RUSSIAN MARKET OUTLOOK 2004

January 14, 2004

MUCH ADO ABOUT LITTLE

2003 defied expectations... With a 2003 return of 58%, Russian equities defied all expectations last year, driven by persistently high commodity prices, a strong economy, shrinking sovereign spreads, domestic and global liquidity and a rise in M&A activity.

..but we see little upside for Russian equities in 2004. Entering 2004, we expect some of the key driving forces of the 2003 rally to weaken, while others are likely to be superceded by newly emergent political risk. The room for sovereign spread contraction appears decisively smaller, while corporate earnings are likely to be flat and the market's volatility has increased. Meanwhile, President Vladimir Putin's seemingly inevitable re-election promises no help for equities. After reviewing our key assumptions, we have lowered our end-2004 bottom-up RTS target to 597, implying no upside from current levels.

Strong economy, high liquidity, deteriorating stock fundamentals – are we in for a bubble? Despite deteriorating fundamentals and increased risks, domestic (as well as global) liquidity is likely to remain abundant in 2004, while a strong economy will be supportive of investor sentiment. This represents an almost classic recipe for a bubble – and the first couple of weeks of 2004 have certainly felt like it.

Defensive driving recommended: we have looked for company- or sector specific stories. The abovementioned conditions explain our choice of investment picks for 2004: we looked for company-specific or sector-specific themes that would provide at least some hedge against general market risks. Our overall cautious view towards Russian equities also explains our preference for ruble-denominated bonds – in 2004, a 20% dollar return in Russia is likely to be regarded as a good performance.

As of Jan 11 04	Rating	Current price, $	End-04 target price, $	Upside potential	EV/EBITDA (X) 2004F	EV/EBITDA (X) 2005F	Comment
Large-cap							
Lukoil	Buy	24.57	30.73	25%	5.3	5.4	Volume growth accelerates, low political risk
Gazprom common	Buy	1.25	2.09	67%	3.5	3.7	High gas prices to remain + possible ring fence removal
UES	Buy	0.30	0.35	14%	4.8	4.4	Demand to pick up as OGK auctions get underway
MTS	Buy	87.99	103.30	17%	6.1	5.5	Strong subs growth in the regions to drive results in 2004
Vimpelcom	Buy	78.13	92.30	18%	4.8	4.0	Strong subs growth in the regions to drive results in 2004
Severstal	Buy	132.50	147.88	12%	3.2	3.8	Leading steelmaker still cheap+ ADRs + dividends
Wimm-Bill-Dann	Buy	17.31	22.98	33%	8.6	6.1	Russia's leading consumer good company

	Theme	Key picks	Upside potential
Mid- and small-caps			
Regional power utilities	Undervalued generation, overlooked distribution	Kuzbass, Krasnoyarsk, Chita, Novosibirsk, Tomsk, Udmurt, Kirov, HPIC	100%+
Regional telcos	Strong traffic, tariff growth, Svyazinvest privatization	Sibir Telecom	20%
TNK-BP	Can this be the year when TNK-BP finally keeps its word?	Orenburgneft prefs	68%
Fixed income			
Ruble-denominated	Double digit yields + strengthening ruble	Reg telcos, steel-makers, PIT, Archang Pulp	@ 20%

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2004 INVESTMENT CASE

2003 IN REVIEW: "IT WAS A VERY GOOD YEAR"

The Russian market rallied 58% in 2003, defying expectations of more moderate gains, and unlike 2002 the rally was very broad-based, affecting all sectors of the market. In the global context, the Russian market finished 11th after being one of top three performing markets in the world in 2001-2002.

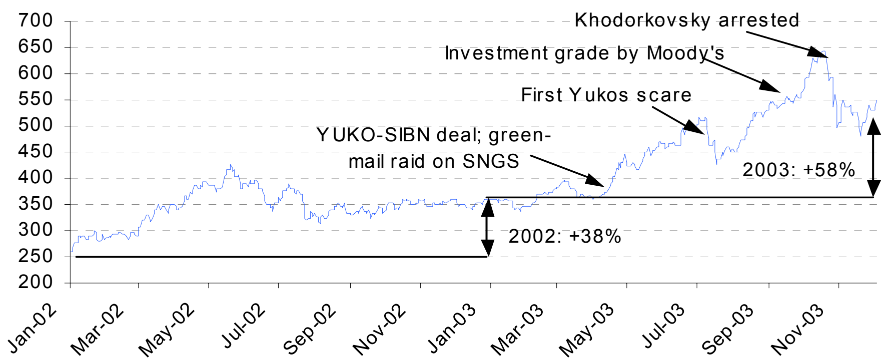
RTS climbs 58% in 2003 amid soaring commodity prices, equity markets worldwide

In Frank Sinatra's words, 2003 – "it was a very good year" for Russian equities, which returned 58% in dollar terms as measured by the RTS Index. At the beginning of 2003, we had envisaged more normal market returns of around 25% due to moderating commodity prices, a generally sanguine economy, stabilizing sovereign debt spreads and a benign global environment for equities.

Instead, Russian equities soared, driven by commodity prices at multi-year highs, a worldwide rally in both developed and emerging market equities, contracting bond spreads and strong economic growth. On top of that, perhaps for the first time in the history of the Russian market, a flurry of mergers and acquisitions swept through nearly all key sectors of the economy, bolstering valuations and equity values in the process.

The year started with the landmark $6.4bn TNK-BP deal, but the market really took off in April on expectations of a Yukos-Sibneft merger (which materialized) and an apparent hostile raid on Surgutneftegaz (which proved to be just a greenmail attempt, but managed to lift the stock price nonetheless). The market rallied 40% in 2Q03 and then added another 12% in 3Q03 despite the beginning of investigations into Yukos and the July arrest of company core shareholder, Platon Lebedev.

RTS 2003 performance: market up 79% at intra-year high before Yukos affair



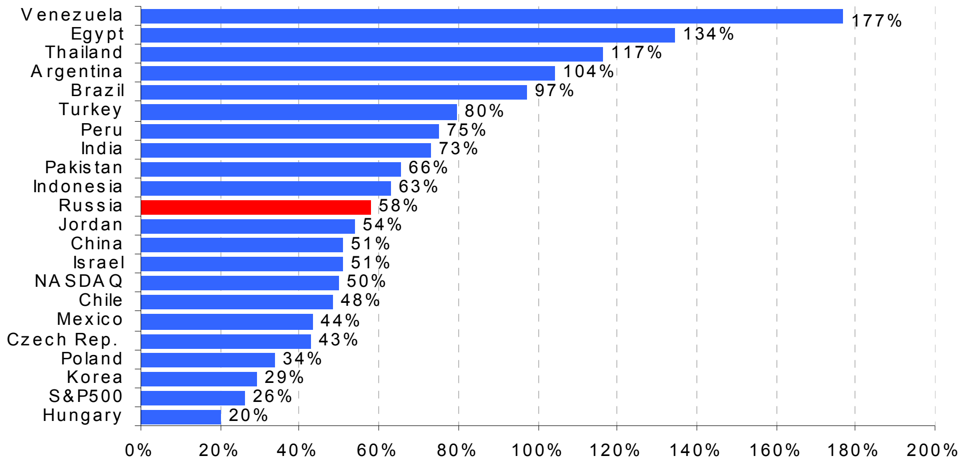
Source: Bloomberg

The rally continued into 4Q03 and following the Moody's upgrade on Oct.8, the sky appeared to be the limit for the RTS Index, which was up 79% at its 2003 high of 643. It all went downhill from there. First, prosecutors launched a full-scale investigation of Yukos, including arresting CEO Mikhail Khodorkovsky on Oct. 25, sending the market into a tailspin and reminding investors that despite Russia's remarkable progress on many fronts, it remains a risky emerging market.

Second, the State Duma election sparked the demise of pro-market parties, leaving the parliament without liberal voices for the first time since the collapse of the Soviet Union, with a surprisingly strong showing by the leftist-nationalist Motherland party and Vladimir Zhirinovsky's LDPR, who strongly advocated radical populist moves against big business.

Russia rises along with other emerging markets. While the Russian market delivered an outstanding performance in 2003, it was no longer one of the top performing markets in the world, an honor it enjoyed in 2001 and 2002. In the global emerging market context, Russia came 11th, outperformed by Thailand, Argentina, Brazil, Indonesia and others. However, Russia still shined in the EMEA context, where it was bested only by Turkey.

Performance of select global equity markets in 2003: Russia rallies with the rest



**In local currency, RTS in US$ terms*

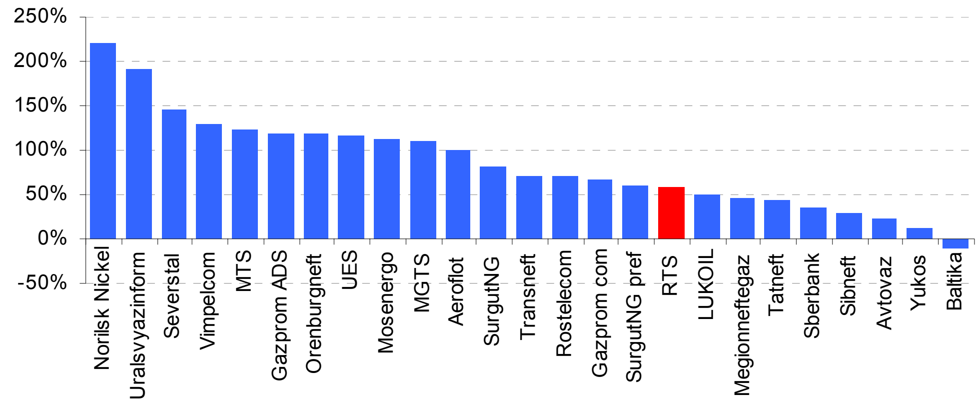
Source: Bloomberg

Stars and laggards of 2003

Turning to individual stocks, the Russian rally of 2003 was very broad-based – in contrast with 2002 when just a handful of stocks accounted for most of the performance.

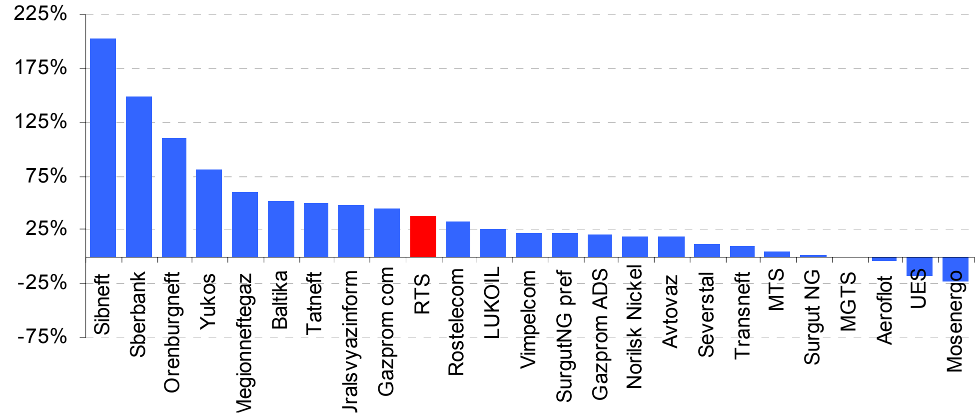
- **UES, Mosenergo and other electricity stocks** surged after the passage of power sector restructuring laws triggered a wave of strategic buying.
- **Gazprom** shares rocketed, with ADS (up 119%) outperforming common (up 66%) due to record high export gas prices and volumes, which resulted in material improvement in financials.
- **Mobile blue chips MTS and Vimpelcom** rode the wave of rising disposable incomes across the country.
- **Regional telecoms** rallied following the completion of sector restructuring on the back of strong growth in local tariffs and traffic.
- **Mining and metals** blue chips Norilsk Nickel and Severstal benefited from a strengthening price environment, after a dismal 2002. Second tier names such as NTMK, CHEP, VSMPO and Vyksa all delivered triple-digit returns as well.
- **In the oil sector,** only Surgutneftegaz, Transneft and Orenburgneft managed to beat the index whereas Lukoil, Tatneft, MegionNG, Yukos and Sibneft (the last two were engines of the 2002 rally) all under-performed due to various company-specific issues.
- **Sberbank,** another star performer in 2002, also underperformed the market.

2003: Top performers are metals, telecoms and electricity stocks; laggards are oils, Sberbank, Avtovaz, Baltika (all performance ex. dividends)



Source: Bloomberg

2002: Sibneft, Yukos, Sberbank drive the rally (all performance ex. dividends)



Source: Bloomberg

Of our 12 top picks for 2003, nine outperformed the market on a full year basis, an acceptable 75% ratio. Most of our top picks, however, were downgraded throughout the year as they reached their fair value targets; as the full year returns suggest, we were apparently excessively conservative in some cases. Among the investment themes we offered, the natural monopolies restructuring/turnaround theme turned out to be the best one.

Performance of 2003 top picks: getting too conservative mid-year

	Price Dec. 31, 2003, $	Price Dec. 31, 2002, $	2003 change, %	Comment
RTS Index	567.250	359.070	58%	Initial FV of 452 changed to 532 in July and then to 715 in Oct
Emerging global players				
Lukoil	23.270	15.420	51%	The most liquid Russian stock narrowly under-performs
Yukos	10.560	9.450	12%	Was up 64% with buyback and dividends before we suspended rec after CEO arrest
TNK	2.420	1.360	78%	Downgraded to Hold at $1.8 right after the deal
Norilsk Nickel	65.150	20.250	222%	Downgraded to Hold at $26, upgraded to Buy at $30, back to Hold at $40
Restructuring / turnaround plays				
Gazprom local	1.248	0.753	66%	Under-performs ADS, but beats the market for the second year in a row
Gazprom ADS	25.900	11.800	119%	Downgraded to Hold at $15.2, to Sell at $20, back to Hold at $23.5
UES	0.279	0.129	117%	Downgraded to Hold at $0.22 (Jun), upgraded to Buy at $0.24 (Nov)
Rostelecom	2.060	1.210	70%	Downgraded to Hold at $1.53
Domestic consumption growth plays				
MTS	82.800	37.140	123%	Downgraded to Hold at $51, under review for upgrade at $66, restored to Buy at $78
Vimpelcom	73.500	32.010	130%	Downgraded to Hold at $43 (May), upgraded to Buy at $46 (July)
Uralsvyazinform	0.038	0.013	191%	Downgraded to Hold at $0.027
Avtovaz	27.000	21.000	29%	Rallies towards the end of the year but still under-performs

Source: Aton; Bloomberg

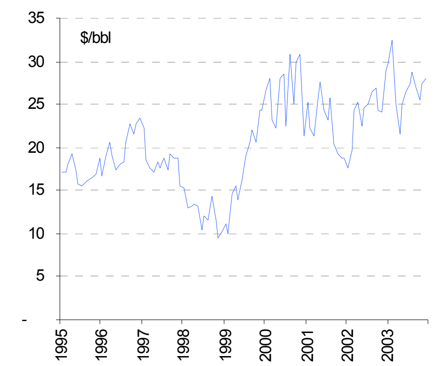
MARKET DRIVERS IN 2003: GLOBAL RALLY IN COMMODITIES, EQUITIES; M&A/STRATEGIC BUYING

From the fundamental perspective, the 2003 rally came as a result of a turbocharged combination of multi-year high prices on key Russian commodity exports and a worldwide rally in equities. In addition, perhaps for the first time not only portfolio but strategic investors too realized the appeal of publicly traded Russian equities; demand from strategic investors provided further support to equity values.

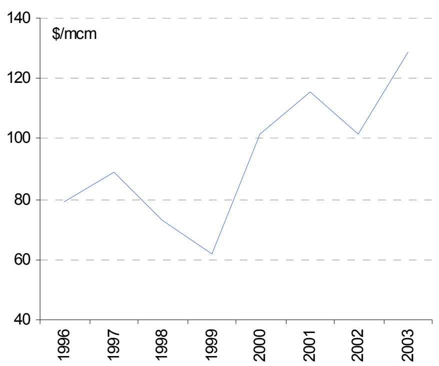
Factor 1: Strong commodity prices

Like the old real estate saying on location, a strong Russian equity market performance is almost always because of three things: commodity prices, commodity prices and commodity prices. There can be little question that Russia has to thank another year of high commodity prices for its 2003 economic, fixed income and equity performance. The Brent oil price averaged $29/bbl, the highest level in almost 20 years. Gazprom's export price stood above $120/mcm, the highest level since the company started reporting under IAS in the mid-1990s. Meanwhile, key metals prices, such as steel, nickel, gold and platinum all soared to multi-year highs driven by a global economic recovery and a weak dollar.

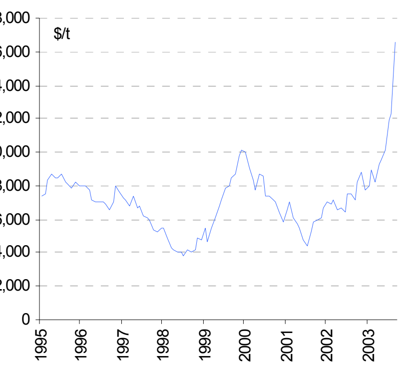
Oil price (Urals)



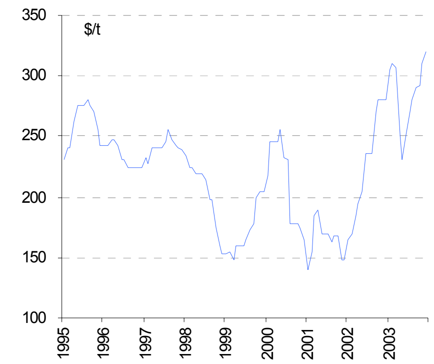
Gas price (Gazprom, net of export duty)



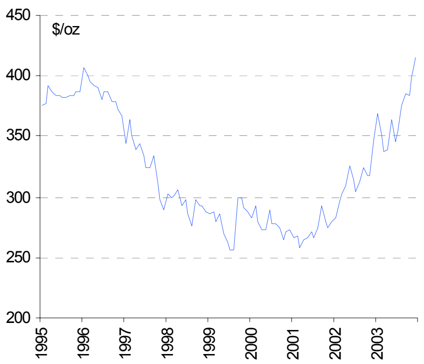
Nickel price (LME)



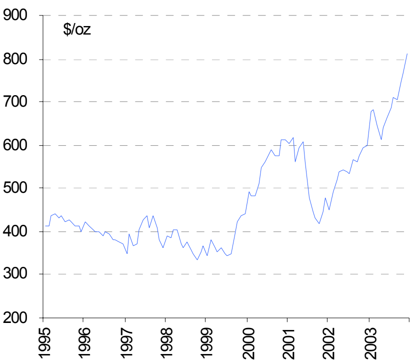
Steel price (Metals Bulletin CIS)



Gold price (COMEX)



Platinum price (COMEX)



Source: Bloomberg; Gazprom

Consequently, it was primarily very high commodity prices that resulted in all of the following:

1) **strong economic growth** and a budget surplus;

2) **rising Central Bank reserves** and foreign debt repayments, which led to falling sovereign spreads and Moody's investment grade rating;

3) **rising corporate earnings**, which made oil/gas/metals stocks that comprise 80% of the market look increasingly inexpensive; and

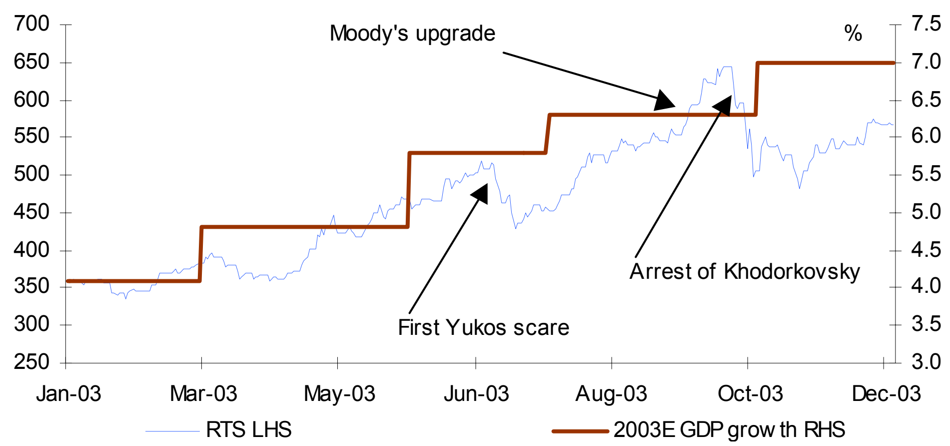
4) **increased domestic liquidity**, which put more money into the hands of domestic investors and consumers alike and thus provided the market with support when foreign investors were exiting.

A set of charts and tables below illustrates our point.

1a) Macroeconomic strength and prudent fiscal and monetary policies

Russia's economy benefited massively in 2003 from high commodity prices as well as sound economic, fiscal and monetary policies, surprising investors on the upside and prompting a spate of GDP forecast upgrades. The most visible effect of the macro strength was on such consumption plays as mobile operators Vimpelcom and MTS.

2003 GDP growth forecasts repeatedly raised in 2003



Source: Bloomberg; Aton estimates

Russia's achievements on the macroeconomic front were underscored by Moody's awarding investment grade status to the country's sovereign debt on Oct. 8. Although the move may have appeared premature considering the recent political turmoil surrounding Yukos and the still slow progress on structural reform, from the pure creditworthiness perspective it was justified (see table).

Credit rating: Russia clearly belongs in the investment grade club

	Russia	BB	BBB
Net external debt, %CXR	**63.1**	64.7	32.4
Current account, %/GDP	**8.9**	-3.5	-1.4
Public debt, %/GDP	**33.4**	48.1	40
Fiscal balance, %/GDP	**1.6**	-3.6	-3.5
Liquidity ratio, %	**148.7**	137.0	98.0
Per capita income, $	**3,046**	1,800	4,130

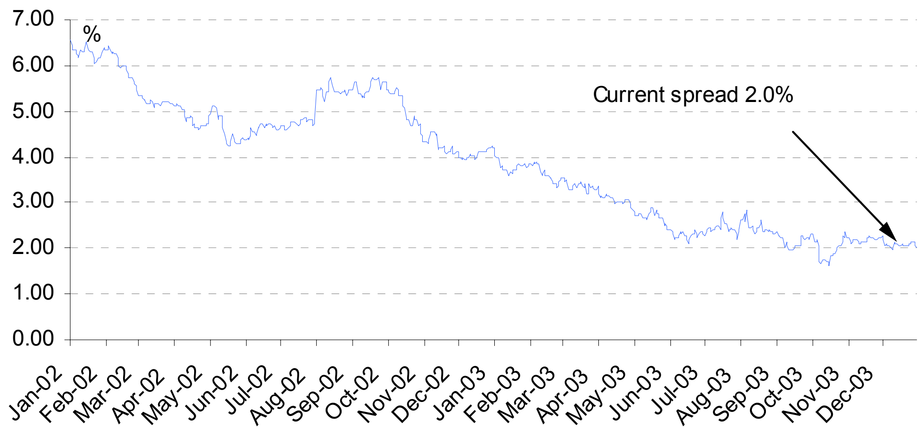
Source: Moody's; CBR; Aton estimates

1b) Continued spread compression and falling risk-free rate

A direct reflection of Russia's improved finances and political stability, the spread between its 2030 Eurobond and 2030 US Treasury bonds dropped to 1.75% in October (after the Moody's upgrade), from 4.2% at the beginning of the year, reflecting a reduction in its country risk premium. Following the arrest of Khodorkovsky the spread recovered to its pre-upgrade range of 2.0-2.3%; nevertheless, the figure halved during the year.

As a result of the falling spread, the required rate of return for Russian equities also declined, providing upside to the DCF-based value of stocks.

Continuing spread compression: Russia 30 vs US 30



Source: Bloomberg

1c) Rising corporate earnings

As the chart below shows, the aggregate net income of Russia's top 15 companies by market capitalization increased by 92% in 2003; aggregate EBITDA, which represents a less volatile measure of cash flows, increased by 41%. Adjusted for Gazprom (which accounts for around 25% of the total), aggregate net income increased 58% in 2003.

We must note that EBITDA and net income growth in 2003 far exceeded both our own and consensus expectations, leading to numerous upward earnings revisions throughout the year.

Aggregate corporate earnings up 92% in 2003

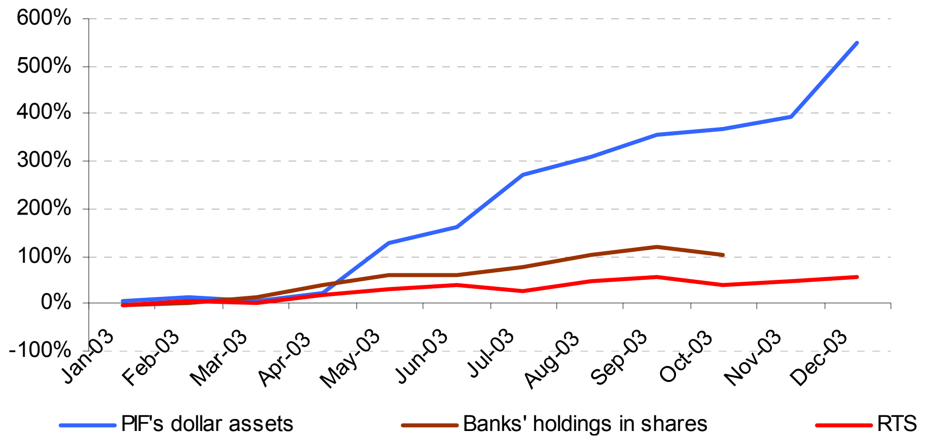
In $mn	2002		2003E		Change	
	EBITDA	Net Income	EBITDA	Net Income	EBITDA	Net Income
Yukos	4,118	3,432	5,346	4,275	30%	25%
Surgutneftegaz	2,725	1,555	3,463	2,094	27%	35%
Lukoil	3,658	1,850	4,124	2,113	13%	14%
Norilsk Nickel	1,195	315	2,236	1,228	83%	278%
Sibneft	1,818	1,158	2,418	2,118	33%	83%
UES	2,343	-523	3,504	748	50%	NM
Sberbank RF	844	923	832	728	-1%	-21%
Severstal	512	189	1,105	661	116%	250%
Tatneft	780	438	943	480	21%	10%
Mosenergo	267	-74	647	293	142%	NM
Rostelecom	327	37	375	76	15%	105%
Baltica	234	140	221	124	-6%	-11%
Gazprom	7,301	876	11,236	4,993	54%	470%
MTS	667	277	1,259	464	89%	68%
Vimpelcom	322	130	585	221	82%	70%
Aggregate	**27,111**	**10,723**	**38,294**	**20,616**	**41%**	**92%**
Aggregate (ex-Gazprom)	**19,810**	**9,847**	**27,058**	**15,623**	**36%**	**58%**

Source: Company data; Aton estimates

1d) The rise of the domestic investor

Domestic investors step in…In 2003, domestic investors emerged as a force to be reckoned with. Accurate domestic shareholding statistics are not available, but the fact that the growth of equity holdings by Russian banks and mutual funds (PIFs) - a useful proxy for domestic institutional participation, outpaced that of the RTS by a wide margin seems to show that domestic portfolio purchases were an important factor behind the market's rally.

