



SOVLINK

YOUR FIRST CALL – FOR THE SECOND TIER

April 29, 2008

VTB

Company
Note

BUY

Upside: 40%

Target price: 0.124 RUR, \$10.61 (GDR)

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Stock data

Ticker	VTBR	M.Cap, \$ mn	25,382
Shares Ords, mn	6,724,138	Free Float, %	22.5%
Shares Prefs	-	Free Float, \$ mn	5,711
Bid Ords, \$	0.0038	Offer Ords, \$	0.0038
Bid Ords, RUR	0.0887	Offer Prefs, RUR	0.0909

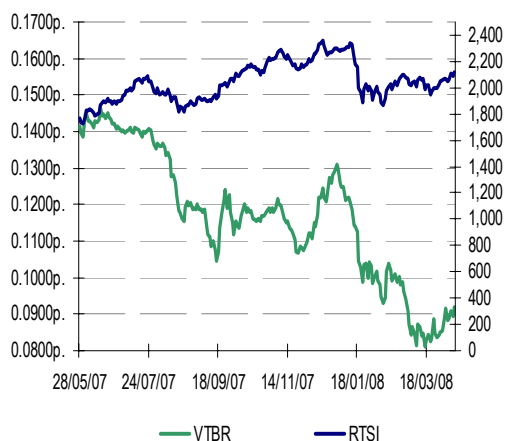
Market performance

		1 month	6 months
Absolute	Ords	4.8%	-24.7%
Relative to RTSI	Ords	-0.1%	-22.7%
Price range, \$			
High, RUR	Ords	0.092	0.131
Low, RUR	Ords	0.085	0.081

Financials, 2008E

Assets, \$ mn	117,854	ROE	9.3%
Book Value, \$ mn	17,296	P/E	16.3
Net income, \$ mn	1,584	P/BV	1.4

VTB – Relative performance



Source: RTS, MICEX

Target price revision

- We revised our valuation model for VTB, based on its 2007 IFRS reports, the statements of its management and adjustments in our near term financial sector development forecasts.

- Last year turned out to be very successful for VTB – the Group grew at a faster rate than the banking sector in general due to the capital raised via its IPO and the stronger positions of state-run banks after the onset of the global credit crunch. The Group more than doubled its loan portfolio and corporate deposits, expanded its retail loan portfolio by more than three times, and its mortgages by more than four times over 2007. This is a very positive step towards improving the bank's midterm net interest margin and profitability in general. Net profit beat market expectations and at the same time its quality improved (as the bank succeeded in significantly reducing its non-recurring income).

- We have kept the basic assumptions of our previous model regarding the bank's growth rates and its market share in its main market segments. VTB will continue to grow at a faster pace than the market; however, its growth rate is likely to slowdown as a result of the general restrictions on funding sources. According to our estimates, the bank's loan portfolio will grow at 33% CAGR through 2008-10, with the share of retail loans exceeding 25% by the end of 2010. The group intends to replace financing from the capital markets with customer deposits (with retail deposits expected to grow at 39% CAGR and corporate deposits at 33% CAGR). In 2008, we expect its loan portfolio to increase by \$22bn (vs. \$29bn in 2007), customer accounts by \$15bn (vs. \$17bn in 2007), total borrowings (on external and internal debt markets, and private transactions) by \$8.5bn (vs. approximately \$13bn in 2007).

- Assuming borrowing costs continue to grow, we conservatively forecast the bank's interest margin to decline slightly from 4.5% to 4.3-4.4%. As a consequence of its greater base (the size of the bank's loan portfolio and liabilities) in 2007, we have raised our forecast for the bank's interest income and expenses by 7.5-11% vs. our previous forecast. We have also increased our net interest income by 7.6-8.5%. We have lowered our operating income forecast by 2-3% because of lower expectations on trading revenues and FX and other non-recurring income due to the difficulties prevalent on global financial markets.

- Due to higher inflation forecasts, which directly affect payroll expenses, and the \$500mn investment plans announced by VTB over the next two years to develop its investment banking business, we revised operating expenses upward by 5-7%. Accordingly, we lowered our net profit forecast by 11-13% for 2008-10. We lowered our net profit forecast for the next 3 years from 29% to 23% CAGR. Moreover, we expect net profit to grow at a slower rate, ranging between 5-10% in 2008. We expect the bank's ROE to reach 15% only by the end of 2010, which is why we lowered its terminal ROE from 18% to 17.5% (compared with VTB's target of 15-20%).

