

# The Russian Finance Report

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## FEATURE STORIES

### YUKOS TO RETURN 72% OF SIBNEFT SHARES TO FORMER OWNERS

Sibneft is getting closer to the long-awaited freedom from YUKOS. On September 9, subsidiaries of Millhouse Capital representing the interests of Chukotka Governor Roman Abramovich achieved recovery of 72% of Sibneft shares through the court. YUKOS promises to complain against this verdict and analysts already do not believe that YUKOS will manage to receive back \$3 billion from the former partners.

The deal of merger as a result of which YUKOS received more than 92% of Sibneft shares consisted of three phases. At first, YUKOS bought out 20% of Sibneft for \$20 billion. After completion of this stage YUKOS bought out additional 8.8% of its own shares mostly from Group Menatep and exchanged them for 14.5% of Sibneft shares. Finally, YUKOS received the remaining 57.5% of Sibneft shares in the course of placing of the additional shares of YUKOS in October 2003. Sibneft paid for 17.2% of YUKOS shares with its securities.

After the arrest of Mikhail Khodorkovsky, former owners of Sibneft started accelerating the termination of the merger deal. In February 2004, representatives of Millhouse Capital and Group Menatep signed an agreement on the reverse, "mirror" deal and afterwards achieved invalidation of the additional issue of YUKOS shares through the court to return 57.5% of Sibneft shares to the former owners of the company. In July, the Federal Service of Financial Markets informed shareholders of YUKOS and Sibneft about annulling of the additional issue and on September 6 the Executive Board of YUKOS decided to return 57.5% of Sibneft shares to Millhouse and already prepared all necessary documents. Managers of YUKOS hoped to start the last stage of the breakup then, as a result of which the company planned to receive back \$3 billion.

The former partners had different plans and invalidated the second stage of the deal. On September

10, the Arbitration Court of the Chukotka Autonomous Area allowed the lawsuit of Nimegan Trading Limited offshore company close to Millhouse against YUKOS and former shareholders of Sibneft regarding invalidation of their agreement on shares exchange as a result of which YUKOS exchanged its 8.8% for 14% of Sibneft. The court decreed that YUKOS should return 72% of Sibneft shares to former owners of Sibneft and the former owners of Sibneft should return 8.8% of YUKOS shares to YUKOS.

The court verdict comes into effect in a month and a spokesperson for YUKOS says that the company is going to protest against the verdict. A spokesperson for Sibneft abstained from comments.

Now analysts are convinced that it is not beneficial for former owners of Sibneft to terminate the deal to the end and return \$3 billion to YUKOS in exchange for remaining 20% of Sibneft shares. In the best case Sibneft will reduce the sum of payments to YUKOS, presumes Sergei Suverov from Zenit bank. The analyst adds, "former owners of Sibneft may pay something but this will be much smaller than it has been planned initially. Theoretically Sibneft can prove that the deal of merger with YUKOS has incurred damage to business and capitalization of Sibneft." Dmitry Lukashov from Aton agrees that shareholders of Sibneft will try not to return the money.

Return of the entire sum of \$3 billion is possible only "if there is an order of the state," adds Suverov but the authorities obviously do not wish to help YUKOS to pay off the debts.

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### NATURAL RESOURCES MINISTRY MAY REVOKE OIL PRODUCTION LICENSE FROM YUGANSKNEFTEGAZ

Yuganskneftegaz may lose the license for natural resources production, say officials of the Natural Resources Ministry. Analysts say that this is done to reduce the value of the main upstream subsidiary of YUKOS and facilitate its purchase by certain Russian companies.

The Natural Resources Ministry does not rule out that the natural resources production licenses of

Yuganskneftegaz may be suspended and later revoked through the court. A spokesperson for the Natural Resources Ministry announced this on September 10.

This issue will be settled in two weeks, at the nearest meeting of the ministry's commission for observance of license agreements.

Press secretary of YUKOS Alexander Shadrin states,

"President Vladimir Putin requested naming of state officials who wish bankruptcy of YUKOS, as they should be fired due to this. Today's statement of the Natural Resources Ministry enables us to say with assurance that these officials work for this very governmental institution."

The licenses may be revoked because of the tax debts accumulated by Yuganskneftegaz including the arrears in payment of the tax on natural resources production (royalty) and the tax for the right to use natural resources. According to experts of the Natural Resources Ministry, non-payment of taxes in the time set by the law can be a sufficient ground for revoking of licenses because such term is included into the license agreements.

The fact of appearance of the tax arrears was mentioned in the appeal of the Federal Tax Service to the Natural Resources Ministry. An official of the Natural Resources Ministry said, "The Federal Tax Service informed us that the debts of Yuganskneftegaz regarding the tax payments, for example, the tax on use of natural resources, amount to 3.5 billion rubles and keeps growing permanently." For example, at the end of August the company had to pay 4.9 billion rubles of royalty but paid only 1.9 billion rubles.

According to Managing Director of Yuganskneftegaz Sergei Kudryashov, company's debt to the budgets of all levels exceeds 4 billion rubles. Overall, taking into account this sum, the company needs to pay 10 billion rubles to the budgets.

Kudryashov explained that decision on suspension of tax payments by subsidiaries was made by YUKOS in late August. This decision was made due to the ruling of the Basmany court that arrested accounts of YUKOS' subsidiaries on August 31.

Meanwhile, the last of the ten days given to YUKOS for appealing against the verdict of the Basmany court ended on September 10. There is no information that the company has used its right to appeal against the verdict.

Stanislav Kleshchev, director of the analytical department of Financial Bridge investment company, comments, "This is very strange. Everyone has already got used that YUKOS uses every pretext; that is why giving up of appealing against this verdict would be an absolute surprise."

The analyst presumed that in reality YUKOS used its right. Kleshchev said, "Information that the letter of YUKOS with an appeal against the verdict of the Basmany court will most likely appear at the beginning of the next week."

On the contrary, Maxim Shein, director of the analytical department of BrokerCreditService investment company said that YUKOS did not appeal against the verdict on arresting of accounts of its subsidiaries. Shein explained, "Why should YUKOS appeal against this verdict whereas it has already opened other accounts for the subsidiaries?"

Shein is convinced that revoking of the license from

Yuganskneftegaz will be a catastrophe for YUKOS. According to the analyst, the unexpected attack of the Natural Resources Ministry on the company has to reduce the value of company's assets with a view of their further sale to the "appointed" Russian buyers.

Shein explains, "Without the natural resources production license Yuganskneftegaz loses the major part of its value. Even a possibility of license revoking from the company has negative impact on company's value."

This means that Russian companies including Surgutneftegaz will be able to claim acquisition of the main subsidiary of YUKOS. Yuganskneftegaz is currently being assessed by the international investment bank Dresdner Kleinwort Wasserstein.

It was expected that the bank would name the price of \$12-16 billion. If the Natural Resources Ministry makes a decision on revoking of licenses before accomplishment of the assessment procedure, which is quite likely, and a discount for loss of licenses is included into the company's price, it will be possible only to dream about such price. Shein presumes that in this case YUKOS will have nothing left but for debts.

Sale of Yuganskneftegaz without the production licenses will not allow earning of enough money to pay off the debts of YUKOS to the state.

Most likely, two other upstream subsidiaries of YUKOS, Samaraneftgaz and Tomskneft, will be the next on the sale list. There are no grounds to doubt that they will be sold according to the same scenario with revoking of licenses. In this case YUKOS not only will lose its licenses but also remains indebted to the state.

Kleshchev from Financial Bridge presumes, "Really, such scheme looks the most likely motive for actions of the Natural Resources Ministry. Without the license Yuganskneftegaz will be sold literally at a price of metal scrap."

The analyst also sees another possible scenario for development of events. Kleshchev explains, "From the standpoint of the state YUKOS is paying off debts too successfully. That is why the state wants to be sure that the company will not succeed."

It is not even necessary to actually revoke the license. As soon as the authorities decide that the sum of YUKOS' debts has decreased dangerously they may suspend the license for natural resources production and may deprive the company of sources of income: While YUKOS is protesting against this verdict new tax bills for 2002 and 2003 will be presented.

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## **THE STATE TAKES OIL WELLS FROM YUKOS TO SELL COMPANY'S ASSETS CHEAPER**

Yuganskneftegaz, the main income source for YUKOS, may lose the right to produce oil. Thus the Natural Resources Ministry is going to punish the company for non-payment of taxes. Without the oil production licenses Yuganskneftegaz will also be much cheaper and it will be easier for bailiffs to sell it to a Russian company, explain analysts.

In May 2004, the Federal Tax Service won the controversy about enforcement of 99.4 billion rubles of tax arrears from YUKOS for 2000. The company has already paid off more than \$2.2 billion of this debt. The Federal Tax Service sent a new tax bill worth 119.9 billion rubles for 2001 and bailiffs already started writing this money off accounts of YUKOS and its subsidiaries. Bailiffs are going to sell Yuganskneftegaz, the main upstream subsidiary of YUKOS, for debts. In 2003, Yuganskneftegaz produced 49.7 million tons of oil (62% of the entire output of YUKOS). In the first six months of 2004, Yuganskneftegaz produced 25.6 million tons of oil.

A source close to the Natural Resources Ministry reported that on September 10 the Federal Tax Service appealed to the Federal Natural Resources Development Supervision Service about non-payment of taxes by Yuganskneftegaz. In its letter the Federal Tax Service spoke about the unpaid tax on natural resources production exceeding 3.5 billion rubles, which kept growing. Rinat Gizatullin, director of the PR service of the Natural Resources Ministry, says, "Our officials preliminarily studied the facts outlined in the letter. Non-payment of taxes is a serious ground for discussion of fulfillment of the license agreement. It is possible that termination of these agreements will be proposed."

A source close to the Natural Resources Ministry considers revoking of the license from Yuganskneftegaz very likely. Representatives of YUKOS are convinced that the ministry wants bankruptcy of the company. Director of the PR service of YUKOS Alexander Shadrin states, "President Vladimir Putin requested naming of state officials who wanted bankruptcy of YUKOS. The present statement of the Natural Resources Ministry enables us to say definitely that these officials work for this very governmental institution." Another source in YUKOS remarks that the government definitely knows that YUKOS has suspended tax payments to the regional budget not voluntarily but due to arrest of 76 billion rubles on accounts of YUKOS' subsidiaries imposed on September 1 according to demand of the General Prosecutor's Office. The source is indignant, "The state officials understand what will happen if operations of a company with annual production of about 50 million tons of oil are suspended, do they not!"

However, state officials do not see such threat. A source close to the Natural Resources Ministry is convinced

that there will be no need to mothball the wells at the fields of Yuganskneftegaz. Most likely, provisional license for these fields will be issued to Yuganskneftegaz or another oil company until announcement of a new tender.

Still, Senior Vice President of YUKOS Alexander Temerko hopes that Yuganskneftegaz will retain the licenses. Temerko explains, "We do not wish bankruptcy and hope for assistance of the state. The company making \$20 billion a year can solve the problem without giving away of its key assets. It is possible to fund the money for return of the debt at our own expense, compensation of the value-added tax, proceeds from the reverse deal with Sibneft and sale of non-core and unimportant assets. We also hope to persuade the major shareholders of the company to give up a part of their shares in the framework of repayment of the remaining part of the debt."

Analysts do not share his optimism and are convinced that the government needs to revoke licenses from Yuganskneftegaz to lower the company's price before the sale. Steven Dashevsky from Aton explains, "Very few companies have \$12-14 billion for acquisition of Yuganskneftegaz now. For example, it is possible to sell the licenses at a tender with investment terms and Yuganskneftegaz proper with infrastructure may cost \$1-2 billion." Analyst Oleg Maximov of Troika Dialog agrees that revoking of the license may be caused by the wish of the state to reduce the price of Yuganskneftegaz.

This price may be announced already this week because Dresdner Kleinwort Wasserstein has nearly completed assessment of Yuganskneftegaz, reports a source close to YUKOS. Bob Foresman, director of the investment banking division of Dresdner Kleinwort Wasserstein in Russia, does not name the date for approval of the estimate but states that "the work is going on very intensively."

Despite the bad news, on September 10 YUKOS' shares were the leaders of growth and on MICEX their prices grew by more than 9%.

Steven Dashevsky explains this by the information about achievement of an agreement between YUKOS and Sibneft. Alexander Temerko states that YUKOS really hopes to come to agreement with Sibneft on a reverse deal in the near future. Temerko is convinced that Sibneft will fulfill its obligations and YUKOS will receive \$3 billion fully.