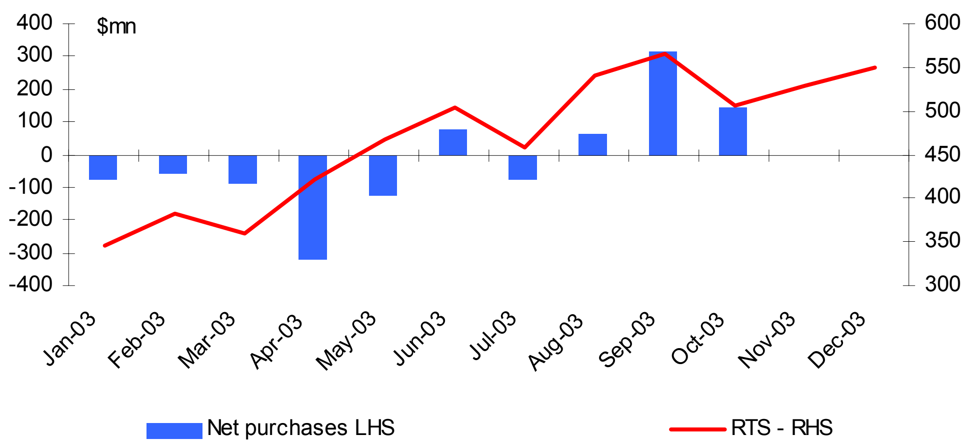
Equity holdings of Russian institutions soar in 2003



Source: CBR; Bloomberg; Aton estimates

…while foreigners were net sellers. Statistics for GEM/International and EMEA funds suggest that in contrast with domestic investors, foreign investors were net sellers through most of 2004. During January-October 2003, total foreign cumulative net flows were negative $144mn. Given that during the year the overall appetite for emerging market equities was apparently high, the selling suggests that investors were likely re-allocating their portfolios in favor of other emerging markets.

RTS vs. net monthly inflows from GEM/Int'l/EMEA funds



Source: Emerging Portfolio; Aton estimates

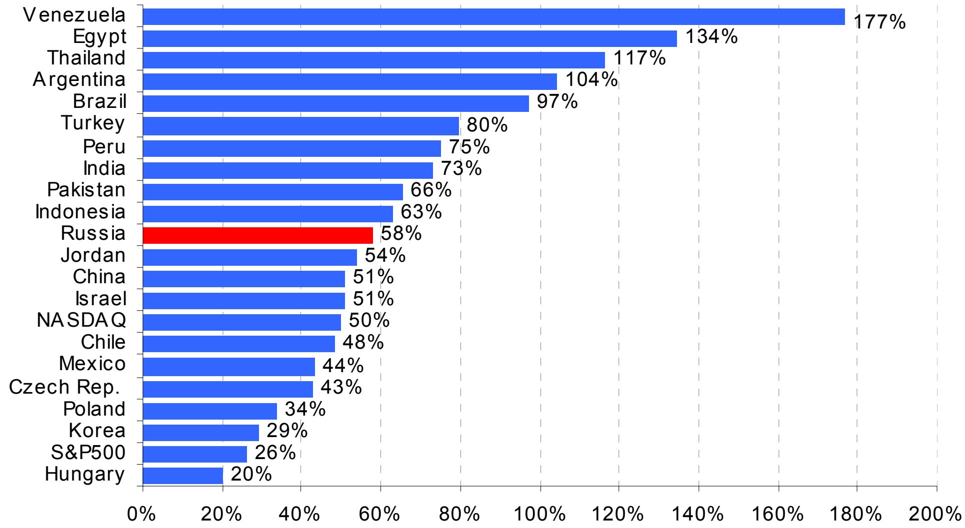
Factor 2: Global rally in equities

Global equity markets staged a powerful rally in 2003 after three years of lackluster performance. The low interest rate environment in the U.S., Europe and Japan created substantial liquidity, while the apparent resolution of global political problems, accelerating economic growth and rising corporate earnings all gave investors reason to buy equities. As usual under such circumstances, emerging markets worldwide benefited as well, with the 10 best-performing markets in the world in 2003 all being emerging.

Although the usually strong correlation between Russia and major global indices has weakened in recent years, **the worldwide rally in developed and GEM equities clearly benefited the Russian market in 2003; without it, the beneficial impact from commodity prices would likely have been far more subdued.**

We note that in 2000, when oil prices were also very high and Russia's GDP advanced 10%, the RTS Index actually fell by 20% as global equity markets plunged. Thus, a strong global appetite for equities was also instrumental in the RTS recording a 58% gain in 2003.

Performance* of select global equity markets in 2003: Russia rallies with the rest



In local currency, RTS in US$ terms

Source: Bloomberg

Factor 3. M&A deals/strategic buying

2003 was perhaps the first year in the history of the Russian stock market when publicly traded equities attracted the attention of not just portfolio, but strategic investors as well. For the first time ever, strategic investors (primarily domestic) apparently realized that shares traded on Russian exchanges represented not only tickers on traders' screens, but conferred economic ownership rights as well. What ensued was a flurry of M&A deals and strategic buying; M&A transactions primarily involved Russian oil companies and cellular operators, while strategic buying was most pronounced in power utilities.

In the oil sector alone, we counted more than $20bn worth of completed M&A transactions (excluding strategic buying in SNGS which probably amounted to $200mn-$500mn). In the power utility sector, by our estimates, a buying spree in UES shares saw inflows of some $2.5bn-$3bn that led to 117% stock price appreciation; the UES rally was accompanied by 100%-200% gains in many other power utilities.

While strategic purchases on the open market had a clear direct impact on share prices, M&A deals also provided important support to equity values by providing valuation benchmarks and prompting the market to incorporate potential takeover premiums into the share prices of many Russian companies.

2003 saw $27bn-$28bn worth of M&A deals/strategic purchases

	Major M&A deals / strategic purchases	Estimated value (actual deals only), $bn
Oil and gas	TNK-BP, Yukos-Sibneft, SurgutNG, BP-Slavneft, TNK-ORNB (from Sibneft), YukosSibneft-global major (talks fell through)	21-22
Power utilities	Various-UES, Gazprom-Mosenergo, regional utilities	3.5-4
Telecoms	Alfa-Megafon, Golden Telecom-Combellga, Sistema-DT (MTS), regional telcos and cell operators	2
Consumer/Industrials	OMZ-Power Machines, AVAZ, Danone-WBD (talks fell through)	0.3 - 0.4
Metals and Mining	Severstal-Rouge, SUAL-Vsmpo	NM
Total		**26.8-28.4**

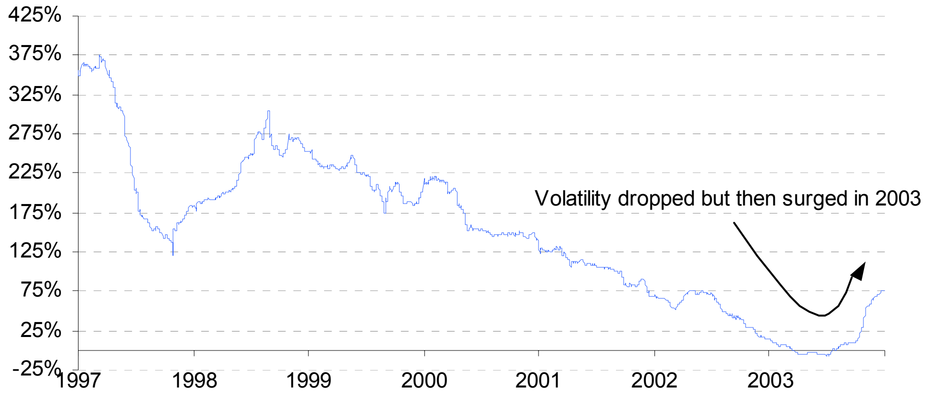
Source: Company data; Aton estimates

Market volatility U-shaped

Another interesting feature of the 2003 rally was the steady reduction in the market's volatility through 10M03, followed by a powerful upward spike late in the year. The market's excess volatility – measured by comparing the RTS index's daily fluctuations to those of the S&P 500 – dropped from 50%-60% in 2002 (which meant the Russian market was 50%-60% more volatile than S&P 500) to near zero in May-October 2003. However, the attacks on Yukos resulted in excess volatility returning to 50%-70% levels. In our valuation framework we assumed a 2003 excess volatility factor of 1.2 (or 20% greater relative volatility for the RTS), compared to 1.5 for 2002, which resulted in a reduction of some 150bp in the equity premium; the actual reading came in at 1.08.

While our average 2003 excess volatility forecast was thus rather accurate, the high 2003 exit volatility bodes negative for 2004 returns in our view.

Relative volatility of RTS vs. S&P: late year spike after the Yukos affair



Source: Bloomberg

2003: bottom line

All of the stars were in alignment for Russian equities in 2003: global commodity prices hovered near all time highs, global developed and emerging equity markets soared after years in the doldrums, strategic buyers joined portfolio investors in a major way and market volatility declined steadily through most of the year. Going into 2004, however, many of the 2003 catalysts appear to be missing, as we explain in the following section.

2004 MACRO OUTLOOK: STILL POSITIVE, BUT FEW KEY 2003 CATALYSTS MISSING

Turning to 2004, we believe that commodity prices – the key market driver of 2003 – will remain fairly strong. Therefore, two of its derivative products – economic strength and domestic liquidity – are likely to remain in place as well. However, other crucial elements of the 2003 rally – sovereign yield spread compression, rising corporate earnings (which made undemanding end-2002 valuations seem outright cheap) and M&A activity – are all likely to have a far less pronounced impact on the market.

Several 2003 catalysts likely to be missing in 2004

Key market drivers	2003	2004 outlook	Factor relevance in 2004
1) Strong commodity prices	All key commodity prices near multi-year highs	Expected to remain strong, but moderate slightly	**Unchanged/Less pronounced.** Brent forecast at \$25.5/bbl vs. \$30/bbl at present; nickel at \$12,000/t vs. \$15,000/t at present
a) Strong macro performance and prudent policies	GDP growth of 7%, inflation of 12%, current account surplus 8.9% of GDP	GDP growth of 5.9%, inflation of 11%, current account surplus 5.1% of GDP	**Unchanged.** Growth with falling inflation and strong ruble possible even at a lower level of oil, gas and metals prices
b) Yield spread compression; falling risk free rate	Russia 30 - US 30 spread down from 4.2% at end-2002 to 2.0% at end-2003	Russia 30 - US 30 spread expected down from 2.0% end-2003 to 1.7% end-2004	**Much less pronounced.** There is precious little room for further compression; even if the spread falls to just 1%, our FV would rise by 5%-10% at best
c) Rising corporate earnings	Combined 2003 earnings of top 15 Russian corporates forecast up 92% y-o-y	Combined 2004 earnings of top 15 Russian corporates forecast down 2% y-o-y	**Much less pronounced.** We expect virtually no growth in oil sector profits due to a strong ruble, rising transport costs and possibly higher taxes
d) Domestic liquidity	Holdings of equities by Russian institutions up 125-140%	Trend likely to be sustained	**Unchanged.** High commodity prices and rising domestic liquidity go hand in hand
2) Favorable emerging markets backdrop	Top 10 markets worldwide all emerging markets, rising 70%-100%-plus	Major global banks forecast continued strength in 2004, but at a more moderate pace	**Unchanged/Less pronounced.** Asian economies likely to sustain growth, but in Latam and EMEA, many event-specific stories (economic turnaround/recovery, EU accession, etc.) appear to have been priced in
3) M&A activity/Strategic buying	TNK-BP, Yukos-Sibneft, power utilities, BP-Slavneft, Alfa-Megafon, Danone-WBD, OMZ-Power Machines, AVAZ	Lukoil, Sibneft mentioned but unlikely; power utilities story likely to continue	**Much less pronounced.** Yukos affair – yet to be resolved – likely to deter a substantial number of potential suitors
4) Falling excess volatility	Average 1.08, down from 1.5 in 2002, but back up to 1.5-1.7 by year-end	Assumed at 1.25 for 2004	**Much less pronounced.** A great way to assess the impact of political issues on equities, we expect relative volatility in 2004 to exceed 2003 levels.

Source: Company data; Aton estimates

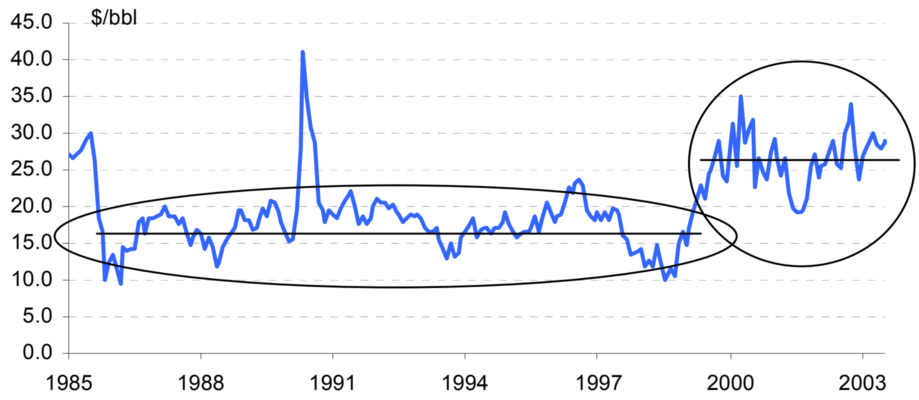
Commodity prices likely to remain high

In our Oct. 2003 strategy report (*RTS 1,000 in three years? The fundamentals are there),* we noted that in the last four years Brent crude oil has averaged \$26.7/bbl, the first time such a high price has been sustained over such a prolonged period. And while as a rule we refrain from making extensive arguments for higher or lower oil prices (we leave this job to global investment banks equipped with strong commodity research teams), it appeared reasonable to us to suggest that in addition to cyclical factors, the price strength of recent years could also be attributed to some secular changes in the supply-demand balance for this finite commodity.

In particular, we thought that in the longer run structural supply factors like the declining availability of oil reserves (particularly those cheap to develop), low global inventories and OPEC's influence, coupled with steady increases in demand from Asian economies, are very supportive of a long term upward trend in oil prices.

We thus believe the oil price will remain rather strong in 2004 and beyond, although we expect prices to moderate in 2004. We forecast Brent crude oil to average \$25.5/bbl in 2004 vs. \$28.9/bbl in 2003, thus securing a fiscal surplus and allowing the Russian government to continue to honor its debt obligations. In addition, this should enable the government to add almost $3bn to its newly created stabilization fund.

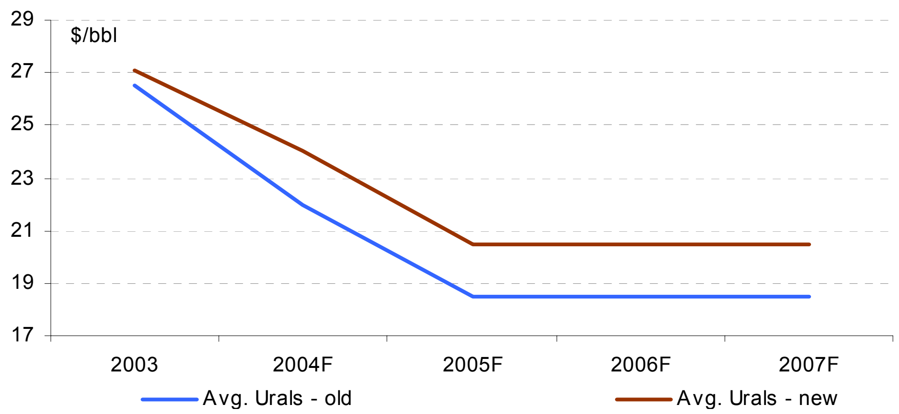
Brent price trajectory: what level is "normal?"



Source: Bloomberg

Beyond 2004, we are now effectively assuming an average Brent price of $22/bbl (i.e. 10% above the previous forecast, in line with 10 year trailing average and at the lower end of OPEC's $22-$28 target range, which suggests our forecast is still very conservative).

Changes to oil price assumptions



Source: Aton estimates; Bloomberg

Export gas prices will likely remain unchanged at their high levels throughout 2004 as they are yet to reflect 2H03 oil price strength. Key metal prices, which benefited substantially in 2003 from what appears to be a massively one-sided trade on rising Chinese consumption, are also expected to remain high, although we expect them to retreat below their current levels and 2003 averages.

Nickel, which in 2003 gained more than 100%, is set to remain strong due to the market's structural imbalances, even though in coming months the price could ease after spiking on the back of speculative squeezes. For 2004, we expect an average price of $12,000 against the current reading of $15,000.

We note that nearly all of our commodity price forecasts are well below their current levels, which suggests scope for potential out-performance vis-à-vis our estimates; however, in the event of this occurring the resulting ruble strengthening would likely further eat into the profit margins of commodity exporters, largely offsetting the impact from higher prices.

Key commodity prices expected to remain strong in 2004

Average	2003	2004F	Price as of 09 Jan 2004
Oil (Brent), $/bbl	28.9	25.5	31.4
Gas (Gazprom), $/mcm	129	125	129
Nickel (LME), $/t	9,980	12,000	15,310
Steel (Metals Bulletin), $/t	285	300	350
Gold (COMEX), $/oz	368	330	418
Platinum (COMEX), $/oz	696	500	844

Source: Bloomberg; Aton estimates

Strong economic performance set to continue, but does this mean another rally for equities?

We expect the strong economic momentum in 2003 to continue in 2004, leading to GDP growth of 5.9%. While strong commodity prices will indisputably play an important role, domestic demand will remain they key growth driver, as incomes are expected to rise and consumption to increase well above the expected GDP growth rate. We expect consumption to grow 7.5% (measured by retail sales) with real disposable income up 9.5%.

2003 growth was also partly driven by booming investment by Russian companies (up 12% y-o-y), we remain cautiously optimistic that this will continue to be a driver and predict a 9.5% increase in fixed investment for 2004.

2000-04F macroeconomic highlights

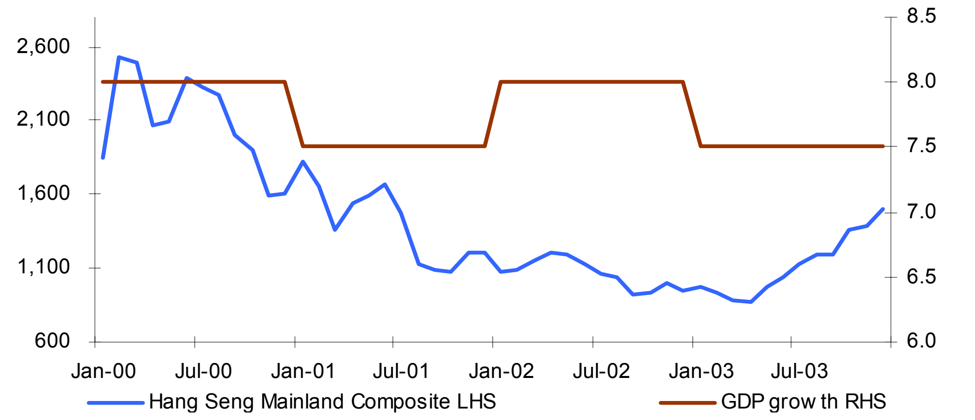
	2000	2001	2002	2003F	2004F
Nominal GDP (Rbn)	7,306	9,039	10,863	13410.0	**15,800.0**
Nominal GDP ($bn)	260	310	347	437.0	**552.4**
Real GDP growth (%)	**10.0**	**5.1**	**4.7**	**7.0**	**5.9**
Industrial production (%)	12.0	4.9	3.7	6.9	**5.9**
Fixed investment (%)	17.3	8.3	2.5	12.0	**9.5**
Real retail sales (%)	8.7	10.6	9.0	8.2	**7.5**
Real disposable income per capita (%)	**9.7**	**8.5**	**10.1**	**13.9**	**9.0**
CPI growth, (% ch. y-o-y, eop)	20.1	18.8	15.1	12.0	**11.0**
Fiscal surplus (% of GDP)	2.4	2.9	1.4	1.6	**0.6**
Current account (% of GDP)	**18.0**	**10.8**	**8.6**	**8.9**	**5.1**
Average Ural Med ($/bbl)	26.5	22.9	23.7	27.2	**24.0**

Source: State Statistics Committee; CBR; Bloomberg; Aton estimates

In general, a strong economy should be very positive for equities as it will lead to: **(a) higher corporate earnings**; and (b) **likely prompt other rating agencies to follow Moody's lead and award Russia investment grade status**. An upgrade by S&P, for example, would trigger a further reduction of the theoretical discount rate, meaning upside to valuations. In our view, this scenario is possible even though both S&P and Fitch have repeatedly voiced concerns about diversification of the Russian economy and the speed of structural reform.

Yet, on the first issue we note that the relationship holds well when a stock market is representative of the economy as a whole. While this may be true for a developed country like the U.S. or Germany, we note that 80% of Russia's large-cap stocks represent oil, gas and metals sectors, which are driven first and foremost by global prices for the commodities they are selling rather than by the state of the national economy (which in fact is driven by the same commodity prices).

China: macroeconomic strength no guarantee of stock market performance



Source: IMF; Bloomberg

Indeed, the example of China shows that macroeconomic strength can be accompanied by a dismal stock market performance (see chart above) due to issues such as weak global equity markets, corporate governance, political concerns, economic reforms, regulation, etc.

Due to the above mentioned dependence of their earnings on commodity prices, in 2004 we are very likely to see flat to lower corporate earnings at Russia's major oil and metals companies, as moderately lower export prices and higher costs offset any benefits of rising production volumes. We again make the point that were commodity prices to exceed our expectations, any benefits from this would likely be lost to higher inflation, a stronger ruble and higher taxes.

Flat aggregate EBITDA/net income seen in 2004 as oils' profits contract

	2003F		2004F		Change, %	
In $mn	**EBITDA**	**Net Income**	**EBITDA**	**Net Income**	**EBITDA**	**Net Income**
Yukos	5,346	4,275	4,989	3,156	-7%	-26%
Surgutneftegaz	3,463	2,094	2,948	1,652	-15%	-21%
Lukoil	4,124	2,113	4,176	2,179	1%	3%
Norilsk Nickel	2,236	1,228	2,722	1,623	22%	32%
Sibneft	2,418	2,118	2,814	1,904	16%	-10%
UES	3,504	748	4,354	1,187	24%	NM
Sberbank RF	832	728	782	626	-6%	-14%
Severstal	1,105	661	925	534	-16%	-19%
Tatneft	943	480	918	469	-3%	-2%
Mosenergo	647	293	743	352	15%	NM
Rostelecom	375	76	409	96	9%	26%
Baltica	221	124	251	145	14%	17%
Gazprom	11,236	4,993	11,264	5,461	0%	9%
MTS	1,259	464	1,667	678	32%	46%
Vimpelcom	585	221	937	464	60%	110%
Aggregate	**38,294**	**20,616**	**39,899**	**20,526**	**4%**	**-1%**
Aggregate (ex-Gazprom)	**27,058**	**15,623**	**28,635**	**15,065**	**6%**	**-4%**

Source: Company data; Aton estimates

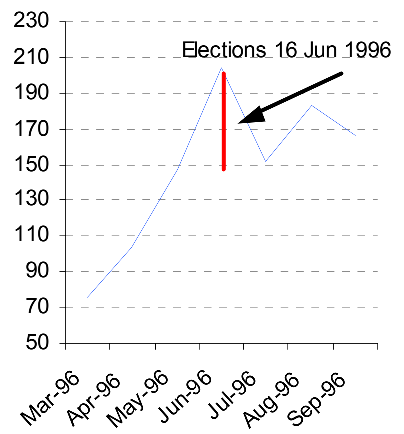
As regards the second point, while further spread contraction on the back of ratings upgrades is likely, the scope for reduction is now decisively smaller. The spread of 30 Russian Eurobonds to 30 US Treasuries barely moved despite increased political tension and now remains around 1.7%, the same as for Mexico and other Baa/BBB rated countries. If the spread were to fall even further to the 1%-1.5% levels seen at select BBB+/single A countries, it would result in no more than a 10% increase in our fair value targets.

2004 PRESIDENTIAL ELECTION: EXPECT LITTLE IMPACT

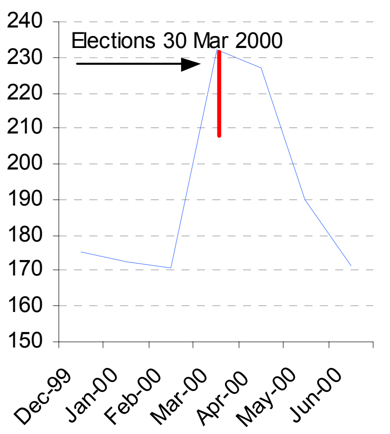
Using history as a guide, some investors may be expecting to see a “presidential rally” in 2004; on the last two occasions Russia was electing its president the market rallied very strongly. In 2004, however, the history is not a good guide as the result of the March election is easily predictable and the potential upside from the event therefore likely to be little, if any.

In 1996, the market soared 150% in the three months ahead of the election as investors became increasingly confident of Yeltsin’s victory. In 2000, although Putin’s chances of winning were clearly very high due to his incumbent role, the RTS Index still rallied 30% in the three months to the election as investors appreciated the greater certainty of Putin moving from acting to elected president.

RTS rallying before Yeltsin’s re-election…



…and Putin’s election



Source: Bloomberg, Aton

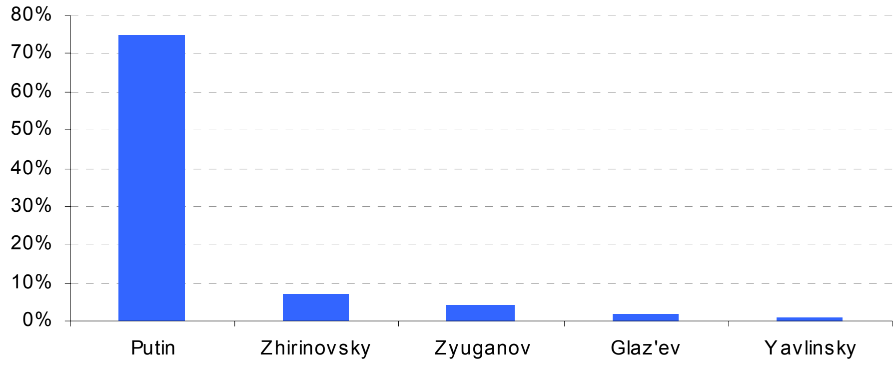
If we fast-forward to the present, the question is whether the 2004 presidential election and Putin’s winning a second term could be something for the market to look forward to?

We believe in this case history is not a good guide as the result of the March election is easily predictable and the potential upside from the event therefore likely to be little, if any.

In the volatile environment of pre-Putin Russia, the outcome of the 1996 and 2000 presidential elections produced a huge reduction in uncertainty, as the issue of succession was of paramount importance to the economy and capital markets, and the final result difficult to predict.

In contrast, political stability has become a given in Putin’s Russia and the president’s re-election appears all but certain, as evidenced by his unparalleled popularity (see chart below). As a result, the election is likely to be something of a non-event for the markets.

Putin leads the presidential contenders' pool by a wide margin*



**Who would you vote for if presidential elections were held tomorrow?*

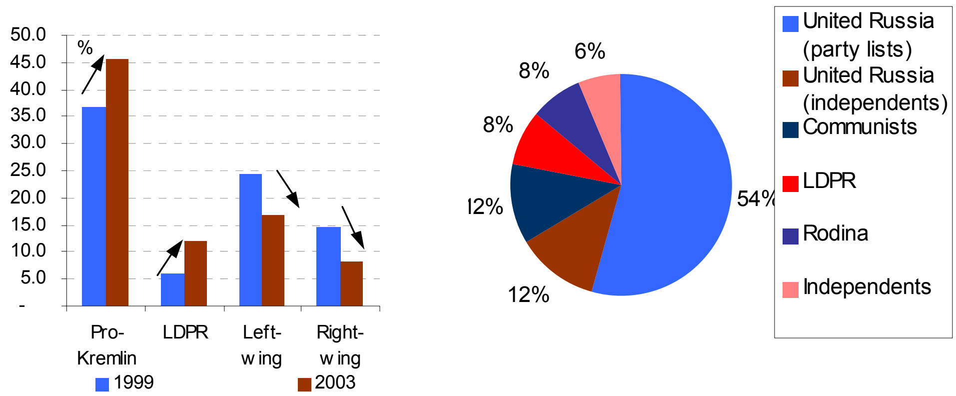
Source: VTsIOM

Underlining our thesis about the 2004 presidential elections being a non-event, three of the four presidential candidates mentioned above – Zhirinovsky, Zyuganov and Yavlinsky – have opted not to run in the presidential election, which they have no chance of winning.

