Investing in Russia

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PRICEWATERHOUSECOOPERS

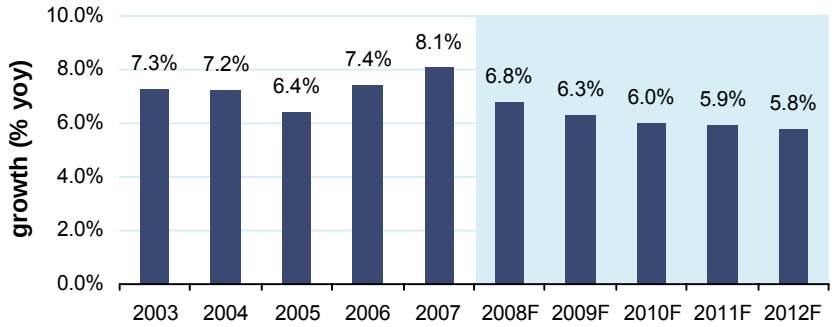
Agenda and contents

Section 1

Overview of Russian economy and potentially attractive segments

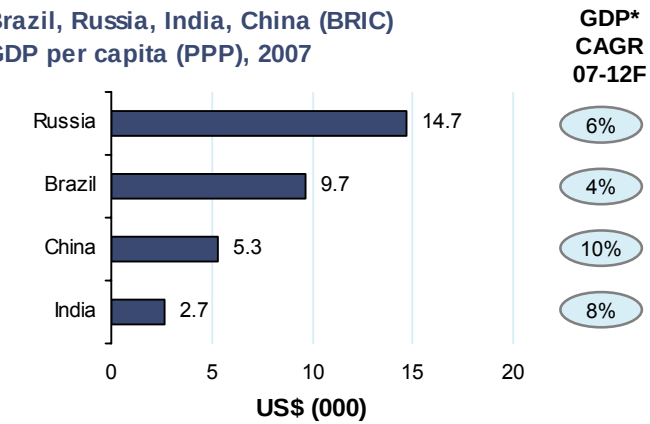
Before the current crisis Russia's economy was expected to continue growing strongly at over 6% per annum towards 2012 and fundamentals of Russia are still strong

Russian GDP growth forecast (constant prices), 2003 - 2012F



Source: International Monetary Fund, World Economic Outlook Database, April 2008

Brazil, Russia, India, China (BRIC) GDP per capita (PPP), 2007



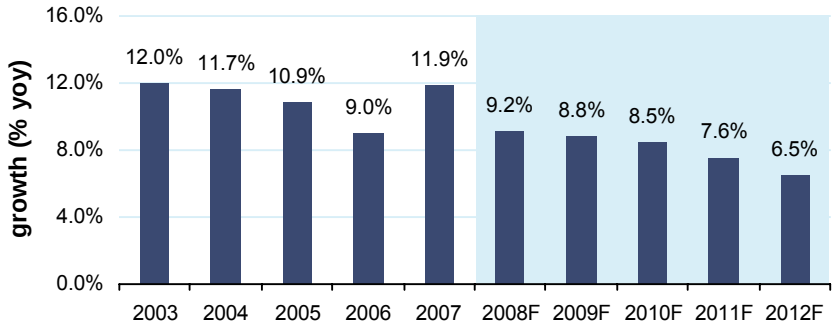
*Note: GDP CAGR (07-12) based on constant prices
Source: International Monetary Fund, World Economic Outlook Database, April 2008

- Russia is the 9th largest economy in the world based on GDP
  - Based on GDP in purchasing power parity terms, Russia is the 6th largest economy, ahead of for example the UK
- The Russian economy has expanded at an average rate of 7.3% per annum between 2003 and 2007
- Going forward, Russian GDP is expected to continue growing at an average of 6.2%
  - Despite global slowdowns, Russia's economy is expected to continue its strong growth due to the government's macro-economic policy, rising domestic demand, high oil prices and revenues accumulated in the country's Stabilization Fund
- Per capita, Russia's GDP is expected to remain significantly above those of other BRIC countries in the coming years
- Russia has been called the most macro-economically stable country in Europe by the Economist* at it is supported by a stabilisation fund of $150bn (7% of GDP), central bank reserves of $550bn (23% of GDP), a budget surplus of 4% and a total debt of just 8% of GDP
- Russia's budget is based on an oil price of $70 p.b.
- The effect of the current crisis is uncertain. For example S&P has downgraded Russia's country rating in October, while Moody's remains positive (and Russia has limited country debt). At the moment however, the limited access to corporate and consumer debt is likely to have a negative impact on the economy in the short term

*Source: EIU, Russia – economic and political outlook, July 2008

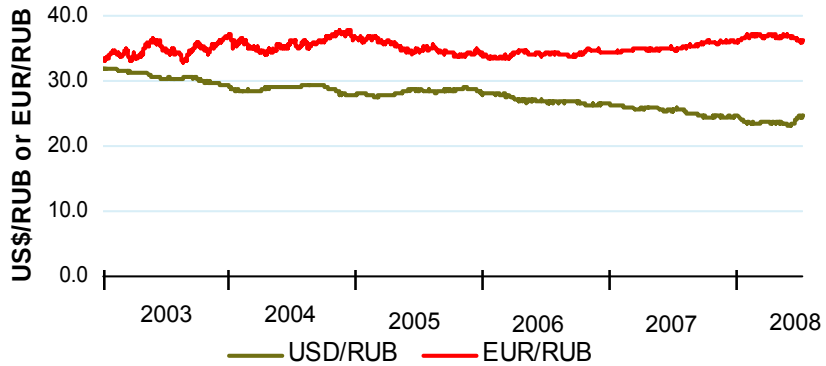
High inflation is one of the government's key priorities. Although inflation is expected to decline to 6.5% in 2012, 2008 has not shown a decline yet. Russia might also face significant impact of the credit crisis

Russian Consumer Price Inflation forecast, 2003 - 2012F



Source: International Monetary Fund, World Economic Outlook Database, April 2008

Russian Rouble exchange rates (US$ and EUR), 2003 - August 2008



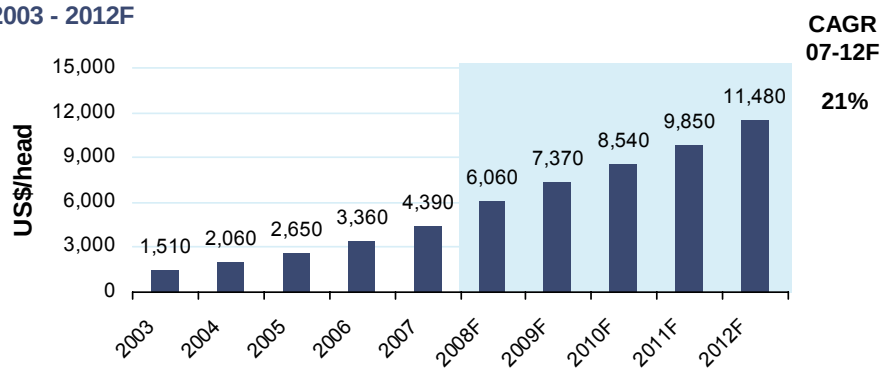
Source: PwC based on www.oanda.com, August 2008

- Inflation is one of Russia's key economic concerns
- Russia's CPI has remained fairly stable around 11%-12% in recent years. Going forward, the Russian government aims to reduce inflation to below 7% in 2012
  - Russia's most recent 2008 inflation forecast has been raised to 11.8%*
  - Russia's latest inflation targets have recently been increased by 1%-2%, to between 7.5%-8.5% for 2009 and 5.5%-7.0% for 2010**
- The Rouble has appreciated in value against the US Dollar but it remained broadly stable against the Euro. In recent months the Rouble has shown s weakness driven by the Ossetia conflict and by the overall strength of the dollar
  - The Russian's exchange rate is set using a trading band based on a basket of Euros and US Dollars

*Source: EIU, Russia – economic and political outlook, July 2008
** Source: IMF on Russian Federation

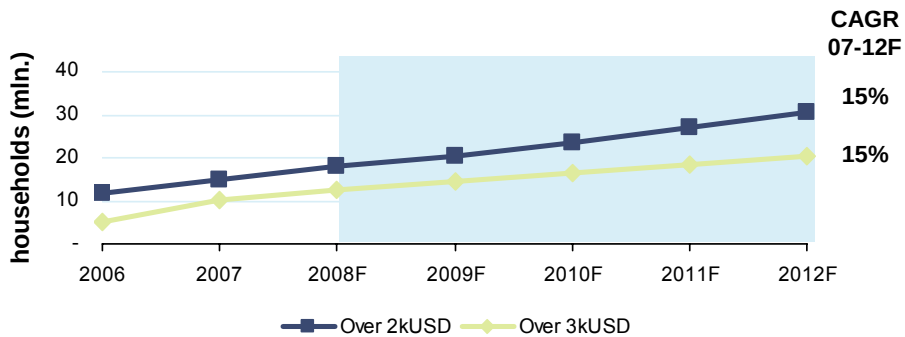
Russia's increasing consumption and strongly growing middle class drive industries such as Retail and FMCG

Russian private consumption per head, forecast, 2003 - 2012F



Source: EIU, Russia: 5-year forecast table, August 2008

Population with monthly income over US$ 2k and US$ 3k, 2006 - 2012F



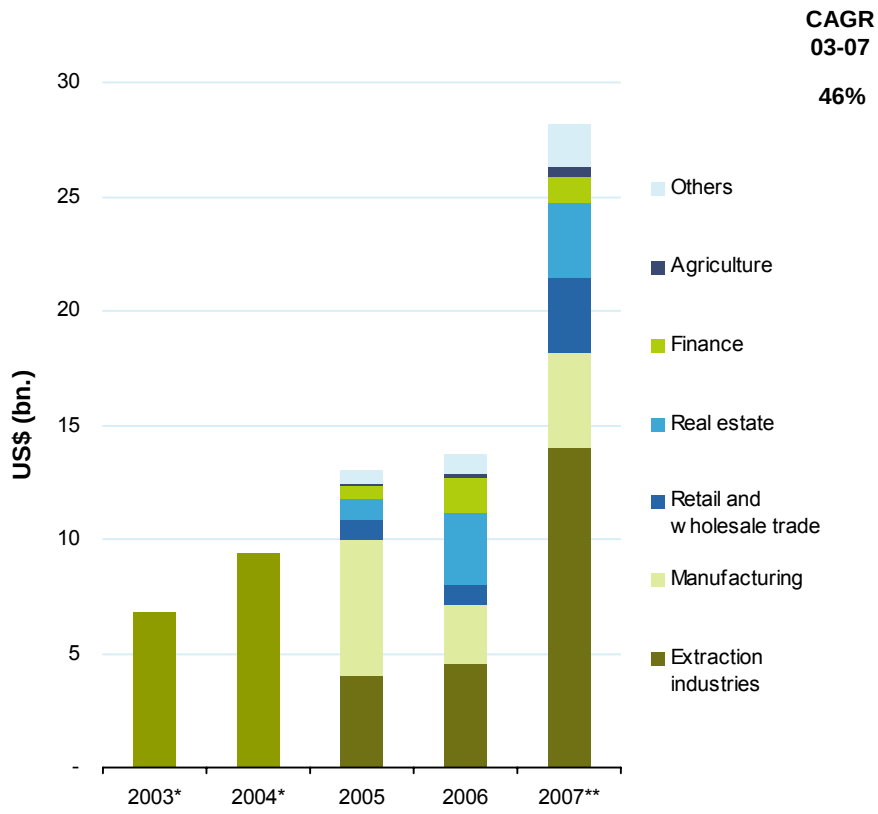
Source: Rosstat, Aton estimates

- Growing wages and disposable incomes drive private consumption, thereby driving growth in industries such as retail, FMCG and automotive
  - The large majority of Russians own their own homes (75%) without mortgages due to privatizations after the collapse of the Soviet Union. As a result, Russian households generally have relatively high disposable income
- 60% of the population is estimated to have an average disposable income (after household costs) of over US$ 350 per month, thereby representing a consumer base of over 85 million people
- The number of households with monthly income over US$ 2,000 in 2007 was circa 15m. and is expected to increase by 15% annually towards 2012 (to 30m. households)
  - Due to strong wage growth, the middle class is likely to continue growing strongly (real wages have grown by 14% p.a. between 2006-2008)*
  - This growing middle class drives demand across many industries such as retail, FMCG and automotive
  - Wage inflation could however be a downside for a potential investor
- Additionally, Russia is an attractive luxury market as it features one of the largest bases of high net worth individuals (HNWIs) and Russian consumers are very brand conscious
  - The number of Russian HNWI has grown by 14% between 2006-2007, to a total of 136k (compared for example to 495k in the UK, growth 2%)

*Source: EIU, Russia – economic and political outlook, July 2008

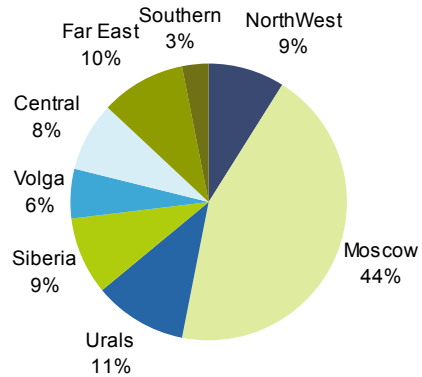
Foreign Direct Investment (FDI) into Russia grew by 43% annually between 2003-2007. As well as in extraction of natural resources, FDI is significant in both manufacturing and trade. The Russian regions are increasingly attracting FDI

Russian foreign direct investment (FDI), 2003 - 2007



- Foreign direct investment in Russia has shown strong growth, and is expected to continue growing driven by Russia's strong economic forecasts and the country's economic stability
- Russia's potential accession to the World Trade Organisation is broadly expected to further drive growth in FDI in the medium term
  - However, the timing of Russia's potential accession remains unclear, potentially in 2009 or 2010
- FDI has historically mainly targeted Moscow. However, the regions are starting to catch up e.g. as retail and manufacturing rolls-out to the regions

Regional breakdown of FDI, 1996-2006

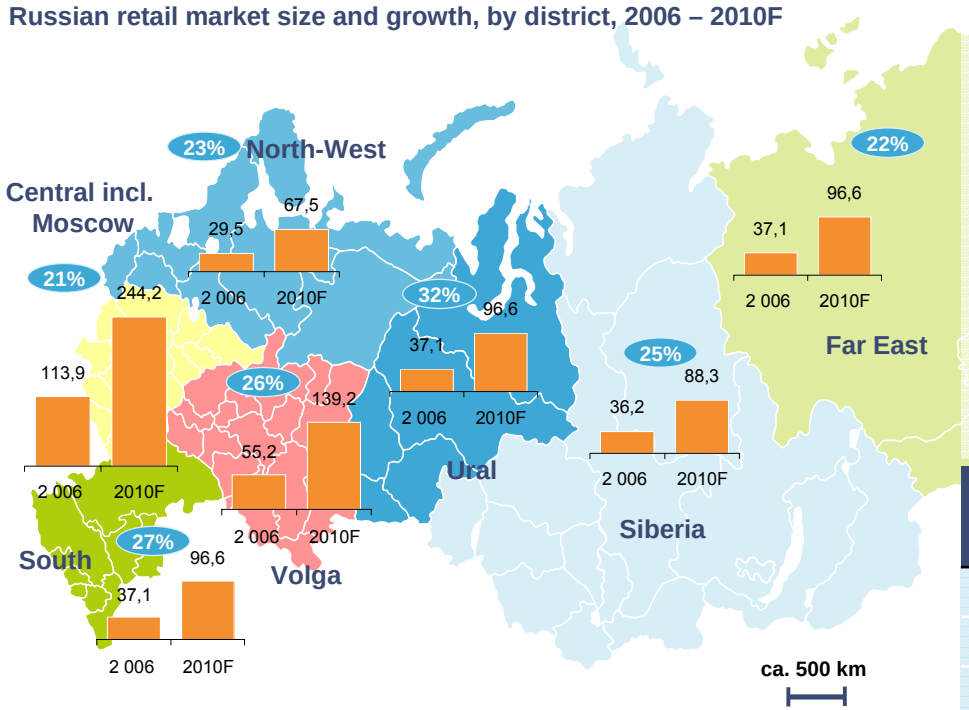


*Note: 2003-2004 split by industry not available
**Note: the relatively high share of FDI in 2007 for extraction industries, is driven partly by the sale of former Yukos assets (20% of Gazpromneft by Eni for US$ 3.7 bn) and the start of the privatisation of RAO UES (OGK-4 bought by E.On for US$ 5.9 bn.)
Source: Rosstat 2008

Source: Troika Dialog, Russia's Regions – the Engine of Growth, January 2008

Going forward, the Russian regions are expected to become significantly more important for the overall economy