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## **YUKOS TO BE SOLD AT AUCTION**

Federal authorities confirmed inevitability of sale of Yuganskneftegaz, the main upstream subsidiary of YUKOS,

for debts at an auction. Finance Minister Alexei Kudrin said in his interview to The Financial Times that "the state will

do its best to ensure striking of the deal in accordance with the law, absolutely transparently and in accordance with the marketing principles." In any case, even if Russian laws are understood literally, they are not always competitive with the marketing principles. Thus, according to representatives of the Federal Agency for Management of Federal Property, the law allows sale of Yuganskneftegaz at a closed auction with a limited circle of participants or directly to the candidate that is the first to submit the bid. Experts say that the most likely candidates for acquisition of Yuganskneftegaz are Surgutneftegaz, Gazprom and Rosneft.

Kudrin does not say which assets are interesting for

the state but judging by the fact that Dresdner Kleinwort Wasserstein is finishing pre-sale assessment of Yuganskneftegaz according to the order of the Russian government it is possible to say that this will be Yuganskneftegaz.

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## **GAZPROM TAKES OVER ROSNEFT**

Gazprom and Rosneft will merge into one company. This will open the path to liberalization of the market of Gazprom shares and will further increase influence of Putin's team in the fuel and energy sector. From its parents the company controlling one-fourth of Russia's oil production will inherit inefficient management.

At the meeting of Vladimir Putin with Prime Minister Mikhail Fradkov on September 14 it was announced that in the framework of preparation for liberalization of the market of Gazprom shares a part of Gazprom shares would be exchanged for assets of Rosneft. According to the Prime Minister, this action will enable the state to retain control over the company even after the liberalization.

Vladimir Putin approved the liberalization and the measures for its achievement, "I am convinced that double regulation of the market of Gazprom shares should be stopped and the sooner this is done and the more marketing are the tools, the better." With regard to the actual takeover of Rosneft by Gazprom Putin says that such decision "is in the competence of the government and if the government thinks that this is expedient let it do this."

CEO of Gazprom Alexei Miller comments, "The decisions that are made today are aimed at liquidation of quotation for foreigners and creation of a common market."

Consolidated financial statements of the companies for 2003 prepared by Gazprom according to US GAAP and by Rosneft according to international accounting standards gives an approximate idea of the main parameters of the new company:

- assets - \$102.11 trillion;
- liabilities (both short-term and long-term ones) - \$35.578 billion;
- equity - \$66.532 billion;
- revenue - \$31.908 billion;
- net profit - \$5.869 billion.

This is a rare case when positions of the CEO of Gazprom and minority shareholders of the company coincide. Vadim Kleiner, corporate research director of Hermitage Capital Management, says "this is one of the

turning points for the market of Gazprom shares. The main obstacle for its further development is eliminated."

Leading oil and gas analyst of Finam investment company Maria Radina comments, "Rumors about the upcoming merger of Gazprom and Rosneft have been circulating on the market for a long time. The next step will obviously be consolidation of oil assets of both state-run companies under the aegis of newly established Gazpromneft."

Both parties will benefit from the merger deal. Rosneft, the net debt of which amounts to about \$2 billion, will receive access to new reserves and a possibility to strengthen financial condition. At present, Rosneft produces about 20 million tons of oil a year and production of the united company will exceed this level at least by 50%. According to the CEO of Gazprom, in the future oil production will reach 45 million tons. For Gazprom the merger with Rosneft opens the path to the long-awaited liberalization of the market of the company's shares.

On September 14, Miller said that Gazprom will pay 10.7% of its shares for 100% of Rosneft shares. According to Miller, as a result of the deal the share of the state in the corporation will grow to 50% plus one share. Along with this, in exchange for shares of Gazprom being on the balance of its subsidiaries the state will contribute all 100% of Rosneft shares.

According to Stanislav Kleshchev, director of the analytical department of Financial Bridge investment company, 17% of Gazprom shares being on the balance of its subsidiaries will be exchanged for shares of Rosneft. Thus the state will receive controlling interest in Gazprom through addition of the aforementioned 17% to 38% of Gazprom shares already belonging to the state.

Control over Rosneft will not be lost, either. Although the state will formally lose its share in the oil company, it will still control it through Gazprom.

Says Kleshchev, "Henceforth the domestic and foreign markets of Gazprom shares will be united." After the merger attractiveness of Gazprom for foreign investors will grow. With regard to uniting of the markets the expert expects that domestic and foreign prices of Gazprom shares "will meet each other halfway." The potential for

growth of the domestic price is bigger than the potential for decrease of the foreign price. Now company's shares cost \$2.20 on the domestic market and \$3.20 on the foreign one. Kleshchev predicts that the prices "will meet" at a level of approximately \$3. Dynamics of quotations after the announcement of the upcoming deal confirms this forecast: on the domestic market Gazprom shares grew by 8% and on the foreign market they fell only by 2%.

Maria Radina from Finam says that the state has not only economic interest in the deal for merger of Gazprom and Rosneft. She adds, "Deliberate changing of the structure of the industry is underway. Further the oil and gas sector will obviously develop according to the quasi Middle Eastern scenario. Private producers will remain but the strategy will be determined by the powerful state-run company." Hence, experts say that it is quite likely that Gazpromneft will acquire assets of YUKOS, primarily Yuganskneftegaz. In this case the new company will control one-fourth of Russia's oil production.

Radina notes, "Conversations about strengthening of the oil and gas vertical have been going on for a long time. This is just another matter how efficient will be the new structure." Neither Gazprom nor Rosneft can boast a high management quality. The latest appointments in the management of the companies like appointment of Igor Sechin on the post of the Chair of the Board of Directors of Rosneft can hardly change anything. Radina states, "These appointments were purely political. I am afraid that we will not see any dramatic changes in the management even

after the merger."

Analyst Konstantin Gulyaev of Region investment group says, "There are big questions regarding the efficiency of the united structure being formed from Gazprom and Rosneft. I am absolutely sure that Gazprom will have problems with over-crediting of Rosneft." According to the analyst, for Gazprom the debt problem is on one of the most important places.

Gulyaev adds, "The process of the merger will take six to twelve months. During this period it is not worth even dreaming about any deliberate restructuring and separation of non-core assets." This means that at least for a year Gazprom will remain a loose conglomerate of most diverse assets, both the core and non-core ones.

Gulyaev is afraid that situation that already exists in the gas industry will be repeated in the oil industry. He explains, "There is a very high risk that Gazpromneft uniting the lobbyist potentials of Gazprom and Rosneft will promote its own projects at expense of the interests of private oil companies." The process of increase of the state presence in the oil industry most likely will not stop at creation of Gazpromneft.

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## **PRIVATIZATION OF ROSNEFT TURNED INTO NATIONALIZATION OF GAZPROM**

For the sake of growth in capitalization of Gazprom the state decided to sacrifice the state-run oil company. Rosneft will go to the gas monopoly in exchange for its shares. President Putin approved such plan on September 14. The government and Gazprom hope to close the deal until the end of the year. The next step will be uniting of the domestic and foreign markets of Gazprom shares. This prospect already caused a dramatic growth in the gas monopoly's capitalization.

The state owns 38.37% of Gazprom shares directly and 0.9% belongs to state-run company Rosgazifikatsiya. According to Gazprom, its subsidiaries have 16.2% and foreign shareholders have 11.5% (including 4.58% belonging to Gazprom Finance BV). In 2003, net profit of Gazprom according to IAS amounted to 159.1 billion rubles and revenue amounted to 819.7 billion rubles. In 2003, Gazprom produced 540.2 billion cubic meters of gas and 11 million tons of oil and gas condensate. In 2003, Rosneft produced 19.6 million tons of oil and 7 billion cubic meters of gas. Revenue of the company according to US GAAP amounted to \$3.6 billion and net profit amounted to \$386 million.

On September 14, President Vladimir Putin approved proposals of the government aimed at acceleration of liberalization of the market of Gazprom shares. At first, the

state will exchange shares of Rosneft for shares of Gazprom controlled by the gas monopoly. Direct control over Gazprom will enable the state to abolish all barriers for the foreigners willing to become company's shareholders without any apprehensions.

Prime Minister Mikhail Fradkov said, "We have speaking about the need for form state-owned controlling interest in Gazprom for a long time. Gazprom will be transformed into a transparent structure and will unite oil and gas assets to increase competitiveness on the international market."

This news caused quotations of Gazprom soar by 15%. Moreover so that CEO of Gazprom Alexei Miller immediately announced that Rosneft would become a subsidiary of Gazprom. Miller said, "Gazprom would become the largest oil and gas company of the world. We will reach production of 40-50 million tons of oil a year."

Miller states that for all 100% of Rosneft shares Gazprom will give 10.73% of its own shares to the state. This very quantity of shares is needed for state control over Gazprom taking into account the stake of Rosgazifikatsiya. Although banks will be hired for independent assessment of Rosneft, Miller considers the value of Rosneft and this stake in Gazprom comparable.

The CEO of Gazprom said that incumbent President of

Rosneft Sergei Bogdanchikov was proposed to become the head of Gazpromneft company, which would unite the oil assets of Gazprom and Rosneft.

On September 14, 10.73% of Gazprom shares cost more than \$4.6 billion. According to representatives of Rosneft, the entire oil company costs \$6 billion. Pavel Kushnir from UFG estimates it at \$4-5 billion. According to Maxim Moshkov from Brunswick UBS, Rosneft costs not more than \$4.9 billion, whereas the average capitalization of 10.7% of Gazprom shares is \$5.2 billion. Moshkov presumes, "If prices of Gazprom shares keep growing, the value of the stake may exceed the price of Rosneft significantly."

"If this happens, the state has some other energy assets that will allow provision of parity for the deal," says Miller. The analyst states that Yuganskneftegaz may be the most suitable asset of the assets being currently prepared for sale. At any rate, Miller states that Gazpromneft does not even consider a possibility to take part in the tenders for sale of oil assets of YUKOS.

If the quotas for ownership of Gazprom shares for foreigners are really abolished, the map of the Russian stock market will change radically. To date shares of Gazprom were not taken into account during calculation of Russian stock indexes because the shares were placed in non-marketing conditions. They were often neglected in calculation of Western indexes for emerging markets or for Russian market separately. According to analyst Ronald Smith of Renaissance Capital, the weight of Gazprom shares in such indexed amounted only to about 3%,

whereas the real weight of the company after inclusion of Rosneft would amount to about 30% of the entire Russian stock market. Smith expects that after liberalization the volume of securities of Russian issuers in free float will grow significantly on account of Gazprom shares. This will increase liquidity of the market and will result in revision of all existing stock indexes.

Acquisition of Rosneft will change the situation on the oil market very little. According to analysts, as a result of the deal Gazprom will increase its reserves by approximately 3-5%. Having ceased being a purely gas company Gazprom will not enter even the top five of largest oil producers. At first, after the merger of assets with Rosneft the company will produce not more than 25 million tons of oil a year. Probably in five years the company will be able to increase production to 45 million tons of oil a year but other oil companies will grow too. Although now it is already obvious that Gazprom and Surgutneftegaz will become the main players in Eastern Siberia, this does not change anything and influence of the state will remain on the same level, says analyst of Sovlink Lev Snykov.

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## **MERGER WITH ROSNEFT THREATENS GAZPROM WITH EXPENDITURES AND RISKS**

Takeover of Rosneft will not be as easy as it is posed by the management of Gazprom. Among the problems waiting for the corporation, experts and state officials mention a huge tax on profit from sale of shares, potential threat of default on the part of creditors of Rosneft and possible claims of minority shareholders of its subsidiaries.

In 2003, net profit of Gazprom according to IAS amounted to 159.1 billion rubles and revenue amounted to 819.7 billion rubles. In 2003, the gas monopoly produced 540.2 billion cubic meters of gas and 11 million tons of oil and gas condensate. In 2003, Rosneft produced 19.6 million tons of oil and 7 billion cubic meters of gas. Its revenue according to US GAAP amounted to \$3.6 billion; net profit amounted to \$386 million. Its current debt amounts to \$2.4 billion. At the end of 2003, Rosneft owned 83.1% in Purneftegaz, 63.3% in Sakhalinmorneftegaz, 51.1% in Krasnodarneftegaz and 72% in Stavropolneftegaz.

