break for greenfield sites came into effect on 1 April 2013. Several sites in eastern Siberia, the North Caspian sea region and on the Russian continental shelf will now be eligible for reduced export duties* until the internal rate of return of the project reaches 16.3%. These amendments are expected to raise the EBITDA per barrel for greenfield sites from around USD 15 to USD 45 (depending on the site) and should stimulate investment in drilling. Companies that are likely to benefit the most from the tax break are Gazprom Neft, Rosneft, and LUKoil.

Furthermore, the tax rate for high viscosity oil was reduced to 10% of the regular crude oil export duty. Only a limited number of fields, particularly those of LUKoil and Tatneft, will be eligible for the tax break. While this will lead to only a marginal increase in crude oil production, it will allow LUKoil to save as much as USD 1 billion in tax payments a year.

Another part of the fiscal stimulus package being discussed by the government is a tax break for tight oil production via a more attractive MET rate framework. If implemented, a number of tight oil fields will be relieved of MET taxes for up to 15 years; others might get a tax break ranging from 60% to 80% of the regular duty, depending on the permeability of the rock. The law, if finalised and passed, is expected to be introduced in early 2014 and, according to the Ministry of Finance, will allow for the extraction of an additional 40-100 million tonnes of oil per year.

* 45%*(Urals price - USD 50)

Maximum tax savings from current and potential taxation changes*



* Assuming Urals at USD 100/bbl

** in East and North Siberia

Source: Bloomberg, TKB BNP Paribas Investment Partners, April 2013

Privatisation progress

The government has recently updated its privatisation roadmap, revising downwards the target revenues for this year to RUB 60 billion. Aside from the headline number, the main difference with the previously mentioned target of RUB 427 billion is that deals will likely be structured as additional share issues rather than direct sales of the state's stakes. Large names such as NCSP group, Sovkomflot and Alrosa remain on the list for 2013, with VTB and Alrosa shares to be placed domestically. We believe that top priority will likely be given to VTB. Although the government owns 75.5% of Russia's second largest bank and plans to privatise it completely by 2016, the current intention is to issue a further RUB 100 billion-worth of shares (about USD 3 billion or 10-15% of the market capitalisation) on the Moscow Exchange by the end of 2013.

In further support for new equity offerings, the government announced its intention to ease restrictions on pension fund investments in equities, these being currently limited to the so-called A1 list of 37 stocks. Signalling recognition of the breadth of pension system reform required, a number of intentions have been announced, including:

- Future ability of pension funds to invest in IPOs
- Changes to pension fund regulations to allow them to extend the investment horizon (there is currently a 12-month accounting period during which pension funds cannot show a loss during any calendar year)
- Reduction in limits on investments in local corporate bonds.

The period at which these reforms may be reflected in legislation is yet to be determined.

Q1 2013 macroeconomic results

The Russian economy showed signs of slowdown in the first quarter of 2013. Government figures put real GDP growth at 1.1% YoY, half that of the 2.2% YoY recorded in Q4 2012. January's relatively modest performance worsened in February, with near-zero GDP growth and negative figures for industrial production, which was partially caused by the calendar effect of a shorter month (2012 was a leap year). March data signalled a revival of activity, showing a rebound across all key indicators. In light of a more pronounced downward trend, however, the Ministry of Economics cut its official GDP growth target for 2013 from 3.6% YoY to 2.4% YoY.

The overall sluggish growth was attributed to a combination of weakening external demand and internal supply. Exports fell by 5.0% YoY in January-February and industrial production showed zero growth in Q1. Raw materials extraction was the main detractor in industrial production, shrinking by 0.9% YoY during the quarter. At the same time, manufacturing supported industrial production with 1.2% YoY growth in Q1. Investments weakened: fixed capital investment growth gradually contracted, from +1.1% YoY in January to +0.3% YoY in February and -0.8% YoY in March.

In contrast, consumer data improved during the quarter. Retail sales grew steadily, accelerating to 4.4% YoY in March from 2.5% YoY in February. Sales were supported by a positive trend in income growth, with real disposable income rising to 8.3% YoY in March after 5.9% YoY in February. The unemployment rate rose marginally to 5.7% in the first three months of the year; in December, it had been 5.3%. Overall inflation rose in early 2013 due to the base effect of last year's global food price spike, peaking in February at 7.3% YoY before slowing to 7.0% YoY in March. In our opinion, the above-target inflation of the first few months of 2013 is only temporary; the rate should ease in the summer when the food price base effect falls away over June-July, after which there should be deeper falls in the rate. It should be noted that the lower March readings included fruits and vegetables, but did not extend to wheat products such as bread and cereals, which were major drivers of the headline CPI spike in June-July 2012.

% YoY	Dec.	Jan.	Feb.	Mar.	2012	2011
GDP growth	2.4%	1.6%	0.1%	2.3%*	3.4%	4.3%
CPI	6.6%	7.1%	7.3%	7.0%	6.6%	6.1%
Fixed capital investment	-0.7%	1.1%	0.3%	-0.8%	6.6%	10.8%
Industrial production	1.4%	-0.8%	-2.1%	2.6%	2.6%	4.7%
Manufacturing	1.5%	-0.3%	-0.1%	3.4%	4.1%	6.5%
Retail sales	5.0%	3.5%	2.5%	4.4%	5.9%	7.0%
Real disposable income	4.9%	0.7%	5.7%	8.3%	4.2%	0.4%
Real wages	5.0%	5.4%	5.2%	4.2%	7.8%	2.8%
Unemployment rate	5.3%	6.0%	5.8%	5.7%	5.5%	6.5%

*Preliminary estimates

Source: Ministry of Economic Development, April 2013

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