In our view, the key question is thus not whether Putin will win a second term, but rather what policies he will pursue in that term.

This question is of particular importance as assuming Putin is re-elected he is set to hold an unprecedented level of power in post-Soviet terms, as the pro-Kremlin United Russia party together with independents who joined it now holds a constitutional majority in the Duma, with 67% of total seats. The Kremlin also controls the upper house of parliament, the Federation Council, and the national television networks.

The Kremlin achieves super-majority of Duma seats in 2003, the first time ever



Source: CEC

One popular refrain on the executive branch controlling the legislative arm of government is that the reform process is likely to accelerate due to more streamlined decision-making and implementation. While we certainly hope this to be the case, there are several caveats that give pause for thought.

First, we note that working with the previous Duma the Kremlin hardly had any problems putting through the legislation it required, no matter how controversial. In the last four years, revolutionary tax and power sector reforms as well as a new Land Code and rail sector restructuring were all approved by the Duma, although they probably required serious lobbying efforts. In fact, since late 2002 United Russia and its allies have held a simple majority, which was enough to pass any legislation.

Second, the reason some reforms are not progressing as fast as investors would like – banking reform, gas sector restructuring, judicial reform – is not because of Duma recalcitrance, but rather because many vested interests (ministries, the Central Bank, companies, etc.) fail to agree on various key issues.

Third, many representatives of Yabloko and SPS (the two liberal parties that failed to cross the 5% threshold) played an important role in formulating, presenting and lobbying the reform agenda at various Duma committees and sub-committees; with their departure, the reform drive at the functional levels of the Duma may wane.

Finally, we note that although there are no such indications at present, the Kremlin's two-thirds majority in the Duma opens up the possibility of amending the constitution in the absence of any opposition. Such a lack of "checks and balances," however imperfect they were in the past, appears negative to us.

Overall, we conclude that the chances of passing reform legislation through the new Duma are not materially better than they were in the old, while the significant weakening of the checks and balances of Russia's political system presents a risk to the market.

The main risk we see is that the three main winners in the Duma election, United Russia, Vladimir Zhirinovsky's LDPR and Motherland, all ran on the ticket of taking from the rich (i.e. Russia's largest corporations) and giving to the poor; the Communist Party by default subscribes to the same ideals.

As a result, Russia's corporate world is likely to see a more hostile operating environment in coming years.

Higher oil sector taxes a likely reality

We believe the most serious and likely ramification of the new political landscape in Russia will be a harsher tax regime for natural resource companies, such as the oil majors, Gazprom, Norilsk Nickel and others.

Calls for an increase in the government's take of the oil sector's windfall profits have been coming since the middle of 2003 and intensified in the run-up to the Duma election. The government reportedly planned a total increase of $3bn in oil sector taxes, however an attempt to push legislation through the Duma met stiff resistance from the oil lobby.

To date, however, the government has already succeeded in pushing through numerous other legislative initiatives aimed at increasing taxes on the oil sector, such as:

1) Closing the regional tax breaks that allowed Yukos, Sibneft and others to save $1bn-$1.5bn in income taxes per annum;

2) Removing the 90% cap on refined product export duty relative to crude oil export duty, which will likely result in a net increase in refined product export duties.

3) Asking relevant ministries to develop a differentiated tax system that will seek to levy higher taxes on companies with better quality reserves (Yukos and Sibneft would be worst hit, while Tatneft and Surgut may benefit); and

4) Asking relevant ministries to develop a new "tax on excess profit from hydrocarbon production" that will sharply increase the budget's take of oil company profits over a predetermined level of costs and allowed rate of return. The law is to be developed next year, introduced to the Duma in 2005 and become effective on Jan. 1, 2006.

We note that the above-mentioned $3bn increase in total sector taxes could also be easily achieved within the existing tax framework by simply increasing the rates at which the export duty and Unified Minerals Production Tax (UMPT) are charged.

The only thing that may spare oil companies a higher tax burden would be a meaningful reduction in export oil prices to $20-$22 per barrel; this would likely result in more normalized profits and somewhat deflate the case for extracting greater taxes from the oil sector.

In any case, the proverbial $3bn in new taxes amounts to approximately 17% of the estimated $18bn in net income Russian oil companies generated last year. While such a reduction in profits does not appear life-threatening at current oil price levels, it may be felt more if the oil price weakens.

We also note that in 2004 the new tax regime for Gazprom comes into effect, with the net impact being a $1bn rise in Gazprom's total tax burden. Given the extraordinary profitability of Gazprom, we believe it is only a question of time before the government returns to Gazprom to ask it for more money.

We believe the same fate awaits Russia's largest metal exporters, such as Norilsk Nickel. We note however that thus far neither Gazprom nor Norilsk Nickel have been expressly mentioned by the authorities as possible candidates for higher taxation.

In sum, we believe the most direct impact of the recent changes in the Russian political climate will be higher taxes on natural resource industries, with the oil sector the primary target. Considering that companies from these sectors comprise around 80% of the Russian market, their lower and more volatile earnings due to the possible introduction of new taxes will have a meaningful impact on the Russian equity market.

The only hope we harbor is that moderating commodity prices will somewhat deflate the argument for higher taxes; we also hope that such taxes will focus primarily on profits generated by well above-average commodity prices.

Government and big business: conflict unresolved

One sad legacy the Russian market inherited from last year was a remarkable worsening of the relationships between the government and big business – epitomized by the political attacks on Yukos and the arrests of its key shareholders.

The events posed serious questions in relation to whether the investigations would be limited to just Yukos and if they meant:

1) the final decisive victory over oligarch rule (which unfortunately had to be achieved through heavy-handed tactics) and the onset of rule of law;

2) or the beginning of a new era of property redistribution, selective justice and the prosecution of political opponents through all means possible.

Unfortunately, we are skeptical about the government's explanation for its actions: since Yukos's track record on privatization and tax payments in the mid- to late 1990s is hardly unique, the case against it in our view represents a clear example of selective justice.

While we hope that the Yukos affair might be finally wrapped up in 2004, the implications for the company are likely to be severe. Despite Putin publicly warning off zealous attempts to damage Yukos itself, the investigations may translate into a crippling tax fine, as high as $3bn-$5bn, and disruptive changes to ownership and management.

As for the scope of the investigations, we tend to take Putin's statements that there will be no revision of privatization and assurances that the current investigations will be limited to

Yukos at face value. Worryingly though, signals from the government on this issue tend to be conflicting; thus Putin himself mentioning “5-7 individuals” who broke the law during privatizations sent a chill through the market. Indeed, given Russia’s murky legal system and still-questionable judicial independence, the government may use law enforcement powers beyond justified limits.

It is worth noting that to outsiders the extent of the resurgent political risk may be hidden by the fact that Russia’s Eurobond spread has barely moved in the wake of the Yukos affair. However, we caution that Russian country risk is not fully captured by its Eurobond yield spread over benchmark U.S. Treasuries. While the bond yield spread is a fairly accurate measure of Russia’s relative propensity to pay its debt, it fails to adequately reflect the risks to Russian corporate assets stemming from questionable legal practices and tenuous property rights.

To summarize, as we enter 2004 the Yukos affair in particular, and the relationship between government and big business in general, remain unresolved. As 2004 brings closure to some of these issues, we see the newsflow risk skewed to the downside.

2004 EQUITY MARKET OUTLOOK: NEW RTS TARGET OF 597 IMPLIES UNEXCITING PERFORMANCE

After reviewing our DCF assumptions, we have lowered our end-2004 RTS target to 597, implying virtually zero upside from current levels. This means Russian equities no longer look attractive en-masse. We must note that from a technical perspective, the market may briefly enter bubble territory in 2004 as domestic liquidity chases increasingly fundamentally unattractive and volatile stocks against a generally favorable macro background.

DCF inputs fine-tuned; cost of equity little changed at 12.4%

Entering 2004, we have reviewed the key assumptions used in our DCF discount rate calculation. We have left our benchmark cost of equity estimate largely unchanged, increasing it by just 10bp to 12.4%, as the benefits of a lower Russian risk free rate were offset by increased forecast volatility.

As described earlier, we have also made changes to our oil price assumption, one of the most important inputs for valuing oil and gas companies and the market as a whole. This has led us to upgrade our operating forecasts for oil and gas companies, which partly offset the effect of the higher cost of equity estimate.

Cost of equity increased by just 10bp to 12.4%

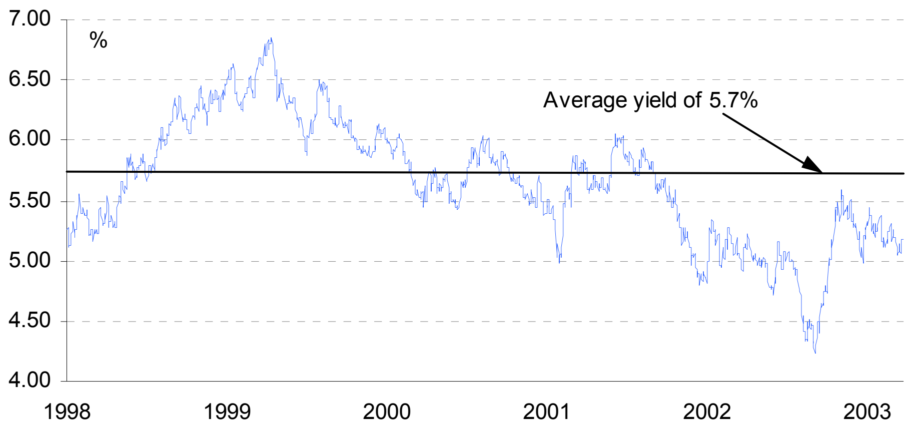
Assumptions	Previous	New	Comment
Long-term risk free rate, %	6.00	5.70	Based on 5-yr. trailing average yield of LT US govt. bond futures
Russian country risk premium, %	1.50	1.70	Spread of LT Russian Eurobonds over US govt. bonds
Russian risk-free rate, %	**7.50**	**7.40**	
Standard equity premium, %	4.00	4.00	Historic difference between stocks and bonds
Excess RTS volatility factor	1.20	1.25	Increased forecast excess volatility due to recent upsurge
Russian equity market premium, %	**4.80**	**5.00**	
Base cost of equity*, %	**12.30**	**12.40**	Barely changed

**Calculation of cost of equity for individual companies is adjusted for company-specific factors*

Source: Bloomberg; Aton estimates

Russia's risk-free rate reduced to 7.4%. We have reduced our estimate for Russia's risk-free rate to 7.4% from 7.5%. First, we have reduced our estimated long-term risk-free rate by 30bp to 5.70%, matching the five-year average yield of long-term US Treasury bonds (down from the 6.0% used previously). We reiterate our view that using the average yield is better for two reasons: first, it is more consistent with the long-term nature of our DCF models, and second, given US interest rates are at abnormally low levels, using the spot rate would not be sufficiently conservative.

Historic yield of long-term US Treasury bonds



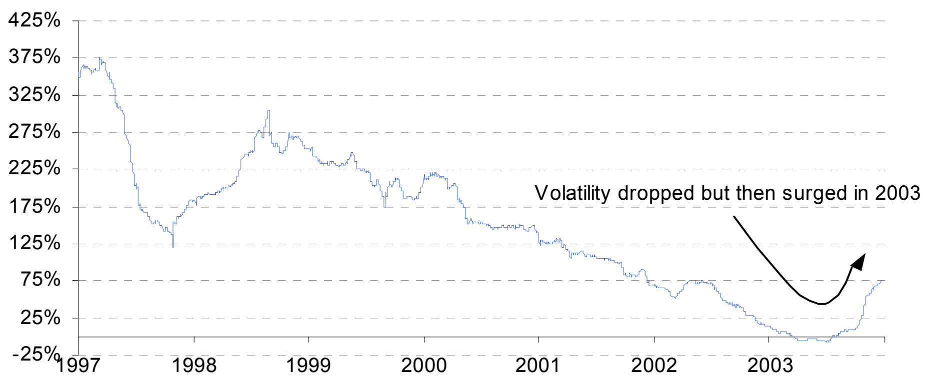
Source: Bloomberg

We have also slightly increased our estimated Russian country risk premium by 20bp to 1.7%, in line with the current spread between the yields of long-term US and Russian government bonds. We note that a contraction to 1.5% (our previous target) is still possible. Yet, given the increasingly volatile environment, we would rather err on the side of caution; moreover, the sensitivity of our valuation models to a 20-30bp change in the sovereign risk premium is very small.

Russian equity premium risk increased to 5.0% due to increased volatility. We have left unchanged our standard equity risk premium of 4% based on the historic differential in returns on US stocks and bonds. However, we have increased our Russian equity market premium estimate from 4.8% to 5.0% due to an increase in the RTS Index's forecast excess volatility factor from 1.2 to 1.25 (the excess volatility factor captures the relative volatility factor of the RTS against the benchmark S&P500 index).

Although the excess volatility factor averaged just 1.1 in 2003, as we noted earlier, following the Yukos events of Nov-Dec this figure had soared to 1.5-1.7 by the end of 2003, close to levels last seen in 2002. **In our view, the increase in the excess volatility factor represents perhaps the best way to quantify the impact of the Yukos affair on Russian equities and incorporate this impact into market-wide equity valuations.** Simply put, since the market has gotten more volatile in recent months, investors should justifiably require compensation in the form of higher expected rates of return.

Relative volatility of RTS vs. S&P: late year spike after the Yukos affair



Source: Bloomberg

We thus increased our forecast excess volatility factor to 1.25, which cost Russian equities 20bp on the discount rate, offsetting the benefit of a lower risk free rate and resulting in an increase of 10bp to 12.4%.

New RTS target of 597 highlights unexciting outlook for 2004

As a result of the changes to our target prices, we have lowered our bottom-up end-2004 fair value target for the RTS to 597 from 715 (also see our Oct. 17 strategy update *RTS target upgrade: Buy another day*) implying modest 5% upside from 2003 close and no upside from current levels.

Moreover, with Yukos and Sibneft (i.e. the companies with the highest political risk factor) accounting for more than a quarter of the RTS's capitalization, the risks to our RTS forecasts are skewed to the downside.

New target prices translate into 2004 RTS target of 597

Company	% Weight in the index	Prices as of 6 p.m. Moscow time 31 December 2003	2004 target price, $	Upside from 2003, %	Weighted upside, %
Yukos	17.3%	10.560	10.607	0%	0.1%
Surgutneftegaz	15.2%	0.582	0.415	-29%	-4.4%
Lukoil	14.1%	23.270	30.731	32%	4.5%
Sibneft	9.9%	2.850	2.650	-7%	-0.7%
Norilsk Nickel	9.8%	65.150	73.100	12%	1.2%
UES	8.5%	0.279	0.345	24%	2.0%
Sberbank	3.6%	260.500	247.050	-5%	-0.2%
Surgutneftegaz pref.	2.1%	0.390	0.370	-5%	-0.1%
Severstal	1.9%	121.900	147.880	21%	0.4%
Tatneft	1.8%	1.125	1.034	-8%	-0.1%
Mosenergo	1.4%	0.067	0.088	31%	0.5%
Rostelecom	1.1%	2.060	2.700	31%	0.3%
Baltika Brewery	1.0%	12.000	14.720	23%	0.2%
Orenburgneft	1.0%	20.750	23.200	9%	0.1%
Uralsvyazinform	0.9%	0.038	0.038	0%	0.0%
Slavneft-Megionneftegaz	0.9%	12.750	19.900	56%	0.5%
MGTS	0.7%	12.900	11.800	-9%	-0.1%
Transneft pref.	0.7%	591.500	599.020	1%	0.0%
Avtovaz	0.5%	27.000	41.070	52%	0.3%
Nizhny Tagil Iron and Steel	0.5%	0.540	1.250	131%	0.7%
RTS		**567**	**597**	**5.3%**	
Vimpelcom		73.500	92.3	26%	
MTS		82.800	103.3	25%	
Gazprom local		1.248	2.09	67%	
Gazprom ADS		25.90	27.81	7%	

Source: Bloomberg; Aton estimates

It is worth noting that the RTS index is not perfectly representative of the Russian market as a whole because it excludes such blue chips as Gazprom, Vimpelcom and MTS, which are not RTS members but are likely to deliver stellar returns in 2004 (with the exception of Gazprom's ADS). Stil even after these names are taken into picture, the risk-return profile of the Russian stock market does not appear particularly compelling.

Our DCF-based neutral view on the market in general is supported by comparative valuation on financial multiples: on 04FF multiples of 9 times earnings and 5 times EBITDA (considering that for most of the market 2004 is going to another peak eyar), the Russian market as a whole is no longer cheap relative to peers, although it's does not appear overvalued either.

We must note that from a technical perspective, the market may briefly enter bubble territory in 2004 as domestic liquidity chases increasingly fundamentally unattractive and volatile stocks against a generally favorable macro background.

Being fundamental analysts at heart, we cannot advise investors to buy Russian equities on the sole premise that other people will buy them too; yet, in the following section we present several stock picks that will provide investors with defensive, fundamentally attractive exposure to the market.

INVESTMENT STRATEGY: DEFENSIVE DRIVING RECOMMENDED

Having laid out our macro and political forecasts, which generally paint a rather bearish picture, we now have to develop an investment portfolio that would be defensively positioned in light of the above-mentioned risks while giving investors exposure to the positive trends in Russia's economic development.

By way of reminder, the key macro assumptions for 2004 we were working under were:

1) Commodity prices are likely to remain resilient;
2) Strong economic growth, increasingly driven by consumer demand, will continue;
3) The ruble will continue to appreciate;
4) Domestic and global liquidity will likely remain abundant;
5) M&A activity on the scale seen in 2003 is unlikely;
6) Stock valuations appear less compelling, particularly for oils/metals due to flat/lower earnings expected in 2004, as well as a stronger ruble and potentially higher taxes eating into profit margins;
7) Changes in the political landscape suggest a challenging operating environment for Russia's largest corporations; while market volatility has surged indicating a riskier environment.

Large-cap stocks

To select our top picks among Russia's largest corporations, we were thus looking for companies that possessed one or more of the following characteristics:

1) Low political risk (not being severely tainted by the privatization process, a good tax payment record, government ownership, etc);
2) Exposure to Russian economic growth and domestic demand, minimal negative impact from the strengthening ruble;
3) Exposure to company-specific or sector-specific trends or developments that would provide some hedge against general market risks; the presence of clear catalysts in 2004;
4) An attractive valuation, both DCF and relative to peers
5) A reasonable dividend yield/dividend payout

Given our rather stringent criteria, it is little wonder that only a handful of blue chips made their way onto our Buy list. We would like to highlight the defensive nature of our picks, which we primarily expect to provide downward protection in the event the market corrects, rather than delivering massive capital gains.

That said, in the table below we summarize our top 2004 picks among blue chips.

Top 2004 picks among large-cap Russian stocks

Prices as of Jan 11 04	Rating	Current price, $	End-04 target price, $	Upside potential	EV/EBITDA (X)		Comment
Large-cap					**2004F**	**2005F**	
Lukoil	Buy	24.57	30.73	25%	5.3	5.4	Lukoil remains our top pick in the oil sector due to a combination of accelerating production growth, continued internal restructuring, valuable portfolio of Caspian assets and relative immunity from the ongoing political pressure on the industry.
Gazprom common	Buy	1.25	2.09	67%	3.5	3.7	Our Buy case is based on a continued strong financial performance, still-undemanding multiples and relatively low political risk. The expected (for the umpteenth year already!) removal of the ring fence would be an added bonus if it actually happened.
UES	Buy	0.302	0.35	14%	4.8	4.4	The stock retains decent appreciation potential, particularly for those seeking liquid exposure to the utility sector. The OGK (wholesale generation company) auctions due in 2H04 are a key catalyst along with continued sector reform.
MTS	Buy	87.99	103.30	17%	6.1	5.5	Russia's mobile sector remains attractive due to strong disposable income growth and still-low cellular penetration. With 37% of Russia's mobile market MTS has the biggest market power. The adopted dividend payout policy (at least 20% of RAS net income) adds attraction
Vimpelcom	Buy	78.13	92.3	18%	4.8	4.0	Russia's mobile sector remains attractive due to strong disposable income growth and still-low cellular penetration. Because of market share expansion outside the MLA, Vimpelcom's top line should demonstrate above-average growth, Vimpelcom margin should further improve as regional green fields mature.
Severstal	Buy	132.50	147.90	12%	3.2	3.8	The stock is expected to perform well in 2004 due to such catalysts such as liquidity improvements (a recent ADR issue, free float increase), high dividend payout and expected strong financial results.
Wimm-Bill-Dann	Buy	17.31	22.98	33%	8.6	6.1	Expected turnaround in financial performance as previous acquisitions begin to bear fruit

Source: Aton

Mid- and small-cap stocks

In the mid-cap/small cap world, we see a number of interesting themes that may generate returns that long-term investors in Russia have grown to expect. Our preferred investment theme is regional power utilities, which are clearly set to benefit from the continuation of reforms and the narrowing valuation spread between UES/Mosenergo and less liquid names.

Top 2004 investment themes among mid- and small-cap stocks

	Theme	Key picks	Estimated appreciation potential
Mid- and small-caps			
Regional power utilities	With many second- and third tier energos still significantly undervalued, Russia's booming economy and utility sector restructuring will continue to serve as drivers for unlocking the sector's value.	Kuzbass, Krasnoyarsk, Chita, Novosibirsk, Tomsk. Udmurt, Kirov, HPIC	100%+
Regional telecoms	Although the 2003 rally has reduced the appreciation potential of regional telcos, the coming Svyazinvest privatization and further tariff and traffic growth keep the sector story interesting	Sibir Telecom	20%
TNK-BP consolidation	Can this be the year when TNK-BP finally keeps its word and makes a consolidation/buyout offer to all minorities?	Orenburgneft prefs	68%

Source: Aton

Ruble-denominated fixed income

Finally, we see no better way to play the "limited downside-strong economy-strong ruble" theme than **ruble-denominated bonds.** With 2-3 year second-third tier names offering yields in the low teens and nominal ruble appreciation of 6.3%, ruble-denominated fixed income securities can return around 20% in dollar terms in 2004.

What is interesting is that the corporate ruble bond market represents a much broader cross section of the Russian economy than its stock market. This is because most Russian oil majors and Gazprom had relatively easy access to the Eurobond and syndicated loan markets, whereas many mid-size companies outside of the natural resource universe (telecoms, power utilities, food and beverage producers, etc) only had access to the domestic bond market.

As a result, if our thesis regarding strong economic growth continuing in 2004 and filtering further into the non-export-oriented sectors of the economy is validated, then companies operating in these sectors are likely to see rising revenues and profits. In turn, this should improve their creditworthiness and result in falling ruble yields.

Top picks among Russian ruble-denominated bonds

Prices as of Jan 12 04	Price, $	YTM, %	Current spread to sovereign, bp	Target end-04 spread to sovereign, bp	Expected 2004 total return in RUB terms	Expected 2004 ruble appreciation	Expected 2004 total return on USD terms	Comment
Sibirtelecom	110	10.15	310	200	12%	6.3%	18.3%	1st-2nd tier spreads likely to tighten
Uralsvyazinform	105.5	10.15	310	200	12%	6.3%	18.3%	
Volgatelecom	109.8	10.00	330	200	12%	6.3%	18.3%	
Akron	101	12.90	850	550	15%	6.3%	21.3%	
RusAl	99.00	10.6	550	400	12%	6.3%	18.3%	
Archangelsk Pulp and Paper (ACVK)	100	15.7	1080	900	15%	6.3%	21.3%	Undervalued, strong financial data
PIT Investments	101	16.8	1170	900	17%	6.3%	23.3%	Undervalued relative to other consumer sector companies
Amtelshinprom	108.5	14.4	850	850	17%	6.3%	23.3%	Good business prospects, foreign ownership
Evrazholding	105	11.0	530	300	13%	6.3%	19.3%	Positive outlook for the steel sector
Mechel	97	13.8	715	500	15%	6.3%	21.3%	Positive outlook for the steel sector
Dalsvyaz	107.5	11.4	500	250	14%	6.3%	20.3%	Excessive spread relative to peers
WBD	96.8	12.4	600	300	15%	6.3%	21.3%	Coupon is linked to CPI

Source: Bloomberg; Aton estimates

2004 ECONOMIC OUTLOOK

ECONOMY GOING FROM STRENGTH TO STRENGTH

Russia's macroeconomic strength looks set to extend into 2004 supported by robust commodity prices and sound policy. We predict Russia's GDP to grow 5.9% in 2004 with matching growth for industrial production. Inflation is forecast at 11% compared to 12% in 2003, as inflationary pressures remain.

We believe that growth will be maintained both in the natural-resource industries and domestically oriented sectors, fuelled by rising consumption and fixed investment. This will continue to create a favorable backdrop for Russia's capital markets.

Key economic indicators

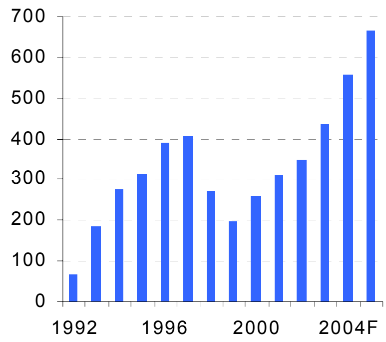
	2001	2002	2003F	2004F	2005F
GDP (Rbn)	9039.4	10863.4	13410.0	15800.0	18249.0
GDP (%)	**5.1**	**4.7**	**7.0**	**5.9**	**5.5**
Industrial output (%)	4.9	3.7	6.9	5.9	5.5
Inflation (%)	**18.8**	**15.1**	**12.0**	**11.0**	**10.0**
Budget surplus (% of GDP)	2.9	1.4	1.6	0.6	0.7
Urals Med ($/bbl)	**22.9**	**23.7**	**27.2**	**24.0**	**20.5**
Current account surplus (% of GDP)	10.8	8.6	8.9	5.1	3.0
Exchange rate (eop)	**30.1**	**31.8**	**29.5**	**27.7**	**27.1**
Exchange rate, (aop)	29.2	31.4	30.7	28.6	27.4
Real appr.(+) / depr.(-) (%, eop)	**9.3**	**6.6**	**18.7**	**15.2**	**9.7**

Source: State Statistics Committee; Central Bank; Aton estimates

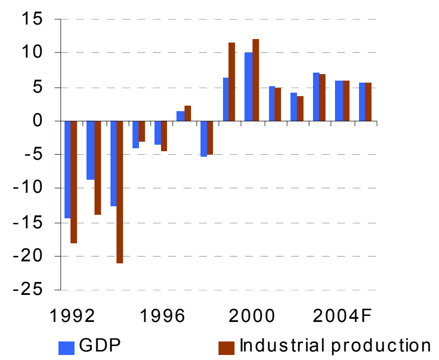
Growth: momentum remains

With growth at close to 7% in 2003 we expect this momentum to be maintained through 1H04, weakening slightly in 2H04. Overall, we expect GDP to grow 5.9% in 2004.