- Based on our revised model, we have **lowered** the year-end target price of VTB's ordinary shares by 7.9% or from **\$0.0058 to \$0.0053 per share (RR0.124)**, and its GDR – from **\$11.52 to \$10.61**. Nevertheless, as the target price still offers very strong growth potential (40%) in comparison to the current market price, we reiterate our **BUY** recommendation.



We revised our valuation model for VTB, based on its 2007 IFRS reports, the statements of its management made during a teleconference and also announced to the media. Please refer to our previous research “VTB: strong BUY opportunity over the mid-term” issued on 22.01.2008.

1. Revised retail portfolio growth estimates

In 2007, the bank’s loan portfolio more than doubled (exceeding our expectations). In comparison, the Russian banking sector’s credit portfolio grew at a pace, which was 1.5 times slower (64% in dollar terms). This year, we expect the bank to increase its loan portfolio by 39% (about \$22bn), against growth of 35% forecast for the market in general. We estimate, VTB’s credit portfolio will grow at 33% CAGR over 2008-10.

We agree with management’s plans, which forecast the bank’s retail loan portfolio to double in 2008 (following 300% growth in 2007) and reach 25% of the bank’s loan portfolio by 2010. However, we expect the growth rates of the bank’s corporate loan portfolio to plummet from 89% to 30%.

Mortgages will continue to grow extremely rapidly in the bank’s retail portfolio. In 2007, the bank’s mortgage portfolio grew 4 times, with the bank’s market share jumping from 5.7% to 10.7%. According to VTB 24 forecasts, its mortgage portfolio will, at least, double to reach \$7.5bn in 2008. We expect VTB to expand its market share for mortgages to 15% by 2010, which matches management’s statements and our previous forecast.

Table 1. Loan portfolio forecast

	\$ mn	2005	2006	2007	2008E	2009E	2010E	Note
VTB loans (gross)		20,533	30,235	60,021 (53,516)	83,405 (73,523)	110,314 (97,067)	142,323 (121,805)	
VTB loans (net)		19,925	29,262	58,549 (52,071)	81,320 (71,611)	107,556 (94,543)	138,765 (118,638)	
Growth rates		96%	47%	100% (78%)	39% (38%)	32% (32%)	29% (25%)	
Loans/Assets		54%	56%	63% (63%)	69% (66%)	72% (69%)	75% (71%)	
Corporate loans, \$mn		19,682	27,702	52,339 (44,900)	68,041 (60,615)	85,731 (75,769)	105,449 (90,922)	
Market share, %		13.3%	12.2%	14% (13.0%)	13% (13.5%)	14% (14.1%)	15% (15%)	Target- 15-18% of the market by 2010
Retail loans, \$ mn		851	2,533	7,682 (7,171)	15,364 (12,908)	25,351 (21,298)	38,026 (30,883)	Target – to double in 2008
Market share, %		2.1%	3.2%	5.8% (5.5%)	7.9% (6.9%)	10.1% (8.8%)	12% (10%)	Target – 10-11% of the market by 2010
Portfolio share, %		4.1%	8.4%	12.8% (13.4%)	18.4% (17.6%)	22.3% (21.9%)	25.9% (25.4%)	Target – 25-30% by 2010
Mortgage / retail loans			30%	48% (45%)	49% (51%)	51% (53%)	53% (55%)	
Mortgage, market share, %			5.7%	10.7% (11.2%)	13.2% (12.8%)	14.0% (14.0%)	15% (15%)	Target – 15% of the market by 2010

() – previous forecast

Source: Company data, CBR, SOVLINK estimates



2. Deposit base growth

In 2007, the growth of the bank's deposit base exceeded our expectations. This primarily relates to corporate deposits (which doubled over the year, and grew by 37% in 4Q07). We expect the Group to raise approximately \$15bn in customer deposits this year, with the growth of the bank's retail deposits growing at a faster rate than the market due to the aggressive expansion of VTB 24's network (last year the number of outlets grew by 165, with another 200 planned for this year) and the aggressive marketing policy of the bank. On April 15, the bank raised its interest rates on term deposits, offering 10% p.a. for a 13-month deposit (which is considerably higher than its immediate competitor - Sberbank), and introduced new types of long-term deposits (for 3 and 5 years). Mr. Zadornov, VTB 24's president, is looking to double the bank's retail term deposits during the year. However, we should take into account the fact that such growth will be underpinned by the reallocation of funds within the Group – with the continued transfer of VTB North-West's retail customers.