The Board of Directors of Gazprom will discuss the main details of takeover of Rosneft at the nearest meeting on September 28. The working group for organization of the second stage of Gazprom's reforming is instructed to prepare a detailed plan of the deal in two weeks. CEO of Gazprom Alexei Miller hopes to close the deal by the beginning of 2005. However, experts and state officials

say that the deal may not be as smooth as the management of Gazprom would like it to be.

First, says lawyer of Gide Loyrette Nouel Victor Topadze, in case of sale of its own shares, no matter what is paid for them, Gazprom will definitely have to pay a big tax on profit. A source close to the deal reports, "When takeover of Rosneft was discussed, tax schemes were not studied seriously. Afterwards it turned out that the tax might amount to about \$1 billion. The major part of the shares being on the balance of Gazprom's subsidiaries has been bought two or three years ago and has cost 33.4-50% cheaper. Theoretically, the tax on profit is already included into this difference but the company is seeking a possibility to minimize it."

According to another source close to the working group of Gazprom, as an option lawyers of Gazprom are studying a scheme in which subsidiaries of Gazprom will invest shares of the gas monopoly at a market price in their own subsidiaries and these new subsidiaries will in turn exchange these shares with the state.

Managing partner of Timothy's Yevgeny Timofeev agrees, "Then it is possible to avoid the tax on profit. But problems appear with reassigning of Rosneft shares from these companies to Gazprom. From the standpoint of civil right there is a risk that such operation may be recognized



as a gift, which allows invalidation of the deal."

Gazprom may also have equally serious problems when it places Rosneft shares on its own balance. According to Anatoly Yushin, director of the legal company A.S.T., for the state this is a deal with interest and the state should participate in voting about this deal. It will depend on parameters of the deal if minority shareholders of Gazprom support it.

Analyst Maxim Moshkov of Brunswick UBS remarks that the merging companies have different level of debts on credits. At the end of 2003, the ratio of the debt to capital of Rosneft amounted to 54.4% and for Gazprom it amounted to 21.5%.

A source close to one of the creditor banks of Rosneft explains that theoretically the creditors may demand early return of credits in case of force majeure circumstances to which actions of the authorities belong. An expert of Gazprom is convinced that most likely this will not happen because "the market takes Gazprom as a serious

borrower."

Minority shareholders of Rosneft's subsidiaries may also create additional problems for the deal, says an official of a federal ministry. For example, they may protest against the assessment of Rosneft necessary for reassigning of its shares to Gazprom. Analyst of UFG Pavel Kushnir believes that it is not necessary to be afraid of minority shareholders of Rosneft's subsidiaries in such scheme of the deal.

"I do not think that it is principally important for Gazprom to consolidate 100% in each subsidiary of Rosneft," concludes Kushnir.

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## **THE STATE "NATIONALIZED" THE GAS MONOPOLY**

On September 14 the government struck the deal of the year. It decided to give state-run company Rosneft to Gazprom, in which it controlled not more than 40%. In exchange the state will receive shares of the gas corporation increasing its share in it to controlling interest. Afterwards the state will lift all limitations on trade in remaining shares on the free market. Capitalization of Gazprom already grew after the announcement. Prices of its shares grew by 15% and reached a historic maximum. In any case, participants of the deal do not rule out that Gazprom can resell Rosneft later having actually privatized it.

Two persons made the event of the year. The first is Prime Minister Mikhail Fradkov notorious for his rejection of reforms of natural monopolies including Gazprom. The second is President Vladimir Putin who has supported Fradkov's opponents and demanded reforms. As a result, on September 15 Fradkov brought a plan for liberalization of Gazprom's shares to Putin personally. The President supported this plan.

The idea of the plan is very simple. The state exchanges assets of its own oil company Rosneft for shares of the gas company Gazprom and thus receives controlling interest in the company. After that the state allows foreigners to buy the remaining shares of the gas corporation on the domestic market. One of the state officials who struck "the deal of the year" commented on political importance of the entire combination, "Yeltsin lost Gazprom and Putin regained it."

Vadim Kleiner, corporate research director of Hermitage Capital Management, said, "The most important event of the whole year took place on the market. The government finally liquidated the main systematic contradiction having launched a mechanism for liberalization of Gazprom shares." Now the state controls about 39% of the gas company's shares. Circulation of

other shares on the market is limited because the authorities have been afraid that there will be someone who manages to consolidate a larger stake and to receive access to the national gas heritage. The state was afraid of foreigners most of all. As a result, shares of Gazprom were traded at different prices at different markets: cheaper in Russia and more expensive abroad. Many honest foreign investors started simply avoiding shares of Gazprom being afraid of losing of a part of money in case of uniting of the markets. Their place was filled with the lovers of risks who bought shares on the domestic market through Russian intermediaries. It was even impossible to find an analyst who could responsibly determine the real share of Gazprom's capital belonging to foreigners.

Already in 2001, the government announced its intention to abolish limitations on circulation of Gazprom shares. For this purpose it organized a special commission, many persons released loud statements but there was no liberalization. The market finally even stopped taking them seriously. At the end of 2003, Vladimir Putin provided personal guarantees of restoration of justice at a meeting with representatives of investment companies and the market believed him. It was clear to everyone from the very start that the state would not allow liberalization until it legalizes its control over controlling interest. In any case, the state was not going to pay cash for the shares too because it did not include the relevant allocations into the budget. Says Kleiner, "There were not less than five various plans for exchange of Gazprom shares for other assets." Among them there was also the scenario for reassigning of Rosneft. Financial analysts recognized it as the most likely option. Hence, the yesterday's statement was not a surprise for those who were watching the market of Gazprom shares attentively.

The main question now is what Gazprom will do to its new acquisition. Independent director of Gazprom Boris

Fedorov does not rule out sale of the oil assets of the company in the future. If this is true, it is possible to take the initiative of the government as "soft" privatization of Rosneft. So far, this scenario does not look quite credible. In the last few years, Gazprom was gradually increasing oil production and this spring it even announced the intention to establish its own oil company Gazpromneft. At present, oil production of the gas monopoly (11 million tons a year) is quite comparable to production of Rosneft. On September 15, CEO of Gazprom Alexei Miller announced, "Due to the fact that Rosneft actually becomes a subsidiary of the gas corporation, the overall production of liquid hydrocarbons will grow to 45 million tons." After that it was announced that former head of Rosneft Sergei Bogdanchikov would become the head of Gazpromneft.

Elena Anankina, analyst of the Moscow office of Standard & Poor's, comments, "Yesterday's statements have once again shown to us that policy of the Russian government in the energy sector is difficult to predict and

political factors have an excessively big weight."

Not all analysts are inclined to expect a general growth of the Russian stock market due to the news about Gazprom. Asset manager Alexander Baranov of managing company Prospect stated, "If money is spent on purchase of Gazprom shares this means that some assets will be sold." Baranov does not rule out that investors will simply sell shares of Surgutneftegaz and LUKoil to invest money in renovated Gazprom. Baranov concludes, "There has been no new money on the stock market and this year we see capital outflow."

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## **CENTRAL BANK AND TREASURY**

### **CENTRAL BANK CREDITED COMMERCIAL BANKS WITH A RECORD SUM**

Striving for restoration of the inter-bank credit market, in August 2004 the Central Bank allocated 156 billion rubles to commercial banks thus breaking a record. Meanwhile, the major part of this money remains in the largest banks that do not hurry to credit their small colleagues.

The inter-bank credit market that has shrunk because of the crisis does not recover quickly. The Central Bank has to take measures for financial support of banks. Direct repurchase operations (short-term purchase of state securities by the Central Bank under condition of their obligatory repurchase by banks) became the main tool. A record turnover of such deals, 155.8 billion rubles, was registered in August. This is almost twice as much as in July and almost 50% of the turnover of repurchase deals in entire 2003.

According to the Central Bank, such policy bore fruit. Thus, the Central Bank managed to limit the growth of interest rates on inter-bank credits and avoid problems with "planned payments."

Bankers agreed that efforts of the Central Bank were efficient. There are no problems with payments and interest rates on inter-bank credits are adequate to other tools of the financial market, says Deputy CEO of Probiznesbank Sergei Kozlov. Deputy CEO of ORGRESBANK Alexei Volkov agrees that a 100% growth of repurchase operations turnover indicates the deficit of liquidity that the Central Bank has helped the banks to overcome.

President of the Moscow International Currency Association Alexei Mamontov stresses that only first-class

banks (Russia's largest banks and subsidiaries of foreign banks) can borrow money from the Central Bank and tension in other segments of the inter-bank market remains.

It is impossible to say that first-class banks have started crediting smaller colleagues more actively. Their limits are still rather stringent and there is no significant increase in them, says Kozlov. He explains growth in the turnover of deals with the Central Bank by the fact that some large banks have accepted credit portfolios or real estate objects of small banks as collateral. Along with this, large banks wanted additional guarantees and borrowed more money from the Central bank than they actually needed.

The largest banks attracted resources from the Central Bank for their own needs, confirmed Victor Zhidkov, director of the financial markets department of MDM-bank. He explains, "The main taxpayers buy their services, many large banks credit other banks under collateral of blue chips and have to maintain liquidity."

According to Mamontov, only about 15% of turnover of repurchase operations of the Central Bank with large banks go to their smaller colleagues. Kozlov warns, "I do not think that the situation will change seriously in the next few months. The market will recover gradually. Nobody hurries to undertake additional risks yet."

Nonetheless, activeness of small banks grows. According to Mamontov, in August turnover of operations grew by 15% and in September it grew already by 30%. He adds, "Banks open limits not because they have received liquidity but because they need to work. The most

important thing is that there have been no scandalous precedents on the part of the authorities."

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## CURRENCY

### RUSSIANS BREAK A RECORD IN PURCHASE OF FOREIGN CURRENCY

The recent crisis of confidence on the inter-bank market resulted in a situation when frightened depositors nearly rewritten the book of records of the market of foreign currency cash. Parameters of the foreign currency cash market in July 2004 published by the Central Bank showed that population had never bought so much currency before in a single month and demand for foreign currency was not as high.

The currency market grew hot in June. Then, according to the Central Bank, population bought and withdrew from foreign currency accounts \$5.5 billion or 40% more than a year before and 70% more than in June 2002. Representatives of the Central Bank explained this growth by the seasonal factor and "nervousness of the population conditioned by the situation in the banking sector." The "situation" represented a crisis of confidence of banks in each other.

This crisis reached an apogee at the beginning of July, when Gута-bank stopped operations and queues of depositors appeared near the branches of Alfa-bank. Many depositors lost the nerves and they rushed to withdraw the money. Along with this, a part of the money withdrawn from the ruble accounts was converted into foreign currency. According to the Central Bank, in July banks sold to the population and paid from accounts a record sum of \$6.9 billion. Currency exchange operations accounted for \$3.7 billion of this sum. Russians have never bought so much foreign currency before, at least since 2000 when the Central bank started publication of such data. As to the significant withdrawal of money from deposits, it already happened before. For example, in April 2004 people withdrew \$3.3 billion from the foreign currency accounts.

Net demand of the population for foreign currency (difference between the purchased foreign currency and foreign currency withdrawn from accounts and sold foreign currency and foreign currency laid on deposits) almost broke a record. According to the Central Bank, in July it amounted to \$3.1 billion or was twice as much as in June and slightly less than the record values of July 1996 and 1997. To meet this demand banks had to double import of bank notes and to import foreign currency cash worth \$3.4 billion in July. As a result, difference between import and export of foreign currency cash (\$3.3 billion) was the maximal since the end of 1997.

The foreign currency market review published on

September 9 on the website of the Central Bank says, "In July 2004, there was a peak of activeness of the population in purchase of foreign currency cash." The authors of the review explain the growth in demand by the "seasonal factor, namely growth in the number of tourist trips abroad and discussion of liquidity problems of some Moscow-based banks by mass media." According to the authors of the review, the season of vacations encouraged conversion into foreign currency of "significant quantities of rubles withdrawn by the residents from their accounts" and publications of mass media caused withdrawal of foreign currency from deposits.

In any case, bankers have a different opinion. Deputy Director of the financial markets department of MDM-bank Vasily Zablotsky comments, "Those who withdrew rubles from banks bought foreign currency too." Senior Vice President of BIN-bank Oleg Kharitonov estimates the share of tourists among the buyers of foreign currency at not more than 25%.