Russian retail market size and growth, by district, 2006 – 2010F



Key: – *retail market size, USD bln.*
– *retail market size CAGR 06-10F*

Source: IGD research and estimates; Infoline; GfK; Goskomstat

- Although GDP per capita in Moscow is significantly higher than in other regions, the regions are beginning to catch up
- The regions account for all the oil, gas and mineral extraction. However, income levels are rising there as well, thereby driving growth in other industries
- It is estimated that the regions on average lag Moscow by approximately 4 to 5 years in development based on indicators such as retail sales, real estate, car ownership etc.*
- For example, forecasts for the retail market indicate sales to grow significantly faster in most regions than in Moscow. As a result, large retailers are rolling-out stores in the regions

Region	Population (mln.)	GDP/cap (US$, 000)	Retail sales/cap (US$, 000)	Retail loans/cap (US$, 000)	Broadband %
Moscow	10	27	6.9	1.3	47%
Urals	12	19	2.8	0.9	8%
North-west	14	12	2.4	0.7	12%
Far East	7	11	2.1	0.5	8%
Siberia	20	8	2.1	0.7	5%
Volga	31	7	2.0	0.5	5%
Central	28	6	1.9	0.7	5%
Southern	23	5	1.8	0.4	3%

*Source: Troika Dialog, 2008

Overview of potential attractiveness of sectors

Industry	Comments	Attract.
Retail	Both food and non-food retail are attractive segments. Penetration and consolidation rates are still low for most segments and expansion to Russian regions and increasing disposable income will be key drivers for all retailers	●
Consumer goods	In food there are good opportunities driven by income growth. Some markets have already been consolidated, like beer and juices, but some remain relatively fragmented, like vodka, meat products and dairy. In non-food there are less opportunities as in most segments international producers have already established strong positions	●
Financial sector	Russian financial sector is under development and the banking industry is still not consolidated, with some opportunities and targets available, especially for a retail strategy and longer term mortgages and leasing	●
Media & entertainment	Russian media players have already attracted a number of international investors. Some large segments such as the TV are controlled by the government. However, segments like outdoor advertisement, magazines, internet and cinema market may provide attractive opportunities	◐
Real estate & construction	Construction is booming in Russia with large investments in infrastructure (e.g. Sochi-2014), residential and commercial building. This growth will drive demand for construction materials, construction equipment and building materials with potential niche investment opportunities	◐
Manufacturing	Russian manufacturing sector attractiveness varies across sectors. Large industrial manufacturing is either consolidated or challenged by cheap Asian or quality global producers. However some specific niche markets can be attractive, for instance industrial electronics, pharmaceuticals	◐
Agriculture	Russia provides significant opportunities for further agricultural development with investment opportunities in land development, consolidation and efficiency increase of loss making cooperatives	◐
Oil & gas	Oil & gas are treated in Russia as strategic sectors of economy. Market is divided between government-associated groups and oligarchs with high barriers to enter	○
Metals & mining	Metals and mining is a sector mainly owned by Russian oligarch groups and could be a very risky investment for international investors.	○

○ Low ● High

Some restrictions exist to investing into a number of industries labelled “strategic”

- **The Law on Foreign Investments sets restrictions on transactions both inside and outside Russia in respect to businesses of strategic relevance for national defence and security:**
  - Transactions on acquisition of shares of Russian companies which operate in at least one of the strategic areas
  - Other transactions, which lead to the Investor's control of such companies

- **The full list includes 42 types of activities of strategic relevance for national defence and security. These types may be grouped into the following areas:**
  - operations with nuclear and radioactive materials and sources
  - operations with information encryption and encryption devices
  - operations with covert listening and surveillance devices;
  - operations with weapons, military equipment and ammunition
  - aviation and space activities;
  - TV- and radio- broadcasting, printing, editing and publishing*
  - operations of natural monopolies and businesses dominating on the market
  - subsoil use, and catch of water fauna

Note: *TV broadcasting - if broadcasting is for >=50% of the population in the region of Russia where broadcasting is performed
Radio - if broadcasting is for >=50% of the population in the region where broadcasting is performed
Polygraphic - if printing is over 200 mln. of printout sheets per month
Publishing - if circulation is over 1 mln. per title per issue

Section 2
Due diligence

As challenges of investing in Russia persist, due diligence plays a crucial role in successful deal-making

Risks	Key issues
Financial	• Lack of reliable financial information • Impact of tax minimization schemes • Incomplete management accounts • Lack of full provisions and accruals
Tax & Legal	• Tax minimization schemes through SPVs • Historic tax risks • Russian law does not fit international M&A practices

Commercial	• Less transparent markets with limited readily available market information and less accuracy
	• All companies have very aggressive growth plans in an increasingly competitive environment
	  • are these plans sensible?
	  • can management realize them?

Financial, **Tax & Legal**, **Commercial & Operational** due diligence are crucial in Russia

Doing due diligence in Russia

- Doing financial due diligence in Russia often presents a significant challenge to foreign investors.
- There are two main problem areas that we and our clients encounter when doing financial due diligence in Russia:
  - The impact of tax minimisation schemes
  - Lack of reliable financial information
- However the problems are normally not insurmountable if you know where to look and how to deal with them.

Impact of tax minimisation schemes

- Many Russian companies use tax minimisation schemes.
- For example, sales or purchases may be made through SPVs or related parties at artificially low or high prices. This results in minimisation of the companies taxable profit and a high profit in the SPV. Alternatively the SPV may issue fictitious invoices for services which are not actually rendered.
- This profit may then be returned to the company as “black cash” which is used to pay part of the employee remuneration in cash without recording it in the statutory accounts and thereby avoiding payroll taxes.
- The SPVs are often companies with “simplified tax structures” which in other words avoid paying VAT and profits tax. Their legal ownership often disguises their effective control by the company, its management or shareholders.
- However, we are seeing a movement away from the use of tax minimisation schemes, especially in large companies, following both the high profile Yukos case and many Russian companies preparing themselves for foreign ownership.

Impact of tax minimisation schemes – impact on due diligence

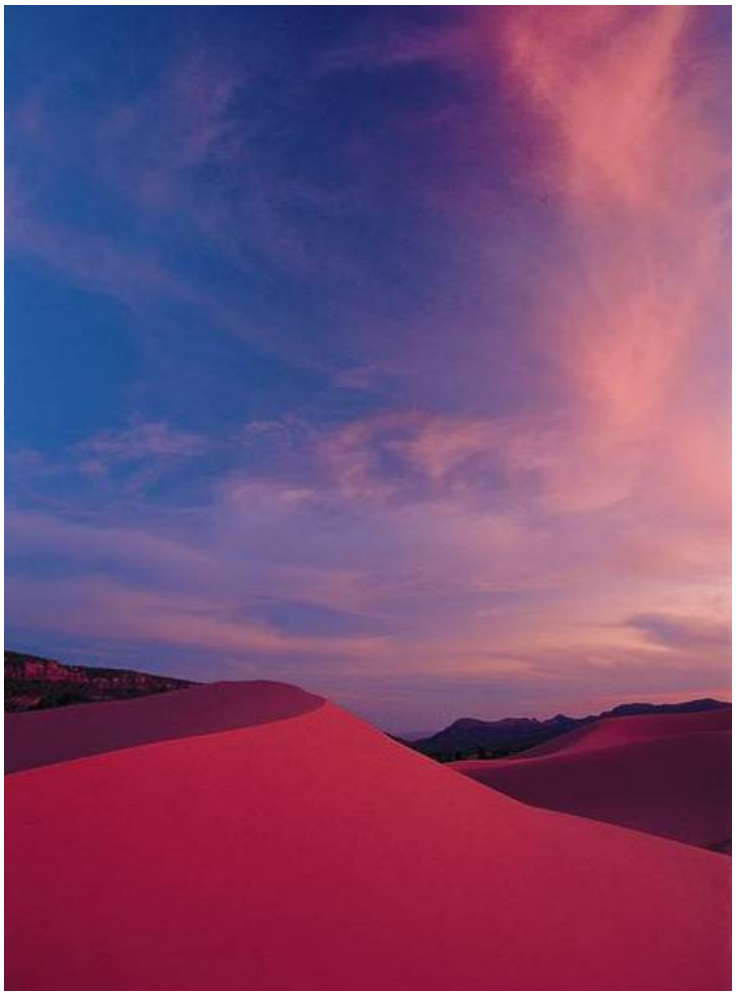
- The tax due diligence will need to make an assessment of the risks and potential impact of investigation, additional liabilities, interest and penalties imposed by the tax authorities.
- However, there is usually an impact on financial due diligence in that the statutory accounts themselves are heavily distorted by the use of such schemes.
- It is therefore necessary to make adjustments to reflect the true performance of the business as well as an assessment of the additional tax costs which will be incurred if the business were to operate on a fully legalised basis. This would include for example, additional payroll costs to compensate employees for additional tax on previously undeclared income.
- These additional taxes may in fact make the company uncompetitive against rivals who continue to use tax optimisation schemes. Consequently, the post acquisition competitive environment needs to be carefully considered.

Lack of reliable financial information – RAR is tax driven

- Russian companies are required to keep statutory financial statements in accordance with Russian Accounting Regulations (“RAR”).
- Revenues and costs are typically recorded in the statutory accounts only once the formal documentation (invoices, acts of acceptance etc) is complete. Therefore, revenues, costs, receivables and payables may not be complete, especially at interim periods.
- By far the most popular financial system used by Russian companies is 1C, While a solid system, 1C does not provide the level of detailed analysis which may be required by a western investor.
- Russian accounting principles do not require the production of consolidated financial statements.
- It is essential that the due diligence process obtains an understanding of the cashflows and economic and ownership relationships between the company and its related party entities as well as third party customers and suppliers.

Lack of reliable financial information – auditing standards

- Most Russian companies are required to be audited by law.
- However, the audit practices applied by many local audit firms do not meet internationally recognised auditing standards.
- Russian companies often do not make full provisions or impairment reviews
- Fixed asset valuations may not be reliable and depreciation rates may not be economically justifiable. Assets are sometimes “conserved” without being further depreciated or written off.

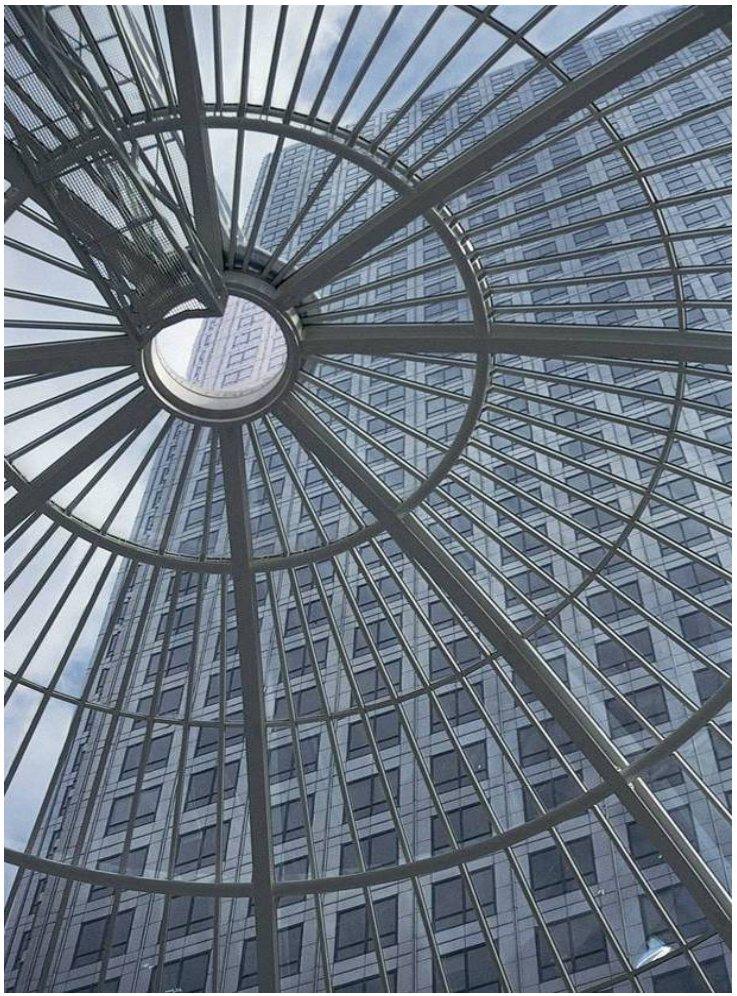


Lack of reliable financial information – management accounts

- In many instances the most useful financial information available on a target company is its management accounts.
- These may be prepared to reflect the true performance of the business without the use of SPVs i.e. reflecting true 3rd party sales and purchase prices. However, they may be prepared on a cash basis and may not reflect full accruals.
- However they rarely meet the standard of management accounts seen in western companies and typically lack:
  - Cashflow or even balance sheet information
  - Detailed product performance
  - Comparisons to budget and prior year
  - Narrative explanations of performance
  - Reconciliation to statutory accounts

Lack of reliable financial information – lack of projected financial information

- Russian companies often do not prepare any prospective financial information apart from the annual budget.
- The budget itself may consist of only a cash flow forecast (cash is usually managed very closely).
- In order to value the business a prospective investor will probably need to build its own financial model.



What can be done to minimise risks?

- Completion of a transaction in Russia is a challenge. However, this is manageable. In particular:
  - Allow sufficient time to complete the due diligence process
  - Explain the process to target management and get their buy-in
  - Use advisors with local experience and expertise
  - Manage expectations within your own company

Section 3
Managing tax and legal risks in Russia

Managing tax and legal risks in Russia

Technical risk

- Tax legislation is only 20 years old
- Ambiguity of tax laws
- Lack of well established and working clarifications
- Court decisions are useful, but no precedence allowed
- No rulings
- Private “clarifications” of Ministry of Finance – unlikely to help in a transactions context

Tax authority risk

- Resource constraints, lack of sophistication
- Harsh and indiscriminate actions
- Bias against taxpayers in general

Managing tax and legal risks in Russia

- Politics may drive change of common tax practices
- Emergence of anti-avoidance practices based on substantive approach
- New tax policy instruments in the pipeline
  - CFC
  - Tax residence based on place of management and control
  - Development of transfer pricing rules
- Russian laws (i) are contradictory, (ii) contain “grey” areas, and (iii) are inflexible.
  - Good news: recently quality of laws has improved
- Russian court practice is of certain help but (i) it differs from Region to Region, (ii) it changes in time and (iii) not all court decisions are publicly available.
  - Good news: Supreme Courts are addressing these issues
- Russian contract law does not fit international M&A practices
- Russian corporate laws are inflexible to regulate shareholder matters

Tax & Legal highlights
Tax due diligence

- Tax driven “schemes”
  - Unrecorded revenues and expenses
  - Unrecorded salaries
  - VAT and customs underpayment
- Intra-group transactions (many legal entities, including offshore) potentially leading to transfer pricing adjustments
- Uncertainties of the law
- Poor documentation

Tax & Legal highlights
Deal structuring

- Typical structure choices
  - Share deal is most common
  - Share/asset deal is regularly used
  - Pure asset deal is rare
- Sellers would typically prefer to sell shares in an offshore level
- In a JV situation Russian partners' structuring choices may differ from "western choices" (use of Cyprus and BVI instead of Luxemburg and Netherlands)
- Russia has wide treaty network and treaties work, typical structure:
  - 5% WHT on dividends
  - No WHT on capital gains and interest

Tax & Legal highlights
Financing and Debt push down

- No capital tax on equity contributions
- Interest is deductible, provided:
  - it is economically justified
  - interest rate within limit (15% on currency loans; 1.1 times re-financing rate on Rouble loans)
  - thin capitalization requirements (3:1 debt – equity ratio) are met
- Interest is deductible on an accruals basis
- Debt push down possibilities exist, but no “standard” solutions

Tax & Legal highlights
Choice of applicable Law

- Deals in Russia are structured in non-Russian jurisdictions or under non-Russian law, because in Russia:
  - Buying shares does not always mean buying business
  - Russian law does not fit international M&A practices; application of traditional Representations & Warranties, Indemnities is problematic
  - Investors do not trust Russian courts
  - Russian law and courts do not recognize and protect shareholders agreements

Tax & Legal highlights

Legal “Red Flags”

- History of change of shareholders/owners
- History and availability of regulatory consents (e.g. competition approvals)
- Availability of corporate approvals for previous business transactions
- Intellectual property rights
- Rights to property, especially land
- Legal risks related to tax optimization schemes

Tax & Legal highlights
Transaction costs

- Transaction costs are not specifically named as deductible, need to analyse line by line
- General deductibility rules for profits tax, i.e. expense should be
  - Aimed at generating income (by the company deducting the expense)
  - Economically justified
  - Supported by proper documentation (quite burdensome than typical western requirements)
- VAT recovery – all of the above and more requirements
- Pushing banking costs is realistic, legal and consultants fees – more problematic to push down

Tax & Legal highlights
Management incentive plans

- Widely used in Russia in various structures, i.e.
  - Cash-based
  - Phantom shares
  - Classic stock options
  - Combinations of the above
- Personal tax and payroll tax burden is relatively low
  - Personal tax is 13% for residents on most income types
  - 9% on dividends for residents
  - Social tax – on employer only, if applies at all. Effective tax rate on significant income level is close to 2%

Section 4
Industry overview

Section 4.1
Retail

Many segments of the Russian retail industry appear attractive due to high forecasted growth rates and low levels of consolidation (1 of 2)