However, given the general trend of shrinking retail deposits over the last few months, we lower VTB Group's growth rate forecast from 60% to 45%. However, we still expect the Group to attain about 7-8% of the retail deposit market by the end of 2010.

Following the rapid growth of the bank's corporate deposits, which doubled last year, we slightly raised their forecast for 2008-2010. So far, state-owned banks have managed to effectively raise deposits from enterprises and organizations, and appear to be the key beneficiaries of the funds allocated by state corporations in the banking system. Other key factors that concern clients are the reliability of the bank and the range of its banking services, including the prospects for its investment banking business.

mn.\$	2005	2006	2007	2008E	2009E	2010E	Note
Customer accounts	12,767	19,988	37,098 (32,514)	52,471 (46,648)	70,037 (61,094)	90,432 (76,920)	
As % of liabilities	40.6%	44.0%	48.7%	52.5%	53.9%	55.0%	
Retail deposits	5,180	7,326	10,683 (10,989)	15,490 (17,589)	21,222 (24,189)	28,437 (30,789)	
Growth rates	145%	41%	46% (50%)	45.0% (60%)	37.0% (37.5%)	34.0% (33%)	
Market share	5.4%	5.1%	5.1%	5.6%	6.3%	7.2%	Target – 7-8% of retail deposit market by 2010
Corporate deposits	7,587	12,662	26,415 (21,525)	36,981 (29,059)	48,815 (36,905)	61,995 (46,131)	
Growth rates	94%	67%	109% (70%)	40% (35%)	32% (27%)	27% (25%)	
Market share, %	7.4%	7.3%	9.6%	10.5%	12.1%	13.9%	

() – previous forecast

Source: Company data, CBR, SOVLINK estimates

3. Other funding sources

Last year, the net increase of the Group's borrowings in the debt markets, in terms of bank loans and other borrowings reached almost \$13bn (\$7.2bn – loans and deposits of banks, \$4.9bn – debt securities, and \$708mn – other borrowings). 4Q07 appeared to be highly productive for VTB – it successfully issued bonds despite the extremely weak external and internal debt markets. This year, according to VTB, the Group will have to repay \$5.4bn of its foreign debts. Nevertheless, we expect the Group to raise approximately \$8.5bn (net) on foreign and domestic markets and through private transactions (versus \$10.5bn according to our previous estimate). We expect the bank's borrowings to reach previous levels in the next few years – which,



given the anticipated influx of customer accounts, will allow it to support the growth forecast for its loan portfolio.

4. Interest margin and interest income

In 3Q07 VTB managed to swiftly respond to the anticipated rise in borrowing costs by raising its rates (initially – for corporate clients). This allowed VTB to generate an unusually high interest margin in 3Q07. However, as the bank's annual statement shows, the Group did not manage to transfer the burden of escalating borrowing costs to its borrowers, since its interest margin in 4Q07 dropped vs. 3Q07 (from 4.9% to 4.6%, according to the bank). Yet, in late 2007–early 2008 VTB again raised its rates for all loans, including mortgages (approximately 1.5 p.p.) and consumer loans (more than 2 p.p.), which, according to management, should have a positive impact on the bank's margin despite further growth in borrowing costs.

Nevertheless, we anticipate higher borrowing costs to persist in 2008. This is due to the continuation of the credit crunch, the reduced access of Russian companies and banks to debt markets, rising inflation and increasing competition over deposits in the domestic market. According to our forecasts, the Group's borrowing costs will rise by 1.0 p.p. (from 5.1% to 6.1% p.a. on average) in 2008, with the bank's rates lending rates increasing by about the same amount (from 10.8% to 11.7% p.a. on average). According to our estimates, the bank's interest margin in 2008-10 will range within 4.3-4.4%. This is a conservative forecast, and the bank's interest rates on loans may easily be higher.

Given the effect of a higher 2007 base (loan portfolio and liabilities), we raised our forecast for the bank's interest income and expenses by 7.5-11% on average as compared to our previous forecast. We also increased our net interest income forecast by 7.6-8.5%.