Tourist operators confirm the conclusions of financiers. Mikhail Lapshin, General Director of the tourist company Turinfo RFR complains, "The high season of 2004 was a flop." According to Lapshin, "There have been no such bad July and August even in post-crisis 1999." According to Lapshin, one of the main reasons for the flop was the banking crisis. He explains, "People who have savings can afford traveling. Having learned about the problems of banks everyone recalled 1998, hurried to withdraw money from deposits but did not spend it."

At any rate, according to bankers, the peak of foreign currency purchase occurred in the few crisis days in early July and afterwards panic was settled down very quickly. Zablotsky said that everything was settled down in two or three days. Kharitonov said, "There were literally two peak days when information about the problems of Alfa-bank appeared."

In any case, Kharitonov warns that "It is impossible to stop the switched on mechanism at once." That is why he does not rule out that statistical data of the Central Bank for August may also show a significant outflow of money from the private foreign currency accounts. This conclusion is confirmed by preliminary estimates of the net demand of the population for foreign currency in August by the Central Bank; that is \$1.9-2.2 billion. Kharitonov explains, "Confidence in banks is undermined and,

although there is no outflow of deposits, very few depositors risk prolonging deposits now." Whereas, according to him, up to 70-80% of the money placed on deposits formerly remained in banks for a new period after expiry of the deposit term, by now this share fell to not more than 50%. Vadim Maslennikov, director of the currency exchange operations department of Bank of Moscow, says that currency exchange offices are also very busy.

Zablotsky is more optimistic. According to him, the

depositors who took their money from private banks brought it to Sberbank and Vneshtorgbank or returned them to banks very soon.

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## **CORPORATE PROFILES AND REPORTS**

### **FOREIGNERS MAY PARTICIPATE IN PRIVATIZATION OF MAGNITOGORSK METAL WORKS**

On the eve of sale of the state-owned 17.8% stake, Magnitogorsk metal works (MMK) demonstrates growth of its investment attractiveness and receives foreign investors.

Former New York Mayor Rudolph Giuliani visited Magnitogorsk at the beginning of the last week. Now he is the head of Giuliani Partners consultancy. Giuliani brought an entire delegation of representatives of investment companies "to establish contacts between the Russian and American business." Visit of the American guests including the meeting with MMK management and presentation of the company coincided with publication of some results of MMK according to international accounting standards for the first half of 2004. Representatives of MMK reported about a 71% growth of net consolidated profit in comparison to the same period of 2003 to \$524 million, revenue growth by 47% to \$2.166 billion and EBITDA growth by 53%.

Analysts were not surprised by such results. Vyacheslav Smolyaninov from UralSib comments, "Financial statements according to international standards have little differences from the statements according to Russian standards, in accordance with which revenue of MMK amounted to \$2.07 billion and net profit amounted to \$522 million." Experts agreed that such significant growth in parameters was achieved primarily due to growth in metal prices (since the beginning of the year, steel prices in Russia grew by 55% and in Eastern Europe they grew by approximately 65%) and not due to actions of the management. In any case, according to Timur Pestov from Aton investment company, interim financial statements are not illustrative because the main expenditures occur at the end of the year. He says, "Whereas, for example, in the first half of 2002 administrative costs of MMK amounted to \$71 million, by the end of the year this figure reached \$231 million. The figures presented by MMK are also insufficient for analysis."

It was obvious that MMK published its results simultaneously with the visit of investors deliberately.

Representatives of MMK explain that meeting with investors is one of the steps on the path towards strategic goal of the company, namely entrance to the American stock market. According to MMK, Giuliani was pleasantly surprised both by the performance of the company and by the scale of production. The PR service of MMK quotes Giuliani as saying, "The metallurgical complex astonished me. I did not expect that it would have such huge size. It is impossible to say that this is one plant, these are many-many plants on a gigantic territory. I believe that the products that are produced there would be sufficient not for one but for several countries."

Interest of foreign investors, which MMK managers encourage, appeared on the eve of sale of the state-owned stake in MMK. On September 8, when Giuliani and his American colleagues visited MMK, Deputy Economic Development and Trade Minister Andrei Sharonov reported that his ministry received proposals regarding the form and date of MMK shares sale from the Federal Agency for Management of Federal Property. It is planned that the auction will be held in December 2004 or January 2005. The Economic Development and Trade Ministry promised to include the company not listed in the privatization plans for 2004 and 2005 into the list of additional proposals to be submitted to the government by October 1.

Since 2001, the government was postponing privatization of MMK probably waiting for a better time. Year 2004 was a record year for metallurgical companies. Vyacheslav Zhabin from BCS investment company presumes, "probably the government was afraid, in my opinion quite justly, that current prices would not be as high in 2005, due to which appeared such haste." Sergei Suverov from Zenit bank adds that ferrous metallurgy is a cyclic sector and rise is always followed by decline.

This time the government did not name the price. In July, director of a department of the Economic Development and Trade Ministry Igor Grechukhin said that the state budget would receive 8 billion rubles (about \$275.8 million) from sale of the state-owned stake in

MMK. The market where MMK shares appeared in February literally for a few days (according to one of the versions, anonymous brokers included MMK shares into the quoting list of RTS Board in the interests of state officials) estimated the state-owned stake at \$600 million. Estimates of experts reach \$1 billion.

Theoretically, growth of financial results of MMK increases the price of the stake, which is not beneficial for potential buyers, the first of them on the list being company's managers. The management controls 58% of company's ordinary shares. At any rate, practically all large Russian players including MMK shareholder Mechel, UMMC, EvrazHolding, Novolipetsk metal works and Severstal demonstrated their interest in the auction. Although General Director of MMK Victor Rashnikov was going to accumulate approximately \$1 billion for the auction, he complained that the sum named by state officials and experts was overvalued and the just price was \$180-250 million. Timur Pestov from Aton explains, "High results are beneficial for the management of MMK if it is

going to come to agreement on drawing of a large credit, which will be just on time on the eve of sale of the state-owned stake." Pestov adds that sometimes companies even exaggerate their results to obtain better crediting terms. Increase of investment attractiveness is also beneficial in the light of the visit of American investors. According to Suverov, this visit is not incidental. The expert presumes, "Americans have probably discussed metal supplies but we cannot rule out that they are interested in the upcoming privatization. Bearing in mind high steel prices in the US American investors can invest in Russian steel assets."

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## **NET PROFIT OF NORILSK NICKEL UP 320%**

Norilsk Nickel issued interim financial statements for the first quarter of 2004 in accordance with international standards. In the first quarter of 2004, the company's metal sales revenues increased by 40% against the first quarter of 2003 and totaled \$1.583 billion. The main reasons for revenue growth were the growth of the average quarterly realized prices of produced metals and the consolidation of financial results of Stillwater in the financial statements for the first quarter of 2004; in the first quarter of 2003 financial results of Stillwater were not consolidated.

In the first quarter of 2004, total cost of metal sales increased by 1.5% and amounted to \$693 million, while cash operating cost decreased by 2.8% to \$557 million in the first quarter of 2004 from \$573 million in the first quarter of 2003.

Amortization and depreciation of operating assets increased by \$5 million to \$102 million in the first quarter of 2004 as a result of recording new production assets on the company's balance sheet and consolidation of Stillwater's production assets.

Net profit for the first quarter of 2004 amounted to

\$460 million - a 322% growth against the first quarter of 2003.

In the first quarter of 2004, property, plant and equipment increased by \$116 million primarily due to the implementation of a capital investment program.

Acquisition of a 20% equity stake in Gold Fields Ltd at the end of the first quarter 2004 resulted in increase in the company's other non-current assets. Also as the actual payment for the shares was made only in the second quarter of 2004, in the first quarter of 2004 we reflected our liability to pay \$1.235 million as a consideration for shares as other current liabilities.

In the first quarter of 2004, operating cash flow grew to \$895 million as a result of a significant growth of metal sales.

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## **PROFIT OF TNK-BP UP 45%**

Chief Financial Director of TNK-BP reported that in the first half of 2004 net profit of the company grew by 45% from the first half of 2003 and amounted to \$1.73 billion. EBITDA of the company amounted to \$2.78 billion. The company reduced the net debt to \$691 million from \$1.86 billion in the first half of 2003.

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## **MENATEP-SPB BANK TO BE RENAMED INTO TRUST**

MENATEP-SPb, which has changed hands, will change its name soon too. In a month, shareholders of the bank will vote for its renaming into national bank Trust. Officially this decision is explained by the wish to indicate affiliation of the bank with investment bank Trust. Market players explain the re-branding by the wish of MENATEP-SPb to be distanced from persecuted Group MENATEP or by possible merger of both Trust banks. Representatives of MENATEP-SPb deny both versions.

MENATEP-SPb was established in 1995 and has 57 regional branches. According to Interfax economic analysis center, as of July 1, 2004, assets of the bank amounted to 27.8 billion rubles (the 27th place), equity amounted to 3.5 billion rubles (the 36th place) and private deposits amounted to 5.2 billion rubles (the 23rd place). In 2003, owners of Group MENATEP started consolidation of their financial assets on the basis of IFO MENATEP and by the end of the year IFO MENATEP had almost 100% of MENATEP-SPb shares and about 70% of shares in Trust investment bank (other 30% belonged to the bank's management). Later, almost all owners of Group MENATEP became accused in the framework of the "YUKOS affair." In May 2004, the managerial team of the banks headed by Chair of the Board of Directors Ilya Yurov bought out controlling stakes in MENATEP-SPb and Trust.

Soon after the deal for buyout of controlling stakes in MENATEP-SPb and Trust Yurov announced, "We will start building a new reputation connected already exclusively with our ability to do business and to earn money without relying on something."

First of all, the new owners decided to rename MENATEP-SPb, the name of which was associated both with the bank that went broke during the crisis in August 1998 and with the group of the major shareholders of YUKOS headed by Mikhail Khodorkovsky. According to official reports of MENATEP-SPb, on October 11 its shareholders plan to approve the new name, national bank Trust. The new name will probably indicate a new development strategy and new opportunities of the bank, presumes analyst Irina Penkina of Standard & Poor's. Ivan Chimburov, Chief Creative Director of the advertising agency RAVI, comments, "It was definitely necessary to leave the old name." Chimburov adds that the word "MENATEP" is rather abusive now and may cause apprehensions. Xenia Telyakovskaya, General Director of advertising agency Barkstel specializing in branding, adds

that confidence is the most important thing in the banking sector and that is why the name of the bank should not generate negative associations. However, a banker willing to remain anonymous comments that changing of the name for Trust, when the investment bank bearing the same name is strongly associated with Group MENATEP and YUKOS too, makes sense only in case of the upcoming merger of both banks. "I see no other logic," concludes the source.

Nikolai Fetisov, member of the boards of directors of MENATEP-SPb and investment bank Trust states that such possibility is not discussed even for the medium term. After changing of owners a new business strategy of MENATEP-SPb is being worked out. This strategy will be supported by the new brand, new marketing and advertising strategies, explains Fetisov. According to him, the new name "stresses connection with successful investment bank Trust having strong market positions and reputation" and the word "national" points at the broad branch network of MENATEP-SPb.

Fetisov abstained from more detailed comments saying that national bank Trust was only a working name that should be approved by shareholders of MENATEP-SPb and Central Bank.

Penkina from Standard & Poor's says that to emphasize belonging of several structures to one group a similar component is often used in the names. But when banks have fundamentally different clients re-branding will be successful only if attention is focused on the adjectives in the names of the banks, namely "investment" and "national" and then there will be no confusion, remarks CEO of MDM-bank Andrei Savelyev. Investment bank Trust has a strong image and its brand is better known than the brand of MENATEP-SPb, says Savelyev. Sergei Lobanov, director of the PR department of UralSib bank, which has recently changed its name from Bashcreditbank, says that use of the word "national" adds a kind of statehood tint to the brand, which "will be positively taken by the target audience of the bank."

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## **MECHEL IS PERMITTED TO ISSUE ADRS**

The Federal Service of Financial Markets permitted the metallurgical company Mechel to issue ADRs. Henceforth Mechel will receive a possibility to place up to 40% of its authorized capital on foreign markets. In any

case, it is not known if investors will wish to buy shares of one of the most non-transparent metallurgical companies.