Industry	Market value, bln USD (% of retail market)	Forecast growth rate (08-10)	EBITDA margin	INDICATIVE Level of consolidation (share of top-5)
Food	198 (45%) [*1,2]	15-20% [*2, 3]	6 - 9% [*1,3,4,5]	10% [*1]
Clothing, Footwear and Accessories	56 (13%) [*6]	10-15% [*6]	16% [*6,7]	3-6%* [*6]
Electronics	34 (8%) [*8]	5-10% [*8]	2 - 7% [*5,8,9]	38% [*10]
DIY& household goods	11 (3%) [*5]	10-15% [*5]	n/a	14% (top -3)[*1,2,10]
Cosmetics	10 (2%)**	5-10% [*11]	10 - 15% [*5]	12% (top-3) [*10]
Furniture	9 (2%) [*5]	10-15% [*5]	n/a	23% (top 2) [*5,10]
Pharmacy	8 (2%)**	15-20% [*9]	3% [*9]	15% [*5, 10]
Jewelry	5 (1%) [*5]	20-30% [*5]	n/a	10-20% [*5]
TOTAL	437 (100%) [*1]	10-15% [*2]		

Sources: (1) Raiffaizen bank, (2) Mintel, (3) UniCredit, (4) UBS, (5) Press research, (6) PMR, (7) Troika Dialog, (8) Credit Suisse, (9) RenCap, (10) Kommersant, (11) Datamonitor,

Note: Although we have based our research on a number of sources and publicly available information, this market assessment should be treated as indicative
*Varies if include or exclude luxury CFA retailers/distributors.
**Based on estimates

Many segments of the Russian retail industry appear attractive due to high forecasted growth rates and low levels of consolidation (2 of 2)

Key characteristics

Overall retail in Russia
- Excellent future perspectives driven by income growth
- Very low levels of consolidation to date (excl. electronics)
- Retailers need financing to expand into regions
- Some retail chains have problems with custom/tax issues

Food
- Concentration of modern trade formats is very low
- Growth in regions is likely to be faster than in Moscow
- National players are actively increasing their market share

Clothing
- Fast growing middle and upper class and a very large number of High Net Worth Individuals
- International brands are growing quickly and are taking control of the distribution and retail
- Rapidly expanding Russian chains with own brands
- Strong brand awareness of Russian consumers
- Luxury is dominated by four distributors selling key premium brands from cars to accessories and expansion potential to regions (e.g. Sochi)

Electronics
- More mature comparing to other retail markets
- High level of consolidation with strong local companies

DIY
- Due to growth of net income and high home ownership Russians are investing into their houses and “dachas”
- In general people are used to “DIY”
- International DIY chains have already established their presence with hypermarkets and some of them mention that the market for hypermarkets is already saturated
- Smaller formats may provide growth and investment opportunities

Cosmetics
- Retail chain development is in an early stage, led by local players
- These chains are selling mainly imported cosmetic products
- Strong roll-out opportunities

Furniture
- Market is driven by residential/construction boom and refurbishment process in Russia
- Outside IKEA consolidation is low
- Some local manufacturers have their own retail chains

Pharmacy
- The population is ageing and expenses on medicine are anticipated to increase in Russia
- The current penetration rate of preventive treatments and medications is low
- Potential for growth through performance improvement and product portfolio extension (e.g. para-pharmaceuticals) is still high

Jewelry
- Part of luxury jewelry retail is dominated by big national distributors
- There is a significant potential for existing big Russian players to expand into regions

In most retail industries, the top 5 retailers hold a cumulative market share of less than 20% and these are mainly Russian players

Food [1]

- X5 (2.7%)
- Metro (2.2%)
- Magnit (1.9%)
- Auchan (1.7%)
- Lenta (1.3%)

CFA [4]

General CFA:

- Sportmaster
- Detsky Mir
- Snezhnaya Koroleva
- Sela

Luxury:

- Crocus International
- Mercury
- JamilCo
- Bosco di Ciliegi

Electronics [5]

- Eldorado (13%)
- Evroset (10%)
- M.Video (6%)
- Svyaznoy (4%)
- Tekhnosila (4%)

Cosmetics [5]

- Alkor (Letual, Sephora) (8%)
- Arbat Prestizh (5%)
- Ile de Beaute (3%)

Pharmacy [3],[5]

- 36.6 (8%)
- Rigla (5%)
- Pharmakor (3%)
- Imploziya (2%)
- Mosoblpharmacia (2%)

DIY [1],[2],[5]

- OBI (8%)
- Maxidom (4%)
- Starik Hottabich (2%)

Furniture [3],[5]

- IKEA (15%)
- Grand, Tri kita (8%)
- Gromada
- Shatura

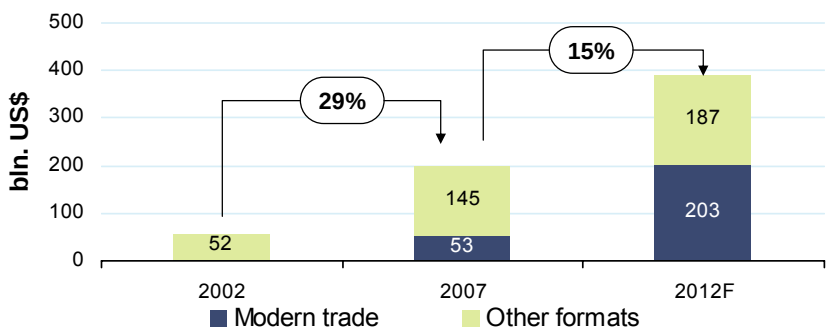
Jewelry [3]

- 585 (4%, 408 stores)
- Adamas (3%, 216 stores)
- Yashma Zoloto (212 stores)
- MYUZ (128 stores)

Sources: (1) Raiffaizen bank, (2) Mintel, (3) Press research, (4) PMR, (5) Kommersant

Food retail is one of the most attractive segments in Russia with very low consolidation and high forecasted growth rates

Russian food retail market, 2002 - 2012F



Source:
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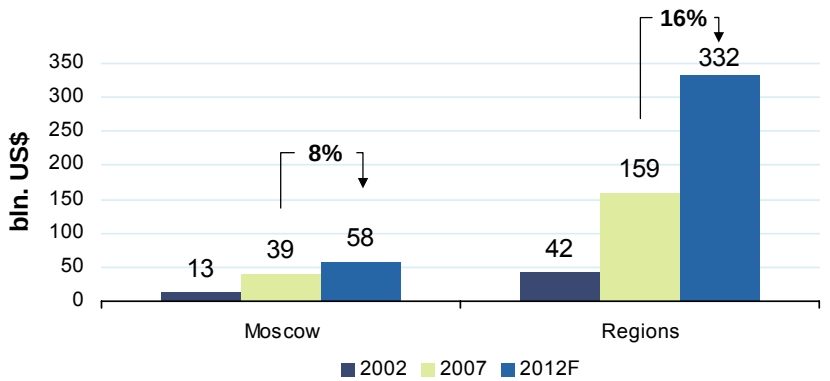
Russian food retail market, 2002 - 2012F



Source:
Deutsche Bank

- **The overall Russian food retail market is expected to grow at 15% p.a. between 2007 and 2012, with modern trade growing at 31% p.a.** The concentration of modern trade formats is still very low as a large share of food purchases in Russia are still made through traditional channels, including neighborhood stores, open markets and kiosks. Forecasted share of modern trade formats in Russia is 52% in 2012, as consumers opt for service, convenience and, over time, more attractive pricing.
- **Growth in the regions is likely to be faster than in Moscow.** Although the overall market will continue growing strongly, the regions are set to grow faster as standards of living and income levels will begin to catch up with Moscow and St. Petersburg.

National players are actively increasing their market share, however M&A activity slowed down due to pricing and integration risks. However regional chains could still be attractive (e.g. in Siberia)

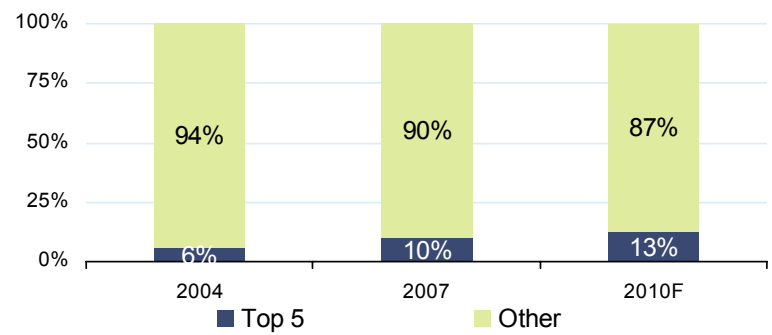
The largest food retailers in Russia, 2007

Retailer	Names	Format	Revenue ($ mln)	Comments about origin and status (listed or not)
X5	Pyaterochka Perekrestok	SM, D	5284	Listed
Metro Group	Metro	HM	4801	International
Magnit	Magnit	D, HM	3676	Listed
Auchan	Auchan	HM	3400	International
Lenta	Lenta	HM	1559	Regional
Kopeyka	Kopeyka	D	1490	Owned by Uralsib
Dixi	Dixi, Megamart, Minimart	D, HM, CS	1431	Listed
7 Continent	7 Continent, Nash	SM, HM	1400	Listed
O'key	O'key, O'key express	HM, SM	1200	Regional
Viktoriya	Viktoriya, Kvartal, Deshevo	SM, CS	1200	Originally regional
Formata Hold.	Karusel	HM	831	In 2008 became a part of X5
Alpi	Alpi-Market, Laplandiya	HM, CS, SM	800	Regional
Ramenka	Ramstore	HM, SM	770	International
Holiday	Holiday-classic, Sibiriada, Kora	SM, CS	770	Regional
Mosmart	Mosmart	HM, CS, SM	748	
Green	Liniya	HM, SM	660	Regional
Omega-97	Paterson	SM	500	
Marta	Billa, Grossmart	SM, CS	493	
Element-trade	Monetka	D	446	Regional
Vester	Vester, Sosed	HM, SM	435	Regional

Comment: HM – hypermarket, SM – supermarket, D – discounter, CS – convenience store
Source: Kommersant

- Top 5 players are growing faster than the market (54% p.a. since 2004 vs. 30% market growth) and future market consolidation is anticipated
- Local players try to sell their business as the national players start penetrating the market and are currently trying to dispose their business for the highest price possible
- According to industry experts, regional chains currently demand high prices for their businesses. However as soon as they will see themselves loosing market share to national operators i.e. hypermarkets, they will be actively looking to sell their business

Market share of top-5 players in Russia

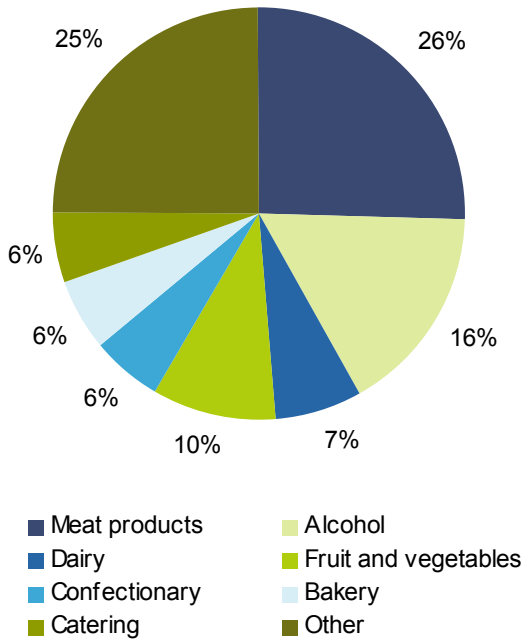


Source:
Kommersant, Raiffaizen bank, Troyka Dialog

Section 4.2
Consumer goods

In food there are good opportunities driven by income growth. Some large markets remain relatively fragmented, like vodka, meat products and dairy

Structure of food consumption in Russia, 2007

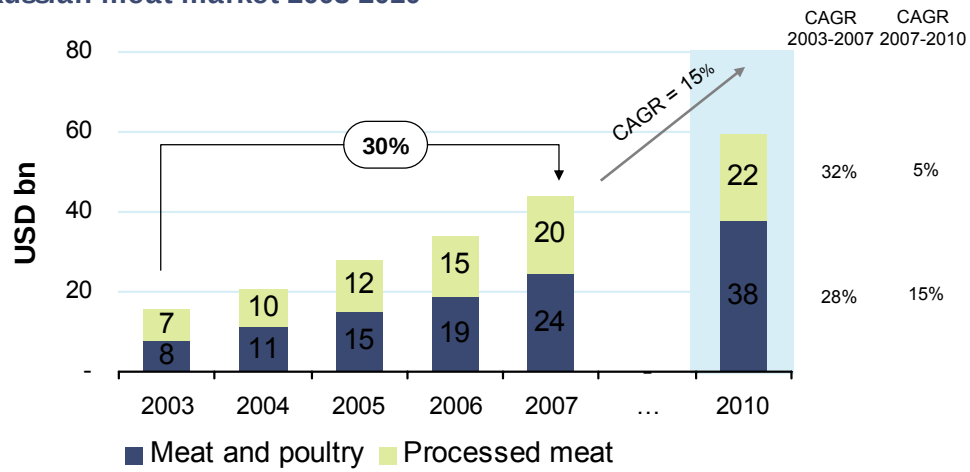


Source: Euromonitor International 2008

- Due to rapid growth in income levels, both food and non-food consumption are increasing
- In food in most of the segments there are regional or national Russian players with high brand awareness
- Share gains and shifts can still be realized
- The development of national retailers drives the emergence of less but larger national players
- **Meat products** is the largest market growing 30% p.a. since 2003. Current players want to consolidate market, but it is still fragmented in each segment
- The **alcohol** market consists of two main segments: beer and vodka. While beer is highly consolidated, vodka is a relatively fragmented market with good growth perspectives especially in the middle and premium segments
- **Fruits and vegetables** is not structured in Russia, however packaged such as frozen food segment could be of interest for PE investors with high growth potential due to increasingly busy lifestyles, income growth and relatively low penetration
- **Dairy** is large and fragmented with many relatively small regional players and big national producers
- **Agriculture** production is benefiting from increasing agro products prices and essential state efforts to increase investment attractiveness of the sector while providing significant efficiency and consolidation opportunities

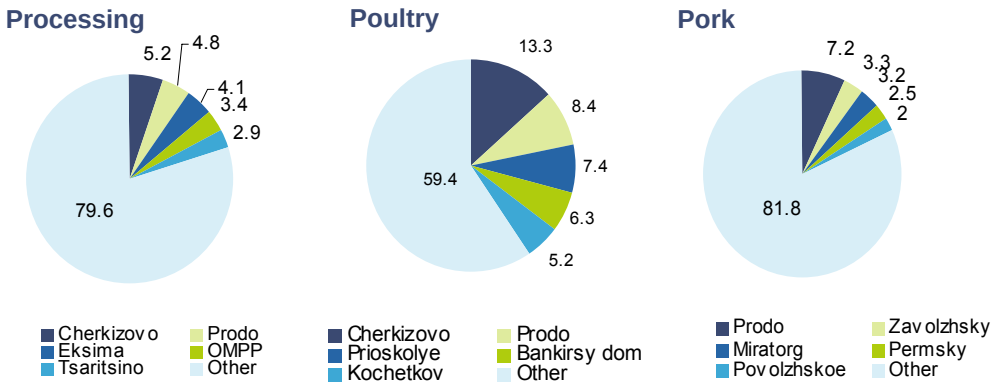
The Russian meat market is fragmented and may offer good consolidation opportunities. In addition, growth is expected to be 15% p.a. going forward

Russian meat market 2003-2010



Source: Rosstat, Russian Meat Union (RMU), UniCredit
Note: Forecast based on retail market growth and a share of meat on the 18% level of the total food sales by 2010 and declining share of processed meat (forecasted by UniCredit based on RMU)

Market share of top meat processing companies, %, 2006 (Volume)

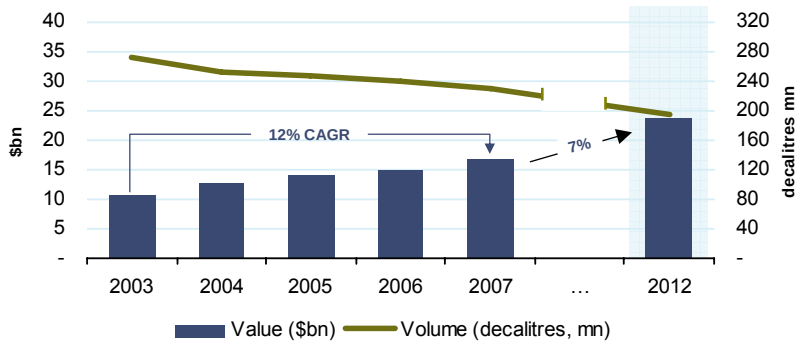


Source: Russian Meat Union

- The sales of meat products in Russia grew by 30% p.a. between 2003-2007, driven by disposable income growth
- The market is expected to grow 15% p.a. through 2010
  - Meat consumption per capita is below developed market benchmarks and is expected to increase
- The Russian meat market remains fragmented with the top 10 companies controlling less than 30% of the market in pork and processing segments and slightly above 40% in Poultry.
  - The largest companies are interested in geographical expansion acquiring regional players (e.g. Cherkizovo)
- Raw meat price inflation remains a risk. However domestic supply is expected to increase
  - Russian government is strategically targeting less dependence on imports and supports local players, import quotas resulted in raw meat price hikes, however, significant government support is expected to improve domestic supply
  - Meat market players are stimulated by subsidized loans and tax breaks and are encouraged to develop production facilities
- Gross profit margin for top players is estimated to range from 15% to 20% with net margin for top players around 2-3%
  - Margins are generally higher in poultry segment