GDP 1992-2005 ($bn)



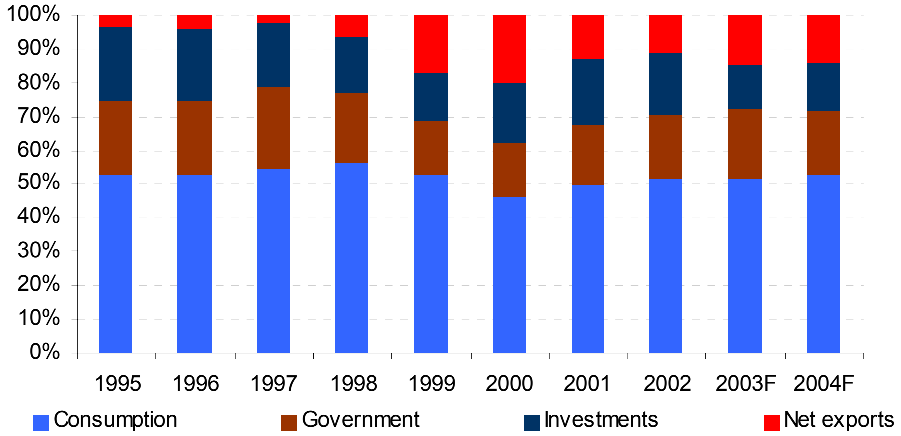
Growth in GDP and industrial output (%)



Source: State Statistics Committee; Aton estimates

While we expect growth in 2004 to remain strong in the **natural resource extraction industries** we also foresee a further **broadening of growth into domestically oriented sectors** such as construction, retail, transport and communication. From the demand-side growth will continue to benefit from rising household consumption and fixed investment.

GDP and its components



Source: State Statistics Committee; Aton estimates

Industry's performance is expected to track that of GDP, with our 2004 growth forecast being 5.9%. With the global recovery having a positive impact on world commodity prices, Russia's natural resource exporters are set to enjoy continued high growth rates.

As in 2003, we expect machine building and construction materials to be among the fastest growing sectors as these are strongly linked to the success of fixed investment, which we expect to grow 9.5% in 2004. We also expect growth in food processing to be maintained at around 5%.

A word of warning should be given on fixed investment, however. While continuing to grow in 2H03 despite the intensified probes into Yukos, a spread of the oil company's legal woes to other businesses could moderate this trend.

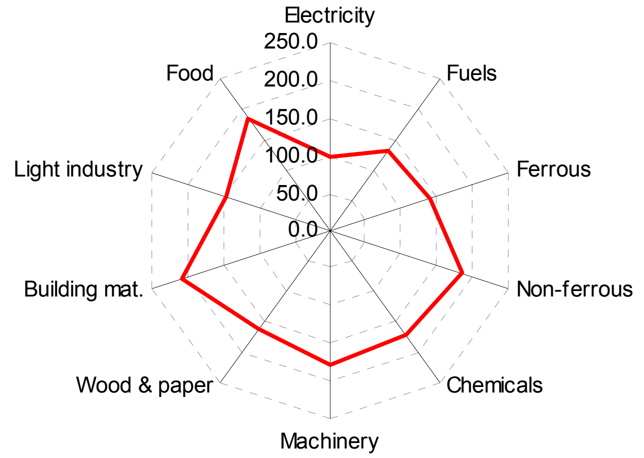
Industrial production by sectors (% growth y-o-y Jan-Nov 2003)

Fuels	9.4%
Machinery	8.7%
Ferrous	8.7%
Non-ferrous	6.9%
Building mat.	6.3%
Food	5.3%
Chemicals	4.6%
Electricity	4.3%
Wood & paper	2.3%
Light industry	-0.9%

Source: State Statistics Committee

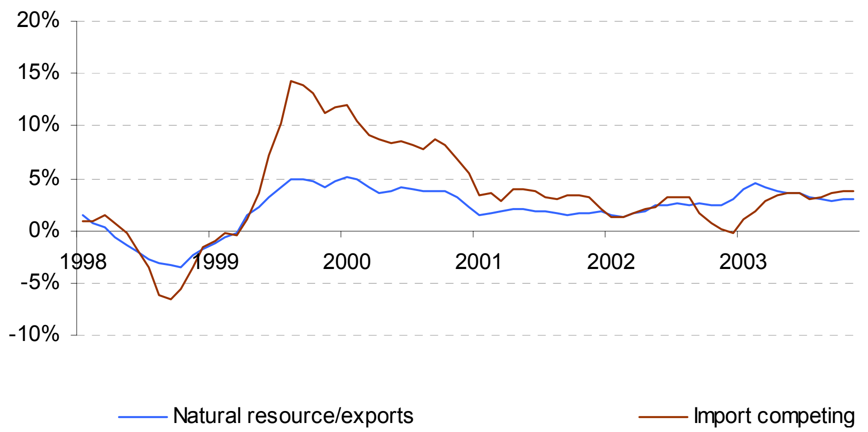
A glance back to 1998 shows the remarkable recovery that has taken place, with the fastest growth in domestically oriented sectors (together with non-ferrous metals). While overall industrial production stands 40% higher than it did in January 1998, building materials, machinery/equipment and food processing have almost doubled since that time. The only sector that stands just below its January 1998 level is electricity.

Breakdown of industrial production growth by sector (January 1998 = 100)



Source: State Statistics Committee; Aton estimates

Industrial production by import competing and export oriented sectors (%, y-o-y)



Source: State Statistics Committee, Aton estimates

It has to be noted, however, that the graphs above do not take into account the value of exports as industrial production is expressed as value added in domestic prices, thus explaining the lower growth in export oriented sectors.

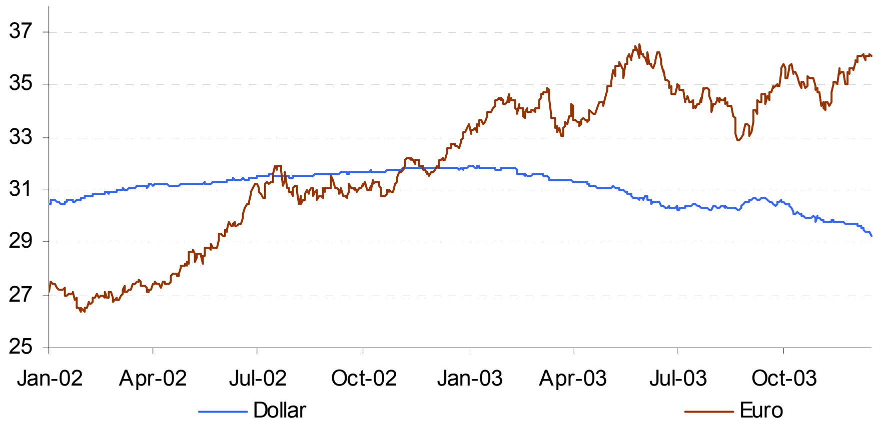
THE RUBLE IN DEMAND

Real and nominal appreciation of the ruble is expected to continue in 2004 in light of a healthy external balance, fiscal prudence and increased transaction demand for rubles (also helped by the weak dollar). We very conservatively forecast an end-2004 exchange rate of R27.7/$ and an average exchange rate of R28.6/$. This would put pressure on the profit margins of export-oriented companies and enhance dollar returns on ruble bonds.

The ruble is likely to continue rallying against the dollar in real and nominal terms. Possibly the most interesting development in 2003 was the nominal rise of the ruble against the dollar, with the exchange rate appreciating 7.9% from January to December, ending the year at R29.45/$.

We identified several factors contributing to the ruble's strengthening. Strong capital inflow from export revenues due to rising commodity prices was clearly the key factor, as was increased investment and foreign loans taken out by Russian enterprises. Moreover, demand for rubles relative to hard currency rose throughout 2003 as the Russian population responded to the weakening of the dollar.

Ruble exchange rate in 2004: ruble strong vs. dollar, falls vs. euro



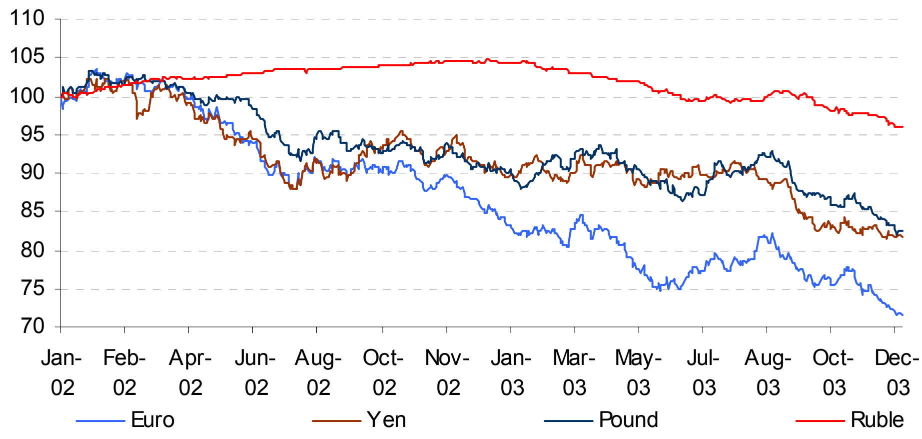
Source: Central Bank; Bloomberg

The same drivers apply in 2004. We expect the drivers listed above to remain present, leading the ruble to even stronger levels. We forecast an average 2004 exchange rate of R28.6/$, ending 2004 at R27.7/$, which is equal to a nominal appreciation of 7.3%, compared with 2.2% in 2003. However, with inflation expected to come in at 11% this implies a real appreciation of 15.2% (January to December), compared to 18.7% in 2003. The average R/$ exchange rate is expected to appreciate 16.2% in 2004 compared to 12.8% in 2003 in real terms.

The oil price, having averaged $27.2/bbl in 2003 (Urals Med), is expected to weaken somewhat in the second half of next year, leading to an average $24/bbl for 2004 as a whole. We also expect other world commodity prices to remain high as the global recovery continues, with total exports of $126.5bn, down slightly from $134.4bn in 2003, with the current account surplus at a healthy 5.1% of GDP. International reserves will continue to grow as a result of capital inflow and are expected to reach $88bn by end-2004.

Since the ruble in 2003 was affected by the dollar's weakening vs. major global currencies, the greenback's 2004 forecast movement against world currencies is of importance. As the consensus view expects the dollar to weaken further against the euro and other major currencies, this should again be supportive of the stronger ruble as the R/$ exchange rate's correlation with the €/$ exchange rate strengthened recently. From Jan. 2003 to date the correlation equals 0.89 while from Jan. 2001 to date it is negative 0.27.

World currencies, the ruble against the dollar (January 2002 = 100)

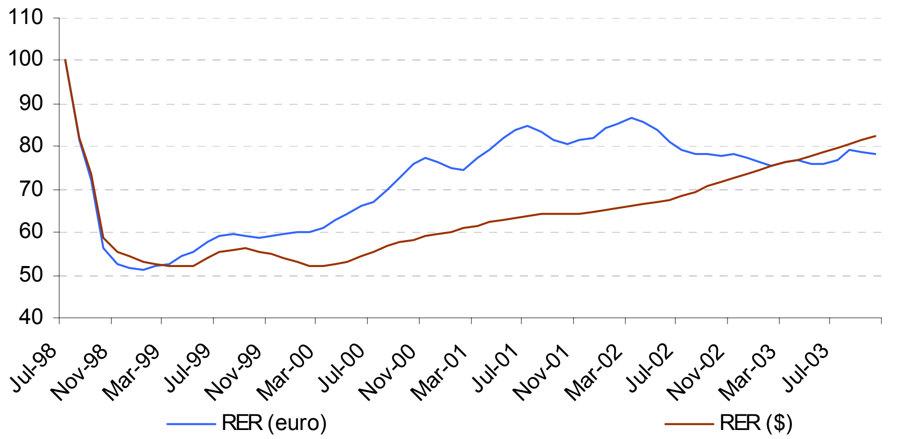


Source: Central Bank; Bloomberg

As we are not equipped to analyze world exchange rates, we have examined $/€ forecasts from a number of global banks and are working under the assumption that the end-2004 exchange rate will be $1.3/€ with an average exchange rate of $1.35/€. This assumption is crucial in estimating the so-called real effective exchange rate (REER), which in our case is based on a basket made up of 60% dollars and 40% euros.

With the R/$ (average) exchange rate expected to appreciate about 16% in real terms, and the R/€ real exchange rate expected to depreciate 2%, applying the weights gives us a REER appreciation of 8.8%, compared to 7.4% in 2003. This will put increasing pressure on domestic producers and exporters alike to curb costs and raise productivity.

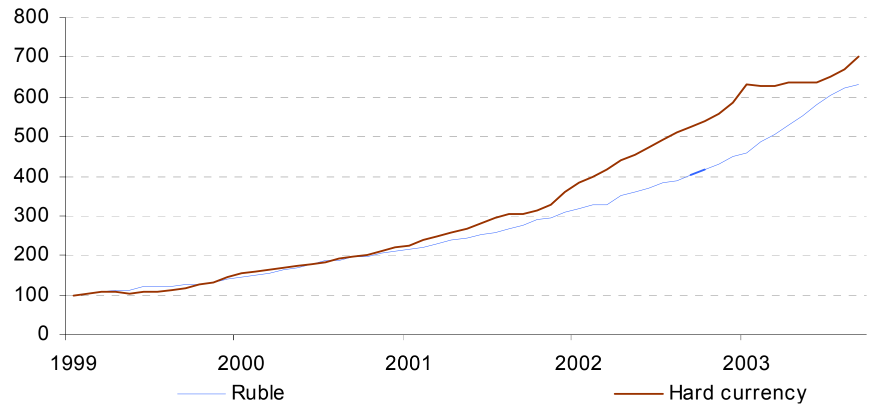
The real exchange rates (July 1998 = 100%)



Source: Central Bank; Bloomberg; Aton estimates

Transaction demand, rising savings to boost ruble. We believe the Russian population's rising trust in the national currency will be an important factor in its expected strengthening. Last year a clear shift in savings preferences could be observed, as for the first time in recent years the growth in ruble denominated savings outpaced that of dollar-denominated deposits.

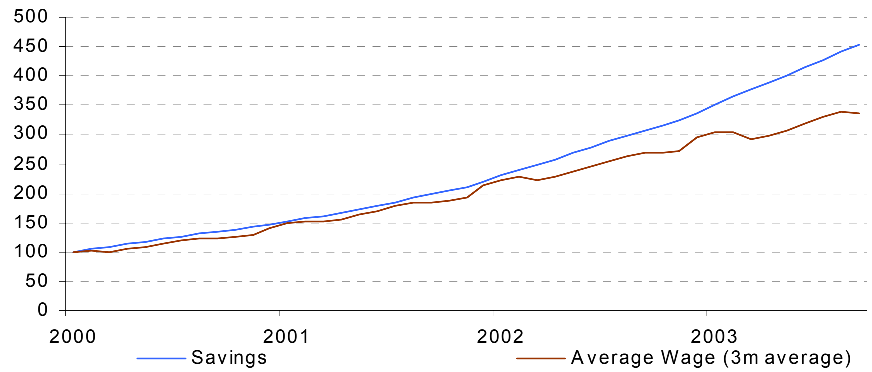
Household savings: ruble vs. hard currency (Jan 1999 = 100)



Source: Central Bank; Aton estimates

Propensity to save strengthening. By comparing wage increases to overall household savings increases we can see that since the beginning of 2002 savings have increased at a faster pace than wages, indicating that individuals are increasingly putting their money into banks rather than holding "mattress" dollars.

Household savings vs. average nominal wage (January 2000 = 100)



Source: State Statistics Committee; Central Bank; Aton estimates

Two factors are apparently contributing to the increased intermediation of the population's savings: (1) inflation, which still runs at double-digit levels, coupled with the dollar's weakening, makes it expensive to hold "mattress" savings; and (2) the population may be increasingly comfortable with the idea of holding their money in a bank for security reasons.

Many Russian banks do not ask questions when individuals open a bank account, and as a large number of potential depositors would obviously be unwilling to declare how they earned their "mattress" dollars, this is also important for attracting money into the banking system. Therefore, we expect the trend for greater banking intermediation of the population's savings to continue in 2004.

How much is the ruble really worth? Finally, we revisited the issue of the degree of the ruble's under-valuation. As we showed in an earlier research piece[1], two different measures for the purchasing power parity (PPP) exchange rate[2] both point to an exchange rate of R18/$ - R20/$.

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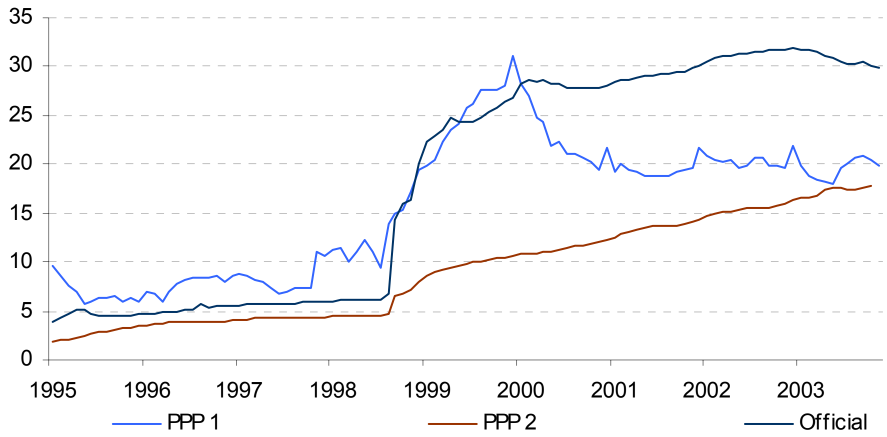
[1] "Russia starting to appreciate the ruble," published on June 27.

2 PPP1 is the "rated exchange rate," used by the Russian business magazine Expert. This looks at the difference between the broad monetary base (Central Bank liabilities) and gross international reserves (foreign assets). The problem is that the Central Bank only started to report the broad monetary base in 2002; as a result, to provide a longer time frame we have added up the narrow monetary base and credit institutions' balances on correspondent accounts as a proxy for the broad monetary base. PPP2 can be considered the classical PPP exchange rate using the

Investors should note that the PPP rate does not govern exchange rates in the short-term, as these are driven by issues such as interest rate changes and growth outlook. Instead, it looks at the long-term behavior of exchange rates, with the idea being the economic forces behind PPP will eventually equalize the purchasing power of currencies. But it is very much a long-term measure, with a typical horizon of four to 10 years.

Thus, the long-term outlook for the ruble appears very strong as well.

PPP exchange rates vs. the official exchange rate



Source: Goslkomstat; Aton estimates

Official 1995 (base year) PPP estimate and adjusting it for the differences in inflation between Russia and the US (to present day).

INFLATION, INTEREST RATES, POLICIES AND REFORMS

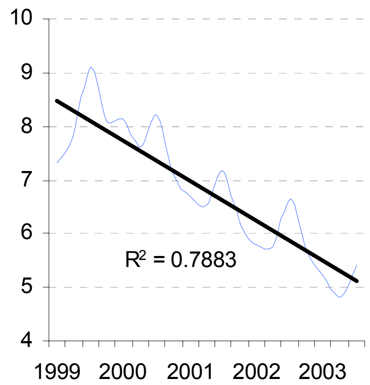
Inflation at bay for a change

With inflation coming in (against all expectations) at the government's target of 12% in 2003 – the first time the target has been reached since 1997 – we forecast 11% in 2004, slightly above the government's target of 8%-10%.

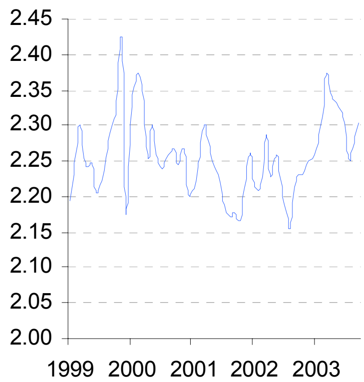
Three factors will help keep inflation in check:

- A continued increase in demand for rubles will mean a decline in the velocity of money as de-dollarization continues and people choose to hold rubles;
- The government continues its efforts to limit the rise in natural monopoly tariffs; and;
- Slow progress on banking reform means the banking system continues to be slow in creating money, so the money multiplier remains low, with a cushioning effect on inflation.

Velocity of money



The money multiplier



Source: State Statistics Committee; Central Bank; Aton estimates

The beast is down, but not out. However, inflationary pressure is still lurking. First, money creation will remain high; the monetary base increased close to 50% in 2003 and given the limited means for sterilization we expect continued high capital inflow to force the Central Bank to stick to its policy of financing hard currency purchases by building up domestic liquidity.

We forecast Russia's monetary base to expand another 28% in 2004 with M2 increasing 32%. With only limited deceleration of monetary growth, disinflation will become increasingly difficult.

The reason effective disinflationary policy remains a challenge is that Russia is in the process of adjusting its relative wage and price structure. With nominal wage growth set to outpace inflation for the fifth year in a row, this could cause demand-driven inflation. Also, the relative success of controlling natural monopoly tariffs may turn out to be short-lived, as natural monopolies accelerate their restructuring process and demand compensation for inflation. Therefore, we believe the current tariff regulations can be seen as simply postponing inflation.

Still, we do not see any risk of rampant inflation in Russia, and although reducing inflation is a priority we do not view the current level of inflation as alarming.

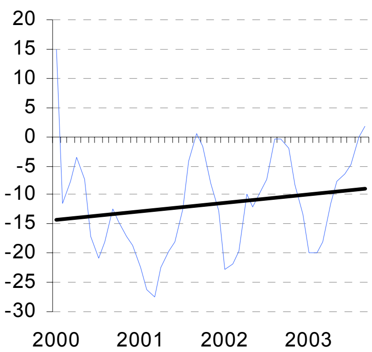
Interest rates to remain low, bond yields may decline further

The excess liquidity environment has also produced low and even negative real interest rates. Together with high commodity prices this helped to push growth higher than expected last year as it allowed for cheap borrowing for investment purposes and also helped the ruble corporate bond market, which doubled in size last year.

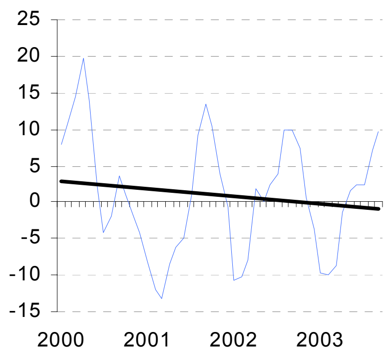
With interest rates expected to remain low and possibly decline further, the strengthening of the ruble makes ruble-denominated assets attractive compared to their hard currency peers. A good example again is household savings. Bank deposits render very low real interest rates, which theoretically should discourage saving, but (as we have seen) ruble savings took off in 2003 as a 7.9% nominal appreciation of the ruble vs. the dollar meant that exchange rate gains compensated for the low interest rate.

Although yields may increase at some point, it is unlikely they will reach levels seen a couple of years ago. The graph below also shows that the spread between the lending and deposit rates is narrowing, indicating some efficiency gains in Russia's banking system.

Real deposit rate (3M moving average)



Real credit rate (3M moving average)



Source: Central Bank

With reference to fixed income we remain bullish on domestic (ruble-denominated) debt for 2004. With our expectations for a 6.3% nominal appreciation of the R/$ exchange rate in 2004 (an 7.3% appreciation using the average exchange rate) domestic debt clearly gives investors a great opportunity to participate in this exchange rate play.

Fiscal policy

Fiscal policy key to recovery. Russia's fiscal policy and tax reform have undoubtedly been important contributors to its recovery. And although 2003 saw a slight loosening of fiscal policy in light of the elections the government produced a fiscal surplus of about 1.6% of GDP and passed the 2004 budget with an expected surplus of 0.5% of GDP.

Some taxes will be cut. The government already announced a VAT cut from 20% to 18% and removal of the sales tax, effective Jan. 1, 2004. This policy will be financed by cuts in both federal and regional budget expenditures that have yet to be identified. The government also aims to cut the social security tax this year, a move that is to be financed by improved tax compliance. Although we welcome these cuts we recognize that, like the reduction of the profit tax, they will take a negative short-term toll on the budget before a positive effect in the form of increased revenues can be seen.

From financial reserve to stabilization fund. With the oil price having averaged $25/bbl since mid-1999 it is clear that this has assisted oil-dependent Russia and its budget. It also led to the establishment of the so-called financial reserve at the end of 2001, which is being transformed into a stabilization fund this year after a bill on its foundation was signed into law by the president at the end of 2003.

The stabilization fund, a mechanism that has been tried in many countries, most successfully in Norway, Alaska (US), and recently Kazakhstan, aims to build up reserves during times of high commodity prices to relieve fiscal pressure and smooth spending when those prices fall. A stabilization fund makes sense for Russia as oil revenue makes up 30% of the country's budget (and 65% indirectly), and low oil prices over a long period would obviously bring a significant loss of budget revenues.

Under our assumption of an average oil price of $24/bbl for Urals Med in 2003, we expect the government to be able to add about $2.7bn to the stabilization fund in 2004. Given the fact that the government aims to create the stabilization fund using about $3.5bm from its end-of-2003 balance, reaching $8.7bn (even exceeding our own estimate of $8.3bn), the fund should hold more than $6bn by the end of 2004.

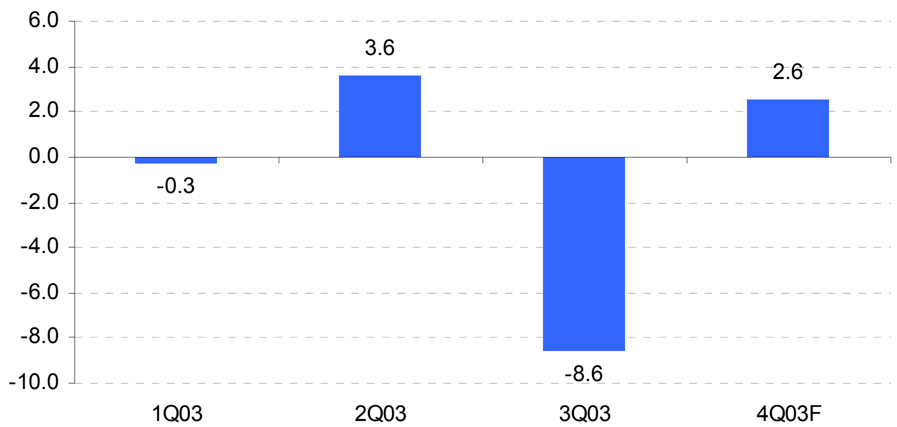
Capital flight

Capital flight resumed in 3Q04 after the probe into Yukos began in July, while 1H03 had actually seen a net inflow of capital. However, the ruble continued to strengthen as the dollar weakened globally and as the oil price surged even higher following OPEC's production cut in late September. The Central Bank has recently released data of estimated Q403 balance of payment, showing that, once again, net private capital flows turned from an outflow to an inflow of $2.6bn.

Analyzing what led to the second reversal of capital flight in 2003, it is clear that the banking sector was fully responsible through significantly increasing its borrowings from abroad in 4Q03. Banks increased their hard currency liabilities by $5.4bn in 4Q03 while reducing their hard currency assets, which fell $2.3bn. As a result, the net inflow for the banking sector amounted to a full $7.7bn in 4Q03. A high oil price and a further strengthening of the ruble vs. the dollar contributed to this development.

As for Russia's corporate sector, its net outflow (including net errors and omissions) amounted to $5.1bn in 4Q03, bringing the full year net outflow to $12.3bn, and thus exceeding the net outflow of $10.8bn in 2002. The deepening probe into Yukos may well have been one of the factors behind this trend. The corporate factor also means that it is too soon to celebrate over the turnaround in capital flight. The Central Bank estimate shows that the corporate sector's net outflow in 2H03 well exceeds the level seen in 2H02.