Interest income and expenses forecast

	2006	2007	2008E	2009E	2010E
Interest income	3,606	5,387	9,410 (+9.7%)	12,050 (+7.5%)	14,976 (+10.9%)
on loans	2,872	4,314	8,167	10,812	13,682
interest rate	11.7%	10.8%	11.7% (11.9%)	11.4% (11.7%)	11.1% (11.1%)
on securities	428	570	668	741	801
interest rate	5.3%	6.5%	6%	6%	5%
on interbank credits	306	503	575	497	494
interest rate	5.6%	6.7%	6.00%	5.0%	5%
Earning asset yield, %	9.4%	9.6%	10.0%	9.8%	9.7%
Interest expenses	(1,892)	(2,831)	(5,318) (+10.7%)	(6,705) (+7.4%)	(8,291) (+13.6%)
Funding costs, %	-5.0%	-5.1%	-6.1% (-6.3%)	-5.9% (-6.2%)	-5.8%
Net interest income	1,714	2,556	4,091 (+8.5%)	5,345 (+7.5%)	6,685 (+7.9%)
Interest margin	4.5%	4.5%	4.3%	4.4%	4.3%

() – vs. previous forecast, %

Source: Company data, SOVLINK estimates



5. Other operating income

Given the more conservative business growth rate forecasts, we lowered the net fee & commission income forecasts for the Group for 2008-10 by 8.3% for 2008 and by 5.3% for 2009. We expect high growth of fee & commissions in 2009-10 as the bank's new investment banking segment begins to earn income (according to our estimates – up to \$100-150 mn over the next two years). As a result of the difficulties prevalent on global financial markets, we expect lower gains from securities trading. Besides, the transition of VTB's financial statements to rubles starting from 2008 will result in fewer gains from foreign currency revaluations. Management does not anticipate a repeat of last year's non-recurring income from asset sales (about \$300mn in 2007). However, due to higher interest income expectations, our forecast for the bank's operating income forecast has declined only very slightly (2-3%).

	2006	2007	2008E	2009E	2010E
Net fee & commission income	351	557	774 (-8.3%)	1,148 (-5.3%)	1,647 (0.9%)
Growth rates, %	109%	59%/42%	39%/54%	48%	43%
Operating income	2779	3732	5,010 (-2.6%)	6,414 (-2.7%)	7,954 (-3.3%)
Growth rates, %	82%	34%	34%	28%	24%

() – vs. previous forecast, %, / - except one-off fees and commissions in 2007

Source: Company data, SOVLINK estimates

6. Operating costs

We anticipate higher costs for the Group in the years ahead and have accordingly raised our estimates based on higher inflation expectations and the announced investment banking costs. The growth of the main cost items will be related to the expansion of the retail network and investments in the investment banking division. Thus, in forecasting payroll costs, we make allowances for the bank's branches to increase by approximately 200 p.a. (with an average headcount as 30-40 employees per branch), ruble salary inflation of 15-17% (management estimates) and additional IB costs of \$500mn (management forecasts). In 2008, VTB 24 expects to add 180 branches, of which 70-80 will be transferred internally from VTB North-West, (which will not increase operational expenses). The Group also plans to open about 70 branches in Ukraine.

	2004	2005	2006	2007	2008E	2009E	2010E
Headcount	13,132	23,145	28,466	35,945	43,717	51,489	59,261
Expansion of retail network, new branches				165	180	200	200
Headcount growth		76%	23%	26%	19%	18%	15%
Ruble expense inflation					17%	15%	11%
Average salary, \$ p.a.	17,971	15,727	23,607	26,707	32,917	37,428	39,228
Payroll, \$ mn	-236	-364	-672	-960	-1,413	-1,898	-2,294
IB costs, \$ mn					-250	-250	-250
Other operating costs, \$ mn	-278	-375	-698	-988	-1,262	-1,495	-1,669
Total administrative and operating costs, \$ mn	(514)	(739)	(1,370)	(1,948)	(2,925) (+5.2%)	(3,643) (+6.9%)	(4,213) (+5.9%)

() – vs. previous forecast

Source: Company data, SOVLINK estimates



7. Net profit forecast

Based on the above assumptions (growth of operating costs and reduction of non-recurring income), we lowered our net profit forecast by approximately 11-13% for 2008-10. We also lowered VTB’s net profit CAGR from 29% to 23% for 2008-10. At the same time we anticipate higher quality earnings – given the considerable expected decline in non-recurring income, interest and fee & commission income from customer services and beyond 2010, investment banking revenues (which are not included in our model) will boost the bank’s income growth. VTB’s retail division is expected to earn net profit of \$200 mn in 2008 vs. \$30 mn in 2007.