The Russian Vodka market is expected to grow strongly in premium segment by 24% p.a. through 2012 and in spite of some significant acquisitions still offers attractive consolidation opportunities

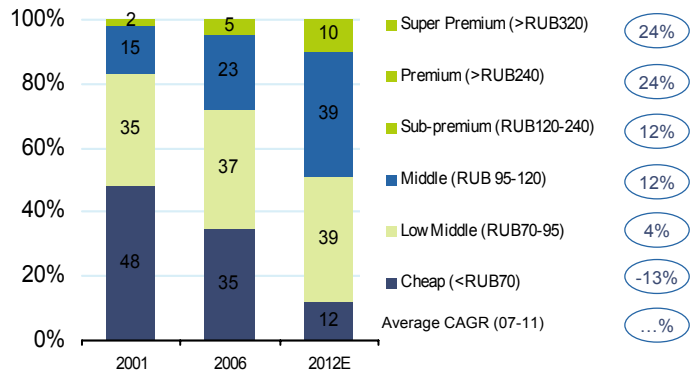
Vodka market volume and value, 2003-2012



Source: Business Analytica

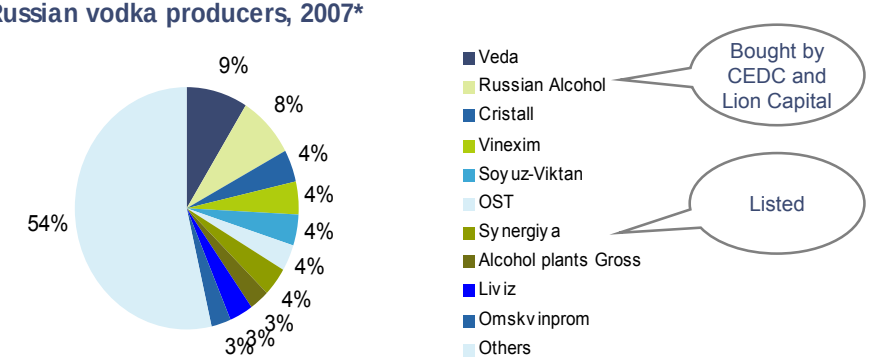
- The Russian alcohol market is the second largest alcohol market in the world, with vodka sales growing c.12% p.a. between 2003 and 2007
- Future growth will be driven mainly by middle and premium products
  - Overall vodka consumption is already at a high level and expected to slightly decline due to loss of share of cheap vodka to beer and wine
  - However middle and premium segment have a big growth potential due to trading-up trend and changes in consumer behavior
- With high profitability of players and a relatively fragmented landscape, the vodka market offers significant investment opportunities
  - The top 10 producers control c.46% of the market by value in 2007 (in the beer industry 6 players control c. 90% of the market)
  - Most leaders operate in the middle/upper segments, with gross margin estimated to be 30-60%, EBITDA margin 15-25%, net profit margin 7-15%

Vodka market structure and value



Source: Renaissance Capital, 2008
Note: Price per 0,5 bottle

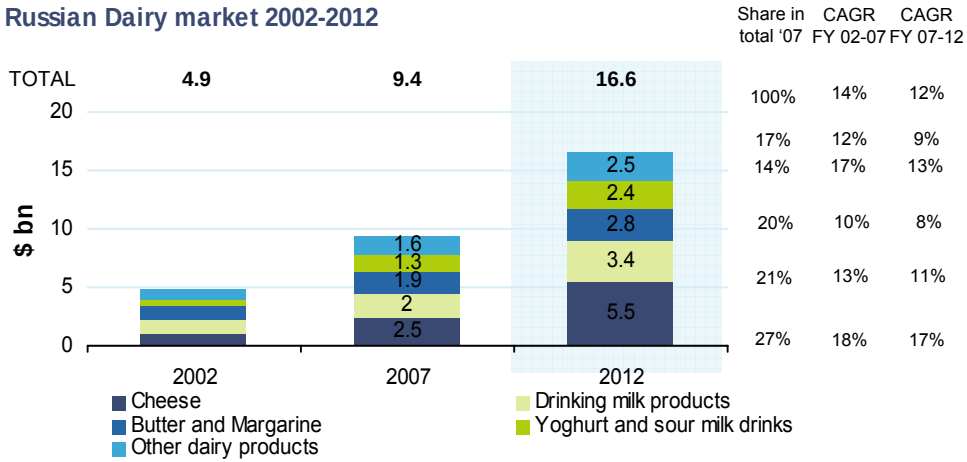
Top Russian vodka producers, 2007*



Source: Business Analytica
*Note: data for Rosspirtprom, large state-owned holding was not available

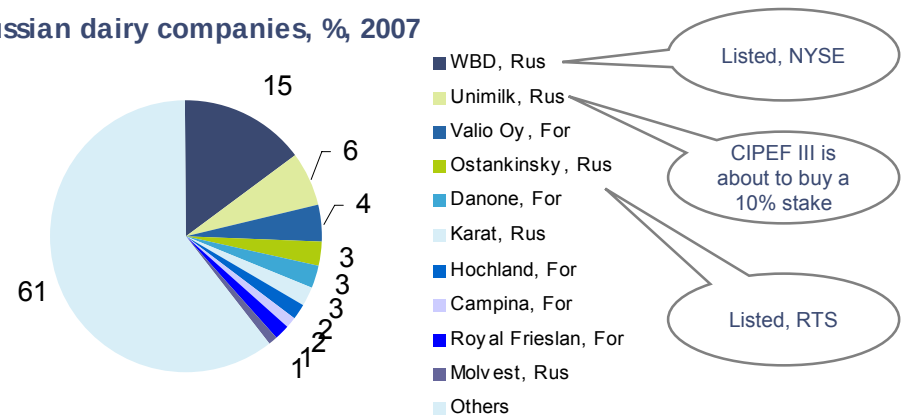
Russian Dairy remains a relatively fragmented market. The largest national players are exploring opportunities to consolidate the market

Russian Dairy market 2002-2012



Note: *Current retail prices, fixed 2007 exchange rates

Top Russian dairy companies, %, 2007



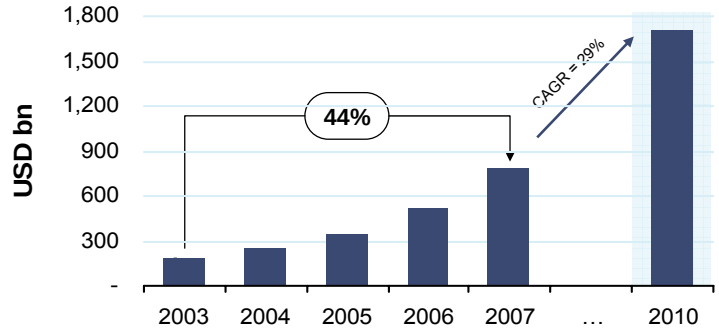
Source: Euromonitor International 2008

- The dairy market shows strongest growth in cheese and yoghurt, these segments also have higher growth potential due to shifts in consumer preferences and lower sensitivity to raw milk price increases
- Although still fragmented, the market is gradually consolidating with the top 10 companies increasing share from 24% in 2001 to c.40% in 2007
- Opportunities for PE may include investing in one of the leaders as portfolio investments or as a platform for future consolidation
  - 2 Russian companies from the top 10 are listed, some others have announced IPO plans
  - Market leaders have more efficient product portfolio follow an aggressive M&A strategy , notably Wimm-Bill-Dann (WBD)
- Profitability is not yet affected by retail consolidation and private label development, however it is affected by raw milk appreciation
  - The average gross-margin for top players is estimated to be 25-30%, EBITDA – 10-12%, net margin – 2-5%

Section 4.3
Financial sector

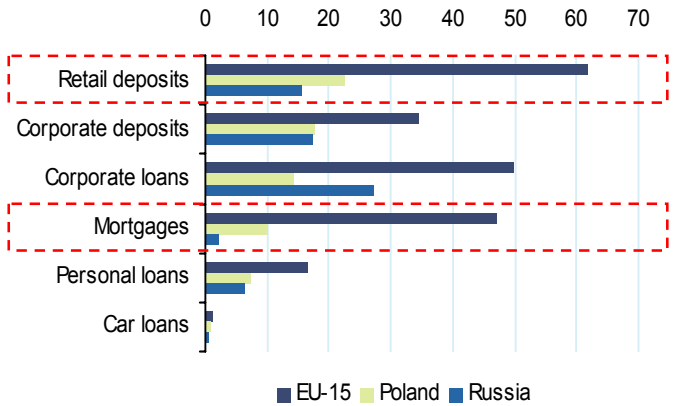
Growth of the banking industry in Russia is strong, and is likely to be sustained as banking services, particularly retail have currently low penetration rates. Consolidation is expected to continue with an increasing share of state-owned and foreign banks

Total assets of the Russian Banking sector 2003-2010



Source: CBR, Troika Dialog

Penetration of banking products to GDP



Source: Central banks

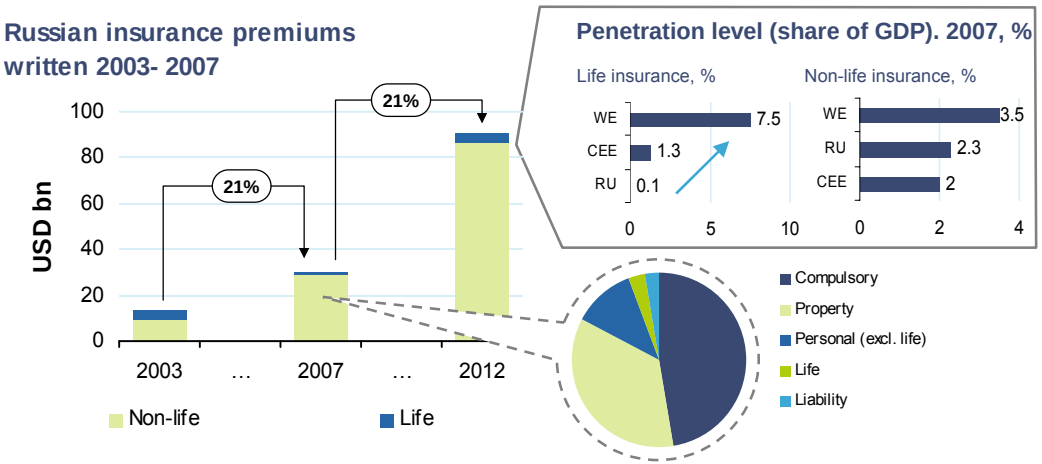
- The Russian banking sector grew c.44% p.a. in total assets for the last 5 years and has experienced a limited impact from the global credit crunch. Further growth is expected to be driven by overall economic growth and growing demand for corporate and retail lending
  - Major growth in corporate lending is coming from real-estate and construction, agriculture, transport and communications
  - Retail growth is driven by personal loans, mortgages and car loans
  - SME lending is believed to offer the largest growth potential, although it is not yet clear how to successfully address this market
- The banking sector is gradually consolidating with the top-20 banks holding c.64% of the market in 2007 versus 60% in 2003. Although the State is interested in maintaining and increasing control over the market, foreign-owned banks are increasing their share
  - Market share of state owned banks increased to 39% in ’07 vs. 32% in ’03. Market leaders Sberbank (currently has a 24% share) and VTB (8% share) are currently undergoing extensive modernization
  - The market share of foreign-owned banks increased to 17% in ’07 vs. 7% in ‘03
  - The share of private banks is gradually decreasing due to loss of licenses because of violations of anti money laundering and reporting regulations. Some smaller banks exited due to increasing competition
- There were a number of Private Equity transactions in the Russian banking sector in recent years
  - Investors are now looking at Russian banks, which are believed to be relatively inexpensive

Russian Private Banks offer multiple options for Private Equity

Group	Description and outlook	Examples of banks	Opportunities for PE
State owned	• Leaders in corporate and retail lending with largest branch networks • Most likely will increase market share • Might make targeted acquisitions to increase capabilities	• Absolute leaders: Sberbank, VTB • Others: Russian Agricultural Bank, Rossiisky Bank for Development	• Two largest banks are public and can be targeted for portfolio investments
Foreign owned	• Rapid organic growth with expansion in SME and retail lending • Most likely will increase market share • Might make targeted acquisitions to increase capabilities	• Raiffeisen International, Unicredit Bank, RosBank, Societe Generale, Citibank, etc.	–
Private – Large private banks	• Many are associated with financial industrial groups • Likely to stay strong, however with declining market share	• Large product offering: Bank Petrocommerce, RosEvroBank, Zenit • Product Specialists: Russian Standard Bank	• Some are rumored to be partly / fully sold, e.g. Bank Petrocommerce, RosEvroBank • Possible takeover targets
Private – Banks with minority foreign stakes	• Relatively high transparency and corporate governance standards	• Promsvyazbank, MDM, URSA Bank, Transcapital Bank	• Likely to become M&A targets or portfolio investment, e.g. Bank Vozrozhdenie (by Brisam Global partners)
Private – Small private banks	• Position in 5-10 years is uncertain • Many regional banks seek new strategy and are ready for M&A	• Mostly regional banks	• Consolidation of regional banks and successful sale of an integrated business, e.g. Investsberbank (by OTP, initially – 4 small banks), Investtorgbank (by Star International), 3 acquisitions by East Capital Private Equity in 2008

The level of concentration in Russian Insurance is increasing as competition and rigorous regulations squeeze small companies. Investments into transparent companies with efficient product portfolios (mainly life and property) appear most attractive

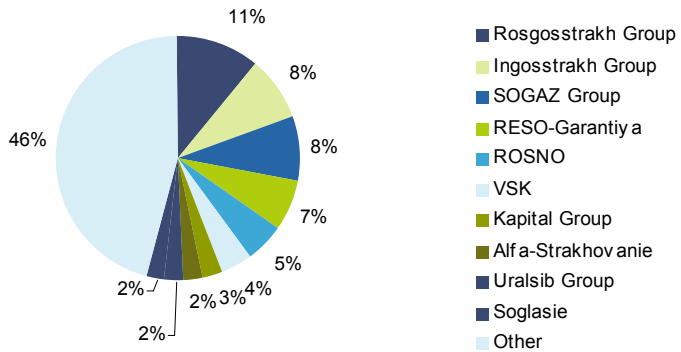
Russian insurance premiums written 2003- 2007



Note: Life insurance figures are distorted by the schemes business. The government succeeded to significantly reduce the share of schemes by 2008

Source: CEA, BMI, PwC Analysis, Federal insurance Supervisory service

Top-10 players in the insurance market, 2007



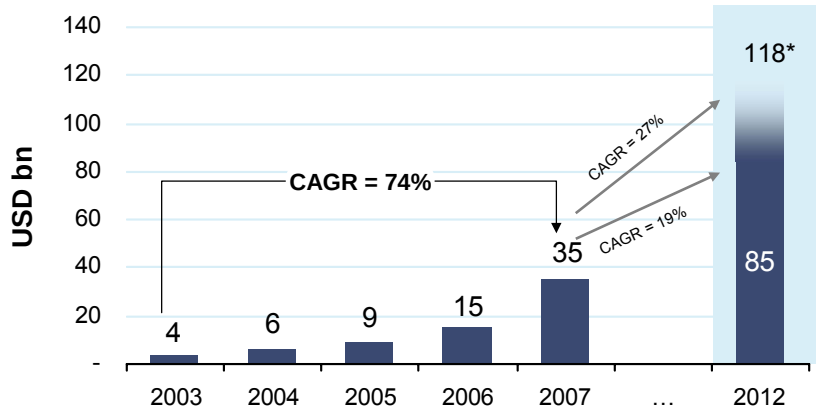
Source: Federal insurance Supervisory service, PwC Analysis

- Russian insurance premiums written grew by c.21% for the last 5 years, driven by increased incomes, development of mortgage and consumer lending and the underinsured nature of non-life assets
  - Compulsory insurance mainly consists of compulsory medical insurance with premiums coming from social taxes and unprofitable third-party motor liability introduced since 2003
- The market is expected to grow 24% p.a. to 2012 with the life segment offering the largest growth potential (36% CAGR) as penetration is very low
- Consolidation is high with the top 10 insurers occupying c.54% of the market, large companies are likely to increase their share
  - Many internationals are present in the market and are expanding quickly: ACE, AIG, Allianz, Aviva, Generali, ING, Mitsui Sumitomo, Munich Re, etc
  - Small companies are forced out of the market due to competition, increased requirements for insurers and rigorous policy to fight tax schemes
- Most M&A activity is coming from international insurance companies and large domestic insurance and financial services groups. Portfolio investment in large companies with efficient portfolios appears the most attractive strategy
  - Investment in small regional companies remains risky: lack of transparency, inefficient portfolio and non-compliance with state regulations
  - However Russia Partners and Genesis Capital have announced a JV to consolidate several companies
- Average net margin for insurance companies is estimated to range from 4 to 5%*