In January 2004, steel group Mechel announced its intention to place ADRs. Then shareholders of the

company approved organization of an additional issue of company's shares worth 1.15 billion rubles for further placing on Western markets. Mechel plans to place the ADRs under a closed subscription in favor of Deutsche Bank TrustCompany Americas, which will issue these additional shares. Initially, Mechel planned this for June 2004 but the Federal Service of Financial Markets approved the additional issue only recently. Representatives of the company do not name the date of the project implementation. Some experts presume that Mechel is waiting until the government announced the auction for sale of the 17.8% state-owned stake in the Magnitogorsk metal works to place ADRs quickly and spend the proceeds at the auction. So far it is not known how much money Mechel is going to receive from Western investors.

Steel group Mechel was founded in spring 2003. It included Russian assets controlled by Chair of the Board of Directors of the group Igor Zyuzin and his partners, namely Chelyabinsk metal works (Mechel), Yuzhuralnickel, South Kuzbass, Beloretsky metal works, Vyartsila metal plant and Uglemet-Trading (now trading house Mechel). Authorized capital of the group amounts to 3.83 billion rubles and consists of 382.97 million ordinary shares with a par value of 10 rubles. The company has never published consolidated financial statements yet. According to RBC Rating, in 2003 consolidated revenue of the group amounted to \$2.2 billion.

Absence of consolidated financial statements according to international standards and transparent ownership structure may prevent Mechel from reception of maximum sum for its securities. Until May 2004, it was only known that 23.02% of Mechel shares belonged to Zyuzin and remaining shares were on balance of offshore companies. In summer 2004, Mechel decided to place a bond worth 2 billion rubles and in the prospectus of the issue indicated the second shareholder of the company. According to the document, Vladimir Iorikh has 17.93% of Mechel shares. In any case, it is still unknown who owns the major part of Mechel shares.

Most likely, financial parameters of the company are not objective too. Thus, in 2003 net profit margin of the Chelyabinsk metal works amounted only to 5.4% (in the first quarter of 2004 it fell to 1.4%), whereas in Russian metallurgy such parameter amounted to 15% on average. Such figures do not look logical because rolled steel prices are very high now. Hence, experts presume that Mechel uses the scheme of the so-called intercompany pricing, where profit is mostly concentrated not in industrial

objects but in trading companies.

Experts say that financial statements according to Russian standards do not reflect the real profitability of the company because they do not consolidate financial results of the trading companies.

Analyst Denis Nushtaev of Metropol investment company says "Representatives of the company say that financial statements according to international standards for 2002 and 2003 are already prepared. In any case, in the course of ADR issue shareholders will have to disclose maximum of information about the company because the proceeds from ADRs placing will depend on this." Expert of Aton Timothy McCutcheon presumes that placing of ADRs may precede the auction for sale of the 17.8% state-owned stake in the Magnitogorsk metal works (MMK). South Kuzbass belonging to steel group Mechel owns 16% of MMK shares and acquisition of additional 17.8% will enable the shareholders of Mechel to influence decisions of the Board of Directors of MMK. For MMK such prospect is undesirable because business strategies of the two metallurgical companies differ seriously. In any case, Mechel has equal chances for victory with the management of MMK; that is why large sums in cash will be badly needed for Mechel.

Some representatives of the metallurgical industry presume that despite the non-transparency Mechel has good chances to attract foreign investors. President of the Russian Metal Traders' Association Alexander Romanov comments, "Mechel has an advantage in comparison to other metallurgical companies: Mechel supplies more than 50% of its products to domestic market, whereas the overall export of ferrous metals in Russia amounts to approximately 50%. This means that Mechel depends on the world market situation less than the other metallurgical corporations."

In any case, most likely ADRs of Mechel will be sold under a closed subscription to investors close to the shareholders of Mechel. Denis Nushtaev comments, "In the best case Mechel will manage, like in the case of placing of Eurobonds by Severstal, to increase liquidity of its shares but placing of ADRs will hardly cause a fever."

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## **ANALYSTS PREDICT THE BEST YEAR FOR NORILSK NICKEL**

This week, Norilsk Nickel is going to place a debut issue of Eurobonds worth up to \$500 million. The company published quarterly financial statements according to international standards for the first time to add enthusiasm to investors: in the first three months of 2004 profit of the company grew by 300%.

Dmitry Usanov, director of the investor relations department of Norilsk Nickel, reports that this week the company starts road show of its debut Eurobond. Lead managers of the issue are Citigroup and Morgan Stanley. The volume and other parameters of the Eurobond are not disclosed officially yet. Previously sources in Norilsk Nickel

said that the volume of the issue might amount to \$500 million. On September 10, banking sources mentioned similar figures and said that the volume of the Eurobond issue might be \$350-500 million.

On the eve of the Eurobond placing Norilsk Nickel published interim financial statements according to international standards for the first quarter of 2004 for the first time. Maxim Matveev from Alfa-bank says, "The fact that formerly Norilsk Nickel released financial statements according to international standards only once a year was a moderate factor for the company because investors could not permanently watch what was going on in the company."

Matveev notes that performance of Norilsk Nickel in the first quarter of 2004 inspires the market players. Company's sales revenue grew by 40% (to \$1.583 billion) from the first quarter of 2003 and net profit grew by more than 300% to \$460 million. Along with this, the net cash reserves at the end of the quarter amounted to \$1.131 billion and operating cash flow amounted to \$895 million. Experts note that the company is accumulating cash reserves twice as fast as in 2003.

Norilsk Nickel explains the good results by the favorable market situation. Dmitry Usanov of Norilsk Nickel says, "In the first quarter of 2004, nickel prices were on a peak and we also managed to establish control over our costs." According to Denis Nushtaev from Metropol, in the first quarter metal prices were very high: nickel cost \$14,000-15,000 per ton, copper cost \$2,850 per ton (now these metals cost \$12,050 and \$2,774 per ton respectively). American company Stillwater Mining acquired by Norilsk Nickel in summer 2003 started making profit in 2004 again (in 2003, its net loss amounted to \$331 million). According to the company, in the first quarter of 2004 it earned \$15.8 million for its shareholders and in the first half of 2004 it earned \$32 million. Through its British subsidiary Norilsk Nickel

controls 55.5% of Stillwater Mining shares.

Analyzing financial achievements of Norilsk Nickel experts point out at slow growth of costs. Production costs of sold metals grew only by 1.5% to \$693 million and operating costs decreased by 2.8% to \$557 million. Alexander Yakubov from CenterInvest Securities comments, "This was expected from them in 2003. Growth of operating costs demonstrated by Norilsk Nickel then was not understood by investors."

Analysts are convinced that due to growth in metal prices year 2004 will be the most successful year for the company. Analyst Vasily Nikolaev of Troika Dialog predicts that revenue of Norilsk Nickel will amount to \$6.751 billion and net profit will amount to \$2.119 billion. Timothy McCutcheon names the figures of \$6.5 billion and \$1.7 billion respectively and Matveev presumes that the revenue will amount to \$6.4 billion.

Analysts hope that dividends of the company will grow respectively because Norilsk Nickel has promised to spend at least 20-25% of net profit according to international standards on dividends.

In any case, McCutcheon from Aton presumes that in 2004 the company will be not very generous to investors and will prefer investments in production and new acquisitions. Really, the quarterly report of Norilsk Nickel states that the company increased the target figure of capital expenditures for 2005-2006 and would spend \$829 million on capital expenditures in 2005 and \$794 million in 2006.

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## **NORILSK NICKEL MAY SELL A PART OF SHARES OF POLYUS GOLD PRODUCING COMPANY**

Norilsk Nickel may sell a part of its gold mining business to a foreign strategic investor or to conduct listing of Polyus shares. Such scenarios for development of this business are outlined in the investment memorandum of the company dedicated to the Eurobond issue. Experts say that the listing scenario is the most likely.

Norilsk Nickel became Russia's leading gold producer in a record short time. In 2002, Norilsk Nickel bought Russia's largest gold producer Polyus and already in 2003 Norilsk Nickel broadened its gold mining assets through acquisition of Matrosov Mine and Lenzoloto (controlling stakes in both companies are consolidated on the balance of Polyus). Norilsk Nickel is the main candidate for acquisition of Eurasia's largest Sukhoi Log gold deposit. The biggest investment in gold mining business for Norilsk Nickel was acquisition of a 20% stake in South African Gold Fields in spring 2004 for \$1.2 billion.

Norilsk Nickel did not say how it planned to use the new asset. It turns out that Norilsk Nickel will not necessarily develop its gold mining assets together with the African ones. In its investment memorandum dedicated to the debut Eurobond issue Norilsk Nickel outlines three possible scenarios for development of its gold mining business.

The first scenario implies that "for achievement of maximum value" of its gold mining assets Norilsk Nickel may enter strategic cooperation with a large international gold producer, which will share with the company "operating risks and will contribute its experience and technologies." According to the memorandum, possibility of such alliance is discussed with Gold Fields. Other scenarios imply "separate listing of the gold mining business" or direct "sale of Polyus shares to an international gold producer." The document stresses that



Norilsk Nickel has not chosen any of these options finally yet.

Majority of experts saw a possible strategic partner of Norilsk Nickel in Gold Fields. Last week, it turned out that such partnership may not take place because until the end of 2004 Gold Fields was going to finish merger of its foreign assets with Canadian Iamgold reassigning them to a separate company. According to a source in Norilsk Nickel, the Russian company was interested exactly in non-African assets.

On September 14, Polyus did not comment on possible plans for development of business. Deputy CEO of Norilsk Nickel Maxim Finsky states that now Norilsk Nickel has other tasks regarding Polyus and it is too early to speak about longer plans yet. Finsky explains, "We are consolidating fold mining assets, standardizing corporate governance of Polyus and preparing its first financial statements according to international standards." Finsky adds that Norilsk Nickel is not seeking any strategic partners for Polyus and is not preparing listing of its shares.

Still, experts believe that even if listing and strategic partner are not on the agenda now, they will appear there in the near future. Denis Nushtaev from Metropol presumes that listing may take place already in 2005. Maxim Matveev from Alfa-bank says that Polyus needs to pass listing because this would increase the value of the company and would make search for investments easier. Nushtaev presumes that Norilsk Nickel may sell to a foreign investor or place on foreign markets 25% of Polyus shares earning \$500 million. Managing Director of Highland Gold Mining Ivan Kulakov presumes that with a foreign partner entrance of Polyus into the stock market would be easier.

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## **SIBUR COMPLETES CONSOLIDATION OF ITS TIRE ASSETS**

Very soon SIBUR is going to buy out 25% of shares of the Yaroslavl tire plant (YASHZ) increasing its stake in the plant to 77%. Quite recently, SIBUR also bought out property of the Urals tire plant being in the state of bankruptcy.

SIBUR includes four tire plants, which in 2003 produced about 18 million tires (approximately 47% of Russia's production). According to SIBUR, turnover of its tire plants amounts to about \$600 million a year. YASHZ is one of the Russia's largest tire plants. In 2003, the plant produced 6.32 million tires. In the first half of 2004, revenue of the plant amounted to 1.56 billion rubles. In April 2003, Yekaterinburg-based Urals tire plant was announced bankrupt and external management was introduced at the plant in October 2003. In the first eight months of 2004, the plant produced 1.22 million tires.

A top manager of SIBUR reports that the company is currently finishing preparation of investment program for its tire business. According to the source, SIBUR plans to invest up to \$300 million in its tire plants until 2008. The investments will be made primarily in upgrading of equipment. Before launching of the ambitious investment program SIBUR is going to consolidate its tire assets, "We should be sure that we fully control the assets in which we invest."

According to the manager, SIBUR already took such steps in this direction. Last week, shareholders of Omskshina voted for the additional issue of shares, as a

result of which SIBUR would increase its share in the plant from 62% to more than 75%. The source adds that very soon SIBUR plans to close the deal for buyout of 25% of YASHZ shares. After the deal the interest of SIBUR in the authorized capital of the plant will exceed 77%.

Managers of SIBUR do not forget about their other tire assets too. A source in SIBUR said that last week SIBUR bought out property of bankrupt Urals tire plant for approximately 200 million rubles at an auction. According to the source, these assets will be contributed to the authorized capital of new company Urals tire plant, a 100% subsidiary of SIBUR.

Analyst Dmitry Mangilev of Prospect investment company presumes that SIBUR cherishes plans to consolidate its tire assets in a united company and to prevent counteractions of minority shareholders SIBUR tries to obtain qualified majority in each plant. Mangilev pointed out that another large Russian tire manufacturer Amtel also tried to buy out shares of its plans from minority shareholders in the course of preparation for IPO.