Capital flight increased temporarily in the wake of the Yukos affair ($bn)



Source: CBR; Aton estimates

The reform agenda 2004

Reforms need to continue. Issues surrounding the continuation and speeding up of institutional reform top the socioeconomic agenda as Russia enters the New Year.

Continued reform is essential to back up Russia's growing economy and this will be a test for the government as most of the "easy" reforms have already been accomplished. By nature the new reforms – judicial, administrative and bureaucratic among others – are gradual, but we believe pledges made by Putin mean we are likely to see some progress in 2004.

Bureaucratic reform promises to be a particularly difficult process as the task largely lies in convincing the bureaucracy to reform itself – which has proven very difficult in other countries. This makes a top-down approach the only possible solution. It is worth noting that Putin has said he wants to strengthen the bureaucracy but whether this means downsizing and more efficiency is still an open question.

Judicial reform promises to be another hard nut to crack, with the aim being to create a fairer and more independent judicial system. Although Putin has stressed he is committed to judicial reform, it is likely to be a long, drawn-out process. Moreover, the call for judicial reform looks somewhat hypocritical in light of the seemingly biased handling of the Yukos affair.

Electricity sector reform: In 2003, the government pushed through legislation setting the rules for electricity reform. This year a number of additional laws governing the reform of UES will be considered and the first auctions of sector assets are set to begin.

Finally, banking reform: Progress on this front has been torturously slow, the only bright spot being the law on deposit insurance. Generally, however, the role of the Central Bank has been rather passive: while improvements are being seen as both savings and lending increase, momentum is coming from the banks themselves rather than financial reform.

Furthermore, the growth of credit (especially as consumer lending is likely to continue to increase) will require strict and prudential regulations to reduce risk; these are also needed to make the new deposit insurance scheme effective.

However, the Central Bank's approach to regulating the industry has been ad hoc and marred by conflict of interest as it still holds a controlling stake in Sberbank while at the same time being in charge of bank supervision.

2004 FIXED-INCOME MARKET OUTLOOK

Despite our rather cautious view on Russia's equity market, we are more upbeat on the bond market's outlook for 2004. Quasi-sovereign corporate Eurobonds and second-tier ruble-denominated bonds appear particularly attractive, while we recommend avoiding Eurobonds of private oil companies and related entities as well as municipal/regional bonds.

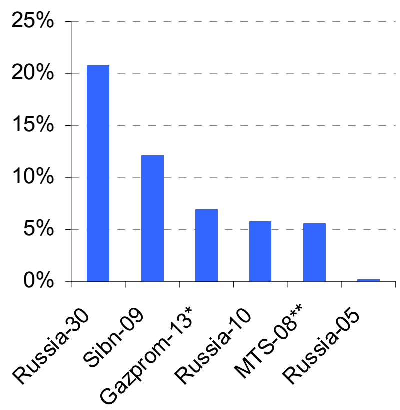
2003 in review

Despite the massive gains of previous years, Russian Eurobonds delivered another stellar performance in 2003, with the benchmark Russia 30 gaining more than 20 % and Russia 10 delivering 6% return. Corporate Eurobonds in general matched the gains on the sovereign issues, leaving corporate spreads unchanged.

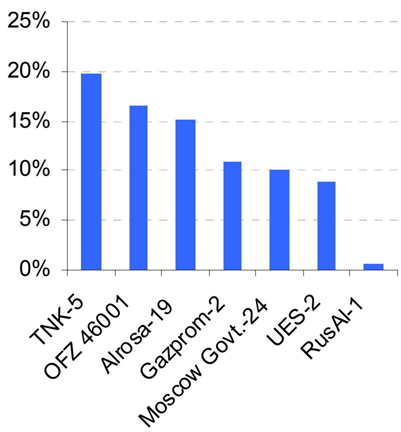
On the ruble-denominated bond front, falling domestic yields and strengthening ruble all contributed to the investors' growing interest in the entire spectrum of ruble-denominated securities – from OFZs to blue chip corporates to second and third tier names.

Returns averaged 10%-15% across the wide range of names; TNK bonds delivered the strongest performance due to the deal with BP and high duration.

2003 performance of Eurobonds…



…and ruble bonds



Source: Company data, Bloomberg

2004 outlook: Eurobonds

Sovereign Eurobonds: expect low single digit returns (assuming flat US Treasuries). We expect to see spread compression vs US Treasuries continued in 2004, providing further support to prices; however, as mentioned earlier the room for such compression is decisively smaller than a year ago.

Currently, yield on the benchmark Russia 30 is hovering 260bp over the US 10-year bond (which has the same duration as Russia 30); we expect the spread to decline by 30-40bp to 220bp - 230bp, i.e. below the low reading of 250bp reached after the Moody's upgraded Russia's credit rating in October 2003.

Our expectations are based on the following considerations:

- The macroeconomic strength is set to continue, positively affecting Russia's hard currency reserves and budget revenues (for more details see the macroeconomic section in this report);
- No new Eurobond issues are expected in 2004;
- The Yukos affair appears an isolated incident. In any case, pressure on big business will not affect Russia's ability to service its debt; in fact, it may improve it since…
- …higher taxes look inevitable for natural resource exporters; this would be positive for budget revenue and, therefore, for sovereign bonds.

Yet, after double digit gains of recent years investors in Russian sovereign Eurobonds may have to curb their appetites: even assuming the above-mentioned spread compression materializes, it will result in low single digit increases in bond values. Moreover, given the increasing likelihood of interest rates eventually rising in the U.S. due to economic growth and dollar weakness, we do not exclude the possibility of returns from Russia's sovereign Eurobonds turning negative in 2004.

Corporate Eurobonds: our top picks are quasi-sovereign issues.

Our top picks in the corporate segment are Gazprom, Rosneft and Alrosa bonds. Pluses here include government ownership of the companies, government-friendly management teams and improving operating and financial performance of these issuers. Our top pick is a Gazprom bond maturing in 2013; its corporate spread of around 170bp is likely to shrink by 70bp-80bp, delivering more than 7.5% total return for the year (our total return forecasts incorporate assumption of 100bp expansion in benchmark US rates).

We also recommend taking a look at MMK and Evrazholding bonds (for details see our Sept. 23, 2003 report *Russia, the Saudi Arabia of steel*) because of their strong financial performance and healthy balance sheets. Among the less liquid issues, we recommend Russkiy Standard's CLN, the first of its kind in Russia's burgeoning consumer sector.

Increased political risks and the strong possibility of oil sector taxes being raised in 2004 explain our neutral disposition to issues of private (as opposed to government owned) oil companies. In particular, we recommend that investors avoid Sibneft bonds as well as CLN issues from Trust Bank, which is related to Yukos.

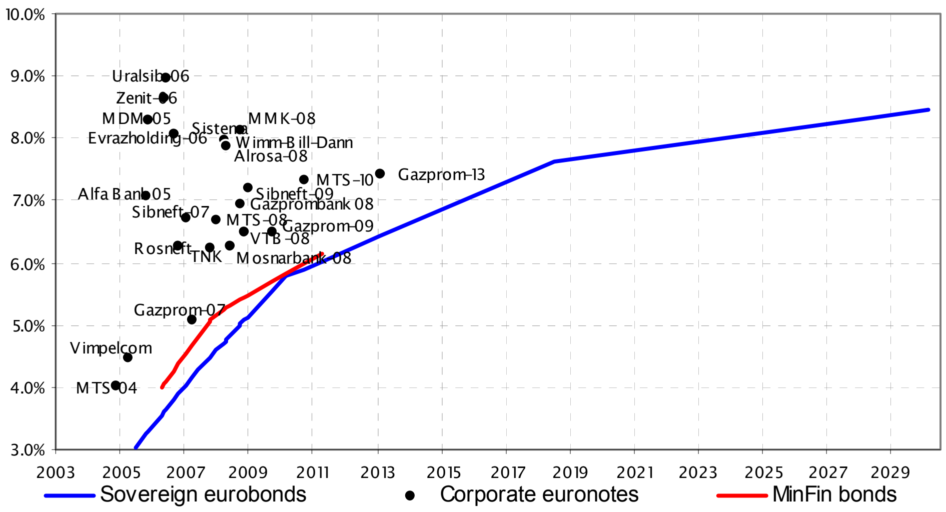
We also don't see a favorable risk-return trade-off in Russian banking sector Eurobonds; Alfa Bank is a rare exception because its strong management, good track record and aggressive investment in branches and infrastructure should enhance its competitive position.

Top picks among Russian Eurobonds

Bond	Price (as of Jan 12 2004), $	YTM	Current spread to sovereign	Target end-04 spread to sovereign	Expected 2004 total return (price change + coupon)	Comment
Gazprom-13	115	7.37	170	100	7.5%	Lack of sovereign issues will push demand for quasi sovereigns
Rosneft	116	6.35	270	200	6.2%	
Alrosa	100.5	7.95	365	250	9.5%	
MMK-08	99.5	8.12	360	300	8.0%	Positive outlook for the steel sector
Evrazholding	102	8.12	460	300	9.5%	

Source: Bloomberg; Aton estimates

Russian Eurobond yield curve (zero-coupon curve)



Source: Bloomberg, Aton estimates

2004 outlook: Ruble-denominated bonds

Blue chips: primarily a ruble play

In general, issues like GKO/OFZ, Gazprom, UES, Alrosa and the municipal bonds of Moscow and St. Petersburg should be viewed primarily as a ruble play as potential for price appreciation remains small due to the already low interest rates. According to our macroeconomic forecast, in 2004 we expect a nominal 6.3% strengthening of the ruble to 27.70/$. Although when adjusted for inflation, yields on the above mentioned bonds turn negative, they are also unlikely to rise, supported by the ruble's strength.

Second tier bonds: interesting risk/reward

The rally in the blue-chip segment is only now starting to spill over into second tier bonds. The most attractive issues in our view include regional telecoms Sibirtelecom, Volgatelecom, Dalsvyaz and Uralsvyazinform, chemical makers Akron, Novomoskovsky Azot, metals producers Mechel, Evrazholding, MMK, Russian Aluminum as well as bonds from larger banks.

Generally, these issues yield in excess of 10% (an annualized yield of 12% on average), have lower participation from non-residents and slightly worse liquidity. However, we think that high demand driven by increasing ruble liquidity will drive yields lower by 100bp-200bp in the next few months as spreads to blue chip peers narrow further. Coupled with the strong ruble, the bonds may deliver dollar-denominated returns in excess of 20%.

Third tier/Junk bonds: the high-yield segment offers a few opportunities

Currently, this segment consists of 30-40 issues that can be categorized as high-yield (junk) bonds. The typical yield here is way above average and can be as high as 16%-19%. Duration varies from six months to 1.5 years and liquidity is naturally lower than in blue chips and second tiers.

In this segment, we recommend bonds issued by consumer-oriented companies because of their strong financials (operating margins can be as high as 60%) and excellent growth potential. Such bonds usually have low sensitivity to general interest rate trends and should be viewed as attractive cyclical plays, with 200bp-300bp contraction in yields possible for the best names. That said, credit analysis of issuers remains very important but can be complicated because the often-small scale of the companies involved makes analyzing financials difficult.

Municipal and regional issues: unattractive

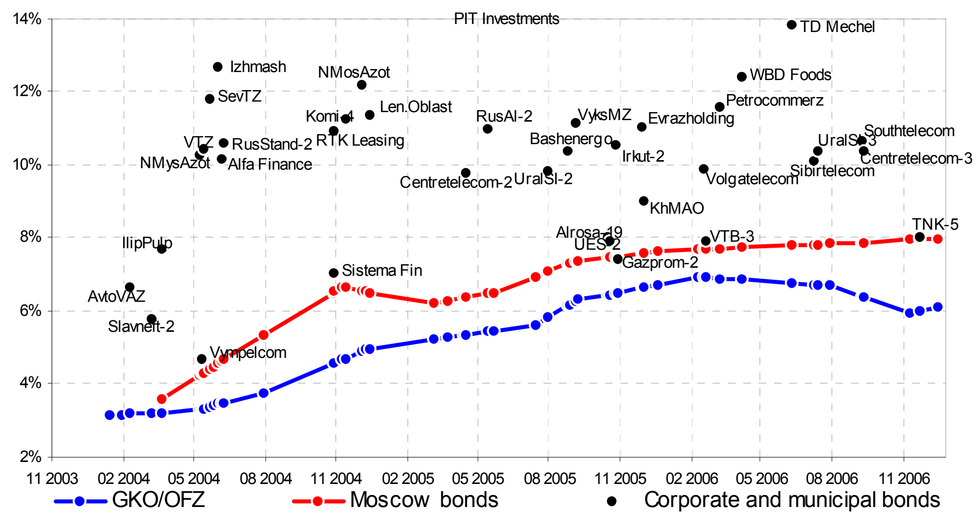
We recommend avoiding most municipal and regional issues, primarily because of political risks. With the pro-government parties in the Duma exceeding the majority threshold and thus capable of changing the Constitution, the risk exists that the government may try to change the country's administrative set-up, throwing the legal status of regional and municipal bonds into limbo.

Top picks among Russian ruble-denominated bonds

Prices as of Jan 12 04	Price, % of par	YTM, %	Current spread to sovereign, bp	Target end-04 spread to sovereign, bp	Expected 2004 total return in RUB terms	Expected 2004 ruble appreciation	Expected 2004 total return on USD terms	Comment
Sibirtelecom	110	10.15	310	200	12%	6.3%	18.3%	1^{st}-2^{nd} tier spreads likely to tighten
Uralsvyazinform	105.5	10.15	310	200	12%	6.3%	18.3%	
Volgatelecom	109.8	10.00	330	200	12%	6.3%	18.3%	
Akron	101	12.90	850	550	15%	6.3%	21.3%	
RusAl	99.00	10.6	550	400	12%	6.3%	18.3%	
Archangelsk Pulp and Paper (ACVK)	100	15.7	1080	900	15%	6.3%	21.3%	Undervalued, strong financial data
PIT Investments	101	16.8	1170	900	17%	6.3%	23.3%	Undervalued relative to other consumer sector companies
Amtelshinprom	108.5	14.4	850	850	17%	6.3%	23.3%	Good business prospects, foreign ownership
Evrazholding	105	11.0	530	300	13%	6.3%	19.3%	Positive outlook for the steel sector
Mechel	97	13.8	715	500	15%	6.3%	21.3%	Positive outlook for the steel sector
Dalsvyaz	107.5	11.4	500	250	14%	6.3%	20.3%	Excessive spread relative to peers
WBD	96.8	12.4	600	300	15%	6.3%	21.3%	Coupon is linked to CPI

Source: Bloomberg; Aton estimates

Russian ruble-denominated bond yield curve (zero-coupon curve)



Source: Bloomberg; Aton estimates

2004 SECTOR OUTLOOK

OIL AND GAS SECTOR: LITTLE TO WRITE HOME ABOUT

By and large, the outlook for the Russian oil and gas sector appears unattractive. Five major factors are likely to shape the financial performance of Russian oils in 2004-05:

Production volumes to grow, but at a more moderate pace. We expect overall Russian oil output to increase 7% in 2004 and 4%-5% in 2005 as the two main growth engines of recent years – Yukos and Sibneft – begin to see their production growth rates moderate.

International oil and product prices to remain strong in 2004, beyond. Following through on the argument we first put forward in our October strategy report, we have raised our 2004 forecast for the benchmark Brent price to $25.5/bbl (from $23.5/bbl) and our long-term forecast to $22/bbl (from $20/bbl). Both estimates appear conservative considering current prices and market fundamentals.

Transportation costs to remain a major drag on profitability. Transportation costs have long been a more critical cost item than the proverbial lifting or refining costs. In 1H03, per barrel transportation costs for major Russian oils soared 30%-40% due to an approximately 20% effective increase in Transeft's charges and the impact of a higher share of combined transportation exports in total. While BPS-2 will likely contribute to easing export capacity constraints, we expect to see at least a 10% increase in per barrel transportation costs following recently approved tariff hikes for Transneft. Companies with above average growth rates (Yukos, Sibneft, Surgut, TNK) will likely see their per barrel costs climb even further as they have to ship increasingly more output via rail, river and other means.

Ruble to strengthen further, affecting both revenues and profits; net impact negative. 2003 was the year when investors realized that the strong commodity prices that are so beneficial to Russian oil and gas plays have an ugly twin – a strengthening domestic currency eating into profit margins. Despite an expected y-o-y decline in the average oil price in 2004, we believe the ruble will strengthen by about 6.3%, resulting in substantial increases in costs as measured in dollars. Although Russian oil companies have a significant portion of their revenues denominated in rubles as well, the net impact on the sector will be negative.

Taxes likely to increase in 2004-05. We believe the recent flood of announcements from senior Kremlin and government officials on the need to increase oil sector taxation is more than election-season rhetoric and that higher taxes are certainly on the way. Ironically, the only thing that could save the sector from higher taxes would be the oil price falling to below the $25/bbl range, which would make talk of taxing excess profits less relevant but would hurt earnings.

If we picture the combined impact of all the forces affecting the sector, the image of a vicious circle gripping Russia's oil and gas majors over the next few years emerges.

If international oil prices stay high, **the ruble will continue to strengthen materially, undermining profitability**, while the government will continue to take in around $0.65-

$0.70 per barrel in incremental taxes for every $1/bbl the oil price exceeds $25/bbl (and possibly more if new taxes are implemented), thus capping excess profits

If international oil prices weaken to a $20/bbl-$25/bbl range**, then profitability will suffer immediately as lower revenues will be matched against already high fixed transportation costs** (although falling revenues will be somewhat balanced by falling production taxes and export duties), while ruble strength is likely to persist at oil prices even below $25/bbl.

In this challenging macro environment, our advice is to focus on two avenues of investment:

Large-cap Russian companies that represent turnaround or special situation plays in addition to providing sector exposure. Our top picks in this category are Lukoil and Gazprom common. We would like to emphasize the relative rather than absolute nature of our recommendations, which are more intended to provide investors with downside protection than massive upside potential. If expected positive company-specific trends and developments materialize, their impact may provide investors with at least some respite from an increasingly cloudy sector earnings outlook.

Mid- and small-cap Russian and FSU oils that offer investors significant upside in exchange for higher risks. Our preferred Russian second-tier name remains Orenburgneft prefs, which offer investors direct ownership of one of the key TNK-BP assets at a highly attractive relative and absolute valuation. In the FSU/Caspian world, we highlight Dragon Oil and BMB Munai, two Caspian basin oil producers that trade at a deep discount to their peer group and have very strong near-term growth outlooks.

Summary of our oil and gas sector views

	Ticker	Rating	Price, $	Fair value (end 04), $	Upside/ Downside	Comment
Oil and Gas						**Steven Dashevsky, CFA; Timerbulat Karimov; Dmitry Loukashov, CFA**
Gazprom, com.	GSPBEX	Buy	1.44	2.09	45%	The best defensive option we see; top pick
Gazprom, ADS	OGZD LI	Hold	28.09	27.81	-1%	Fully valued, new ADS issuance an overhang
Yukos	YUKO$ RU	Hold	11.20	10.61	-5%	Political woes to continue in 2004; high transport costs are a burden
Lukoil	LKOH$ RU	Buy	24.30	30.73	26%	Remains undervalued, fair value seen at $30, solid defensive option
Surgutneftegaz	com.SNGS$ RU	Sell	0.60	0.41	-31%	No US GAAP, no dividends, no changes – and it is still up; may be a new Kremlin
	pref.SNGSP$ RU	Sell	0.41	0.31	-24%	favorite, but for us it's a top short candidate
Sibneft	SIBN$ RU	Hold	2.73	2.57	-6%	Our FV in line with the reported $12bn price tag
Tatneft	com.TATN$ RU	Hold	1.20	1.03	-14%	Some improvements seen, but very sensitive to the oil price
	pref.TATNP$ RU	Hold	0.62	0.78	25%	Discount has room to narrow
Transneft	pref.TRNFP$ RU	Hold	660.00	599.02	-9%	Is this a stock or a bond? No commons, no cap mkt plans; dividends may fall in 2004
TNK	TNKO$ RU	Hold	2.52	2.06	-18%	The largest part of TNK-BP fully valued because of debt
Orenburgneft	com.ORNB$ RU	Buy	20.75	23.20	12%	Increasingly fully valued, price close to that in TNK-Sibneft deal
	pref.ORNBP$ RU	Buy	10.40	17.40	67%	Still the best entry into TNK-BP consolidation story
Megionneftegas	com.MFGS$ RU	Hold	12.75	23.30	83%	Good upside negated by lack of swap/buyout visibility; a side victim of Yukos affair
	pref.MFGSP$ RU	Hold	6.30	17.40	176%	
Ritek	RITK$ RU	Buy	2.04	2.48	22%	Strong fundamentals make RITK one of the top second tier picks; debt a risk
Petrokazakhstan	PKZ LN	Hold	25.38	22.50	-11%	Strong growth outlook offset by logistical challenges and oil price sensitivity
Dragon Oil	DGO LN	Buy	0.66	0.73	11%	To double output, profits in 2-3 years; still a Buy after rallying several-fold in 2003
Sibir Energy	SBE LN	n.r.	0.37	0.28	-25%	Recommendation removed after problems with principal assets/partners
BMB Munai	BMBM	n.r.	5.00	n.a.	-	The cheapest Kazakhstan oil play to start producing in 1Q04
Udmurtneft	com.UDMN$ RU	Buy	235.00	300.20	28%	Attractive albeit not very liquid play on TNK-BP consolidation;
	pref.UDMNP$ RU	Buy	169.00	225.10	33%	pref divs will disappoint in 2004
Saratovneftegaz	com.SNFG$ RU	Buy	52.50	84.70	61%	Attractive albeit not very liquid play on TNK-BP consolidation;
	pref.SNFGP$ RU	Buy	39.00	63.50	63%	pref divs will disappoint in 2004
Purneftegaz	com.PFGS$ RU	Sell	4.70	17.50	272%	No reason to hold on to unless Rosneft changes its ways
	pref.PFGSP$ RU	Hold	3.32	13.10	295%	
Sakhalinmorneftegaz	com.SKGZ$ RU	Sell	4.55	3.20	-30%	No reason to hold on to unless Rosneft changes its ways
	pref.SKGZP$ RU	Sell	2.65	2.40	-9%	
Slavneft	SLAV$ RU	Hold	0.60	0.80	33%	Minorities in limbo as TNK and Sibneft undecided on fate; high dividends to continue
Onaco	ONAC$ RU	Buy	2.50	2.10	-16%	Increasingly fully valued; liquidity disappeared after the swap into TNK
Sidanco	SDNK$ RU	Hold	21.00	16.20	-23%	Seems overvalued relative to our forecast swap/buyout terms
Bashneft	BANE$ RU	n.r.	3.55	6.80	92%	Recommendation suspended after dubious transfer of a majority stake

Source: Company data; Aton estimates

TELECOMS: THE STORY CONTINUES

A combination of strong leverage to domestic consumption and the sector's underdevelopment in terms of contribution to GDP suggests a positive outlook for telecoms in 2004. The pace of growth is likely to moderate compared to the previous year, however, as 2003's spectacular performance diminished the low base effect.

Upside on telecom stocks also appears more moderate compared to 2003 as the market has priced in a reduction in sector and company -specific risks as well as the improved liquidity.

At the current price levels, MTS and Vimpelcom still qualify as our top picks as well as our fixed line favorite, Sibir Telecom, although the latter's risk-return profile is less attractive. RBC remains an interesting play among higher-risk small caps. Rostelecom's improving financials are more than offset by the risk of early liberalization and we rate it as Hold.

Cellulars – No clouds on the horizon

There are still sufficient catalysts to keep cellulars' revenues growing in 2004 after a very strong showing in 2003. Cellular penetration in the regions of just 17% (end-2003) combined with a strong consumption outlook makes the Russian cellular story one of the best investment opportunities in 2004. Last year saw the debunking of many myths regarding returns on investment in regional cellular markets, and 2004 should produce a rich bounty from the provinces. We expect 13mn cellular net adds in Russia in 2004, which would bring the total number of cellular subscribers to about 50mn. This translates into 34% penetration for Russia as a whole by year-end and 59% y-o-y growth in the average number of cellular subscribers. We are forecasting an approximately 15% reduction in ARPU to about $14, including some $10 in the regions. Combined, these assumptions translate into around 35% growth for the Russian cellular market in 2004.

The risks to MTS, Vimpelcom profitability skewed towards the downside. Despite the cellular market still being far from maturity, there is likely to be increasing pressure on profitability as competition builds. As a result, there is a greater chance of downside to our 50% EBITDA margin forecast for MTS than upside; a similar outlook is likely for Vimpelcom's more mature regional operations. Having said that, we still see room for a positive surprise on the gap between MTS's and Vimpelcom's margins, as the latter might improve faster than expected through the maturing of its green field projects.

The risk of over-investment in 2G networks seems low as the bulk of capex is being allocated for expansion to accommodate more subscribers, which generate predictable demand for traditional services. Meanwhile, competition in terms of quality is still to come into play in the regions, so companies have the luxury of maintaining relatively low spare capacity.

Key risks associated with 3G costs and Universal Service Fund. 3G licenses are likely to be distributed as early as this year, but the terms of the issuance and license requirements remain unknown, and costs might turn out to be sizeable. On the regulatory side cellulars face pending contributions to the Universal Service Fund, which will shave 3%-15% from the fair values of MTS and Vimpelcom, depending on the timing of implementation and size of the contribution, both of which are to be set out this year.

Vimpelcom and MTS offer an excellent risk return profile. Our DCF-based target prices of $103.3 and $92.3 for MTS and Vimpelcom respectively offer 17% and 18% upside from current levels. This, combined with low risks, represents one of the best opportunities among Russian equities and we include both companies in our top picks.

Fixed line telecoms

The final verdict on Svyazinvest's privatization remains a major potential price catalyst for regional operators. At the same time, though, on a purely fundamental basis the companies are not especially attractive, as despite strong top line growth their FCF outlook is weak due to soaring costs and high capex.

Svyazinvest privatization remains the major potential catalyst, and a decision is likely this year. The privatization of the government's 75% minus one share stake in Svyazinvest would require an upward revision to regional telecoms' profitability outlook. Despite the continued uncertainty on the timing and size of the stake to be auctioned, there are increasing expectations that the terms will be finalized this year. The rapid progress of sector reform, on the one hand, and companies increasing attractiveness (and hence potential price) on the other, suggest the stars are aligned for a sale (the government simple needs a mechanism to influence the sector through means other than direct ownership). Combined with the near flood of statements from officials on the subject of the privatization and intensified rumors that financier George Soros is preparing to exit Svyazinvest, this leads us to believe the sale will be finalized this year.

Local tariff hike to outpace inflation. In addition to the all but agreed 20% increase in local tariffs in 2004, or 10% above forecast CPI, the strong per capita income outlook in Russia provides potential scope for an even greater rise (as the population can theoretically afford higher costs).

Strong DLD traffic growth to continue. Although mobile cannibalization is likely to become noticeable soon, paring back the growth potential of traditional telecom services, it is unlikely to become fully fledged before 2005, and we thus believe that in 2004 regional telcos will still see some 13%-15% LD traffic growth per line.

New settlement system with Rostelecom to add about 7% to top line, but operating income almost unaffected. From Aug. 2003, the settlement system with Rostelecom changed from a net balance, calculated based on the previous year's traffic mix, to transit-origination-termination based. The result of this was record regional telecom revenues for termination of incoming traffic but their costs increased by a similar amount for the termination of outgoing traffic. The upshot is that an average 7% will be added to companies' top line, but operating income will remain almost unaffected.

Cellular business may surprise on the upside. One of the key takeouts from 2003 was the regional cellular market's much greater than expected capacity. In addition, the three regional telecoms with cellular exposure – Uralsvyazinform, Volga Telecom and Sibir Telecom – held up remarkably well in competition with the Big Three, and we believe there is room for further positive surprises this year.