	2006	2007	2008E	2009E	2010E
Net profit	1,179	1,514	1,584 (-11.8%)	2,106 (- 13.1%)	2,843 (- 12.9%)
Growth rates, %	131%	28%	5%	33%	35%

() – vs. previous forecast

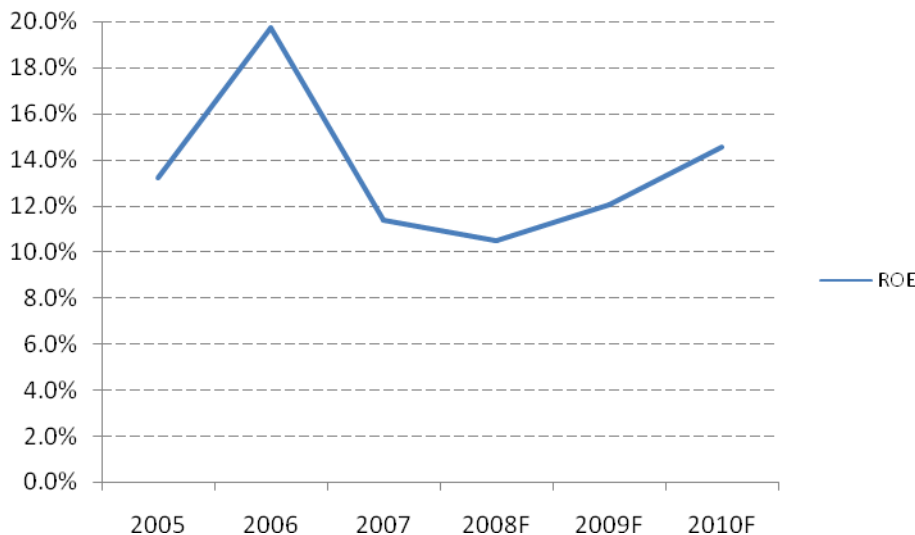
Source: Company data, SOVLINK estimates

We also made allowances for changes in VTB’s dividend policy. The head of the Group, Andrey Kostin, proposes to double 2007 dividend payments – up to 50% of the bank’s RAS net profit, or 20-25% of the Group’s net profit. In 2006, the Group allocated 20% of its RAS net profit and 11% of the Group’s IFRS profit as dividends. Increased dividend payments will result in a lower ROE growth rate. However, the Group’s capital adequacy ratio (about 16%) is still very high after its SPO.

	2006	2007	2008E	2009E	2010E
Group’s equity, total	6,992	16,501	17,684	19,257	21,380
Parent shareholders’ equity	6,604	16,207	17,296	18,869	20,992

Source: Company data, SOVLINK estimates

According to our revised estimates, ROE will only approach 15% by 2010 (vs. our previous estimate of 15.4%).



Source: Company data, SOVLINK estimates



Valuation

We estimate a fair value for VTB's ordinary shares based on the modified Gordon growth model (target P/BV) ($P/BV = (ROE-g) / (r-g)$). We still forecast terminal ROE rate (g) at 6%, however, we lower anticipated ROE from 18% to 17.5% (versus a mid-term target of 15-20%). We continue to use a discount rate of 11.45%.

	2004	2005	2006	2007	2008E	2009E	2010E
Shareholders' equity	2,628	4,920	6,604	16,207	17,296	18,869	20,992
Net profit	205	499	1,137	1,480	1,551	2,062	2,784
Equity value						11.45%	11.45%

Source: Company data, SOVLINK estimates

Then, applying the Gordon model we calculate target P/BV-2010 at 2.11. Taking the budgeted BV-2010 at \$20,992 mn, we estimate VTB's fair value at P-2010=\$44,298 mn by the end of 2010.