Note: *Net profit divided by gross written premiums

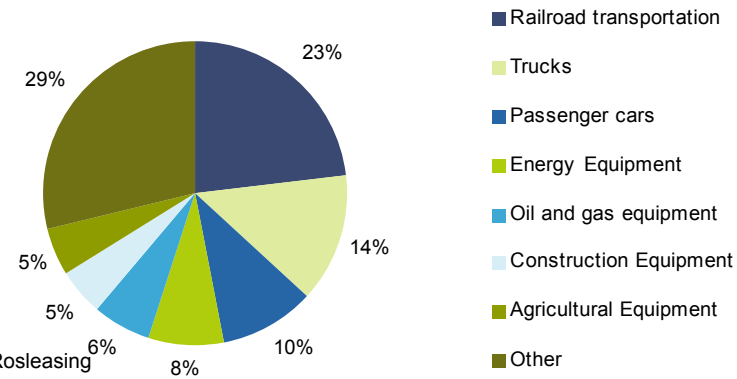
The Russian leasing market offers attractive opportunities due to the low current penetration of leasing services and strong underlying market growth

Russian Leasing market 2003-2007



Source: Rosleasing, 2008, PwC Analysis
Note: *2 scenarios: 1 - Based on growth of fixed capital formation; 2 – additionally based on increase of penetration rate (PR) (at average European pace of growth of PR between 2000 and 2006) to 18% by 2012

New leases in key segments of Russian market, 2007



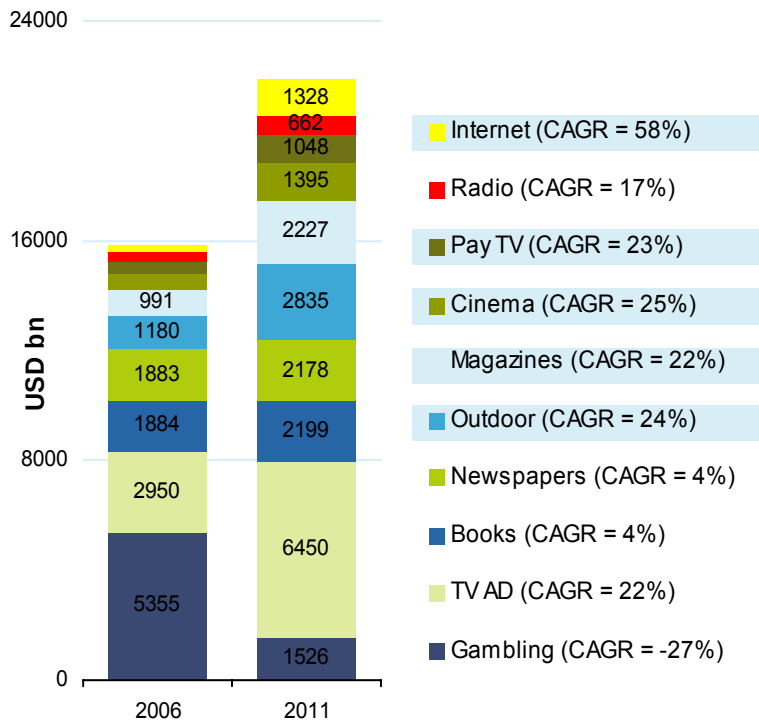
Source: Rosleasing

- Russian leasing has been booming for the last 5 years, CAGR stood at c.74% between 2003 and 2007, the key drivers of market growth are likely to continue in coming years
  - Growth is mainly driven by overall economic growth, strong growth of construction and transportation markets, depreciation of fixed assets and better availability of bank financing
  - Servicing small and mid-sized business remains underdeveloped and offers high future growth potential. Quick emergence of operating lease and leaseback, which are yet underdeveloped in Russia due to lags in legislation, are also expected to contribute to growth
- Top 10 leasing companies occupied c.44% of the market in 2007. Approximately 300 players can be divided in two groups
  - Companies that service a few large customers and are involved in large scale, private or state-owned financial industrial groups or cater to their parent industrial groups (e.g. VTB-leasing, Uralsib, Kamaz Leasing)
  - Diversified independent leasing companies, focused on smaller clients
- High profitability of leasing companies may further attract PE companies, some are already investing in the Russian leasing
  - Gross profit margins for top players are estimated to range from 25 to 30%
  - Net margins for top players vary around 9%, reaching 30% for some companies

Section 4.4
Entertainment & media

The media & entertainment market is expected to grow steadily in the following years with internet, magazines and outdoor advertising outperforming the overall market

Russian media & entertainment market (mln. USD), 2006-2011

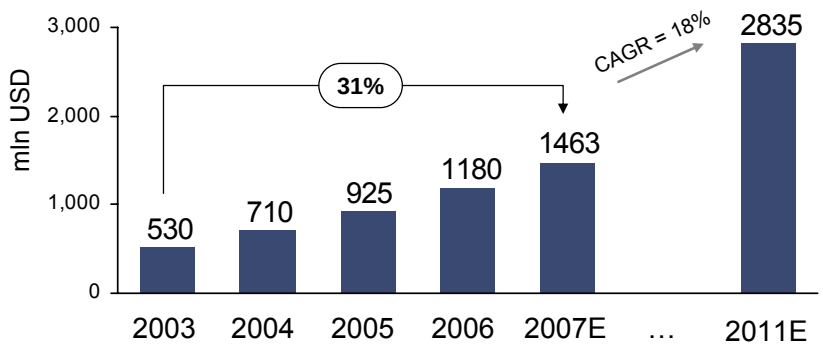


- **TV market**
  - Terrestrial TV is dominated by local companies, mainly associated with the government, because the sector is treated as strategic. Entertainment channels are the only possible investment, but still potentially risky
  - Pay TV is expected to grow in Russia. The total number of potential Pay TV subscribers in Russia is expected to grow to 13.1 mln. within the next 5 years
- **Printed media**
  - In line with global trends magazines is expected to be the fastest growing segment with newspapers and books stagnating
- **Internet**
  - By internet penetration Moscow is approaching developed countries, while Russia overall is lagging behind by 5-7 years. Regional users represent a continuously growing part of Internet audience
- **Outdoor advertisement**
  - Outdoor advertising market is expected to be one of the fastest growing markets in Russia, with a number of international players already there
- **Cinema**
  - The Cinema market is expected to grow significantly in the following years, mainly by expansion to smaller Russian cities
- **Gambling**
  - Gambling has been banned in Russia in most of the major cities, with a plan to open special zones. However this might significantly reduce market value

Source: PwC global entertainment and media outlook, PwC analysis

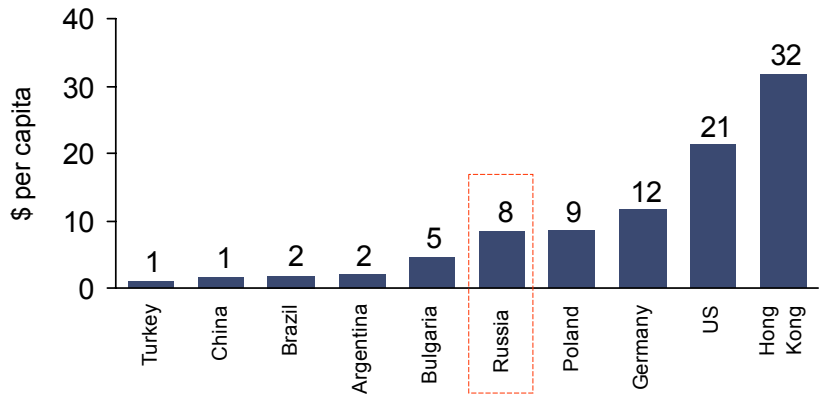
The Russian outdoor advertising market is expected to grow by circa 18% per annum towards 2011, driven largely by price increases. Spend on outdoor advertising is relatively low in Russia

Russian outdoor market size and growth, 2003-2011



Source: ZenithOptimedia, Troika Dialog estimates

Outdoor ad spend per capita, 2006

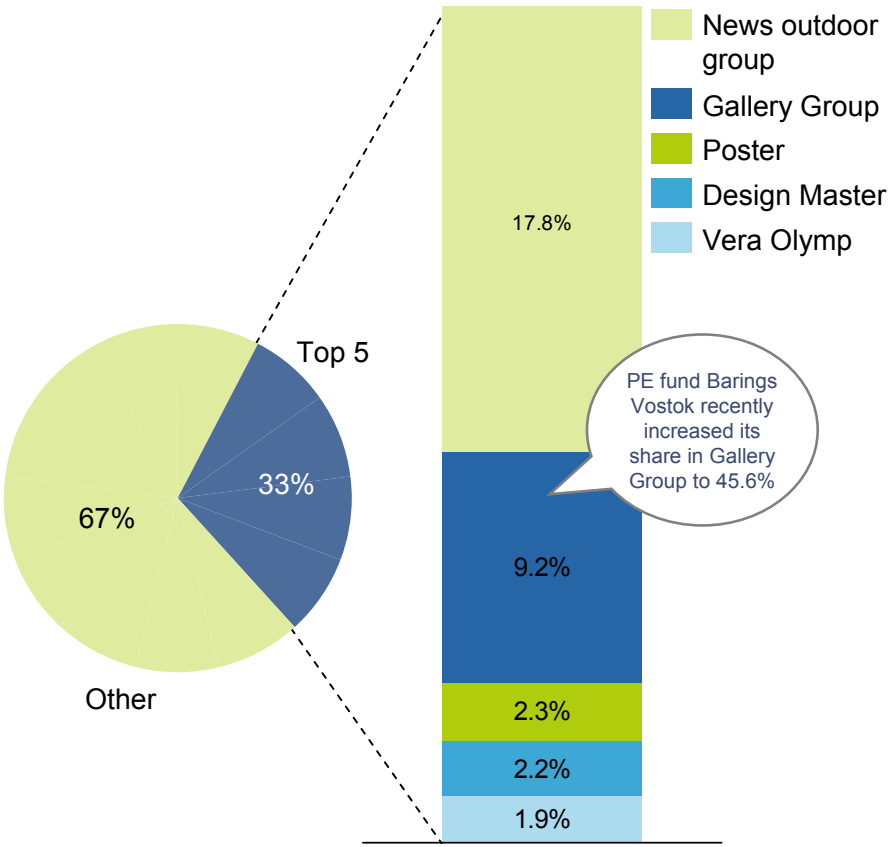


Source: ZenithOptimedia, Troika Dialog estimates

- The Russian outdoor market is expected to grow at 18% per annum through 2011, in line with the overall advertising market
  - In the long-run, the share of outdoor advertising is expected to decline, due to substitution by other media such as internet
- The current market is mainly driven by price increases, rather than volume growth
  - Tobacco and alcohol advertising was banned in recent years, which previously consumed the major part of outdoor advertising (Philip Morris was the largest outdoor advertiser until 2005)
  - Limitation on construction of new outdoor advertising facilities
  - 'Beautification' process of removing outdoor advertising from city centers
- From 2008 onwards, TV commercials are limited to no more than 15% (or 9 minutes) of airtime in any given hour. This may shift some advertising revenues from broadcast to outdoor advertising
- Shift from billboards to street furniture is expected in future
  - Street furniture is one of the most attractive outdoor formats and already accounts for 60% of outdoor constructions in Europe
- Outdoor advertising is exposed to regulatory and tax risks (i.e. obtaining approvals for outdoor constructions)

The Russian outdoor advertising market is fairly fragmented, with the top 5 accounting for 33% of the market. However, consolidation is increasing

Main players and their market shares, 2007



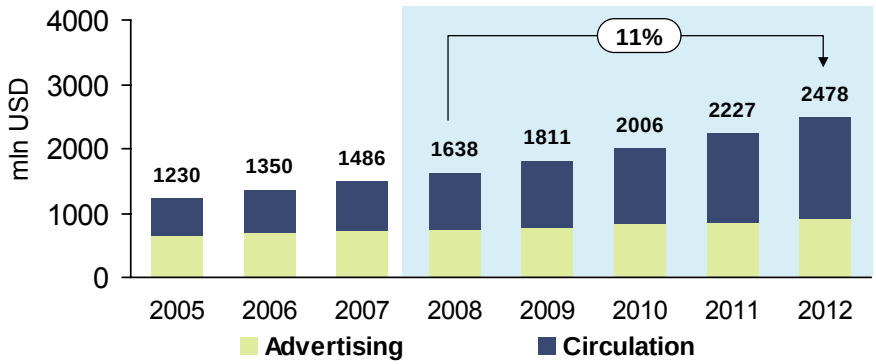
- According to market participants, the outdoor advertising market is likely to be divided between 4-5 large national players in the medium term, with potentially 1-2 strong regional players
- Consolidation is continuing
  - Since 2004 the share of top10 grew from 34% to 40%
  - Gallery Group became the second largest operator by actively seeking M&A opportunities
  - Currently there are over 400 companies, with 60 of them in Moscow while in European countries (e.g. Great Britain or France) there are only 10-15 players
- Competition is expected to increase
  - Outdoor operators will be limited to 35% share of any region's market by regulatory changes
  - Outdoor ad contracts will be limited to five years, hence reducing the predictability of cash flow for a company
- Large international companies such as Stroer and JCDecaux are entering Russian market via a JV
- Domestic outdoor advertisers' EBITDA margins are estimated to range from 20% to 50%, compared to international peers EBITDA margins of 22-45%*

Source: Espar Analitics, Troika Dialog

*Troika Dialog estimates

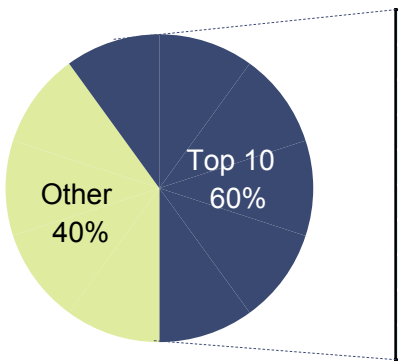
The magazine publishing market is worth circa US$1.5bln and is expected to grow by 11% per annum towards 2012. Consolidation and PE investments are ongoing

Magazine market size and growth rate, 2003-2012



Source: Russian periodical press market 2006, Federal Press and Mass Communication Agency

Key publishers and their market shares*, 2005



Independent media	12.9%
Profmedia	7.7%
Burda	7.2%
7 days	7.0%
HFS	6.5%
Kommersant	6.1%
Conde Nast	5.8%
MK	2.7%
Gruner+Iar	2.2%
SNP	1.9%

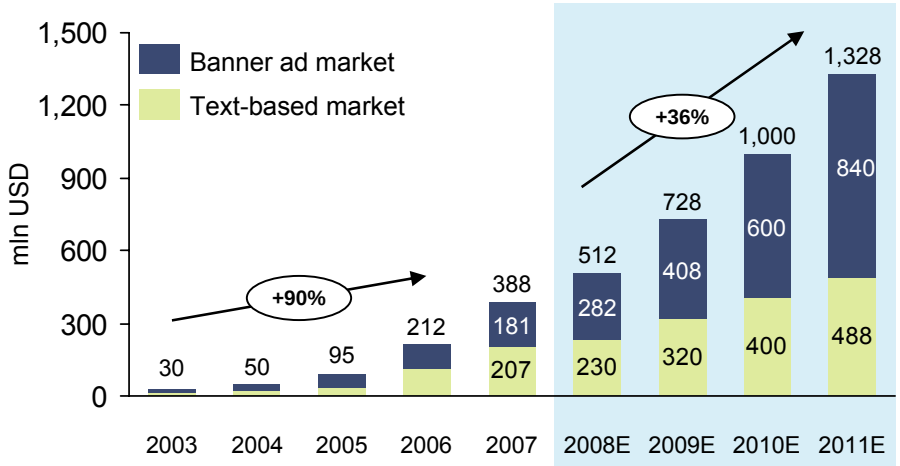
Note: * Market shares were based on advertising revenues

Source: TNS Gallup Ad fact, RBC

- The magazine publishing market was the fastest growing out of all printed advertising markets
  - Current market growth is estimated at about 14% annually
  - Future forecasts vary significantly from 6% to 20% p.a.
- Market growth has been driven mainly by price and circulation increases, and by growth of advertising budgets of large multinational and Russian companies
- The magazine publishing market is rather consolidated with the top 10 players accounting for 60% of the market
- In line with international trends, the number of magazine titles is likely to increase, targeting more narrow target groups
- Consolidation is ongoing
  - Prof-Media Holding bought Afisha Publishers in 2006
  - Gazprominvestholding purchased Kommersant Publishers (~$300mln) and plans to create a major media holding
- PE Funds have also invested in magazine publishers
  - Basic Element bought OVA-Press Publishers and subsequently purchased a 30% stake in the Expert Group
  - Promsvyazcapital acquired Extra M Media Publishers
  - PE fund Troika Capital Partners has acquired two specialized magazine publishers