On the cost side the situation for regional telcos is less optimistic, however, and margin improvement represents a challenge. The main reason for this is that companies' profitability continues to be constrained by overstaffing, which in combination with soaring wages – outpacing revenue growth – is proving a drain on profits. Moreover, we believe there is a risk of a slowdown in staff cuts due to opposition from trade unions. We have therefore assumed a conservative 3% decrease in the number of employees in 2004 for all seven regional companies.

Excessive capex is a major threat to FCF. Companies' capex plans are still heavily influenced by the government's social requirements, implemented through Svyazinvest, which we believe is likely to seize on improved cash generation to expand capex. As a result, companies' growth outlook diminishes significantly as we move from the top line to free cash flow.

Regulatory changes to favor incumbents. However, fixed operators will be net beneficiaries of the Universal Service Fund, which should start functioning from 2005; indeed the very fact the legislation is being finalized should encourage the market. Interconnect reform will be next on the legislative agenda, and we expect this to be net positive for regional telecoms.

While Svyazinvest's privatization remains the key catalyst for all seven regional telecoms' stock prices in 2004, as long as there is uncertainty on the issue we recommend investors switch into stocks with stronger fundamentals. Our top picks are Sibir Telecom and Volga Telecom. We retain out Hold on Uralsvyazinform (it looks overpriced after a strong performance in 2003) and Far East Telecom (low liquidity is the main obstacle to growth) and Sell on Center Telecom, North-West Telecom and Southern Telecom (which are traded above their fair values).

Rostelecom – the weather is highly uncertain. Rostelecom's financials have been improving recently, as management's efforts to regain market share and regulatory lobbying start to pay off. The improved short-term outlook is more than offset, however, by the threat of early liberalization of the domestic DLD market (as soon as 2004), recently mentioned by Communications Minister Leonid Reiman. Despite healthy upside of 22% to our target price of $2.7, we rate Rostelecom's commons a Hold, given the high business risks. Preferred remain on our Buy list due to their high discount to commons and dividend enhancement.

RBC – a small cap for the brave. In 1Q04, RBC will announce the first results of its high-risk business TV venture, launched in September 2003. The channel's viewership (which will be the key gauge of its success) is largely unpredictable and the likelihood of positive and negative surprises seem equal. In the event the TV channel is a success, we see RBC's upside at 49% by the end of 2004.

Summary of our telecom sector views

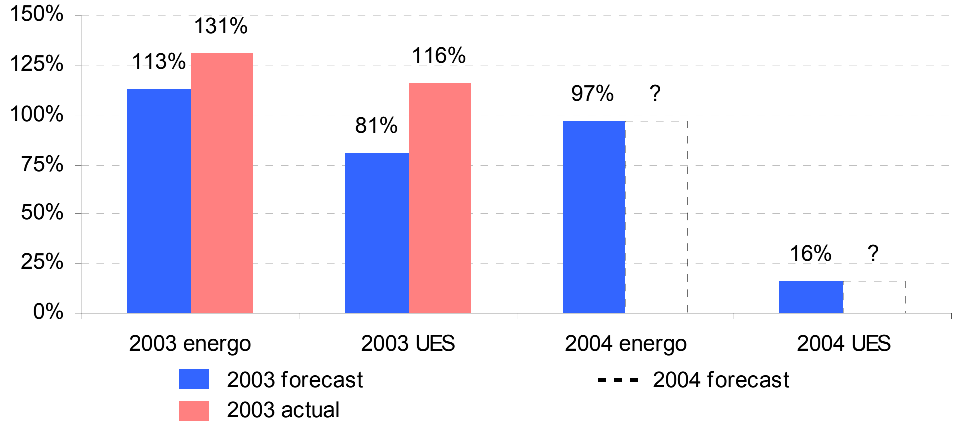
	Ticker	Rating	Price, $	Fair value (end 04), $	Upside/ Downside	Comment
Telecoms						**Nadezhda Goloubeva, CFA; Elena Rogovina**
MTS	MBT	Buy	87.45	103.30	18%	Low risk highly liquid bet on booming cellular market
Vimpelcom	VIP	Buy	75.95	92.28	21%	Low risk highly liquid bet on booming cellular market
Rostelecom	com.RTKM$ RU	Hold	2.18	2.70	24%	Benefits of restructuring offset by the risk of early demonopolisation of LD market
	pref.RTKMP$ RU	Buy	1.43	2.03	42%	High spread between common and prefs, attractive dividend on one-time gains in 2003
MGTS	com.MGTS$ RU	Hold	12.90	11.80	-9%	Benefits of the planned IPO already priced in
	pref.MGTSP$ RU	Hold	8.45	8.90	5%	
Golden Telecom	GLDN$ RU	Hold	30.00	30.60	2%	Streamlining of acquired businesses will take some time
RBC	RBCI$ RU	Buy	2.15	3.20	49%	RBC-TV accounts for most of the upside potential
Uralsvyazinform	com.URSI$ RU	Hold	0.04	0.04	-10%	Expensive on P/E basis, potential for upgrade on strong cellular exposure
	pref.URSIP$ RU	Hold	0.03	0.03	11%	High spread between common and prefs
VolgaTelecom	com.NNSI$ RU	Hold	3.08	3.17	3%	Best among peers on cost and capex control; early breakeven at FCF level likely
	pref.NNSIP$ RU	Buy	1.89	2.38	26%	High spread between common and prefs
Sibirtelecom	com.ENCO$ RU	Buy	0.04	0.05	11%	Material cellular exposure, one of the most attractively priced among peers
	pref.ENCOP$ RU	Buy	0.03	0.03	16%	Strong expected dividend from asset disposal
NW Telecom	com.SPTL$ RU	Sell	0.48	0.37	-23%	Strong competition, limited room for growth in the franchise area, high social burden
	pref.SPTLP$ RU	Sell	0.32	0.28	-12%	
Centertelecom	com.ESMO$ RU	Hold	0.38	0.31	-18%	Poor franchise, huge investment requirements, no cellular exposure, rich valuaton
	pref.ESMOP$ RU	Hold	0.30	0.23	-22%	
Southern Telecom	com.KUBN$ RU	Hold	0.10	0.08	-20%	Merger with adjacent operators, planned for 2004, to delay free cash flow generation
	pref.KUBNP$ RU	Hold	0.09	0.06	-28%	
Dalsvyaz	com.ESPK$ RU	Hold	1.30	1.32	1%	Small market cap, low liquidity, inferior franchise
	pref.ESPKP$ RU	Hold	0.90	0.99	10%	High spread between common and prefs
Bashinformsvyaz	com.BISV$ RU	Buy	0.09	0.14	49%	Bet on merger with Volga Telcom
	pref.BISVP$ RU	Buy	0.07	0.10	41%	

Source: Company data; Aton estimates

POWER UTILITIES: UNDERVALUED GENERATION, OVERLOOKED DISTRIBUTION

The electricity sector still offers attractive upside, particularly in regional energos. Despite a staggering 2003 performance (UES gained 116%, while our average regional energo top pick rose 130%), the electricity sector's potential remains significant. However, we do not expect a repeat of the 2003 across-the-board rally in 2004: UES's expected upside of 14% is relatively modest while an average energo still has the potential to double.

Actual vs. expected performance of UES and energos



Source: Bloomberg; Aton estimates

In 2003, the focus was on generation assets... Investors' primary interest last year was in vertically integrated power utilities. In particular, most interest came from strategic investors seeking: (1) To vertically integrate the generation assets of post-reform energos with a core business (typically gas/coal production), thus securing supply markets (Gazprom, MDM); and (2) A hedge against adverse electricity price movements following market liberalization, thus securing a cheap source of electricity for core energy-intensive operations (Interros, Sual).

…opening valuation gaps. The buying spree resulted in some valuation discrepancies in the market. For instance some standalone power plants, such as Kostromskaya GRES, traded on higher installed capacity multiples than a number of regional power utilities with similar capacity (such as Samaraenergo and Novosibirskenergo).

We believe examples of mis-pricing suggest investors have overlooked the fact that regional power utilities are vertically integrated companies owning not just generation assets like GRES but also: (1) High-voltage lines, or transmission assets that will be transferred to the FSK (federal grid company); (2) Low-voltage lines, or distribution assets, which are to form five large MRSKs (intra regional distribution companies) with an estimated NPV more than $500mn; (3) Supply businesses; and (4) Massive non-core assets.

2004: undervalued generation and overlooked distribution. We see two main investment themes in 2004: (1) undervalued generation; and (2) overlooked distribution. Investors, portfolio and strategic alike, are expected to look into undervalued generation companies, especially in light of the upcoming merger of generation assets in adjacent regions that will see the creation of TGKs (regional generation companies). However, at the same time, we expect strategic investors to pay much more attention to the sector's other undervalued assets such as supply and distribution.

UES, energos offer different risk-reward profiles. We should note that the shares of UES and regional energos offer different risk-reward profiles. UES will remain the main play for strategic shareholders looking to win government stakes in OGKs during the auction process. It thus offers portfolio investors a highly liquid relatively short-term exposure with appreciation potential in the mid-teens.

Energos on the other hand represent more of a long-term investment, but with greater upside due to their lack of liquidity and greater restructuring risks vis-à-vis UES.

We believe that in the course of restructuring the fundamental value of energos will be realized (the UES BoD's approval of the TGK formation scheme being a specific trigger), as happened with UES when the government approved the OGK formation scheme.

For in-depth analysis of power utilities' value, the restructuring process and general power sector matters, investors should refer to our upcoming report on Russian power utilities, due in early February. For investors wanting to buy into the sector's upside, in the next section we provide details of Halcyon Power Investment, an investment vehicle offering such exposure.

Halcyon Power Investment: liquid diversified exposure to energos

Halcyon allows investors to participate in expected sector upside… The recently launched Halcyon Power Investment Company (HPIC) is a special vehicle allowing investors to participate in the electricity sector's upside.

HPIC is looking to raise approximately $50mn by issuing non-voting participating shares with a term of five years since the commencement date. Halcyon's investment strategy is to achieve substantial long-term capital appreciation from investment in Russian energos by buying into equity or equity-like instruments including unlisted securities. Many of these companies are currently "off limits" to investors because of liquidity issues (small size, limited free floats) or lack of international settlement instruments. These constraints, and the fact that the regional utilities' current market valuations by and large reflect only their generation assets mean that energos are grossly undervalued compared to UES and their emerging market peers.

…with the benefit of diversification… By investing in a number of regional power utilities and adopting different strategies for each energo HPIC gives investors exposure to cheap assets while diversifying away energo-specific risks.

…and liquidity. One of the fund's key value-added features is liquidity: by pooling energos, the fund eliminates size constraints. HPIC has applied for listing on an international exchange (Dublin).

Disclosure: Please note that Aton Capital Group and/or one of its subsidiaries has acted as an advisor to HPIC in the last 12 months and has received compensation for investment banking work.

Summary of our power sector views

		Ticker	Rating	Price, $	Fair value (end 04), $	Upside/ Downside	Comment
Power Utilities							**Alexander Korneev**
UES	com.	EESR$ RU	Buy	0.29	0.35	21%	TGK creation scheme, OGK auction mechanism the next powerful catalysts
	pref.	EESRP$ RU	Buy	0.26	0.35	35%	Several indications made in 2003 that should be on par with common
Mosenergo		MSNG$ RU	Hold	0.07	0.09	24%	Potential value loss in distribution to Moscow City, Gazprom eyes generation assets
Lenenergo	com.	LSNG$ RU	Sell	0.72	0.66	-8%	Fortum has 19% and seems to be increasing its stake, most expensive utility
	pref.	LSNGP$ RU	Sell	0.48	0.47	-6%	
Bashkirenergo	com.	BEGY$ RU	N.R.	0.28	0.60	109%	High upside comes with high corporate governance risk, to comprise a single TGK
	pref.	BEGYP$ RU	N.R.	0.28	0.45	67%	
Kuzbassenergo		KZBE$ RU	Buy	0.54	1.02	88%	MDM has 36%, large and undervalued, generation to be put into 2 TGKs
Samaraenergo	com.	SAGO$ RU	Hold	0.07	0.12	68%	Managed by SMUEK, management rumored to have >25%, very liquid among 2nd tiers
	pref.	SAGOP$ RU	Buy	0.06	0.09	41%	
Krasnoyarskenergo	com.	KRNG$ RU	Buy	0.37	1.13	205%	Norilsk Nickel owns >25%, has potential to double, 75% hydro capacity
	pref.	KRNGP$ RU	Buy	0.34	0.85	149%	
Saratovenergo	com.	SARE$ RU	Hold	0.02	0.04	65%	Managed by SMUEK, unknown blocking minority shareholder
	pref.	SAREP$ RU	Hold	0.02	0.03	71%	
Kirovenergo	com.	KIRE$ RU	Buy	0.03	0.06	121%	Solid upside, to become a part of currently undervalued TGK, MDM has >14%
	pref.	KIREP$ RU	Buy	0.02	0.04	156%	
Chitaenergo	com.	CHIE$ RU	Buy	0.03	0.06	121%	Very undervalued, to be a part of small (~430MW) TGK, MDM has >25%
	pref.	CHIEP$ RU	Buy	0.02	0.05	179%	
Kostromskaya GRES		KSGS$ RU	Sell	0.14	0.07	-46%	Most liquid among stand-alone plants, expensive, to form OGK#3

Source: Company data; Aton estimates

METALS: GOOD TIMES ARE HERE TO STAY

The main theme for metals companies in 2004 is going to be continuation of their impressive financial performance of 2003 on the back of stubbornly high prices for their products. HR steel, for example, is currently at $350/ton, a full 20% above the price a year ago, and nickel prices have risen almost 100% in the past year! And although these price gains may look sudden and fleeting, companies throughout the industry have said they see no weakening in their results for 2004, implying that the good times of 2003 are set to continue. Russian companies are among the world's lowest-cost producers and strong commodity prices will further highlight their immense profitability. It also means that Russian metal companies may continue to set the pace of global M&A activity, as their burgeoning coffers prompt them to go shopping.

Domestically, t**he metals industry will likely see continued consolidation around a small group of holding companies next year**. This is a positive trend for the long-term health of the sector because individual metals plants usually lack the scale to access capital efficiently. Moreover, the new conglomerates have sound asset bases as they are being formed for strategic reasons.

Another key sector trend to watch in 2004 will be continued preparations for entering capital markets by major players, which will involve preparations for share consolidation and publishing IAS and US GAAP financials. As these businesses move closer to realizing their capital market plans, investors will have new opportunities to buy into subsidiaries and gain exposure to the holding companies. In our view TMK and Evrazholding will take consolidation furthest, offering the best way for investors to tap into the metals companies' drive to the capital markets.

Severstal (profiled in company pages) is our top pick in the sector, while NTMK is the preferred second tier option.

MMK. As Russia's largest steel producer, with 2003F steel output of 11mn tons and revenues of $2.78bn, MMK certainly has the critical mass to be a headline company on the Russian stock market, and the pending sale of the government's 23.8% common stake may be the catalyst needed to bring the company out of the closet. Another catalyst is MMK's apparent stellar financial performance for 2003 on the back of high and rising world steel prices. For example, MMK's IAS revenue for 2002 was $2.07bn and net income was $115mn. For the first half of 2003 alone, MMK's revenue was $1.48bn and net income was $307mn! In addition, the company's balance sheet remains very strong, with $561mn in cash and $554mn in short and long term debt at the end of 1H03.

Evrazholding was profiled in our September 2003 report *Russia, the Saudi Arabia of steel*. The company has published both full year and interim IAS accounts for its main subsidiaries, NTMK and ZSMK, and for its main holding vehicle Mastercroft. Evrazholding is actively reforming its rather complicated structure, although no decision on an IPO will be made before 2005.

Mechel Steel Group comprises the Yuzhny Kuzbass coalmine, the Mechel steel plant, the Yuzhural nickel plant and two smaller metals companies. The group is Russia's sixth largest steel producer (4mn tons) and third largest coking coal producer. Consolidation of core shareholders' stakes in subsidiaries took place in spring 2003 but Mechel has said it has no intention of bringing minority shareholders into the group. US GAAP accounts are being prepared for the company, although it is not clear if they will be published for the general public.

Sual is Russia's second largest aluminum company and the world's sixth largest, with annual production of 0.9mn tons. Its subsidiaries include the Bogoslovsky, Irkutsk, Kandalaksha, Ural, Nadvoitsy, Volkhov and Volgograd aluminum plants. The company had planned to post IAS results by October 2003, although these have yet to be released. An IPO is planned for end-2004 or later. Sual is 77% owned by insiders/management and 23% by Fleming Family & Partners.

Rusal is Russia's largest producer of aluminum and the world's third largest producer. The company comprises the Bratsk, Krasnoyarsk, Sayanogorsk and Novokuznetsk aluminum plants. Rusal spent 2003 buying out minority shareholder stakes in its subsidiaries, although it has given 2007 as the date for any entry to the equity markets.

AVISMA-VSMPO is the world's largest titanium company. VSMPO acquired a controlling stake in AVISMA, its titanium sponge supplier, in 1998. IAS accounts for the combined company were due by the end of 2003, although they have not yet been released. Having recently emerged from a shadowy takeover battle with Sual, AVISMA-VSMPO can now turn its attention to long-term plans, such as its intention of going to the equity capital markets in 2005. The company is under management control.

TMK represents 42% of Russia's pipe production and includes the Volzhsky, Seversky, Sinarsky and Tagmet pipe plants. The firm is undergoing sweeping shareholder structure reform that should see it become an open joint stock company, consolidate minority shareholders in its subsidiaries and launch an IPO in 2005. TMK is 67% owned by its general director, Dmitry Pumpyansky, with the remaining 33% owned by structures close to MDM bank.

OMK combines the Vyksa pipe plant and several smaller metals companies. There are few synergies between the OMK companies, as acquisitions have been opportunistic rather than forming part of a broad corporate strategy. OMK and Vyksa have no plans to publish financials to international accounting standards, and OMK officials say there are no plans to consolidate subsidiaries and minority shareholders into OMK

Summary of our metals sector views

	Ticker	Rating	Price, $	Fair value (end 04), $	Upside/ Downside	Comment
Metals						**Timothy McCutcheon**
Norilsk Nickel	GMKN$ RU	Hold	68.50	73.10	7%	Multi-year high key metal prices + rising transparency, divs provide solid price support
Severstal	CHMF$ RU	Buy	132.50	147.88	12%	Liquidity enhanced by ADR issue + dividends = most investor-friendly steel stock
NTMK	NTMK$ RU	Buy	0.61	1.25	105%	Greatest upside in the steel sector; sufficient transparency and significant upside
MMK	MAGN$ RU	Buy	0.23	0.27	17%	The coming sale of the 24% stake by the govt could be an important catalyst
NLMK	NFMF$ RU	Buy	350.00	601.11	72%	Most profitable steel company in the world
Vyksa	VSMZ$ RU	u.r.	195.00	u.r.	-	Up strongly as a side play on oil sector growth; price, recom under review
Chelyabinsk Pipe	CHEP$ RU	Hold	0.32	0.24	-25%	Up on higher output, but fear 2003 IAS margins will disappoint
Seversky Pipe	SVTZ$ RU	u.r.	1.70	n.a.	-	
VSMPO	VSMO$ RU	n.r.	33.00	n.a.	-	World's largest titanium company, held back by complex ownership structure

Source: Company data; Aton estimates

CONSUMER GOODS/BANKING: EXPOSURE TO ECONOMIC GROWTH, BUT FEW NAMES APPEAR ATTRACTIVE

On the back of surging GDP growth translating into purchasing power, consumer goods companies are likely to do well in 2004. The main trends to look for are the expansion of companies outside Moscow and St. Petersburg, and new entrants on the capital markets seeking to fund expansion, such as Cherkizovsky, various retail chains and some smaller beer companies.

In the beer sector it seems that the turnaround of Sun Interbrew is complete and although we doubt that the company will give back its market share gains and improved financial performance, it is also unlikely to see a dramatic improvement in 2004 due to increasing competition, competitor consolidation and a slower-growing market (with 2002 growth at 9%, 2003F growth at 5% and 2004F growth at 4%). Because of this, Sun Interbrew will probably not show any surprises in 2004, giving the stock limited upside.

Baltika, as the market leader going into 2003 took the brunt of the more challenging environment, and 2004 is likely to see a continuation of this process. However, unlike in 2003 when the company did not seem to have a response to its deteriorating position, recent distribution and management changes at Baltika may be the first signal that the company will fight back this year. Despite this, Baltika needs to show improving financial results to convince investors that the slide is over.

We believe that both **Sun Interbrew** and Baltika will remain market peformers for 2004. The low liquidity of both companies' shares means it is difficult for investors to capture the small differences between their market prices and fair values. Our target prices are: Sun Interbrew $7.40; Baltika $14.72 common, $11.04 pref.

As with other consumer goods, car sales are poised for steady growth. The overall car market grew 7% in 2002 and about 4% in 2003. Since Avtovaz and other domestic car producers are not expected to raise output in 2004, the bulk of car market growth will mostly come from foreign-made cars and increasingly from domestically made cars of foreign brands. The driver for this growth will come from two sources. First, consumer purchasing power is growing with overall economic growth and a strengthening ruble and second, financing options are expanding and becoming cheaper. The main result of these trends will be a deepening of the auto market, particularly in the $10,000-$15,000 price segment.

Avtovaz is likely to benefit from ongoing internal restructuring and the continuing shift to higher value cars in the production mix. The expansion of the successful joint venture with GM to make the Opel Astra model confirms that the working relationship between the two companies is strengthening, which is positive. The main test for Avtovaz will be to continue revamping its distribution network and maintain the momentum of its new business model of leaner production and higher inventory turnover. With the increase in purchasing power, there should be a bigger pool of customers for Avtovaz to tap. However, the company is threatened by the expansion of financing options that put more expensive cars within the reach of potential Avtovaz buyers.

Our recommendation for Avtovaz is Buy with a target price of $41.07 for common, $30.8 for prefs. The company is a long-term turnaround story, but evidence is accumulating that the turnaround is not just rhetoric. Key clues to the turnaround include the expansion of activity with GM, a change in the business model to meet the changing market, interest from strategic investors in taking a large equity stake and the publication of IAS accounts for half-year periods.

We continue to be cautious about Sberbank, the key play in the banking sector, after it posted weaker than expected 9M03 financials that were particularly disappointing given the influx of cheap funds, high demand for loans and a still-favorable competitive situation.

Sberbank's net interest margin (the key metric of recurring operating profitability) plunged 300bp, while a 33% hike in labor costs outpaced the top line increase, also hurting margins. On a brighter note, recent monthly statistics indicate an improvement in 4Q03, which could mean upside to our earning estimates and to our target price of $247.

The stock remains among the cheapest in the EMEA banking sector and should be viewed as an attractive play on the strengthening ruble. However, we remain concerned about Sberbank's earning growth potential in the longer run due to rising competitive pressures, as well as the government's ownership of a controlling stake, which narrows the scope for efficiency improvements

Summary of our consumer goods/banking sector views

	Ticker	Rating	Price, $	Fair value (end 04), $	Upside/ Downside	Comment
Consumer/Industrials/Banking						Timothy McCutcheon; Alex Kantarovich, CFA
Wimm-Bill-Dann	WBD	Buy	17.00	22.98	35%	2004 results to be verdict on expansion strategy, look for improving P&L
Baltica	com.PKBA$ RU	Hold	11.35	14.72	30%	Losing market share, mgt reshuffling – any chance for turnaround a la Sun in 2004?
	pref.PKBAP$ RU	Hold	9.50	11.04	16%	
Sun Interbrew	SUG GR	Hold	7.66	7.44	-3%	2003 a major success for the company, but now it is priced in
Sun Interbrew, A	SUGA GR	Hold	4.59	6.33	38%	
Avtovaz	com.AVAZ$ RU	Buy	27.00	41.07	52%	This turnaround story will take some time; strategic portfolio investors express interest
	pref.AVAZP$ RU	Buy	17.40	30.80	77%	
Sberbank RF	com.SBER$ RU	Hold	300.50	247.05	-18%	Access to cheap deposits a plus, but profit growth is questionable
	pref.SBERP$ RU	Hold	3.74	3.74	0%	
UHM (OMZ)	com.OMZZ$ RU	n.r.	9.25	n.a.	-	Merger with Power Machines to create $1bn sales giant, but multiples seem demanding
	pref.OMZZP$ RU	n.r.	3.90	n.a.	-	
IAPO	IAPO$ RU	n.r.	0.48	n.a.	-	Big capital market plans for 2003, but current valuation seems full

Source: Company data; Aton estimates

COMPANY PAGES

LUKOIL

Lukoil remains our top pick in the sector due to a combination of accelerating production growth, continued internal restructuring, its valuable portfolio of Caspian assets and relative immunity from the ongoing political pressure on the industry.

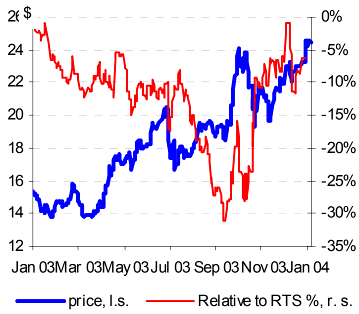
We expect Lukoil's revenues and earnings to remain largely flat in 2004 as stronger domestic prices and accelerating production growth should allow it to offset the impact of weaker global prices. We note that in 9M03, Lukoil's direct production costs remained largely unchanged from 2002 levels at $2.6/bbl despite inflation and ruble strengthening, evidence that the company's restructuring program is bearing fruit; we expect management-controlled costs to remain in check in 2004 as well, providing support to margins.

Accelerating production growth should also be a welcome development in 2004, as investors are likely to see 4%-5% growth in US GAAP production volumes, of which at least 3% will come from organic growth in Western Siberia and Timan Pechora, with the remainder from consolidation of subsidiaries and affiliates.

From the political perspective, the recent anti-oligarch underwater currents appear to relate much less to Lukoil than its peers since the company has always been a fairly law-abiding taxpayer and has successfully represented Russia's interests in the many foreign countries where it operates. The Russian state also owns a 7.6% stake in Lukoil, which may be privatized in 2004**.**

On balance, we find Lukoil very appealing from the risk-reward perspective relative to peers that either carry above-average political risk (Yukos, Sibneft) or have unacceptably low corporate governance standards (Surgutneftegaz, Transneft).

Additional catalysts that may bolster Lukoil's stock price above our fair value target include a possible deal with the Iraqi authorities on the West Qurnah field, a possible agreement with ConocoPhilips and likely forthcoming dividend distribution for 2003, which we estimate at $0.70-$0.80 a share (a dividend yield of 3%-3.5%).