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## **NET PROFIT OF SEVERSTAL UP 230%**

According to financial statements in accordance with

international accounting standards, in 2003 sales revenue

of Severstal grew by 40.87% in comparison to 2002 reaching \$3.202 billion. Such significant growth in the revenues is explained by growth in prices of rolled steel being the main product of Severstal, as well as increase of production and sales volumes. The positive pricing trend started in the second half of 2002 and continued throughout 2003.

In 2003, consolidated operating profit of Severstal grew to \$806 million from \$288 million in 2002, which resulted in growth of operating profit margin from 12.67% in 2002 to 25.17% in 2003.

In 2003, net profit of Severstal amounted to \$591

million in comparison to \$180 million in 2002. The growth amounted to 228.33%. EBITDA grew from \$471 million in 2002 to \$1.002 billion in 2003.

Tax payments in 2003 amounted to \$162 million in comparison to \$63 million in 2002.

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## **IT WILL BE DIFFICULT FOR SEVERSTAL TO SPEND BIG PROFIT**

Financial statements of Severstal for 2003 released on September 15 inspired investors. According to international standards, net profit of the company grew by more than 200% to \$591 million. Experts say that 2004 will be a more successful year because financial statements of Severstal will consolidate performance of the American subsidiary Severstal North America for the first time.

Severstal is Russia's second largest steel company. In 2003, it produced 9.89 million tons of steel and 8.8 million tons of rolled steel. Chair of the Board of Directors of Severstal Alexei Mordashov controls 82.75% of company's shares, 10.75% belong to the management and employees and 6.5% belong to institutional investors.

The main competitors of Severstal published their financial statements according to international standards for 2003 back in summer. Severstal made this only on September 15. Analysts say that the results demonstrated by the company are even better than expected. In 2003, revenue of Severstal grew by 40.87% to \$3.202 billion, net profit more than tripled reaching \$591 million and EBITDA grew by 110% to \$1.002 billion.

Dmitry Druzhinin, director of the investor relations group of Severstal, explains, "Growth of financial results in 2003 is conditioned by growth of steel prices and growth of production (in 2003 it amounted to about 3%)." According to Druzhinin, the average selling price of Severstal products in 2003 grew by 34% on domestic markets and by 15% on foreign markets. Druzhinin adds that Severstal is getting reoriented at production of more expensive items. In 2003, sales of cold-rolled steel of Severstal grew by 65.5% to \$1.2 billion. In 2003, prices of hot-rolled steel on international markets grew from \$280 to \$350 per ton and prices of cold-rolled steel grew from \$360 to \$450 per ton.

In any case, experts note that not everything was as good for Severstal in 2003 as it could be. Denis Nushtaev comments, "In 2003, EBITDA margin of Severstal

amounted to 32% in comparison to 35% of MMK and 40% of NLMK." The analyst explained that in 2003 Severstal reoriented a part of its goods flows to Europe, whereas the highest prices were registered in China. Vasily Nikolaev points out at another negative aspect, Along with growth of profit the operating cash flow decreased by 21% to \$318 million. Nikolaev adds, "Accounts receivable of related parties have grown, which may signal about issue of new credits to major shareholders of the company and related parties."

This way or the other, both analysts presume that 2004 may be the most successful year in the history of Severstal. Nushtaev explains, "Severstal is in a more beneficial position than MMK now because prices in China are lower than Europe. MMK also has no raw materials of its own." Nikolaev adds that consolidation of Severstal North America (owner of the assets of American Rouge Industries acquired in 2004) alone will add about \$1.4 billion to the revenue of Severstal. Maxim Matveev from Alfa-bank predicts that in 2004 revenue of Severstal including the revenue of the America subsidiary will amount to \$5.5 billion and net profit will amount to \$850 million. Nushtaev gives even more optimistic profit forecast of \$1 billion. Experts believe that the company may spend this money on acquisition of assets abroad. Still, Nikolaev warns that Severstal has too much money and it will be difficult to invest it efficiently. He concludes, "According to our estimates, cash reserves on the balance already exceed \$1.2 billion. After the failure at the auction for sale of Krivorozhstal so far there is no suitable object purchase of which may cost so much money."

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## **NET PROFIT OF SUN INTERBREW UP 340%**

In the first half of 2004, net profit of the brewing holding SUN Interbrew according to US GAAP grew by 340% from the first half of 2003 or from 4.494 million to 19.98 million euros.

Revenue of the company grew by 52.5% to 349.37 million euros from 229.116 million euros in the first half of 2003. EBITDA amounted to 69.1 million euros or was 52.8% million bigger than in the first half of 2003 (45.2 million euros).

SUN Interbrew is the second largest beer producer in Russia and the biggest brewer in Ukraine.

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## **BANKRUPTCY**

### **DIALOG-OPTIM BANK DECLARED BANKRUPT**

The Moscow Arbitration Court declared Dialog-Optim bank bankrupt. The court appointed Sergei Dmitriev the external manager of the bank according to the proposal of the Central Bank.

Dialog-Optim remained one of the last victims of the banking crisis of summer 2004.

Problems of the bank in cash payments started in June but these payments continued until September. Revoking of the bank's license was expected back in

August. However, this formality was completed only now.

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## **STATISTICS AND INDICATORS**

### **STANDARD & POOR'S REVISED RATING OUTLOOK FOR GAZPROM AND ROSNEFT**

Standard & Poor's Ratings Services revised its outlook on gas company Gazprom to developing from stable, and its outlook on the government-owned oil company Rosneft to developing from negative. This follows the Russian government's announcement of its plan to increase its share in Gazprom's shareholding capital by contributing the assets of Rosneft, subject to formal evaluation and regulatory and shareholder approvals.

At the same time, Standard & Poor's affirmed its 'BB-' and 'B' long-term corporate credit ratings on Gazprom and Rosneft, respectively.

The outlook revisions reflect the lack of certainty affecting both entities as a result of this announcement. Any assessment of the potential impact on Gazprom and Rosneft will depend on the legal and financial details of the transaction, including whether Gazprom would need to make any merger-related payments, and whether all or some of Rosneft's assets and liabilities are likely to be transferred to Gazprom. The merger announcement also highlights the risks posed by the government's unpredictable strategy in this sector, which seems to be

driven by political rather than financial rationale.

"The ratings on Gazprom may be raised if the merger brings stronger government support for the company, such as more favorable domestic price regulations," said Standard & Poor's credit analyst Elena Anankina.

Currently, the government controls 38% of Gazprom shares, while another

17% is treasury stock controlled by Gazprom's subsidiaries. The contribution of Rosneft's assets would therefore result in direct majority control by the government, a larger and more diversified cash-generating asset base, and even less likelihood of breaking up Gazprom's vertically integrated structure.

The ratings on Gazprom may come under pressure, however, if leverage (including the company's already high short-term debt level) increases in the course of the merger or if the government presses the newly created oil and gas giant to make large, politically motivated, high-risk investments. Gazprom is already highly leveraged and its ability to service debt in the mid-price gas scenario is constrained by still-adverse domestic gas price

regulations. Gazprom's share market liberalization itself is viewed as broadly credit neutral.

The ratings on Rosneft, meanwhile, will likely be raised as a result of the merger with a higher rated entity and a potentially much larger player in the country's oil and gas sector. On the downside, it is not yet clear whether (i) the government plans to transfer Rosneft to Gazprom as a whole or just selected assets and/or liabilities, (ii) all Rosneft's creditors would be treated equally to those of Gazprom, and (iii) Rosneft's liquidity would be affected should some creditors exercise change of control provisions in its debt in reaction to the merger.

"Once these uncertainties have been resolved, and if potential downside scenarios are proved unlikely, Standard & Poor's may consider a further revision to its outlook on Rosneft to positive," added Standard & Poor's credit analyst Tatiana Kordyukova.

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## **STANDARD & POOR'S RAISED THE RATING OF MAGNITOGORSK METAL WORKS**

Standard & Poor's Ratings Services raised its long-term corporate credit rating on Magnitogorsk METAL WORKS (MMK) to 'BB-' from 'B+', reflecting the company's strong operating and financial performance in 2003 and the first half of 2004. The outlook is stable. At the same time, the Russia national scale rating on MMK was raised to 'ruAA-'.

"The company's strong performance is supported by favorable conditions in the global steel industry and the Russian domestic steel market," said Standard & Poor's credit analyst Elena Anankina. "In Standard & Poor's view, MMK's strong profitability, cash flow generation, and solid liquidity help offset the uncertainties presented by the expected privatization of the government's 17.8% (23.8% voting) stake in the company."

The ratings on MMK reflect the company's strong financial profile and low cost position. This is offset by the risks of its position as a land-locked commodity producer operating in a transition economy and in a cyclical industry. By June 30, 2004, the company had a strong net cash position, with \$1.4 billion of cash compared with

\$623 million of total debt.

Standard & Poor's expects MMK to retain a competitive cost position, curb working capital outlays, and benefit from the gradual development of the domestic steel market. The ratings and outlook are based on the assumption that the potential privatization will not lead to any significant deterioration of MMK's financial profile or alter its demonstrated strategy of investment in modernization. Although the company is not necessarily expected to keep the current capital structure in the future, Standard & Poor's believes that large cash balances provide MMK with some protection against cyclical risks, capital expenditure needs, and privatization uncertainties.

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## **STANDARD & POOR'S ASSIGNED RATING TO PROPOSED NOTES ISSUE OF NORILSK NICKEL FINANCE**

Standard & Poor's Ratings assigned its 'BB' long-term senior unsecured debt rating to the proposed note issue by Norilsk Nickel Finance Luxembourg S.A., a finance subsidiary of Russia's largest diversified mining and metal company Norilsk Nickel. The exact amount and maturity of the notes will be determined at placement.

The rating on the notes is equalized with that on Norilsk Nickel. They will be irrevocably and unconditionally guaranteed by the company and will rank equal to its other senior unsecured obligations.

This Eurobond structure has been widely used by other Russian companies. The covenant package includes a negative pledge and a restriction on mergers and disposals that might have a material adverse effect, but no specific financial covenants.

The rating on Norilsk Nickel reflects its strong positions in the global markets for nickel, palladium,

platinum, copper, and gold; unique resource base; and strong financial profile. The key rating constraint for Norilsk Nickel is the risk of operating in Russia, where most of the company's cash-generating assets are based. The rating and outlook factor in the general country risk, but do not assume any potential company specific sovereign interference. The ratings are also constrained by Norilsk Nickel's exposure to commodity price fluctuations, ambitious growth plans, and large capital expenditure plans.

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## **"FREEZING" OF YUKOS' TAX PAYMENTS DID NOT INFLUENCE RATINGS OF FOUR RUSSIAN RATINGS ACCORDING TO STANDARD & POOR'S**

Standard & Poor's Ratings Services said its ratings and outlooks on Russian regional governments remained unaffected by the recent freeze of revenues derived from oil company YUKOS.

Four of the 16 regions in the Russian Federation that are rated by Standard & Poor's receive a substantial share of their tax revenues from YUKOS subsidiaries operating on their territories. These regions are Irkutsk Region (B/Stable/-), the Khanty-Mansiysk Autonomous Area (KMAO; BB-/Stable/-), Samara Region (BB-/Stable/-), and Tomsk Region (Russia national scale rating ruA). The level of their dependence varies greatly from relatively low in Irkutsk to quite high in Tomsk, where YUKOS subsidiary Tomskneft provides approximately 30% of the region's tax revenues.

The Russian authorities have recently frozen the accounts of several YUKOS subsidiaries in the context of the federal government's ongoing dispute with the company. As a result, YUKOS officially informed the governors of the affected regions that the company would stop paying regional taxes.

"We have reviewed the liquidity implications on the rated regions and consider that, at this stage, the current situation will not affect the long-term creditworthiness of these regions," said Standard & Poor's credit analyst Boris Kopeykin.

In the Tomsk Region, which is most affected due to its high dependence on Tomskneft, the liquidity risks are mitigated by the current level of reserves, which exceed 500 million rubles (\$17.1 million), and a relatively smooth debt repayment schedule, with 800 million rubles to be repaid by year-end 2004. Higher-than-budgeted revenue collection should enable the region to finance all of its 2004 budgeted expenditures, even if Tomskneft stops tax payments for several months. In addition, a combination

of sophisticated debt management and rapid economic development will help the region to mitigate the risks deriving from the lack of diversity of the tax base, in conformity with the rating on the entity.