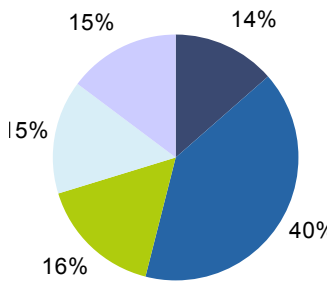
The Internet advertising market is growing strongly and has a large potential. However it is already very concentrated with the top-4 players representing c.80% of the market

Internet ad market size and growth rate, 2003-2011E



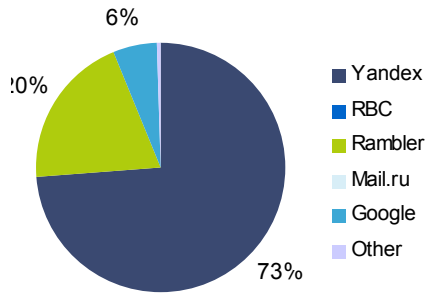
Source: AKAR, ZenithOptimedia, Troika Dialog estimates

Banner ad market, 2007



Source: RBC

Text-based ad market, 2007

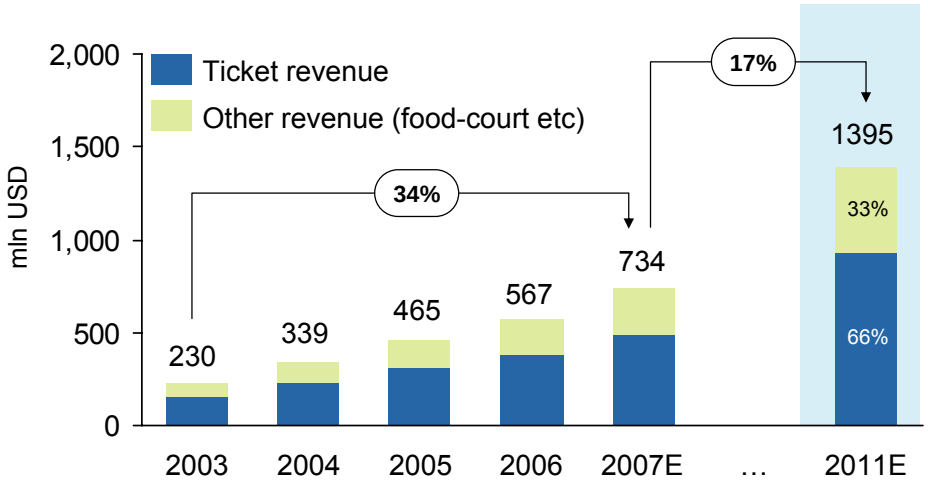


Source: RBC

- The Internet ad market represents only 3% of domestic media market and in 2007 was estimated at only $425 mln (with 388 mln. for banner and text-based ad market)
  - Russia's internet penetration is still very low c.18% and broadband penetration has just exceeded 1%.
- Nevertheless, Russia's internet advertising market is already one of the largest in Eastern Europe
- Internet is the fastest growing segment in the media sector with 2003-2006 CAGR of over 90% and is forecast to grow by 36% a year between 2008 and 2011.
- The main market growth drivers:
  - Increase in broadband and internet penetration
  - Reallocation of advertising budgets from outdoor, press and TV to Internet with younger and more prospective audience
- Traditionally, portals and search engines have acted as the starting point for the majority of online activity, but social networking sites (very popular in Russia) are now increasing their share of internet advertising budgets
- The Internet advertising market is very concentrated in Russia even more than in US (top 10 sites account for 70%)
  - The top 4 Russian companies account for 80% of the internet advertising market
- Average EBITDA is around 10-20%

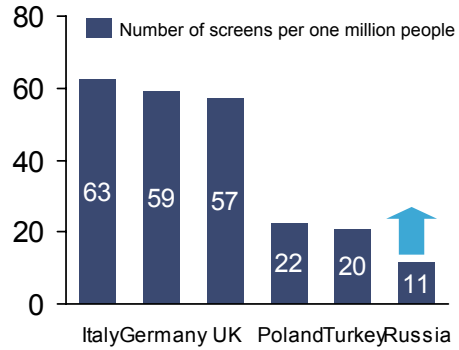
The Russia cinema market is expected to grow by 17% per annum towards 2011, driven by increasing modern screen penetration in regional cities

Cinema market size estimates, 2003-2011E

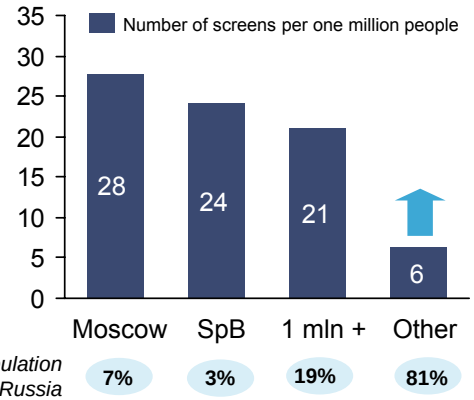


Source: Investkinoproekt, DISCOVERY Research Group, Nevafilm, RBC, PwC analysis

Current and potential number of screens (2006)



The main growth potential lies in the cities outside cities over 1 mln. (2006)



Source: Screen Digest, PwC analysis

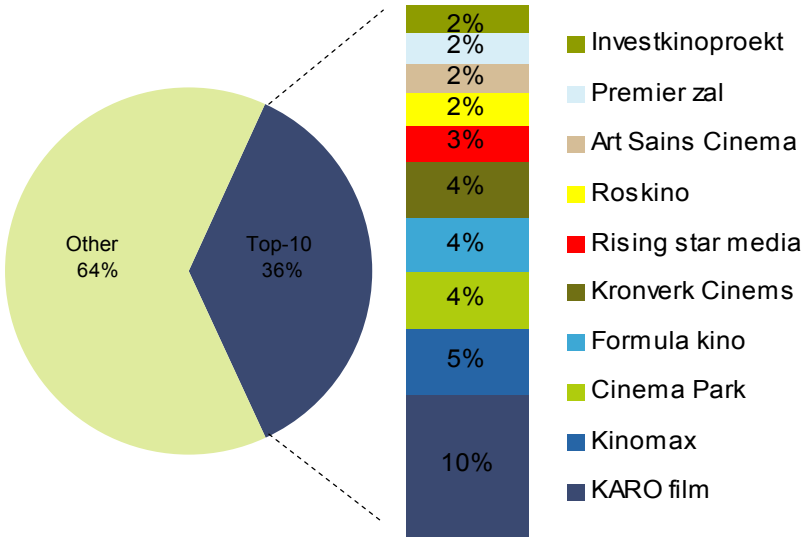
- The Russian cinema market has grown 35% p.a. and is expected to grow by 17% per annum towards 2011
  - The level of cinema-going varies from country to country, however there appears to be some upside potential in Russia
  - Upside potential for price increase is limited. Average price is forecast to grow by 33% to 6 USD which will be almost the current US level
- Because of economic collapse in Russia in 90's currently there is a lack of modern cinema theatres
  - Potential penetration level in Russia could be 3,000-4,000 modern screens comparing with c.1,500 today*
  - In all the cities with population over 1 million inhabitants screen penetration rate is close to benchmarks such as Poland and Turkey
- The main growth is expected to be driven by cities with population over 500K
  - Growth in the cities with less than 500K citizens will be limited because of low income level there

*based on anticipated penetration level of cinema screens (from 1 mln.+ level to Moscow level)

Source: U.S. Census Bureau, PwC global entertainment and media outlook, Screen Australia

The cinema market is fragmented with Top 10 players accounting for 36% of the market, but consolidation is expected

Main market players and their market shares, 2007



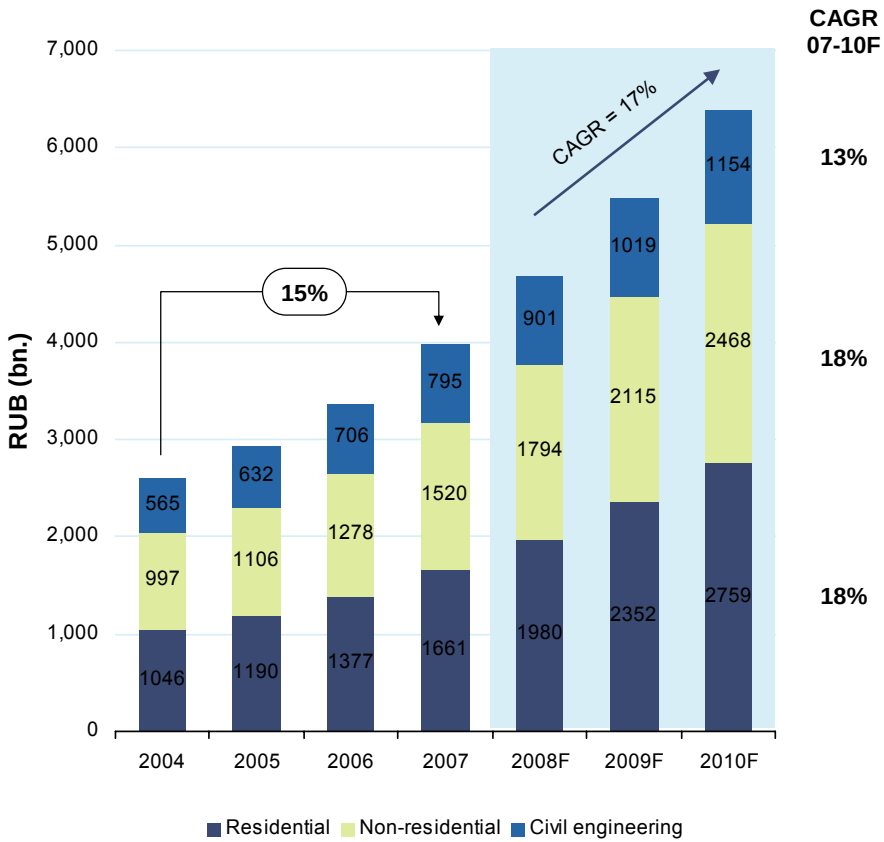
- The cinema market is dominated by Russian companies
  - Barriers to entry may be high as the market leaders have established their presence in 1mln+ cities and now try to capture 2nd tier cities with population over 500K inhabitants
- Although the market is consolidating, compared to international benchmarks the Russian markets appears fragmented
  - Share of cinemas that are owned by top 10 market players increased from 31% in 2005 to 36% in 2007
  - Top 10 Russian players own 30% of screens whether in UK four groups own 70% of the market
  - 80% of the new screens are opened by a few top-players
  - Out of top 10 regional leaders (out of Moscow and SpB) – 6 are from Moscow and 4 are regional players
- Foreign companies (e.g. National Amusements) starting to enter Russian market
- 3 cinema operators have announced their plans for IPOs during 2008-2010 (Kinomax, Kronverk Cinema, Karo Film)
- Indicative profitability of cinema operators**:
  - Gross profit margin ~ 45%
  - EBITDA margin ~ 8-10%
  - Net margin ~ 4%

Source: Investkinoproekt, Nevafilm, RBC,
Note: * Market share was estimated based on number of showrooms, ** Based on Karo Film financial results and forecasts

Section 4.5
Construction

The Russian construction industry is continuing to expand strongly, and is expected to grow by at least 17% per annum towards 2010

Overall construction output, 2004 - 2010F



Note: forecast in real terms
Source: BuildEcon (2008)

- The Russian construction market value has been growing by an average of 15% in the past 4 years and is forecasted to almost double in the next 5 years
- Growth may be higher as the government has large budgets available for renewal and renovation of outdated housing
  - Russian living space per capita is circa 21 sg.m compared to 40 for the EU average, indicating a large potential*
- In addition, the government has ambitious plans to upgrade the largely outdated infrastructure in the country. When accounting for these budgets, civil engineering/infrastructure construction growth may be circa 25% per annum
- This growth drives demand for all construction materials such as cement, bricks, concrete and some specific construction equipment
- The cement market is highly consolidated with a few players dominating in each Russian district. High margins attracts investors and international players
- The brick market will grow steadily in the future, however bricks as a construction material in the long-term will be substituted by concrete and wood
  - The fact that the brick market is a highly fragmented market may create an opportunity for PE investments
- Other construction materials sectors such as paint, elevators, facings and windows may also be attractive for PE investors

*Source: Wienerberger Capital markets 2007 presentation

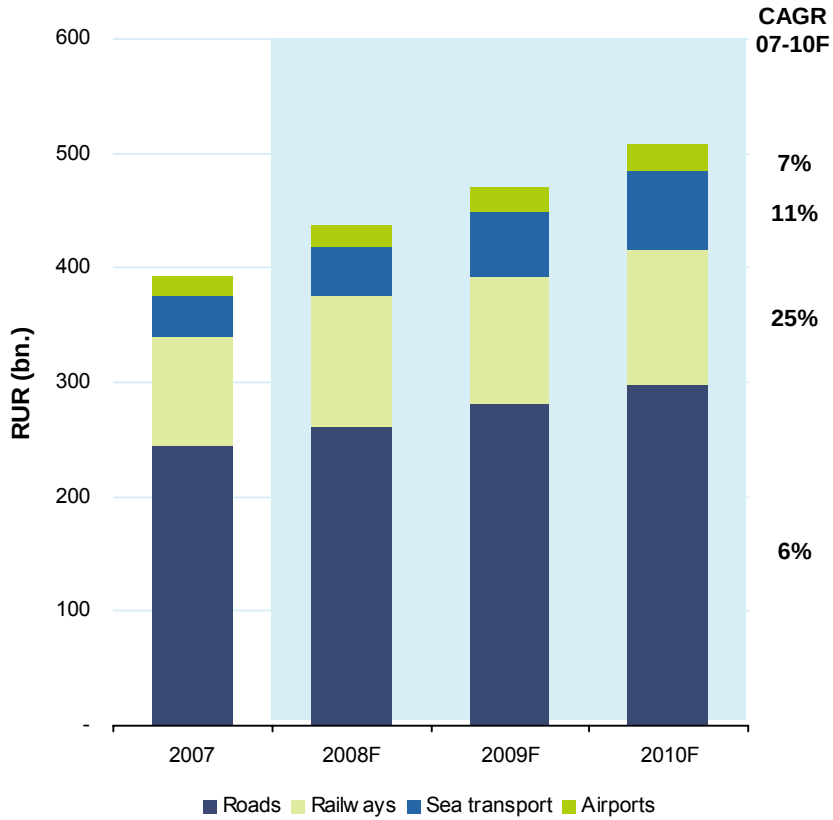
Construction is growing strong across the board

Construction market

Driver	Summary of growth	Expected growth (CAGR) 2008-2010F
Residential construction	• Growth in residential construction throughout Russia is driven by investment by the government in new housing to replace old housing. In addition, private construction is driven by growing disposable income and economic growth, as well as the growing availability of financing for housing	• 18%
Non-residential / commercial	• Non-residential construction is driven by demand for offices in large cities such as Moscow and St. Petersburg, but also by the growing demand for retail space in the regions	• 18%
Infrastructure / civil engineering	• Infrastructure construction is booming in Russia due to high commodity prices and the large investments by the federal and regional governments in infrastructure such as roads and railroads. • Growth forecasts of 13% per annum do not take into account the ambitious plans of the government for infrastructure investment. Although the actual spending of this money is uncertain, if these plans materialise, growth infrastructure could be circa 28%	• 13%-28%

Government plans indicate spend of RUR 400-500bn. p.a. on infrastructure between 2007-2010, with largest investments in roads and railways. If this money is spent, infrastructure construction could grow at circa 30% p.a.

Federal programme for infrastructure development, 2007 - 2010F

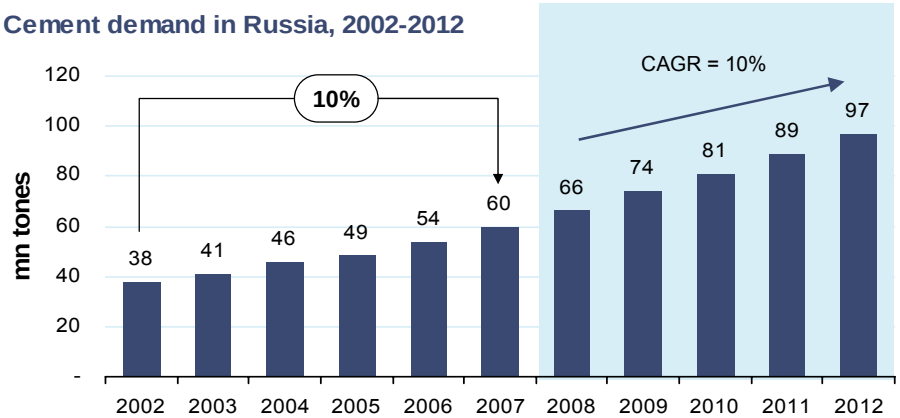


- The Federal Special Program for modernization of Russia's transport system for 2002-2010 assumes funding from the federal budget, regional budgets and from external sources such as credit facilities
- Although the Federal budget for 2008-2010 has been approved there is no certainty that this amount will actually be spent or invested in infrastructure
- However, if these funds are made available, this could add circa RUR 500bn. to the forecast infrastructure construction spend in 2010, bringing the total forecast growth rate to nearly 28% per annum
- There are no specific regional breakdowns available, as many projects span multiple Russian regions
  - A large number of infrastructure projects has been identified in the government programmes, across the country (e.g. 66 projects regarding roads)
  - For example, the Russian roads network will be expanded and modernised. E.g. RUR 200 bn. is planned to be invested in the federal roads "AMUR", M7 "Volga", M8 "Holmogori" and ring road for St. Petersburg
  - The length of the Russian railroad network will be increased by 44.5 th.km.