Ticker (Bloomberg)	Rating	Current price, $	Fair value, $ (end 04)	Upside / Downside
LKOH	**BUY**	**24.6**	**30.7**	**25%**

Capitalization & stock data	
Market cap, $mn	20,085
Net debt (cash), $mn (03F)	1,518
EV, $mn (inc. min. interest)	22,093
Shares out., mn	818.14
Free float, (est.)	68%
Local shares per ADR	4
2002 dividend, $	0.63
Dividend yield	2.6%

Financials (US GAAP), $mn	2002	2003F	2004F	2005F
Revenue	15,449	20,890	20,912	19,552
EBITDA	3,658	4,124	4,286	4,229
Net income (adjusted)*	1,850	2,113	2,256	2,254
Operating cash flow	2,396	2,269	2,953	3,782
Valuation				
EV/EBITDA	6.0	5.4	5.2	5.2
P/E	10.9	9.5	8.9	8.9
P/CF	8.4	8.9	6.8	5.3

GAZPROM COMMON

Gazprom's common shares represent our top 2004 pick in the oil and gas universe, and our investment rationale does not involve the expected (for the umpteenth year already!) removal of the ring fence between common shares and ADS. Rather, our Buy case for Gazprom is based on the following:

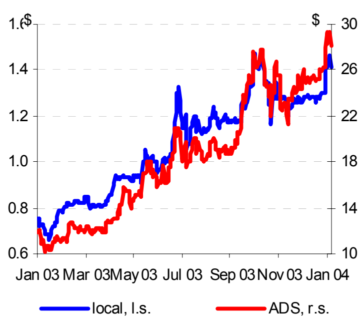
Strong 2003 financial performance likely to be sustained in 2004. The effects of light production growth; 5%-7% non-FSU export volume growth; strong 2H03 international oil prices (implying strong export gas prices in at least 1H04); and an effective 20% domestic tariff hike for 2004 (or a roughly 30% increase in dollar terms when expected ruble strengthening is taken into account) should allow Gazprom to deliver at least 10% revenue growth in 2004. And while EBITDA and net income will likely remain unchanged due to higher costs, the record cash flows of 2003 are likely to be sustained this year.

Gazprom common offer the best value in the sector. At an 04F EBITDA multiple of 3.2 times and 47% upside to our end-2004 target of $1.9, Gazprom common are clearly the best value in the sector. If local and ADS Gazprom share markets do converge, our fair value target would increase to $2.48 – nearly double the current levels.

Relatively low political risk. More than 50% owned by the Russian government (directly and through treasury shares), Gazprom is the largest Russian corporation majority-owned and run by the state. While the negative elements of state control and management are self-evident, in the current political climate they are more than offset by lower political risk.

ADS/common premium well above long-term average; set to contract. Usually at around 60%-65%, Gazprom's ADS/common premium has been hovering around 100% since early September due to strong Western investor demand for ADS as well as some selling in common shares. Clearly, the expanding premium makes no sense in the context of the coming market liberalization; the increasing popularity of Western-listed vehicles for common shares should add to the latter's popularity and thus help the spread between common shares and ADS to narrow.

Wasteful capex plans and an unfortunate return to poor corporate governance in respect to intermediaries represent the two main investment risks for 2004. Yet, as with Lukoil, Gazprom's overall risk-reward is attractive relative to peers and the broader market. And of course, should expectations of the ring fence's full or partial removal materialize, Gazprom common would clearly become the star performer of 2004.



Ticker (Bloomberg)	Rating	Current price, $	Fair value, $ (end 04)	Upside / Downside
OGZD LI (ADS)	**HOLD**	**29.25**	**27.81**	**-5%**
GSPBEX (Common)	**BUY**	**1.46**	**2.09**	**43%**

Capitalization & stock data	ADS	Common	Financials (IAS), $mn	2002	2003F	2004F	2005F
Market cap, $mn	57,346	28,526	Revenue	19,495	25,987	28,823	29,496
Net debt (cash), $mn (03F)	11,000		EBITDA	7,301	11,236	11,264	10,916
EV, $mn (inc. min. interest)	68,746	39,926	Net income (adjusted)	2,690	5,393	5,461	5,140
Shares out., mn	1,961	19,606	Operating cash flow	4,842	5,520	6,778	8,484
Free float, (est.)	3.4%	15%	**Valuation**				
Local shares per ADR	10	NA	EV/EBITDA (ADS)	9.4	6.1	6.1	6.3
			EV/EBITDA (Common)	5.5	3.6	3.5	3.7
2002 dividend, $	0.125	0.013	P/E (ADS)	21.3	10.6	10.5	11.2
			P/E (Common)	10.6	5.3	5.2	5.5
Dividend yield	0.4%	0.9%	P/CF (ADS)	11.8	10.4	8.5	6.8
			P/CF (Common)	5.9	5.2	4.2	3.4

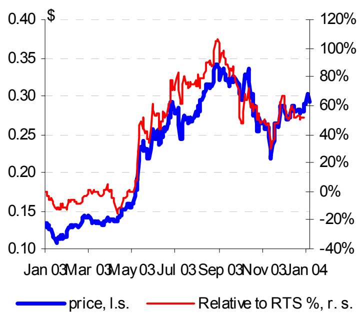
UES

We reiterate our Buy recommendation on UES with a new 2004 year-end fair value of $0.35 for preferred and common shares. We see UES as an attractive play on the Russian power sector for the following reasons:

- **UES boasts a diversified portfolio of assets** controlling 48% of regional power utilities, 100% of FSKs (transmission lines) and stakes in exporting subsidiaries and other operations – in short, the whole spectrum of power sector assets. Therefore, UES offers investors a unique way to diversify within the power sector by buying into its most liquid stock, which is also one of the most liquid stocks on the market;
- **The key catalyst** for UES will be the first OGK auction, which we expect in 2H04. Before that happens, the OGK auction mechanism will have to be finally approved by the UES BoD;
- **The expected passage of relevant governmental regulatory decrees** including antimonopoly restrictions in the wholesale and retail electricity markets. Timely passage of these decrees would send a positive signal to investors that reform is on track.
- Lastly, we view the possible **adoption of a TGK auction scheme** with the use of UES shares as a strong potential catalyst for the share price.

Steady earnings growth expected until reforms begin. As the government has nearly approved the inflation-minus tariff setting for the three years until 2007 (when full liberalization of the electricity market is expected), we expect revenue CAGR of 9.5% to $25.2bn in 2006 with electricity accounting for 76% of total sales throughout the period. Operating costs are expected to grow 10% CAGR to $22.5bn driven mostly by a 20% yearly increase in forecasted gas prices. As a result, we expect operating income to increase 5.4% CAGR to $2.7bn in 2006, while EBITDA is forecasted to rise 4.7% to $4.7bn with EBITDA margin remaining virtually flat. On the bottom line, we expect net income to increase 7.5% CAGR with net income margin remaining flat at 5.5%.

Volatility a risk. As a result of its strategic buying spree, estimated free float in the company has narrowed significantly to about 8% and volatility has increased. Looking forward, free float may shrink even further as strategic buyers have acquired UES shares in preparation for OGK (wholesale generation company) auctions.



Ticker (Bloomberg)	Rating	Current price, $	Fair value, $ (end 04)	Upside / Downside
EESR	**BUY**	**0.28**	**0.35**	**23%**
EESRP	**BUY**	**0.26**	**0.35**	**33%**

Capitalization & stock data	Common	Preferred
Market cap, $mn	11,492	540
Net debt (cash), $mn	975	
EV, $mn	13,006	
Shares out., mn	41,042	2,075
Free float, (est.)	8%	8%
Local shares per ADR	100	100
2003F dividend, $	0.001	0.008
Dividend yield	0.4%	3.3%

Financials, $mn	2002	2003F	2004F	2005F
Revenue	15,223	18,240	21,040	23,273
EBITDA	2,343	3,504	4,354	4,711
Net income (adjusted)	-523	748	1,187	1,333
Operating cash flow	1,769	3,531	4,530	5,006
Valuation				
EV/EBITDA	5.6	3.7	3.0	2.8
P/E (common)	-22.0	15.4	9.7	8.6
P/CF (common)	6.5	3.3	2.5	2.3

VIMPELCOM

Above-average growth expected. Vimpelcom is expanding rapidly in the regions, where the key potential for Russian cellular operators lies. As a result, we expect Vimpelcom's market share gains of 2003 to be sustained in 2004, resulting in above-average revenue growth.

Most growth potential is in the regions

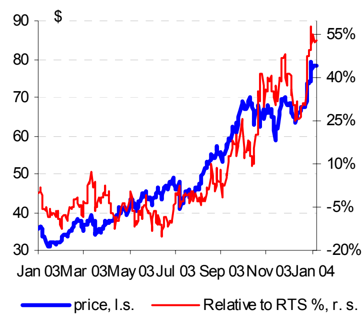
	2002	2003F	2004F
Cellular penetration	**12%**	**24%**	**34%**
MLA	42%	67%	73%
Regions	7%	17%	27%
Net adds, mn	**10.1**	**17.8**	**13.5**
MLA	3.1	4.3	1.0
Regions	7.1	13.5	12.6
Cellular revenue growth, y-o-y			
Regions	33%	37%	16%
MLA	67%	92%	61%

Source: ACM Consulting; Aton estimates

Gaining over competition. Moreover, Vimpelcom retains the potential for positive surprises in 2004 given the recent strengthening of its brand. In 3Q03, Vimpelcom beat MTS in terms of net adds in most regions where they compete head-to-head, despite Vimpelcom's late entry into the market.

Improving profitability. Vimpelcom's margins outlook for 2004 is also better than MTS's. While MTS's margins are likely to suffer from mounting competition, Vimpelcom's EBITDA margins should improve as its regional green fields mature. Given that Vimpelcom enjoys the same profitability as MTS in the MLA despite its weaker subscriber base, we expect the gap between the companies' EBITDA margins to narrow further in 2004.

Our DCF-based valuation yields an end-2004 fair value for Vimpelcom of $92 per ADS, or 18% upside from the current level. We reiterate our Buy recommendation on the stock.



Ticker (Bloomberg)	Rating	Current price, $	Fair value, $ (end 04)	Upside / Downside
VIP	**BUY**	**78.13**	**92.3**	**18%**

Capitalization & stock data	
Market cap, $mn	5,342
Net debt (cash), $mn (03F)	462
EV, $mn (inc. min. interest)	5,804
ADS out., mn	68
Free float, % (est.)	37%
Local shares per ADR	0.75
2002 dividend, $	0.00
Dividend yield, %	0.0%

Financials, $mn	**2002F**	**2003F**	**2004F**	**2005F**
Revenue	768	1,331	1,990	2,333
EBITDA	322	588	946	1,117
Net income	130	223	471	557
Operating cash flow	222	394	705	878
Valuation				
EV/EBITDA	18.0	9.9	6.1	5.2
P/E	41.2	24.0	11.3	9.6
P/CF	24.1	13.6	7.6	6.1

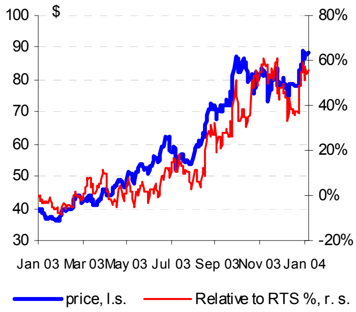
MTS

MTS has the greatest market power, being the largest Russian cellular operator with 37% market share. It is also the largest by revenues in the MLA due to its higher quality subscriber base. Despite an erosion of MTS's market share being all but inevitable, as later entrants Vimpelcom and Megafon move onto its turf, the company is well positioned to grow its top line organically by 30%+ in 2004. As to potential acquisitions, MTS has been active in the past, but there are almost no obvious targets left in Russia; as a result, CIS countries are more likely to be considered. However, given the company's leverage is already reasonably high (D/E of 0.9), acquisitions are likely to be limited.

Margin to remain robust in the high 40s. MTS's operations are predominantly at the mature stage, generating a 50%+ EBITDA margin. Yet even accounting for the growing competition on the market, MTS's profitability is bound to remain in the 40s though 2004 due to still low SAC. MTS also has the best protection from adverse changes in interconnect regulation, as it has more of its own infrastructure in the regions (compared to rivals) and is hence less dependent on leased lines.

Dividends an added attraction for MTS. Unlike Vimpelcom, MTS pays dividends, demonstrating a willingness to share profits with minority investors; the company has said it intends to pay out a minimum of 20% of RAS net income to shareholders. Even though RAS accounts do not consolidate subsidiaries, including UMC in the Ukraine, we estimate the 2003 dividend to stand at about $1.8 per ADS.

We rate MTS as Buy with an end 2004 DCF-based fair value of $103 per ADS, or 17% upside from current levels.



Ticker (Bloomberg)	Rating	Current price, $	Fair value, $ (end 04)	Upside / Downside
MBT	BUY	87.99	103.3	17%

Capitalization & stock data	
Market cap, $mn	8,726
Net debt (cash), $mn (03F)	1,269
EV, $mn (inc. min. interest)	10,210
ADS out., mn	99
Free float, % (est.)	17%
Local shares per ADR	20
2002 dividend, $	1.10
Dividend yield, %	1.3%

Financials, $mn	2002	2003F	2004F	2005F
Revenue	1,362	2,523	3,423	3,844
EBITDA	667	1,271	1,714	1,878
Net income	277	471	712	815
Operating cash flow	413	917	1,258	1,480
Valuation				
EV/EBITDA	15.3	8.0	6.0	5.4
P/E	31.5	18.5	12.2	10.7
P/CF	21.1	9.5	6.9	5.9

SEVERSTAL

Russia's premier steel sector play. Severstal is Russia's second largest steel mill and its most progressive in terms of embracing the capital markets. The company produced 9.7mn tons of steel in 2003 and has a total capacity of around 10mn tons per annum. Export revenues make up about 50% of the total and Severstal's main export markets are Asia and Europe. Domestic customers are mostly from the automobile, pipe and shipbuilding industries.

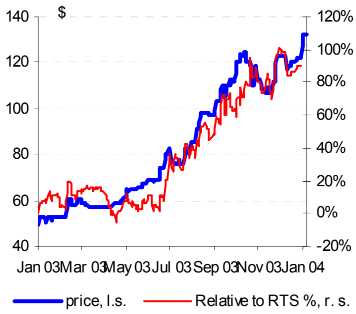
Severstal is set to perform well in 2004 due to various catalysts, main of which are likely to be continuing impressive financial performance and liquidity improvements.

Strong financials to remain the main driver. In 2004, Severstal is set to enjoy in a continuation of 2003's very favorable financial results. As we have consistently argued, the full profit generating power of Russian steel mills is still poorly understood by the market, although the interim numbers coming out of the industry for 2003 are truly eye-popping.

Severstal is on track to meet our 2003 IAS consolidated forecast of $2.9bn in sales, $1.1bn in EBITDA and $660mn net income. Considering that steel is a rather bland commodity product, Severstal's forecasted 22% net margin seems more akin to a consumer goods or hi-tech company than a steel mill. Additionally, steel prices show no sign of weakening in 2004 and interim results are likely to remain positive throughout the year.

Liquidity to improve with ADRs. In terms of share liquidity, the company started its GDR program in December 2003 and is planning a listing on MICEX in early 2004. Additionally, core shareholders intend to sell off 7% of the company, raising free float from 8% to 15%. Finally, a share split is in the works, which will make trading in Severstal shares more convenient for small investors. All these steps should make Severstal shares more liquid in 2004.

10% dividend yield. Another main attraction of Severstal is its willingness to share its good fortune with minority shareholders, a major departure from its domestic peers. The first step was the announcement in July 2003 of a clear dividend policy of no less than 25% of IAS net income. Later that month the company announced an interim dividend of $6.39 per share, which represented in total $141mn (75% of 2002 IAS net income, 100% of 1Q03 RAS net income). Following this was another interim dividend in October of $6.80 per share; total payout $150mn. Thus, Severstal has thus far paid around $13 in dividends for 2003, a 10% dividend yield.



Ticker (Bloomberg)	Rating	Current price, $	Fair value, $ (end 04)	Upside / Downside
CHMF	**BUY**	**132.50**	**147.9**	**12%**

Capitalization & stock data	
Market cap, $ mn	2,928
Net debt (cash), $mn (03F)	-99
EV, $mn (inc. min. interest)	2,865
Shares out., mn	22
Free float, (est)	9%
Dividend, $ (2002)	2.32
Dividend yield	2%

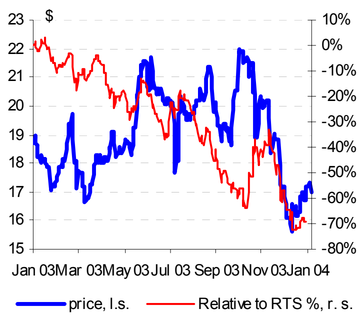
Financials, $ mn	**2002**	**2003F**	**2004F**	**2005F**
Revenue	2,271	2,942	3,149	3,166
EBITDA	512	1,077	1,112	984
Net income	189	640	678	594
Operating cash flow	417	717	860	845
Valuation				
EV/EBITDA	5.6	2.7	2.6	2.9
P/E	15.5	4.6	4.3	4.9
P/CF	7.0	4.1	3.4	3.5

WIMM-BILL-DANN

Wimm-Bill-Dann posted weak financials in 2003 and the breakdown of talks with Danone in November has put a cloud over its shares. As a result, the stock massively under-performed the market. However, as we have long argued, investors should have expected 2003 to be a critical year for WBD as it signaled the end of the company's high growth entrepreneurial phase and the beginning of its life as the established market leader charged with fighting off rivals. The cost of this is low profitability and a constant struggle for market share.

However, we reiterate that WBD is by far the largest player in its universe, with 30% market share in juice and dairy products, as well as being the only company with a truly nationwide footprint. Finally, as the turnaround period for buying a new site, renovating it, and ramping up production to capacity is 12-18 months, only in 2004 should WBD's massive capex and acquisition spending in 2002-2003 begin to affect its profit and loss account.

We believe that WBD still merits a Buy, despite it being out of favor with the mainstream investment community. It is true that WBD faces stiffer competition than was anticipated by the market, but it still has tremendous value through its brand names, distribution network and wide production base. We have trimmed profitability forecasts going forward in light of the strong competition, but we feel the company is still fundamentally under-valued and represents the best opportunity for share price appreciation in the consumer sector. Our target price for WBD is $23, 35% upside from current levels.



Ticker (Bloomberg)	Rating	Current price, $	Fair value, $ (end 04)	Upside / Downside
WBD	**BUY**	**16.98**	**23.0**	**35%**

Capitalization & stock data	
Market cap, $ mn	747
Net debt (cash), $mn (03F)	249
EV, $mn (inc. min. interest)	1,017
Shares out., mn	44
Free float, (est)	23%
Dividend, $ (2002)	0
Dividend yield	0%

Financials, $ mn	**2002**	**2003F**	**2004F**	**2005F**
Revenue	825	948	1,085	1,228
EBITDA	83	85	110	150
Net income	36	18	34	67
Operating cash flow	-7	29	74	126
Valuation				
EV/EBITDA	12.2	12.0	9.2	6.8
P/E	20.8	42.0	21.9	11.1
P/CF	NM	25.7	10.1	5.9

SIBIR TELECOM

Large regional telco with natural competitive advantages. Sibir Telecom serves 3.6mn ALIS and 0.5mn mobile subscribers (2003F) in Siberia. According to most recent IAS accounts (2002), sales amounted to $423mn and we expect the figure to reach $557mn in 2003; 2002 EBITDA margin stood at 27%.

The Siberian Federal District is characterized by vast territories, low population density and severe climate conditions. This makes the cost of telecommunication network construction and maintenance high; however, this is currently a positive for the incumbent, as it limits competition in the region. Moreover, we see substantial solvent demand for telecommunication services in the region's large cities. End-2003 fixed-line and mobile penetration in the district is estimated at 17% and 13%, respectively.

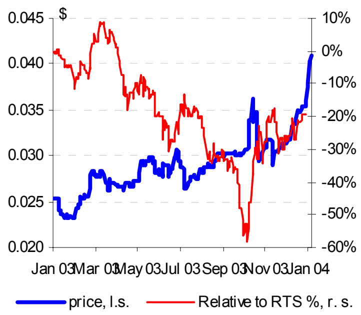
We see Sibir Telecom as the best way for investors to gain exposure to the Russian fixed line telecom sector, for the following reasons:

- **One of the best outlooks for a local tariff raise**. Sibir Telecom has one of the best potentials for extra tariffs increases, as its cumulative local tariff increases over 1999-2003 have been among the lowest in the sector.

- **Strong showing of cellular business.** Sibir Telecom has seen one of the highest cellular subscriber base growth rates among Svyazinvest companies. Although competition is likely to escalate we believe Sibir Telecom has scope for positive surprises in 2004. The company recently said it plans to invest $60mn in cellular network construction in 2004, which we estimate should allow 50% subscriber base growth to 760,000.

DCF, comparative valuation still attractive. Sibir Telecom still offers the best risk-return profile among all Svyazinvest companies. According to our DCF model, end-2004 fair value for Sibir Telecom common and preferred shares stands at $0.046 and $0.034, implying 20% and 32% upside respectively from the current prices (it is worth noting that thanks to the sale of 30% in CCC-900 to MTS for $28.6mn, Sibir Telecom preferred shares represent one of the best dividend plays in the sector for 2003, yielding 5.9%).

The company also looks very attractive compared to sector peers on a multiples basis, trading at 18% discounts to sector average 2004E EV/S and EV/EBITDA respectively. We draw particular attention to the significant valuation gap between Sibir Telecom and Uralsvyazinform, another regional operator with cellular exposure, which in our opinion is not justified given the strong showing of Sibir Telecom's mobile business.



Ticker (Bloomberg)	Rating	Current price, $	Fair value, $ (end 04)	Upside / Downside
ENCO	**BUY**	**0.04**	**0.046**	**20%**
ENCOP	**BUY**	**0.03**	**0.034**	**32%**

Capitalization & stock data	Common	Preferred	Financials, $mn	2002	2003F	2004F	2005F
Market cap, $mn	456	83	Revenue	423	562	757	914
Net debt (cash), $mn	135		EBITDA	115	157	223	273
EV, $mn	684		Net income (adjusted)	22	74	82	96
Shares out., mn	12,011	3,908	Operating cash flow	67	120	136	163
Free float, % (est.)	48%		**Valuation**				
Local shares per ADR	N/A	N/A	EV/EBITDA	5.9	4.4	3.1	2.5
2003E dividend	0.0004	0.0013	P/E (common)	23.2	6.2	5.6	4.7
2003E dividend yield, %	1.1%	5.9%	P/CF (common)	5.8	3.8	3.3	2.8

ORENBURGNEFT (PREFERRED)

Orenburgneft is the fastest growing listed production subsidiary within the TNK-BP universe of companies, with production up 29% in 2003 and further 10% growth expected in 2004. It also benefits from having one of the lowest lifting costs in Russia and closer proximity to key export markets than its Western Siberian peers. The stock trades at a 50% discount to common shares (which we actually find increasingly fully valued) and offers nearly 70% upside potential to our fair value target of $17.4.

ORNB	**Reserves (M&L, end 02)**	**Production (04F)**
In mn bbls	1,345.80	96.17
Target EV multiple, $/bbl	**1.25**	**25**
Target EV, $mn	**1,682.3**	**2,404.2**
Net debt (cash), $mn (2q03)	312.6	312.6
Target equity value, $mn	**1,369.6**	**2,091.5**
Common shares outstanding	66,060,625	66,060,625
Preferred shares outstanding	21,773,125	21,773,125
Prefferred - common ratio	75.0%	75.0%
Target common price, $	**16.6**	**25.4**
Target preferred price, $	**12.5**	**19.0**
Weighting in final target price	25%	75%
Target price - common, $	**23.2**	
Upside/downside	**13%**	
Target price - preferred, $	**17.4**	
Upside/downside	**68%**	

Capitalization			**Stock data**	**Common**	**Preferred**
Total market cap, $mn	1,584.44		Number of shares	66,060,625	21,773,125
Net debt, $mn	312.64		Price, $	20.58	10.35
Enterprise value, $mn	1,897.08		Market cap, $mn	1,359.20	225.24
Valuation	**2002**	**2003F**			
P / E	-62.24	63.91	Bid price	20.40	10.34
EV / EBIT	77.78	58.92	Ask price	20.75	10.35
EV / Production (oil only)	27.40	21.70	Listing	RTS	RTS
EV / Reserves (oil only)	1.95	1.41			
Dividend yield - common	-	-			
Dividend yield - preferred	0%	-			
Ownership					
Onaco	40.2%				
TNK	56.8%				
Other	3.0%				

REGIONAL POWER UTILITIES

Regional utilities: top pick comparables

	Kirovenergo	Udmurtenergo	Chitaenergo	Krasnoyarskenergo	Kuzbassenergo	Novosibirskenergo	Tomskenergo	Mosenergo	UES
Rating	Buy	Buy	Buy	Buy	Buy	Buy	Buy	Hold	Buy
Market data									
Current price, $									
common	0.027	0.238	0.029	0.370	0.575	10.225	0.011	0.071	0.290
pref	0.018	0.194	0.017	0.340	n.a.	7.100	0.008	n.a.	0.263
Fair value, $									
common	0.060	0.764	0.065	1.127	1.017	23.249	0.031	0.088	0.345
pref	0.045	0.573	0.048	0.845	n.a.	17.437	0.023	n.a.	0.345
Upside potential									
common	121%	221%	121%	205%	77%	127%	170%	24%	19%
pref	156%	196%	179%	149%	n.a.	146%	174%	n.a.	32%
MCap, $mn	70	44	55	278	349	156	49	1,996	12,447
Net debt, $mn	4	-5	-6	24	69	20	-11	238	975
EV, $mn	75	39	49	302	417	176	37	2,234	13,421
Operating data									
Total installed capacity, MW	940	480	508	8,188	4,667	2,537	421	14,669	100,000
Thermal generation capacity, MW	940	480	508	2,188	4,667	2,082	421	13,469	80,000
Hydro generation capacity, MW	-	-	-	6,000	-	455	-	1,200	20,000
Electricity production in 2002, GWh	3,677	2,472	2,622	9,758	27,185	11,242	1,689	71,185	617,400
Electricity sales in 2002, GWh	6,283	6,853	4,857	33,320	28,435	11,474	5,226	68,903	598,878
Customer base, 000's	390	404	309	754	735	679	265	3,737	15,699
Ratios									
MCap/Installed capacity, $/kW	75	92	109	34	75	62	115	136	124
EV/Installed capacity, $/kW	79	81	97	37	89	69	89	152	134
EV/Thermal capacity, $/kW	79	81	97	138	89	85	89	166	168
EV/Electricity production in 2002, $/TWh	20	16	19	31	15	16	22	31	22
EV/Electricity deliveries in 2002, $/TWh	12	6	10	9	15	15	7	32	22
EV/Customer base, $/customer	191	96	159	401	567	259	141	598	855
EV/Sales (02)	0.46	0.27	0.42	0.75	0.87	0.66	0.31	1.32	0.88
Price/Book (02)	0.35	0.26	0.40	0.44	0.53	0.36	0.14	0.61	0.73
EV/EBITDA (02)	3.81	2.62	4.15	5.50	5.32	4.51	2.22	9.46	5.73
P/E (02)	46.57	26.87	39.66	-3.90	-19.01	98.36	39.84	96.88	11.76

Source: Company data; Aton estimates

APPENDIX 1: TARGET PRICE REVISIONS

As a result of changes made to our DCF and various macro assumptions, our target prices for most Russian companies have changed. We have updated the DCF-based target prices of stocks in our universe for the following reasons:

- The introduction of a **higher discount rate** due to more conservative assumptions of market volatility.
- The assumption of higher commodity prices (as described above).
- Company-specific adjustments to operating and other assumptions

Despite target price updates, our stock recommendations remain unchanged with the following exceptions:

1) After having previously suspended ratings for Yukos and Sibneft, we reinstated our Hold recommendation on Sibneft while downgrading Yukos to Hold (a detailed discussion will be presented in our forthcoming oil sector report);
2) Irkustkenergo, which we upgraded from Sell to Hold because of high implied upside. However, our key concern remains that metal groups RusAl and SuAl may abuse their role as controlling shareholders.

The table below summarizes the changes to our target prices and discount rates.