In KMAO, where YUKOS subsidiary Yuganskneftegaz provides approximately 20% of the regional budget tax revenues, cash reserves as of August 1, 2004, were more than 8 billion rubles, equivalent to 3x outstanding debt. In the Samara

Region, a combination of the local YUKOS subsidiary and related companies is the second most important taxpayer (providing up to 25% of taxes) after auto manufacturer AvtoVAZ, which provides approximately 30% of tax revenues. As in KMAO, however, cash reserves exceed direct debt, while sound budgetary performances also minimize short-term liquidity risks for both these regions.

Furthermore, the ratings on the four regions already incorporate the effects of existing tax base concentration risks. At the same time, Standard & Poor's expects that the affected oil companies will maintain production levels, and that the possible interruption in tax payments will not exceed the bounds of the 2004 budget year.

"We will continue to monitor these developments very closely, and should the situation persist beyond fiscal year-end 2004, the ratings could come under downward pressure," concluded Kopeykin.

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## **STANDARD & POOR'S ASSIGNED RATINGS TO KRASNODAR TERRITORY**

Standard & Poor's Rating Services assigned its 'B+' long-term issuer credit rating to the Krasnodar Territory. The outlook is stable. At same time, Standard & Poor's assigned its 'ruA' Russia national scale rating to the territory.

"The ratings on Krasnodar are constrained by its high dependency on federal subsidies, its relatively low wealth levels, and its low financial flexibility, caused by the territory's lack of control over its revenues," said Standard & Poor's credit analyst Valentin Bogorov. "The ratings are supported, however, by its low debt burden, the pro-business style of its management, and its well-diversified economy, which has strong potential for sustainable growth," he added.

Krasnodar is Russia's third most populous region, located in the southern part of the Russian Federation. Its economy specializes in agriculture and the food industry. In addition, Krasnodar contains Russia's only part of the Black Sea coastline, thus making it the location for some of Russia's most important seaports and resort areas. The territory's wealth levels are still low, however, with gross regional product per capita at 58% of the national average. This is due partly to the large share of its population living in rural areas, and the unrecorded vast underground economy in the agriculture and service sectors.

Standard & Poor's expects that the territory's adequate financial performance and economic growth will

continue to compensate for its significant needs for infrastructure upgrades.

"Any ratings changes will depend on expansion of the tax base, the reform of intergovernmental relations, the level of indebtedness, and the quality of financial management," said Bogorov.

## **MOODY`S ASSIGNED RATING TO PROPOSED NOTES ISSUE OF NORILSK NICKEL FINANCE**

Moody's Investors Service assigned rating "Ba2" to the proposed notes issue of Norilsk Nickel Finance Luxembourg S.A. subsidiary of Norilsk Nickel. The issue will be worth \$500 million. The rating outlook is stable.

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## **COMMERCIAL BANKING**

### **ITALIAN BANKING GROUP UNICREDITO ESTABLISHED A LEASING COMPANY IN RUSSIA**

One of Europe's largest banking groups, Italian UniCredito Italiano, is interested in the Russian market. To begin with, Italians establish Locat Leasing Russia company in cooperation with the Russian insurer ROSNO.

At the end of 2003, assets of UniCredito Italiano amounted to 238.3 billion euros (\$290.4 billion), revenue amounted to 10.47 billion euros (\$12.8 billion) and net profit amounted to 2.1 billion euros (\$2.6 billion). UniCredito owns the largest private bank in Poland, Bank Pekao, the largest banks of Slovakia and Bulgaria, Zagrebacka Banka and Bulbank respectively. Locat leases cars, real estate, equipment and works with industrial companies and small businesses. About 75% of Locat's business is concentrated in Northern Italy. The company also leases cars through a joint venture with Temsys (division of Societe Generale).

Back in spring 2004, head of the corporate sector of UniCredito Andrea Varesi reported that the group was considering a possibility to broaden its presence in Moscow, for example, through acquisition of a local bank. According to Russian bankers, the Italian group already started making inquiries about the prices of Russian banks including the banks with many branches because the group was interested mostly in retail business.

According to the strategy of UniCredito, Eastern Europe is the second most important market for the group after Italy. Analyst of Standard & Poor's Ekaterina Trofimova says that there the group stakes on development of retail business. "According to the volume, market share and profit the largest business of UniCredito is in Poland and Croatia and on the banking market of CIS countries the group is present only in Ukraine and

Azerbaijan." She adds that in the strategy of UniCredito the CIS is not mentioned as a zone of strategic presence but "growing turnover of trade between Russia and Europe and improving investment climate may lead to decision of the group to have a subsidiary bank there."

So far, say representatives of UniCredito, the group has decided to start its business in Russia from a leasing company. Representatives of the group plan that Locat Leasing Russia will start leasing vehicles and equipment primarily from Italy until the end of 2004. Establishment of the company was initiated by the Italian Ministry of Industry. Almost 33% of the company's shares will go to the venture fund joint venture Russia-Ukraine (16.33%) and Simest and Finest (8.33% each) companies controlled by the ministry. It is planned that 16% will belong to the Russian insurance company ROSNO and 51% will belong to Italy's largest leasing company Locat belonging to UniCredito group. Italians stake at the corporate client base and "solid distributing capability of the commercial chain of ROSNO."

General Director of ROSNO Leonid Melamed confirms that his company may buy into capital of Locat Leasing Russia. The Board of Directors of ROSNO will discuss this possibility in October. If the proposal is approved, the insurer will pay 17 million rubles for a 16% stake in Locat Leasing Russia. According to Melamed, ROSNO counts not only on the revenue from leasing operations but also on insurance of leased property. Authorized capital of Locat Leasing Russia will amount to 3 million euros. Representatives of UniCredito comment, "Russian leasing companies have a big problem, where to take money. Locat Leasing Russia will not have such problem because

its business will be financed by UniCredito group; that is why it does not need large capital." Italians expect that in five years their subsidiary will take the leading positions on the Russian leasing market.

This is not the first leasing subsidiary of Western financial structures, which are demonstrating a growing interest in the Russian leasing market. Nikolai Volyansky, Marketing Director of the leasing company Evroplan managed by Baring Vostok Capital Partners, explains that Russian leasing market grows by 60% a year and its prospects are great. In any case, the size and financial capabilities of the parent group is only the mandatory condition but this is not enough to become a leader of

leasing market in Russia, comments deputy director of the leasing operations department of Alfa-bank Roman Gladkikh. Leasing of transport vehicles and equipment is one of the services that in the biggest demand on the Russian market but it is also the most developed one and competition is high in this segment, warns Gladkikh.

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## CREDITS AND FINANCE

### MEGAFON GETS READY TO ISSUE EUROBONDS

MegaFon is getting ready to issue a \$375-million Eurobond in the fourth quarter of 2004. It seems that this financial operation changes relations between the two main conflicting shareholders, Alfa group and Telecominvest.

MegaFon is currently working in 68 of the 89 regions of Russia for which it has licenses. The operator tries to catch up with its main competitors MTS and VimpelCom.

Simultaneously MegaFon faces the second important task of broadening of coverage in the cities where the company is already present. Fulfillment of this task requires significant resources. Management of the company admits existence of "problematic areas." Igor Parfenov, General Director of MegaFon-Moscow, sees improvement of quality of signal inside of buildings and development of the network in the subway among the priorities.

Unlike its main competitors that are public companies with good international financial history, MegaFon is just beginning to write its history. However, it does not write the history on its own. Alfa-Eco, owner of a blocking stake, makes its permanent corrections. Having just acquired the stake Alfa immediately demanded changing of the management and after that blocked the entrance into international exchanges. Vice President of Alfa-Eco hinted that MegaFon might stop in its development and other shareholders would have to accept the terms of Alfa not to lose the company. Struggle of shareholders created an unfavorable background.

This way or the other, Alfa was wrong. MegaFon received support on the part of manufacturers of the infrastructure equipment. The company signed credit agreements with consortiums of banks including Citibank and ING Bank for supplies of equipment. Guarantees for supplies of Siemens equipment were issued by the German

crediting agency Hermes. In Sweden guarantees for supplies of Ericsson equipment were issued by EKN and supplies of Huawei were supported by Sinosure.

According to General Director of MegaFon, the company also cooperates with the EBRD, IFC, ING, Citibank and also draws credits from International Moscow Bank and Burbank. The investment program of MegaFon for 2004 is set at \$700 million and the company has already invested about \$400 million of this sum. The operator arranged networks in the Smolensk, Ivanovo, Kostroma and Orenburg regions, as well as in Chuvashia.

Alfa probably understood that its head-on attack failed and it would be unable to place its management in MegaFon and decided to change the tactic. At least its representatives did not object to placing of Eurobonds. Representatives of MegaFon presume that Alfa is not interested in undermining of the existing plan and decrease in the value of the operator.

Meanwhile, competitors keep increasing the investments. MTS will invest \$1.4 billion in development of its network in 2004. In July, the company ordered a consortium of banks to organize a syndicated \$500-million credit. In June, VimpelCom placed its bonds worth \$250 million on international markets.

Parameters of the future Eurobond are not known yet. An anonymous source in Troika Dialog presumes that profitability of Eurobonds may vary from 8% to 10%. If the bonds were placed not the profitability would be 9%.

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## **ALROSA BORROWED \$100 MILLION**

ALROSA received the first \$100-million installment worth from the unsecured three-year syndicated credit of Citibank and Societe Generale Corporate and Investment Banking. According to the terms of the credit agreement, the volume of borrowings may be increased to \$300 million through the mechanism of syndication on international capital market. ALROSA will spend the money on refinancing of short-term debts.

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## **MDM-BANK PLACED A \$200-MILLION EUROBOND**

On September 10, MDM-bank placed the first installment of two-year notes worth \$200 million at 9.375% a year. Organizers of the issue are Goldman Sachs and UBS.

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## **RUSSIAN RAILWAYS TO BORROW \$300 MILLION FROM CITIGROUP**

The state-run company Russian Railways (RZHD) established in 2003 reached an agreement on drawing of the first foreign credit in its history. Until the end of 2004 RZHD will borrow \$300 million from American Citigroup for development of its three-year investment program.

RZHD is the largest transport company of the world. In 2003, it was established on the basis of former Roads and Transportation Ministry. In the first half of 2004, revenue of RZHD according to Russian standards amounted to 321.8 billion rubles and net profit amounted to 12.1 billion rubles. The state owns 100% of RZHD shares. According to RZHD, the corporate strategic development program intended for the period until 20100 will require more than \$60 billion including about \$10 billion of borrowings.

According to Vice President of RZHD for finance Fedor Andreev, the company also does not give up its plans to issue Eurobonds worth more than \$500 million in 2005. Andreev explains, "Our task is to have the maximum quantity of financial tools for attraction of cheap money. That is why we need credit and long-term financing in the form of Eurobonds and ruble bonds worth 12 billion rubles that we plan to place in November 2004." President of

RZHD Gennady Fadeev says that the company has decided to limit its credit portfolio by 10% of the revenue or \$2.5 billion a year. Now the overall debt of the company amounts to approximately 17.5 billion rubles and consists of the credits received only from Russian banks including Vneshtorgbank, Sberbank, Bank of Moscow and Gazprombank.

Analyst Pavel Mamay of Renaissance Capital investment company says that the credit of Citigroup may be a test ballot of RZHD before the Eurobond issue. Mamay adds, "Infrastructure companies need long-term money first of all. An interest on a three-year foreign credit is definitely lower than an interest on ten-year Eurobonds. However, not a single bank issues credits for ten years."

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## **INVESTING**

### **GAZPROM TO ENTER AMERICAN MARKET WITH ASSISTANCE OF STATOIL**



On September 9, 2004, Rosneft and Norwegian Statoil signed memorandum on organization of a working group and a trilateral committee to study a possibility of joint gas production in the Barents Sea, production of liquefied natural gas (LNG) and its supplies to the US. Gazprom takes alliance with Statoil and investments in the Norwegian project Snohvit LNG as a possible way to enter the market of the US already in 2007. In any case, most likely Gazprom needs the memorandum to accelerate negotiations on participation in development of the Shtokmanovskoe field with American and Canadian companies.