Source: Federal Special Program for modernization of transport's system for 2002-2010 (http://fcp.vpk.ru/cgi-bin/cis/fcp.cgi/Fcp/ViewFcp/View/2008/1/), Federal budget of RF for 2002-2007 (http://www.budgetrf.ru/Publications/2002/Adoption/Federal/Npd/Budgetlaws/Budget/194fz30122001/194fz30122001_short.htm), Federal budget of RF for 2008 and plan for 2009-2010 (http://www.rg.ru/2007/08/03/budjet-dok.html)

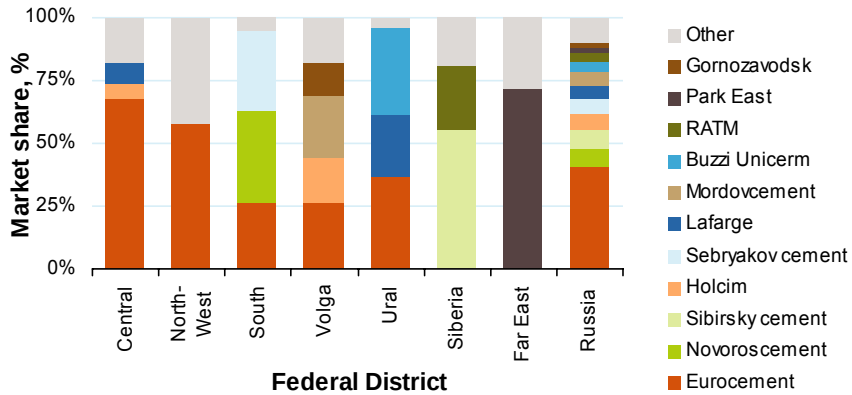
The Russian cement industry is highly profitable and continuing to grow. However, the market is relatively consolidated with a number of strong local companies

Cement demand in Russia, 2002-2012



Source: Deutsche Bank

Leading cement producers in Russia 2006

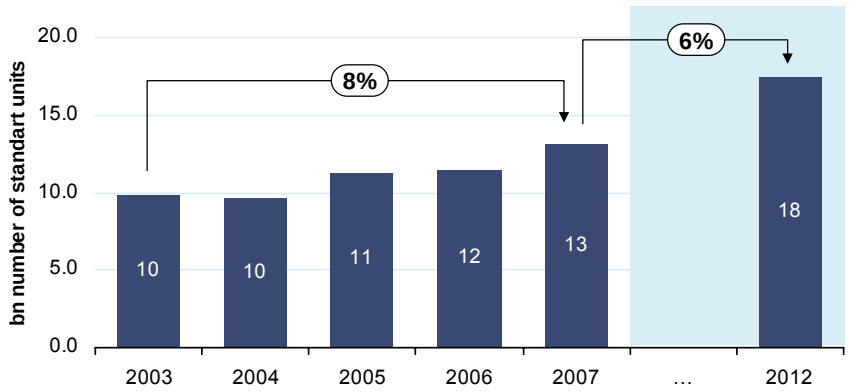


Source: Deutsche Bank

- The cement market is worth circa US$8.4bln. in 2007, and is expected to expand at circa 10% per annum towards 2012
- In the past few years one of the key growth drivers were cement price increases
- The market is consolidated on a national level and with Russian district dominated by one or two local players
  - High transportation costs stimulate high shares of local firms and constrain imports
- Producers are increasing their capacity and in 2010 it is expected that supply will satisfy demand and prices are anticipated to stabilize
- There are over 50 producers in Russia, however the share of the top 10 is about 90% with Eurocement as a leader (40%)
- Global cement industry is also very consolidated with the top 5 producers controlling more than 50% of the global cement market
  - Foreign players (Lafarge, Holcim, Buzzi Unicerm) have already established their presence in Russia
- Profitability of Russian cement producers is very high with EBITDA estimated at c. 50% in 2007 (while global peers EBITDA is 20-30%)
- Sibirsky cement is listed and Park East is owned by Barings PE Fund

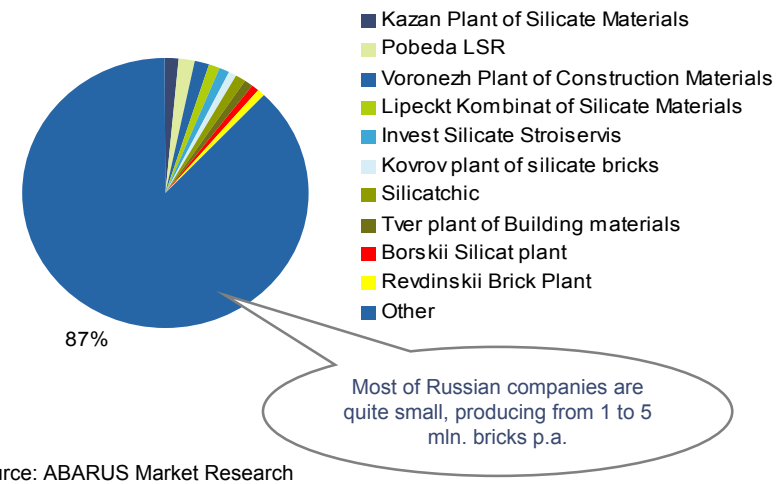
The Russian brick production industry is expected to grow below the overall construction output as bricks are substituted by other materials such as concrete and wood. Brick production, however is highly fragmented

Bricks market, 2003 - 2007



Source: ABARUS Market Research, Minregionrazvitie

Top 10 Russian bricks producers in the total market market, 2007



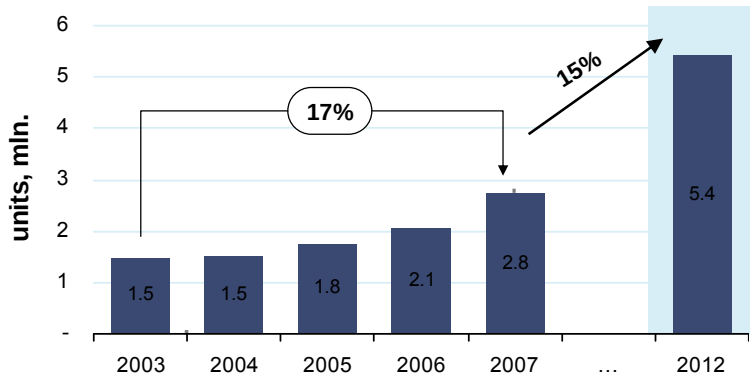
Source: ABARUS Market Research

- The demand for bricks in Russia is forecast to grow by 6% per annum towards 2012
- However the share of bricks used for walling is decreasing due to substitution to concrete and wood
  - Substitution is driven by the relatively high price for bricks and the lower speed of processing in construction
- There are over a 1,000 brick producers in Russia with the largest producers each holding less than 2% of the market (in volumes)
- The imports of bricks grew over the last 5 years and in 2007 the share of imports was 10-15% due to lack of local outer-facing brick production (facing bricks are used for the exterior of walls / visible brick architecture)
- International players started to be interested in Russian brick market. For example, Wienerberger has built 2 plants in Russia and plans to have 8 by 2012
- The profitability of Russian brick producers varies between operating profit of circa 10 to 20%
  - Wienerberger EBITDA rate in 2007 was 21% globally, with 29% in Central-East Europe

Section 4.6
Other

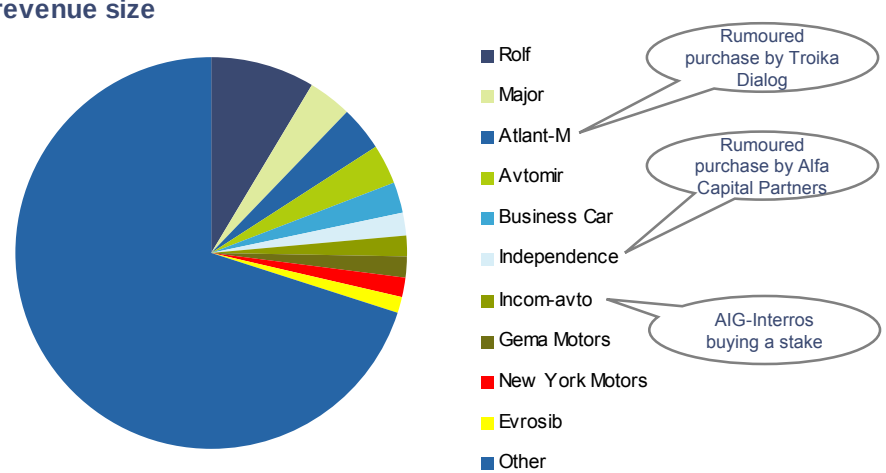
Automotive dealers operate in a market with a booming demand for cars. In addition, the car dealer market is still fragmented

Russian car sales, 2003-2012



Source: Renaissance Capital, 2008

Top 10 car dealers in Russia in 2006 by revenue size

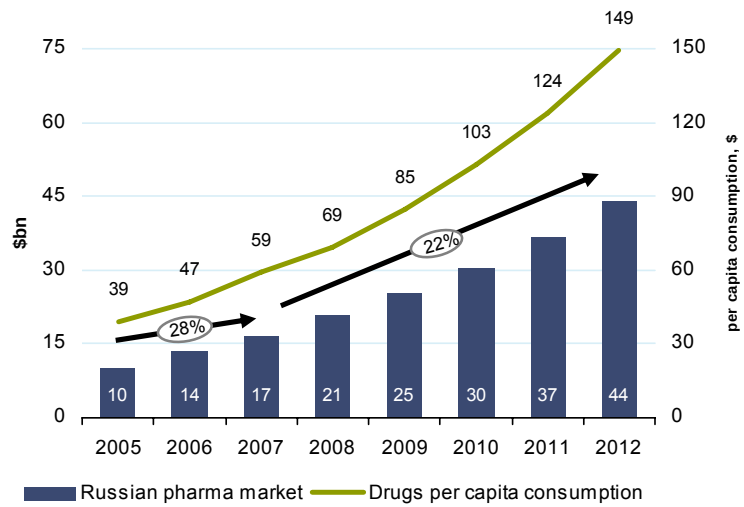


Source: ABARUS Market Research

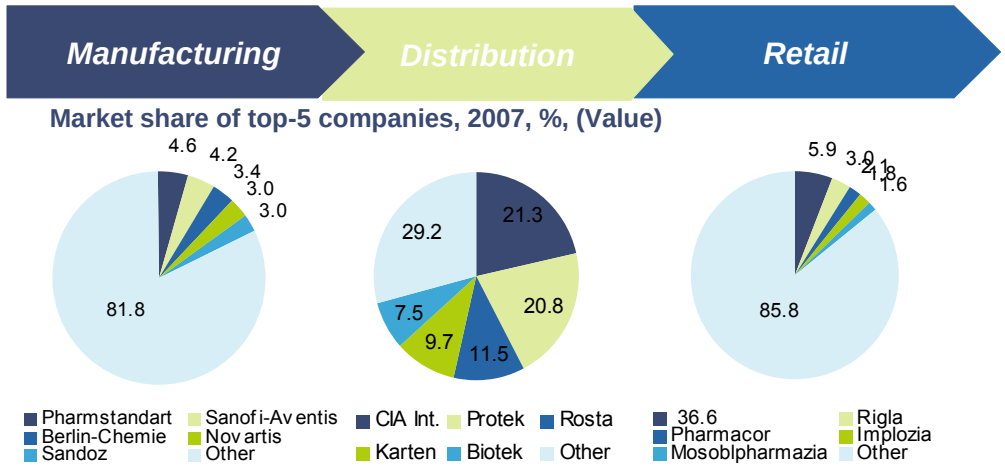
- The Russian automotive market is booming, with a growth of 33% in car sales from 2007/2006. Growth is driven by:
  - Significant increase in disposable incomes
  - Growth in the share of wallet spent on cars (5.2% of disposable income in 2007)
  - Boom in consumer credits for cars (doubled in 2007)
  - Relatively high and still growing average price of cars does not distract car buyers
  - Replacement of existing aged car fleet in Russia (circa 50% of the existing car fleet is over 10 years old)
- The automotive dealer market is forecast to grow further, showing double digit growth, driven by increased used car sales, and significant growth of after-sales
  - Growth is expected to be driven by used car sales (key auto retailers develop used car strategy and trade-in schemes), currently accounting for 0-3% of total sales against 40-50% in the UK
  - Penetration of after sales is expected to increase to western benchmark levels
- In addition to high market growth rates, investors are attracted by relatively low competition and stable profitability of car dealers
  - Level of concentration is relatively low; the top 10 car dealers account for about 30% of the market
  - EBITDA margin for top players is estimated at c. 6-8%, net profit margin is estimated at c. 3-4%

Russian Pharmaceutical business can be attractive through the whole value chain

Russian pharma market, 2005-2012



Source: Pharmexpert
Note: DLO, hospital purchases, para-pharmaceuticals included



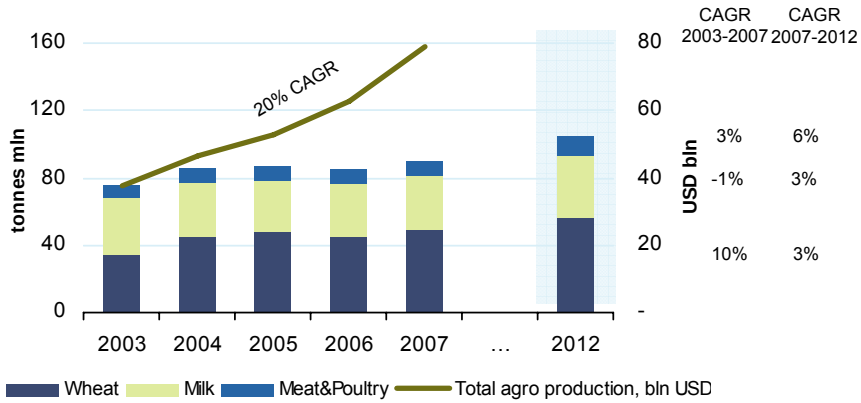
Manufacturing	Distribution	Retail
*GM: 60-65%**		*GM: 25-35%*
EBITDA: 30-40%	*EBITDA: 5-6%*	*EBITDA: 5-10%*
NI: 20-30%	*NI: 2-3%*	*NI: 5-10%*
Listed: Pharmstandart, Veropharm	*Listed: -*	*Listed: "36.6"*

Source: Pharmexpert, Pharm Vestnik. *Based, on top companies per segment

- The Russian pharmaceutical market is expected to grow strongly at c.22% p.a. mainly in value driven by increased incomes. Consumption per capita is still significantly lower than western benchmarks
- M&A activity is occurring throughout all sectors, with potential opportunities for Private Equity
  - Drugs manufacturing is the most risky segment facing strong competition from western branded and CEE/India generic medicine, however several companies showed significant success in generic production with strong sales forces, huge R&D potential, brand awareness and good basis for consolidation. Since 2007 the overall share of Russian producers stopped declining
  - Distributors are expected to further consolidate and top-players have announced or are rumoured to sell stakes to strategic investors
  - Pharma retail remains highly fragmented with perfect consolidation opportunities and opportunities for business model improvement and relatively easier exit strategies

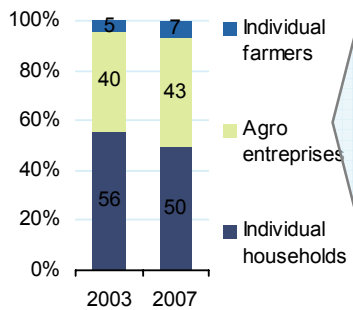
Russia provides significant opportunities for further agricultural development with investment opportunities in land development, consolidation and efficiency increase of loss making cooperatives

Production of key agricultural products, 2003-2012



Source: Rosstat, Russian agriculture development programme for 2008-2012

Agro production by type of companies 2003-2007



Large Agro Holdings
- Razgulyay
- RusAgro
- Agros
- Russian Grain
- Stoylenskaya Niva
- Yugtransitservis
- Nastyusha
- RusAgroProyekt
- OGO
- Black Earth Farming
- Others

Listed, RTS

Listed, RTS

Listed Stockholm

- **Cooperatives** (former kolhoz, sovhoz)