Changes to target prices

	New			Old				
	WACC, %	Target price, $	Rating	WACC, %	Target price, $	Rating	Price as of 9 Jan 2003, $	Upside, %
Oil and Gas								
Yukos	14.5%	10.607	Hold	11.9%	21.1	Buy	11.350	-7%
Lukoil	11.8%	30.731	Buy	11.7%	29.510	Buy	24.570	25%
Gazprom - common	11.8%	2.085	Buy	11.7%	1.621	Buy	1.248	67%
Gazprom - ADS	11.8%	27.805	Hold	11.7%	21.620	Sell	29.250	-100%
Surgutneftegaz – inc. treas. shares	12.4%	0.415	Sell	12.3%	0.421	Sell	0.605	-31%
Sibneft	12.0%	2.650	Hold	11.9%	2.570	Hold	2.700	-2%
Tatneft	12.8%	1.034	Hold	12.7%	1.216	Hold	1.180	-12%
Transneft - pref	13.3%	597.592	Hold	13.4%	550.000	Sell	650.000	-8%
Telecoms								
Rostelecom	12.4%	2.700	Hold	12.3%	2.180	Hold	2.200	23%
Vimpelcom	12.3%	92.300	Buy	12.2%	92.700	Buy	78.130	18%
MTS	12.6%	103.300	Buy	12.5%	103.300	Buy	87.990	17%
Golden Telecom	N/A	31.000	Hold	N/A	31.000	Sell	30.490	2%
RosBusinessConsulting	17.3%	3.200	Buy	17.0%	3.300	Buy	2.150	49%
MGTS	15.2%	11.800	Hold	15.0%	12.000	Hold	12.900	-9%
North-West Telecom	17.8%	0.370	Sell	17.2%	0.330	Sell	0.457	-19%
Center Telecom	16.0%	0.310	Sell	15.3%	0.260	Hold	0.380	-18%
Volga Telecom	15.5%	3.180	Buy	14.7%	2.210	Hold	2.900	10%
Southern Telecom	16.7%	0.084	Sell	17.7%	0.092	Hold	0.105	-20%
Uralsvyazinform	14.2%	0.038	Hold	13.5%	0.028	Hold	0.041	-8%
Sibir Telecom	16.2%	0.046	Buy	14.8%	0.039	Buy	0.040	14%
Dalsvyaz	18.3%	1.320	Hold	17.7%	1.250	Hold	1.300	2%
Power Utilities								
UES	12.3%	0.345	Buy	12.2%	0.306	Hold	0.302	14%
Mosenergo	13.7%	0.088	Hold	13.5%	0.086	Hold	0.072	29%
Bashkirenergo	17.2%	0.602	n.r.	16.9%	0.617	n.r.	0.283	115%
Irkutskenergo	14.9%	0.204	Hold	14.7%	0.115	Sell	0.118	74%
Lenenergo	17.2%	0.661	Sell	16.9%	0.431	Sell	0.725	-9%
Other								
Norilsk Nickel	12.3%	73.100	Hold	12.2%	65.180	Hold	70.450	4%
Severstal	14.8%	147.880	Buy	14.5%	143.290	Buy	132.500	12%
Sberbank	12.4%	247.050	Hold	13.5%	240.300	Hold	300.000	-18%
Baltika	14.7%	14.720	Hold	14.4%	15.670	Hold	11.350	30%
Sun Interbrew	16.4%	7.400	Hold	15.6%	6.330	Hold	3.600	106%
Wimm-Bill-Dann	13.3%	22.980	Buy	13.2%	27.000	Buy	16.500	39%
NTMK	NA	1.250	Buy	N/A	0.980	Buy	0.580	116%
Avtovaz	16.7%	41.070	Buy	16.9%	42.100	Buy	27.000	52%

Source: Bloomberg; Aton estimates

APPENDIX 2: KEY COMPANY VALUATION

As of Jan 13 2004

Company	EV/Revenue			EV/ EBITDA			P/E			P/CF			Accounting
	2003F	2004F	2005F	2003F	2004F	2005F	2003F	2004F	2005F	2003F	2004F	2005F	standard
Oil and Gas													
Gazprom, com.	1.5	1.4	1.3	3.5	3.5	3.6	5.6	5.2	5.5	5.1	4.2	3.3	IAS
Gazprom, ADS	2.6	2.3	2.3	5.9	5.9	6.1	11.0	10.1	10.7	10.0	8.1	6.5	IAS
Yukos	1.8	1.7	1.8	5.2	5.6	5.8	5.2	7.1	6.9	5.1	6.0	5.6	US GAAP
Lukoil	1.0	1.0	1.1	5.3	5.1	5.2	9.4	8.8	8.8	8.8	6.7	5.3	US GAAP
Surgutneftegaz	1.1	1.1	1.2	2.4	2.9	3.4	5.5	7.0	9.0	4.0	4.0	4.5	US GAAP
Surgutneftegaz – inc. treas. shares	2.5	2.5	2.7	5.5	6.4	7.6	10.3	13.1	17.0	7.4	7.5	8.5	US GAAP
Sibneft	2.1	2.0	2.0	6.3	5.4	5.4	6.1	6.8	7.0	6.3	5.1	5.1	US GAAP
Tatneft	0.6	0.6	0.7	3.3	2.8	3.2	4.9	3.9	4.9	3.4	2.8	2.9	US GAAP
Transneft	2.0	1.7	1.6	3.9	3.3	3.1	6.2	5.2	4.9	4.2	3.7	3.4	IAS
Telecoms													
MTS	4.0	3.0	2.7	8.1	6.1	5.4	18.7	12.8	10.8	9.5	7.1	5.9	US GAAP
Vimpelcom	3.3	2.2	1.9	7.4	4.6	3.9	17.5	8.3	7.0	9.9	5.5	4.4	US GAAP
Rostelecom	2.1	1.7	1.5	5.6	5.7	5.9	30.2	30.2	30.5	6.1	5.9	4.6	IAS
MGTS	2.9	2.5	2.3	6.6	6.1	5.8	15.9	14.5	14.1	7.1	6.9	6.6	US GAAP
Golden Telecom	3.2	2.1	1.9	9.3	6.3	5.6	20.7	11.7	10.2	11.4	7.6	6.8	US GAAP
RBC	5.1	3.6	2.4	21.1	14.8	6.2	n.m.	n.m.	12.1	133.4	26.0	7.1	IAS
Uralsvyazinform	2.6	1.8	1.5	8.3	5.3	4.1	20.2	10.7	8.0	10.7	7.2	5.4	IAS
VolgaTelecom	1.9	1.4	1.1	5.4	4.0	3.3	11.5	8.2	7.0	6.2	4.8	4.0	IAS
Sibirtelecom	1.3	1.0	0.8	4.9	3.4	2.7	7.0	6.1	4.9	4.2	3.6	3.0	IAS
NW Telecom	1.3	1.0	0.9	5.1	3.9	3.3	13.4	8.9	6.9	4.4	3.5	3.0	IAS
Centertelecom	1.4	1.1	0.9	5.3	4.0	3.3	22.1	12.8	9.4	4.3	3.4	2.9	IAS
Southern Telecom	1.1	0.8	0.7	3.7	2.8	2.2	8.9	12.4	9.0	2.6	2.3	1.9	IAS
Dalsvyaz	0.9	0.7	0.5	4.2	2.9	2.1	7.5	5.1	3.3	3.1	2.4	1.8	IAS
Bashinformsvyaz	1.2	0.9	0.8	4.0	3.1	2.5	7.1	5.5	4.4	7.4	6.0	4.0	RAS
Power Utilities													
UES	1.1	1.0	0.9	5.8	4.7	4.3	15.9	10.0	8.9	3.4	2.6	2.4	IAS
Mosenergo	0.8	0.7	0.7	3.3	2.8	3.1	6.8	5.7	6.9	3.9	3.2	3.2	IAS
Bashkirenergo	0.7	0.6	0.6	7.4	4.7	4.3	18.6	7.2	6.5	5.4	4.2	3.5	RAS
Lenenergo	0.7	0.6	0.6	6.3	5.1	4.8	n.m.	29.3	25.8	6.8	5.1	4.9	IAS
Samaraenergo	0.5	0.4	0.4	4.9	4.2	5.6	18.5	11.7	31.0	5.3	4.1	5.1	RAS
Metals													
Norilsk Nickel	2.9	3.0	2.9	6.5	6.6	6.5	12.3	12.2	11.5	9.5	8.1	8.0	IAS
Severstal	1.0	1.0	1.0	2.7	3.2	3.8	4.4	5.5	6.7	4.0	3.7	4.2	IAS
Consumer/Industrials/Banking													
Wimm-Bill-Dann	1.1	0.9	0.8	11.9	8.5	6.0	42.7	18.9	9.3	24.6	8.9	5.2	GAAP
Baltica	2.3	2.0	1.8	6.9	6.1	5.5	10.7	9.2	7.9	7.4	6.7	5.9	GAAP
Sun Interbrew	1.6	1.3	1.1	8.4	5.1	4.6	11.5	4.4	3.5	3.5	2.4	2.0	GAAP
Sun Interbrew	1.6	1.3	1.1	8.4	5.1	4.6	11.5	4.4	3.5	3.5	2.4	2.0	GAAP
Avtovaz	0.3	0.3	0.3	3.5	2.5	1.8	9.9	4.6	2.3	3.2	2.3	1.3	IAS
Sberbank RF	1.9	1.7	1.6	7.1	7.5	6.9	7.8	9.1	8.8	n.m.	n.m.	3.1	IAS
UHM (OMZ)	0.8	n.m.	n.m.	n.m.	n.m.	n.m.	8.2	n.m.	n.m.	n.m.	n.m.	n.m.	US GAAP

Source: Company data; Aton estimates

APPENDIX 3: RUSSIAN ECONOMIC DATA

Annual macroeconomic data, including forecasts

	1997	1998	1999	2000	2001	2002	2003 E	2004 F	2005 F
KEY INDICATORS									
Nominal GDP, (R bn)	2,342.5	2,629.6	4,823.2	7,305.6	9,039.4	10,863.4	13,410.0	15,800.0	18,249.0
GDP ($ bn)	404.9	271.2	195.9	259.7	309.9	346.5	437.0	552.4	666.0
GDP per capita ($)	2,759.5	1,853.5	1,345.7	1,793.0	2,152.5	2,405.4	3,045.8	3,867.6	4,681.9
Real GDP growth, (% ch. y-o-y)	1.4	-5.3	6.3	10.0	5.1	4.7	7.0	5.9	5.5
Industrial output growth, (% ch. y-o-y)	2.1	-5.1	11.6	12.0	4.9	3.7	6.9	5.9	5.5
Fixed investment industry growth, (% ch. y-o-y)	-5.2	-10.3	3.5	17.3	8.3	2.5	12.0	9.5	8.0
Real retail sales growth, (% ch. y-o-y)	4.7	-3.0	-7.5	8.7	10.6	9.0	8.2	7.5	7.0
Real disposable income per capita, (%, ch. y-o-y)	6.0	-15.0	-14.4	9.7	8.5	10.1	13.9	9.0	7.4
Industrial PPI growth, (% ch. y-o-y, eop)	7.4	23.0	71.0	31.6	10.6	17.5	13.0	12.0	10.0
CPI growth, (% ch. y-o-y, eop)	11.0	84.5	36.6	20.1	18.8	15.1	12.0	11.0	10.0
BALANCE OF PAYMENTS*									
Exports, ($ bn)	86.9	74.4	75.6	105.0	101.6	107.3	134.4	126.5	122.0
Imports, ($ bn)	72.0	58.0	39.5	44.9	53.8	61.0	74.8	84.8	91.0
Trade balance, ($ bn)	14.9	16.4	36.0	60.2	47.9	46.3	59.6	41.7	31.0
Current account ($ bn)	-0.1	0.2	24.6	46.8	33.6	29.9	39.1	28.0	20.0
Current account ratio (% of GDP)	0.0	0.1	12.6	18.0	10.8	8.6	8.9	5.1	3.0
Urals med C.I.F., ($/bbl, aop)	18.3	11.8	17.1	26.5	22.9	23.7	27.2	24.0	20.5
FEDERAL BUDGET**									
Revenues, (R bn)	293.9	269.9	608.0	1,127.6	1,590.7	2,198.5	2,588.3	2,808.0	3,200.0
Revenues, (% of GDP)	12.5	10.3	12.6	15.4	17.6	20.2	19.4	17.8	17.5
Expenditures, (R bn)	475.6	384.3	664.7	954.1	1,325.7	2,042.2	2,361.5	2,714.0	3,080.0
Expenditures, (% of GDP)	20.3	14.6	13.8	13.1	14.7	18.8	17.7	17.2	16.9
Primary deficit (-)/surplus (+), (% of GDP)	-2.7	-0.3	2.2	4.7	5.5	3.5	3.4	2.4	2.2
General deficit (-)/surplus (+), (% of GDP)	-7.8	-4.4	-1.2	2.4	2.9	1.4	1.6	0.6	0.7
MONETARY INDICATORS									
Monetary base, (R bn, eop)	164.5	210.4	324.3	519.6	708.5	940.3	1,392.1	1,780.0	2,180.0
Gross international reserves, ($ bn, eop)	17.8	12.2	12.5	28.0	36.6	47.8	76.9	88.0	94.5
M0, (R bn, eop)	130.4	187.8	266.6	419.3	584.3	763.3	1,100.0	1,450.0	1,800.0
M0 growth, (% ch. y-o-y)	25.6	44.0	42.0	57.3	39.4	30.6	44.1	31.8	24.1
M2, (R bn, eop)	374.1	448.3	704.7	1,144.3	1,602.6	2,119.6	3,050.0	4,050.0	5,050.0
M2 growth, (% ch. y-o-y)	29.8	19.8	57.2	62.4	40.1	32.3	43.9	32.8	24.7
R/$ official exchange rate, (eop)	6.0	20.7	27.0	28.2	30.1	31.8	29.5	27.7	27.1
R/$ official exchange rate, (aop)	5.8	9.7	24.6	28.1	29.2	31.4	30.7	28.6	27.4

* *per balance of payments methodology*

** *implementation as of cash basis*

Sources: State Statistics Committee, Central Bank, Aton estimates

Quarterly macroeconomic data

	1Q-00	2Q-00	3Q-00	4Q-00	1Q-01	2Q-01	3Q-01	4Q-01	1Q-02	2Q-02	3Q-02	4Q-02	1Q-03	2Q-03	3Q03
KEY INDICATORS															
Nominal GDP, (R bn)	1,527.4	1,696.6	2,037.8	2,043.8	1,922.4	2,119.5	2,536.1	2,461.4	2,267.7	2,522.8	3,074.5	2,998.4	2,893.1	3,134.9	3,688.3
GDP ($ bn)	53.6	59.8	73.3	73.3	67.3	73.1	86.5	82.6	73.7	80.7	97.4	94.3	91.4	101.6	121.2
Real GDP growth, (% ch. y-o-y)	11.4	10.2	10.5	8.2	4.4	5.3	6.0	4.4	3.0	4.1	4.6	5.2	6.8	7.2	6.2
Industrial output growth, (% ch. y-o-y)	14.4	12.0	11.9	9.8	5.2	5.9	4.5	4.1	2.6	3.8	5.6	2.6	6.0	7.5	6.9
Fixed investment industry growth, (% ch. y-o-y)	13.2	19.5	19.7	16.7	5.9	8.3	8.6	10.5	1.1	3.4	2.6	2.7	10.0	13.2	12.3
Real retail sales growth, (% ch. y-o-y)	8.0	8.5	9.2	9.2	7.5	11.6	11.4	11.7	9.1	7.9	9.7	9.5	8.6	9.7	7.0
Real disposable income per capita, (%, ch. y-o-y)	8.6	11.2	11.3	7.7	6.6	6.4	10.1	11.1	10.8	9.9	9.1	10.8	15.5	14.2	11.4
Industrial PPI growth, (% ch. y-o-y, eop)	60.4	50.8	40.9	31.6	24.5	22.3	15.0	10.6	5.6	9.8	15.1	17.5	21.0	14.2	13.7
CPI growth, (% ch. y-o-y, eop)	22.4	20.2	18.6	20.1	23.8	23.7	20.1	18.8	17.0	14.9	15.0	15.1	14.8	13.9	13.2
CPI growth, (% ch. m-o-m, eop)	3.9	5.4	4.2	5.3	7.2	5.3	1.1	4.2	5.5	3.4	1.2	4.3	5.2	2.6	0.6
BALANCE OF PAYMENTS*															
Exports, ($ bn)	23.9	25.5	26.6	29.1	25.5	26.1	25.5	24.4	21.6	26.1	28.8	30.7	30.9	31.5	34.7
Imports, ($ bn)	10.0	10.4	11.1	13.4	11.3	13.6	13.2	15.6	12.3	14.8	15.7	18.1	15.8	18.1	19.5
Trade balance, ($ bn)	13.9	15.1	15.5	15.7	14.3	12.5	12.3	8.8	9.2	11.4	13.1	12.6	15.1	13.4	15.2
Current account ($ bn)	11.6	11.8	10.6	12.9	11.6	8.9	7.0	6.1	6.3	7.8	7.1	8.6	11.8		
Current account ratio (% of GDP)	21.6	19.8	14.4	17.6	17.3	12.1	8.0	7.4	8.6	9.7	7.3	9.1	12.9		
Urals med C.I.F., ($/bbl, aop)	26.2	25.0	27.2	27.9	23.7	25.3	24.0	18.7	19.8	23.6	25.8	25.5	29.6	24.0	27.2
FEDERAL BUDGET**															
Revenues, (R bn)	221.8	285.9	275.5	344.4	318.0	393.0	397.5	482.3	472.4	518.7	586.9	620.5	581.0	663.0	652.3
Revenues, (% of GDP)	14.5	16.9	13.5	16.9	16.5	18.5	15.7	19.6	20.8	20.6	19.1	20.7	20.1	21.1	17.7
Expenditures, (R bn)	191.6	204.9	235.8	321.9	268.8	308.9	351.9	396.1	364.4	463.9	503.3	710.6	491.6	568.1	597.7
Expenditures, (% of GDP)	12.5	12.1	11.6	15.8	14.0	14.6	13.9	16.1	16.1	18.4	16.4	23.7	17.0	18.1	16.2
Primary deficit (-)/surplus (+), (% of GDP)	4.6	7.4	4.9	2.4	7.2	5.7	5.1	4.4	8.2	3.6	5.2	-1.9	6.0	4.1	3.5
General deficit (-)/surplus (+), (% of GDP)	2.0	4.8	1.9	1.1	2.6	4.0	1.8	3.5	4.8	2.2	2.7	-3.0	3.1	3.0	1.5
MONETARY INDICATORS															
Monetary base, (R bn, eop)	318.9	397.2	437.6	519.6	504.7	582.4	649.8	708.5	683.1	787.0	829.1	940.3	930.4	1,123.6	1,186.0
Gross international reserves, ($ bn, eop)	15.5	21.0	25.0	28.0	29.7	35.1	38.0	36.6	37.3	43.6	45.6	47.8	55.5	64.4	62.1
M0, (R bn, eop)	251.5	321.8	351.0	419.3	399.4	474.7	531.0	584.3	552.9	645.9	672.6	763.3	749.5	917.1	957.1
M0 growth, (% ch. y-o-y)	44.5	48.7	64.9	57.3	58.8	47.5	51.3	39.4	38.4	36.1	26.7	30.6	35.6	42.0	42.3
M2, (R bn, eop)	751.4	892.2	992.4	1,144.3	1,149.5	1,294.3	1,414.4	1,602.6	1,562.4	1,751.1	1,846.6	2,119.6	2,208.5	2,604.5	2,732.1
M2 growth, (% ch. y-o-y)	58.6	57.2	66.1	62.4	53.0	45.1	42.5	40.1	35.9	35.3	30.6	32.3	41.4	48.7	48.0
R/$ official exchange rate, (eop)	28.5	28.1	27.8	28.2	28.7	29.1	29.4	30.1	31.1	31.4	31.6	31.8	31.4	30.3	30.6
R/$ official exchange rate, (aop)	28.5	28.4	27.8	27.9	28.5	29.0	29.3	29.8	30.8	31.3	31.6	31.8	31.7	30.9	30.4

* *per balance of payments methodology*

** *implementation as of cash basis*

Sources: State Statistics Committee, Central Bank, Aton estimates

Monthly macroeconomic data

	Jan 02	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan 03	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov
KEY INDICATORS																							
Nominal GDP, (R bn)	713.0	738.0	827.0	845.0	849.0	870.3	953.0	1,021.0	1,059.3	1,042.0	981.0	1,030.9	866.0	911.0	1,024.0	1,041.0	1,039.0	1,075.6	1,146.0	1,200.0	1,340.0	1,253.0	1,151.0
GDP ($ bn)	23.4	24.0	26.6	27.1	27.2	27.7	30.2	32.4	33.5	32.9	30.8	32.4	27.2	28.7	32.6	33.4	33.6	35.3	37.7	39.5	43.8	41.5	38.6
Industrial output growth, (% ch. y-o-y)	2.2	2.0	3.7	4.3	2.8	4.4	7.8	3.4	5.5	3.9	0.8	3.2	4.9	6.5	6.7	7.1	8.5	7.0	7.1	5.5	8.0	7.2	7.1
Fixed investment industry growth, (% ch. yoy)	0.1	0.1	3.2	3.7	3.5	3.1	3.3	1.6	2.9	2.7	2.2	3.2	7.9	10.9	11.3	12.8	14.7	12.0	11.8	12.2	13.0	12.9	12.0
Real retail sales growth, (% ch. y-o-y)	9.7	8.6	9.1	9.7	6.2	7.7	10.5	8.8	9.7	9.9	9.5	9.1	8.2	8.6	9.1	10.0	10.2	8.8	7.9	6.1	7.0	7.1	7.0
Real disposable income per capita, (%, ch. yoy)	12.9	11.3	8.3	16.9	7.8	4.9	12.9	8.7	5.6	11.4	10.7	10.2	14.4	16.8	15.4	9.1	19.7	13.8	10.4	9.5	14.2	14.9	15.1
Industrial PPI growth, (% ch. y-o-y, eop)	9.0	6.9	5.6	7.0	8.7	9.8	11.7	13.6	15.1	17.0	18.0	17.5	17.4	19.4	21.0	20.1	16.9	14.2	13.8	13.4	13.7	12.7	12.0
CPI growth, (% ch. y-o-y, eop)	19.2	17.9	17.0	16.3	16.2	14.9	15.1	15.2	15.0	15.0	15.2	15.1	14.3	14.8	14.8	14.6	13.6	13.9	13.9	13.3	13.2	13.1	12.4
CPI growth, (% ch. m-o-m, eop)	3.1	1.2	1.1	1.2	1.7	0.5	0.7	0.1	0.4	1.1	1.6	1.5	2.4	1.6	1.1	1.0	0.8	0.8	0.7	-0.4	0.3	1.0	1.0
TRADE*																							
Exports, ($ bn)	6.7	6.6	8.3	9.4	8.5	8.2	9.2	9.9	9.7	10.1	9.5	11.2	9.6	9.8	11.5	10.1	10.4	11.0	11.3	11.9	11.5	12.6	11.7
Imports, ($ bn)	3.7	4.0	4.7	5.1	4.7	5.0	5.5	5.1	5.1	5.9	5.7	6.5	4.7	5.2	6.0	6.2	5.9	6.0	6.7	6.3	6.5	7.0	6.6
Trade balance, ($ bn)	3.0	2.6	3.7	4.3	3.8	3.3	3.8	4.7	4.6	4.2	3.7	4.7	4.9	4.6	5.6	3.9	4.5	5.0	4.7	5.6	4.9	5.6	5.1
Urals med C.I.F., ($/bbl, aop)	18.4	18.8	22.1	23.9	23.9	22.9	24.8	25.7	27.0	26.0	22.9	27.6	29.6	30.5	28.7	22.8	23.9	25.2	26.9	28.9	25.6	28.0	27.7
FEDERAL BUDGET**																							
Revenues, (R bn)	161.2	145.2	166.0	184.4	165.4	168.9	208.9	188.1	190.0	225.3	188.0	207.1	180.2	187.8	213.0	223.3	225.0	214.7	222.6	211.4	218.3	231.4	214.2
Revenues, (% of GDP)	22.6	19.7	20.1	21.8	19.5	19.4	21.9	18.4	17.9	21.6	19.2	20.1	20.8	20.6	20.8	21.4	21.7	20.0	19.4	17.6	16.3	18.5	18.6
Expenditures, (R bn)	78.3	138.9	147.1	160.2	149.7	154.0	161.9	174.5	167.0	257.9	198.5	254.2	110.1	182.8	198.7	185.4	178.5	204.2	193.3	201.2	203.2	182.6	185.8
Expenditures, (% of GDP)	11.0	18.8	17.8	19.0	17.6	17.7	17.0	17.1	15.8	24.7	20.2	24.7	12.7	20.1	19.4	17.8	17.2	19.0	16.9	16.8	15.2	14.6	16.1
Primary deficit (-)/surplus (+), (% of GDP)	13.7	5.6	5.7	3.2	3.9	3.6	6.6	4.8	4.5	-2.7	-0.5	-2.2	9.8	4.7	4.4	4.1	5.8	2.5	3.8	3.9	3.0	4.4	2.9
General deficit (-)/surplus (+), (% of GDP)	11.6	0.8	2.3	2.9	1.8	1.7	4.9	1.3	2.2	-3.1	-1.1	-4.6	8.1	0.5	1.4	3.6	4.5	1.0	2.6	0.9	1.1	3.9	2.5
MONETARY INDICATORS																							
Monetary base, (R bn, eop)	678.8	688.9	683.1	728.0	746.1	787.0	815.7	840.3	829.1	844.5	859.4	940.3	894.3	912.2	930.4	988.9	1,043.1	1,123.6	1,164.8	1,183.5	1,186.0	1,216.6	1,232.6
Gross international reserves, ($ bn, eop)	36.4	36.9	37.3	39.2	42.2	43.6	43.3	44.3	45.6	46.8	48.2	47.8	49.3	53.1	55.5	59.8	64.9	64.4	64.5	62.8	62.1	64.9	68.2
M0, (R bn, eop)	533.4	543.4	552.9	610.3	607.5	645.9	659.7	679.0	672.6	675.8	690.5	763.3	709.0	730.9	749.5	822.4	855.6	917.1	940.9	966.3	957.1	975.9	1,002.1
M0 growth, (% ch. y-o-y)	40.3	40.1	38.4	40.2	38.6	36.1	34.5	33.9	26.7	27.1	31.0	30.6	32.9	34.5	35.6	34.8	40.8	42.0	42.6	42.3	42.3	44.4	45.1
M2, (R bn, eop)	1,502.0	1,522.9	1,562.4	1,621.3	1,686.0	1,751.1	1,776.1	1,812.5	1,846.6	1,884.6	1,930.0	2,119.6	2,026.5	2,108.0	2,208.5	2,311.2	2,432.4	2,604.5	2,625.4	2,683.2	2,732.1	2,740.1	2,821.3
M2 growth, (% ch. y-o-y)	39.2	37.2	35.9	34.0	36.7	35.3	33.5	32.7	30.6	30.8	34.1	32.3	34.9	38.4	41.4	42.6	44.3	48.7	47.8	48.0	48.0	45.4	46.2
R/$ official exchange rate, (eop)	30.7	30.8	31.1	31.2	31.3	31.4	31.4	31.6	31.6	31.7	31.8	31.8	31.8	31.6	31.4	31.1	30.7	30.3	30.3	30.5	30.6	29.9	29.7
R/$ official exchange rate, (aop)	30.5	30.8	31.1	31.2	31.3	31.4	31.5	31.6	31.6	31.7	31.8	31.8	31.8	31.7	31.5	31.2	30.9	30.5	30.4	30.3	30.6	30.2	29.8

* *per balance of payments methodology*

** *implementation as of cash basis*

Sources: State Statistics Committee, Central Bank, Aton estimates

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