The document implies that in six months the working group supervised by the trilateral committee will study possibilities for development of three projects. The first is entrance of Statoil into the project for development of the first part of the Shtokmanovskoe field and construction of an LNG plant. The second is possible participation of Gazprom and Rosneft in the project of LNG production from the gas produced at the Snohvit field in the Norwegian sector of the Barents seabed (its natural gas reserves amount to 190 billion cubic meters and gas condensate reserves amount to 21 million tons). The third is possible use of capacity of Cove Point LNG terminal on the Atlantic coast of the US by the Russian company.

All three projects are interconnected. Statoil plans to put into operation the first part of Snohvit LNG plant with capacity of 5.7 billion cubic meters a year in 2007. The

plant costs about \$7 billion and participation of Gazprom and Rosneft in the final phase of the project with investments of approximately \$500-700 million will enable them to control sales of 1-1.5 billion cubic meters of gas a year in the US (the remaining quantities of LNG will be oriented at the market of Spain). Investments of Gazprom may also be offset by investments of Statoil in the Shtokmanovskoe project.

Cooperation with Statoil and combination of resources of the Shtokmanovskoe and Snohvit is very beneficial for Gazprom. Alliance with Statoil will enable Gazprom to enter the market of the US with its gas four or five years earlier and to test new marketing schemes there. American owners of Cove Point (American laws prohibit foreign companies to own LNG terminals in the territory of the US) are also upgrading the terminal on the money of Statoil and by 2008 its capacity will reach 120 billion cubic meters of gas a year. Buying of Gazprom and Rosneft into Snohvit LNG and purchase of quotas for use of Cove Point is also quite realistic.

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## **TNK-BP TO INVEST \$200 MILLION IN DEVELOPMENT OF THE KOVYKTINSKOE FIELD**

TNK-BP plans to invest \$200 million in development of the Kovyktinskoe gas condensate field in 2005, reports Vice President of the company Alistair Fergusson. Fergusson adds, "This will happen if the project is approved by the Russian government. We have entered the most important phase of the field's development. I hope that the project for its development will be approved by the government until the end of 2004." Fergusson explains that a part of money will be spent on the project of gas distribution network arrangement in the Irkutsk Region and a part on the gas export project. Fergusson added, "TNK-BP already invested more than \$200 million in the project."

According to the international business plan signed in November 2003 by TNK-BP, South Korean Kogas and Chinese CNPC, it is planned that the first quantities of gas

will be supplied to northeastern China and South Korea in 2008 (12 billion and 10 billion cubic meters a year respectively). From 2013 China will increase annual purchase by 8 billion cubic meters. The first quantities of gas from the Kovyktinskoe field may be supplied to the market of the Irkutsk Region in 2006 (300 million cubic meters). In 2007, the volume of supplies to the regional market will amount to 2 billion cubic meters and by 2009 it will be increased to 2.2 billion cubic meters.

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## **GOING PUBLIC**

### **TINKOFF CONSOLIDATES ASSETS**

Tinkoff consolidates the formerly independent breweries and restaurants into two separate structures.

Oleg Tinkov explains the reorganization by preparation for sale of 10-15% of the parent company's shares to a strategic investor and IPO. Experts say that the owner of Tinkoff is too optimistic.

Tinkoff owns a brewery with capacity of 250,000 hectoliters of beer a year and a chain of eight restaurant-breweries. In 2003, sales of bottled beer Tinkoff amounted to 90,782 hectoliters and restaurant-breweries of the company brewed 450,000 liters of beer. In 2003, turnover of the company amounted to \$33 million. According to Business Analytica, in the second quarter of 2004 the share of Tinkoff on the market of packaged beer amounted to 0.8% (according to value).

Formerly all breweries and restaurants of the company were separate legal entities. According to Alexei Semenov, Corporate Finance Director of Tinkoff, by the beginning of 2005 structure of the company will change. The acting brewery near St. Petersburg and the brewery being under construction in the same region will be united into Private Brewery Tinkoff and all restaurants of the company will be united into Private Breweries Tinkoff. Both companies will belong to managing company Tinkoff belonging to Oleg Tinkov.

Tinkov explains that reorganization and creation of amore transparent scheme of assets management are done to attract an investor. According to him, he has proposals about buyout of 10-15% of Tinkoff shares from several investment companies, which he has not named. The said, "I plan to earn \$10-20 million from sale of the stake proceeding from the value of our business of \$100-150 million. The money will be spent on return of the

company's debts." Tinkov plans that the deal will take place between December 2004 and January 2005.

Tinkov also plans to place a three-year bond worth 1 billion rubles until the end of 2004. According to Semenov, the proceeds will be spent on construction of restaurants, increase of production and launching of new brands. In 2006, the company wishes to organize an IPO.

Analysts are skeptical about the plans of Tinkov. Analyst Marat Ibragimov of UralSib financial company comments, "The estimate of 10-15% of Tinkoff shares at \$10-20 million looks just. However, the IPO plans of the company are very optimistic because for placing of shares on a Russian market the volume of the issue should be at least \$50-100 million and company's turnover should be at least about \$100-200 million."

Analyst Victoria Grankina of Troika Dialog says that "the company has overvalued itself." Grankina is convinced that 10-15% of Tinkoff shares may be interesting for investment companies but doubts if any of them wishes to buy this block for \$10-20 million.

Kirill Tremasov, director of the analytical department of Bank of Moscow, says, "Company of such scale and the size of the stake offered for sale cannot be very interesting for investors."

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## **STORYFIRST COMMUNICATIONS PREPARES AN IPO**

StoryFirst Communications (SFC), the major shareholder of STS television channel, may become the first Russian media group that has placed its shares on a Western exchange. In the first half of 2005, SFC is going to organize an IPO at NASDAQ.

The main asset of SFC is 75% minus one share of STS (remaining shares belong to Alfa group), Russia's fourth largest television channel with audience bigger than 100 million. SFC has controlling stakes in STS-Region (15 television stations) and stakes in six radio stations. The major shareholders of SFC are Alfa group, Modern Times Group, Barings Vostok Private Equity Fund, News Corp. and Delta Capital. The stakes of the shareholders and

financial results of the company are not disclosed. In summer 2003, the company's founder predicted that company's revenue will amount to \$115 million and EBITDA will amount to \$35 million. Analysts estimate assets of SFC at not less than \$500 million.

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## **INSURANCE SERVICES**

### **AIG ESTABLISHES THE SECOND SUBSIDIARY INSURER IN RUSSIA**

On 2004, Russia fully opened its insurance market for European investors but foreigners used the new

opportunity only now. AIG, one of the world's largest insurance groups, established the second insurance company in Russia, namely AIG Insurance and Reinsurance Company. The new company belongs to French AIG Europe by 100%.

Until the beginning of 2004, activities of insurers with a share of foreign capital exceeding 49% were limited by Russian legislation. They were forbidden to work with life assurance, insurance at expense of budgets and obligatory kinds of insurance including the obligatory motor liability insurance.

Foreigners had to bypass these banks. For example, officially AIG owns only 49% in AIG Russia, Allianz AG has 49% in Ost-West Alliance, Ceska pojistovna has 49% in Czech Insurance Company and ERGO has 49% in Rus, although in reality all these insurers are fully controlled by their prominent founders through Russian companies.

The new version of the law on organization of insurance business came into effect on January 17, 2004, and lifted all limitations for European insurers. Somehow it was American AIG that was the first to use this opportunity. In addition to already existing AIG Russia it established AIG Insurance and Reinsurance Company. Its

only founder is AIG Europe, S.A. registered in France. A source close to AIG explains that business of AIG is divided according to the principle life assurance - non life insurance. According to the source, AIG Insurance and Reinsurance Company will work with property insurance and AIG Russia will work with life assurance.

In any case, the second subsidiary of AIG will not be the first 100% subsidiary of a foreign company. In summer 2003, Zurich Financial Services that owned 49% in Zurich-Rus increased its interest almost to 100%. Along with this, the company lost the right to work with many kinds of insurance. General Director of Zurich-Rus Dmitry Ignatyev said that shareholders estimated transparency of the company's ownership higher. It is possible that experience of AIG will encourage other foreign shareholders to legalize control over the subsidiaries.

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## **MEET NEW GENERAL DIRECTOR OF RESO-GARANTIYA**

Founder and major shareholder of RESO-Garantiya Sergei Sarkisov leaves the post of the General Director of the company. CEO of the Northwestern division of the company Dmitry Rakovshchik will be the new General Director of RESO-Garantiya. Sarkisov will work on the development strategy of the company. He says that no changing of hands is planned for the company.

RESO-Garantiya was established in 1993. In the first half of 2004, the company had the fourth place among insurers according to collected premium (7.6 billion rubles) and the second place on the market of obligatory motor liability insurance (2.6 billion rubles). Management of the company is considered its main owner.

On September 14, RESO-Garantiya announced a personnel reshuffle. Founder and major owner of the company Sergei Sarkisov left the post of General Director of the company. According to Sarkisov, in the last 18 months the load on him "grew enormously." That is why he will become Chair of the Board of Directors of RESO-Garantiya and will work on development of business, government and public relations.

According to Sarkisov, one of the main directions of his work will be development of RESO group that includes subsidiary insurance companies in Ukraine, Belarus, Kazakhstan and Lithuania, three medical insurers, three service companies, two leasing companies and a reinsurance company.

The post of the General Director of the company will be given to Dmitry Rakovshchik, who has been deputy of Sarkisov since 1998 and CEO of the northwestern regional

center of RESO-Garantiya. According to Sarkisov, one of the reasons for the appointment of Rakovshchik is the need to develop the regional business of the company in 16 priority regions and cities with population bigger than 1 million. Sarkisov added that Rakovshchik fulfilled such task perfectly in St. Petersburg.

Insurers took the personnel reshuffle in RESO-Garantiya quietly. In 2004, similar re-division of powers was carried out in National Insurance Group. Its General Director Yury Reshetnyak became the President of the company and his deputy Alexei Sazonov became the General Director. According to Reshetnyak, in development of business it is difficult to combine operational management and strategic development of the company.

A similar re-division of duties was also carried out in Ingosstrakh, when General Director of the company Victor Shcherbakov became the President and Tatiana Dubrovskaya representing Basic Element was appointed the General Director. Basic Element, the major shareholder of Ingosstrakh, decided to control operations of the company, whereas major owner of RESO-Garantiya Sarkisov decided to give up these duties.

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**PEREKRESTOK TRADING CHAIN TO GO INTO DEVELOPMENT BUSINESS**

Alfa group is getting increasingly involved in the developer business. Recently it separated Perekrestok-Development company from trading house Perekrestok. Perekrestok-Development will build trading centers on its own land plots in Moscow and in the regions. The company will lease trading premises in the new centers to other retail operators.

Alfa group established Perekrestok chain in 1995. Now the chain includes 75 stores in the Moscow Region, St. Petersburg, Samara, Togliatti and Volgograd. In 2003, turnover of the chain exceeded \$450 million.

General Director of Perekrestok-Development Oleg Temirov reported that about a year ago trading house Perekrestok bought two land plots in Moscow. Permits are currently being drawn for the third land plot.

Temirov explains, "On this land it was necessary to organize the entire process from designing and construction to leasing of premises, that is why a separate developer structure appeared within the holding." On the first land plot the company plans to build a trading center with area of 75,000 square meters with offices for management of Perekrestok. On the second land plot Perekrestok-Development plans to build more than 20,000 square meters of trading premises in the infrastructure of a residential block.

The company is also seeking land plots outside of Moscow. Says Temirov, "Practically no vacant land is left in Moscow and that is why we are choosing the best land plots in the regions." At the beginning of 2004, trading house Perekrestok bought a production building in the center of Voronezh to build a trading center with area of 20,000 square meters on this site. According to Temirov, many Moscow-based retail chains are interested in renting of premises in the new trading center.

Perekrestok-Development is also drawing permits for two land plots in Tver.

According to Temirov, Perekrestok will invest more than \$150 million in development of all aforementioned projects in two years. This will be money of both Perekrestok and future tenants acting as co-investors.

Establishment of Perekrestok-Development is the second developer project of Alfa group, which bought out a minority stake in Noble Gibbons, a large real estate consultancy, in early August. Two key managers of trading house Perekrestok (Chair of the Board of Directors Lev Khasis and General Director Alexander Kosyanenko) are also members of the Board of Directors of the British company Moscow City Center, general investor of the central part of Moscow City center.



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