Source: Rosstat

- Russian agricultural production is expected to grow strongly due to government support of output growth and increase in yields and arable land
  - Historical growth was mainly in value, with prices growing c.20% p.a in '03-08 being 35-40% above 2006 level while global agricultural-product prices have peaked in Dec07-Feb08 and remain 85% above 2006 price level
  - Agriculture was denominated a National Priority project with the State Program budget '08-12 allocating $23bn over the period mainly to stimulate production and external financing, by providing interest free loans for investments
  - Agricultural land as % of total area by country remains one of the lowest 7.5% vs. 38% in the world, 49% in Germany, 60% in China
  - The new reform is allowing foreigners to own agricultural land, stimulating land purchases
  - Agro production remains undercapitalised (wheat harvest yields are c.2 tons/ha vs 3 globally, 8 - Germany and 4 - China)
  - Consumption per capita for basic products remains behind western benchmarks while the share of imports is planned to be significantly reduced
- Professionally organised agro entrepreneurs (holdings, cooperatives) make up the majority of production with large holdings (reportedly c.15-20%) gradually consolidating former Soviet-era loss making cooperatives
- PE companies can capitalise on strong agricultural market growth
  - Investing into large listed companies e.g. Razgulyay
  - Investing in land acquisition, e.g. Black Earth Farming owned by Vostok Nafta and other int-l investors
- Average profitability for top-players is estimated to be: GM – 15-25%, EBITDA – 5-15%, Net – 5-10%*

Source: *based on Razgulyay and Russian Grain

Appendix 1
Taxation system

Taxation system - rates and rules

General overview

- Corporate profits tax – 24%
- Domestic dividend tax – 9%
- Inbound dividend tax – 0% (from 1 January 2008) or 9%
- Outbound dividend tax – 15% (reduced by many tax treaties)
- VAT – 18% (10% on certain food, children, healthcare and publishing products)
- Property tax – 2.2% of asset value
- Personal income tax – 13% for residents, 30% for non-residents (dividends – 15%)
- Excises – fixed rates for alcohol, automobiles, gasoline/distillate and motor oils, combination of fixed and ad valorem retail price rate for tobacco
- Mineral extraction tax (for oil) – variable specific rate per tonne based on market price
- Mineral extraction tax (except for oil) – ad valorem rates

Taxation system - rates and rules

Profits tax (1 of 2)

- Interest generally tax deductible, subject to rate cap and thin cap rules
  - Loan is aimed at generating income not in excess of an average rate on similar debt or, at the election of a taxpayer, safe harbour rates (1.1 times Central Bank refunding rate for Rouble loans = around 10%, 15% for foreign currency loans)
  - thin cap rules apply to loans from **foreign** parents, their Russian affiliates or loans guaranteed by foreign parents or their Russian affiliates
  - thin cap ratio is 3:1 (12.5:1 for banks and leasing companies)
  - interest on ‘excessive’ loans disallowed for deduction and reclassified into dividend
- Management, consulting, legal, information, market research service fees generally tax deductible
  - robust documentation to support the actual provision of services and their link to income earning activities is required in practice

Taxation system - rates and rules

Profits tax (2 of 2)

- Withholding tax levied on a variety of Russian source income types:
  - distributions of income from corporate and other entities – 15%
  - interest and royalties – 20%
  - income from rents – 20%
  - income from use or sale of immovable property (including shares in real estate companies) – 20% on gross income or 24% on net income
  - freight income 10%
  - rates reduced by most tax treaties (Russia has over 70 treaties)
- Double tax treaties
  - Wide treaty network
  - Dividend withholding tax rate – 5% for substantial interest in most cases, but there are exceptions:
    - UK – 10%
    - Luxemburg – 10%
  - Interest / royalty / capital gains (excluding shares in real estate entities) / other income withholding tax rate – 0%

Taxation system - rates and rules

VAT Highlights

- Reverse charge VAT must be withheld from payment to the foreign supplier and paid over to the budget before claiming (not an entry on a VAT return)
- A list of supplies is exempt from VAT, but fairly prescriptive
- Place of supply rules are broadly similar to the 6th EU Directive
- Input VAT on non-taxable supplies (either based on exemption or the place of supply rules) is not recoverable and should generally be expensed
- Taxpayers must maintain statutory VAT invoices and special VAT records. Failure to comply with stringent formal requirements may render input VAT non-recoverable
- VAT cash refunds claims should technically be honoured within around three months, in practice cash refunds are very difficult to obtain
- Tax authorities are denying VAT refunds at every opportunity, often without much or any technical merit, as part of government clampdown on VAT fraud; getting a cash refund through court has become a much more painful and cumbersome process than 3-5 years ago

Taxation system - rates and rules

Tax administration (1 of 2)

- Ministry of Finance is responsible for developing new legislation and providing clarifications on existing tax laws; no binding ruling as such
- Onsite audits must not cover more than three years preceding the year of the audit
- Where an audit results in tax assessment, 20% (or 40%) penalty and late payment interest (of about 10%) can apply
- Tax dispute resolution process
  - Bringing a tax dispute to court is a common approach for taxpayers
  - It usually takes a case from 9 to 12 months to go through the first, appellate and cassation levels to reach final resolution

Taxation system - rates and rules

Tax administration (2 of 2)

Anti-avoidance rules and practices

- Historically tax laws did not provide anti-avoidance instruments
- This gave rise to widespread use of aggressive tax schemes
- The most vulnerable (and monetarily significant) area was export VAT refunds
- Government is now taking a more assertive approach towards combating tax avoidance and tax fraud, especially in the area of VAT
- Frequently still seen as harsh and unsophisticated, new practices started to emerge both in tax examinations and court precedents based on a substance over form approach
- The emerging practices have recently been effectively codified in guidelines issued by Supreme Arbitration Court. These guidelines instruct courts to disallow tax benefits arising from transactions without a business purpose
- At the same time, the government is considering introducing new anti-avoidance instruments (CFC rules, tax residency based on place of control and management etc)

Taxation system - rates and rules

Tax incentives

Current status

- Regional authorities can reduce profits tax from 24 to 20%
- Regional authorities also have the right to reduce property tax rate from 2.2% to no less than 1.1%
- Residents of special economic zones (technical-implementation, industrial-production, tourist-recreational) enjoy certain tax benefits including (depending on the type) accelerated tax depreciation, reduced property tax and unified social tax rates, exemption from land tax
- There is a broad list of exemptions from VAT for specific types of goods and services; however the economic effect of these exemptions is not always clear, since taxpayers claiming exemptions have to expense (and not recover) related input VAT
- There are special incentives for IT companies (in the form of a reduced unified tax rate scale and accelerated tax depreciation)
- The State Duma (lower chamber of parliament) has recently approved in first reading a draft bill introducing tax incentives for innovation activities, including VAT exemption from certain transactions with intellectual property and R&D, and accelerated tax depreciation.

Appendix 2
Foreign investments to strategic industries

New Law on Foreign Investment to Strategic Industries

- Sets restrictions* on transactions both inside and outside Russia in respect to businesses of strategic relevance for national defence and security:
  - Transactions on acquisition of shares of Russian companies which operate in at least one of the strategic areas
  - Other transactions, which lead to the Investor's control of such companies
- Has no retrospective effect:
  - Applies to relations arising after 7 May 2008
  - Investors have to submit information on holding at least 5% shares/control of a company acquired before the law came into effect, to the Federal Antimonopoly Service (FAS) within 180 days

* With some exceptions

New Law on Foreign Investment to Strategic Industries

Strategic Areas

The full list includes 42 types of activities of strategic relevance for national defense and security. These types may be grouped into the following areas:

- operations with nuclear and radioactive materials and sources;
- operations with information encryption and encryption devices;
- operations with covert listening and surveillance devices;
- operations with weapons, military equipment and ammunition;
- aviation and space activities;
- TV- and radio- broadcasting, printing, editing and publishing;
- operations of natural monopolies and businesses dominating on the market;
- subsoil use, and catch of water fauna.

New Law on Foreign Investment to Strategic Industries

FAS Approval (1 of 2)

Approval

- Acquisition of a direct or indirect right to dispose of 50% (10% and for each over 10%*) of shares
- Acquisition of a right to appoint the sole executive body or a right to appoint 50% (10%*) of a collegial executive body
- Acquisition of management company functions under a contract
- Acquisition of a right to otherwise govern management decisions
- Approval of acquisition of shares is not required for investors, who directly or indirectly own 50% of shares as of the date of the transaction

Notice

- In any case if 5% and over are acquired

An investor may sent in a request inquiring on the need of approval by filing all the documents required for the approval.

*For subsoil users

New Law on Foreign Investment to Strategic Industries

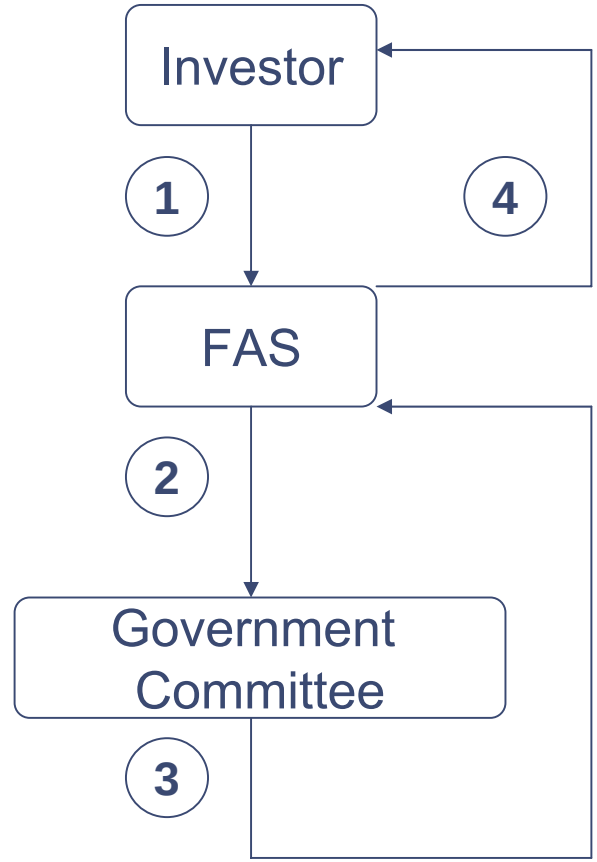
FAS Approval (2 of 2)

1
- Filing a request of provisional approval or institution of control

2
- Registration of the request
- Verification of available required documents
- Definition of the fact of institution of control

3
- Decision on approval
- Decision on approval upon agreement on liability provisions
- Decision on rejection of approval

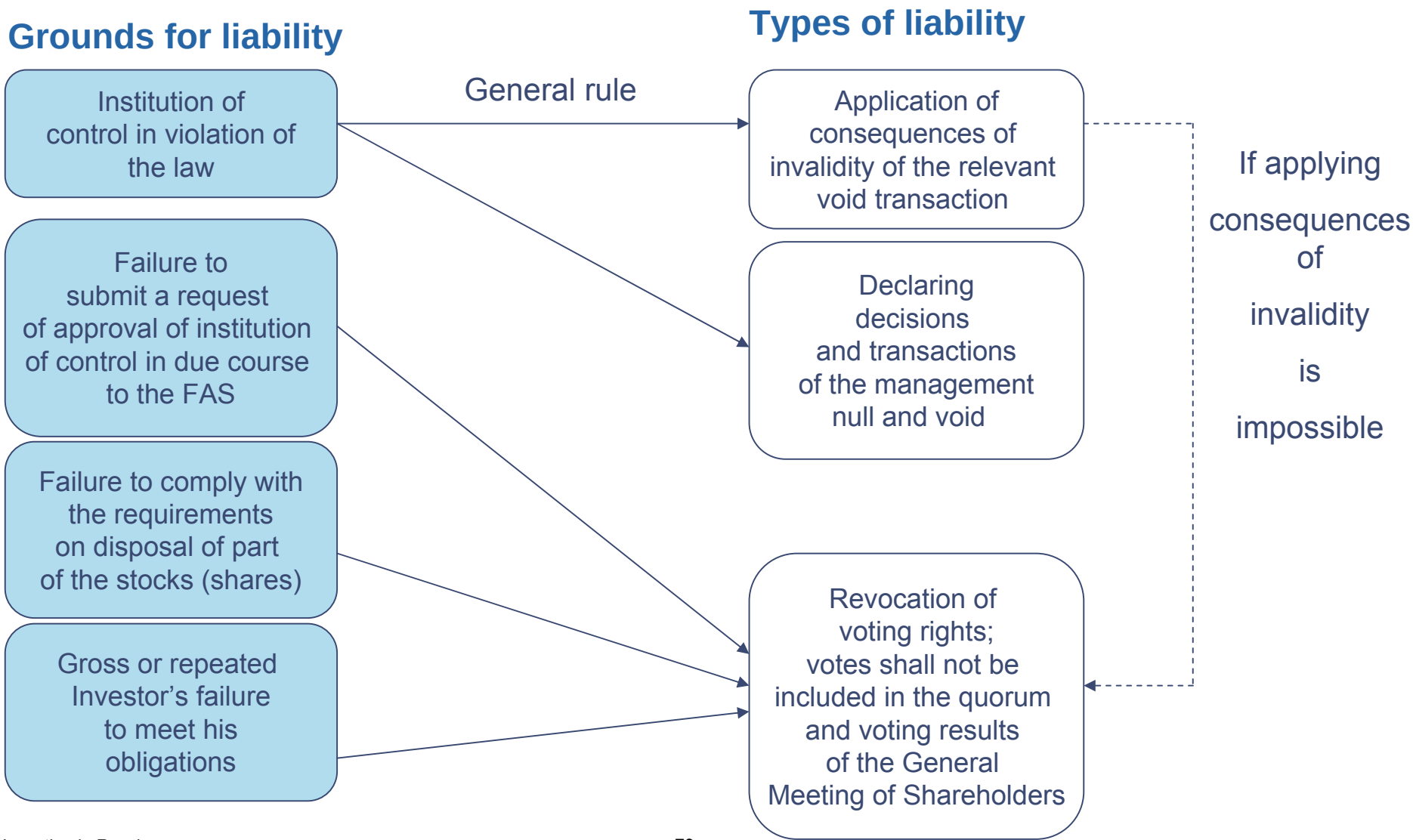
4
- Documentation of approval in accordance with the decision of the Government Committee



Time for review of the request for approval may not exceed three months.

New Law on Foreign Investment to Strategic Industries

Liabilities for breaching the rules



New Law on Foreign Investment to Strategic Industries

Issues with the New Law

Lack of a regulation on automatic approval and lack of a distinct list of reasons for rejection of a request for approval

- The list of strategic types of activity is extensive, and the Law sets very severe liabilities for violations.
- Currently, the law does not specify the procedure of filing notice to the Federal Antimonopoly Service that the law requires.
- If a request for approval is filed, the Investor has to file a complete package of documents along with it.
- The law does not stipulate a situation in which filing of a notice and a request of approval in the same time is required.
- The law sets stricter requirements for the companies-subsoil users.

Appendix 3
PwC Russia – facts and figures

PwC Russia – facts and figures

PwC Russia

More than 2600 staff

90 partners (43 expatriate and 47 local)

Offices in Moscow, Saint Petersburg, Togliatti, Yuzhno-Sakhalinsk and Kazan.

PwC Russia TLS

Almost 500 staff

27 partners

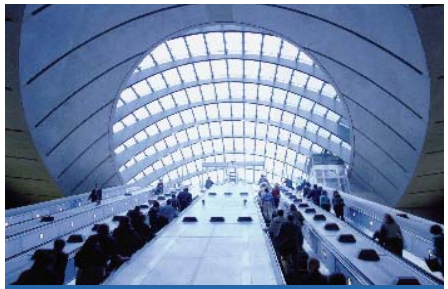
Industry groups: Energy, Utilities and Mining; Financial Services; Consumer and Industrial Products; Technology, InfoComm and Entertainment & Media

Specialisation groups: Indirect tax (VAT and customs), International Taxation Services, Transfer Pricing, Mergers and Acquisitions, International Assignment Solutions, Human Resource Consulting

Includes a Legal practice (1 partner and 80 staff)

“Russian Tax Firm of the Year” – by the International Tax Review magazine, May 2007

“Russian Transfer Pricing Firm of the Year” and “European Transfer Pricing Firm of the Year” – by the International Tax Review magazine, May 2007



Major clients & companies worked with include:

Integra Group

Novatek

Caspian Pipeline Consortium

CEDC

Gazpromneft,

Norislk Nickel

Sakhalin Energy

JC Decaux

Shell

Urals Energy

X5

Resume

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Doug Miller joined PricewaterhouseCoopers in 1991 and worked in our Boston and Costa Mesa, California offices before joining the Russian firm in 1996, where he currently leads the Transaction Services practice, which comprises over 70 dedicated transaction specialists. Doug holds a bachelors degree in government from Wesleyan University, an MBA from Boston University and is a Certified Public Accountant (USA).

During his twelve years in Russia, Doug has provided a wide range of audit, reporting and due diligence services, and in designing legal and reporting structures for Russian and international companies.

Additionally, Doug has lead engagements in areas such as capital markets, results appraisal and remuneration, system implementation and other pre-investment risk activities, and training. He has also worked on audits for a variety of public multinational manufacturing and financial service clients in the United States.