Having discounted the 2008 year-end value, we obtain P-2008=\$35,663mn, **with a year-end target price of \$0.0053 per share, equal to 12.4 kopecks per share at the current exchange rate.** Given the fact that VTB's GDR consists of 2,000 shares, **we obtain a GDR target price at \$10.61. Thus, we lower our target price of the bank's ordinary shares by 7.9%. However, given the potential upside of 40% upside from the current market price, we reiterate our BUY recommendation.**

Terminal ROE rate	17.5%
terminal growth rate	6.0%
Target P/BV-2010	2.1
Fair value of equity (P-2010), \$ mn.	44,298
Discount rate	11.45
Fair value of equity at the end of 2008, \$ mn	35,663
Ordinary shares after SPO, mn.	6,724,139
Fair value of 1 ordinary share, \$	0.0053
Fair value of 1 ordinary share, RUR	0.124
Fair value of 1 GDR, \$	10.61
Total, fair value of 1 ordinary share at the end of 2008, \$:	0.0053
Market value of 1 ordinary share (28.04.2008)	0.0038
Upside, %	40%
Recommendation	BUY

**SOVLINK**

YOUR FIRST CALL – FOR THE SECOND TIER

April 29, 2008

Balance sheet – historic and forecast, \$ mn

	2004	2005	2006	2007	2008E	2009E	2010E
Cash and current assets	1,520	2,692	3,581	5,160	5,893	5,975	7,450
Mandatory reserves	232	404	648	825	1,414	1,942	2,421
Loans to other banks	2,023	4,141	6,813	9,733	9,428	10,457	9,313
Loans and advances to customers	10,169	19,925	29,262	58,549	81,320	107,556	138,765
Securities	3,103	7,291	8,957	13,511	16,500	19,420	23,283
Investments in associated companies	77	118	200	167	167	167	167
Fixed assets	321	832	1,422	1,997	2,357	2,988	3,725
Investment real estate	-	198	178	168	168	168	168
Intangible assets	102	451	455	480	480	480	480
Other assets	263	671	887	2,019	128	231	489
Total assets	17,810	36,723	52,403	92,609	117,854	149,383	186,262
Bank credits and deposits	3,254	6,629	7,587	14,794	19,032	24,724	31,327
Customer deposits	6,024	12,767	19,988	37,098	52,471	70,037	90,432
Other borrowings	1,729	2,937	4,468	5,176	7,176	9,176	11,176
Own debt securities	3,948	7,241	11,565	16,489	19,089	21,689	25,889
Subordinated loan	-	1,161	1,169	1,171	1,171	1,171	1,171
Other liabilities	146	719	634	1,380	1,231	3,329	4,886
Total liabilities	15,101	31,454	45,411	76,108	100,170	130,126	164,882
Equity	2,709	5,269	6,992	16,501	17,684	19,257	21,380
Parent bank's shareholders' equity	2,628	4,920	6,604	16,207	17,296	18,869	20,992

Source: Company data, SOVLINK estimates

Income statement – historic and forecast, \$ mn

	2004	2005	2006	2007	2008E	2009E	2010E
Interest income	1,058	1,830	3,606	5,387	9,410	12,050	14,976
Interest expenses	(475)	(920)	(1,892)	(2,831)	(5,319)	(6,707)	(8,294)
Net interest income	583	910	1,714	2,556	4,090	5,343	6,682
Provisions for loan impairment	(196)	(103)	(442)	(526)	(789)	(1,065)	(1,390)
Net interest income after provisions for loan impairment	387	807	1,272	2,030	3,302	4,277	5,292
Gains less losses arising from trading securities	(5)	261	535	254	234	289	315
Fee & commission income	118	190	401	637	885	1,313	1,883
Fee & commission expenses	(12)	(22)	(50)	(80)	(111)	(165)	(237)
Net fee & commission income	106	168	351	557	774	1,148	1,647
Gains less losses from revaluation of foreign currency	114	(8)	265	108	-	-	-
Gains less losses arising from trading securities	31	8	73	547	350	350	350
Other operating income	296	287	283	108	350	350	350
Net non-interest income	542	716	1,507	1,702	1,708	2,137	2,662
Net operating income	929	1,523	2,779	3,732	5,010	6,414	7,954
Payroll and administrative costs	(514)	(739)	(1,370)	(1,948)	(2,925)	(3,643)	(4,213)
Other operating costs	(114)	(81)	(36)				
PBT	301	703	1,404	1,819	2,084	2,771	3,741
Tax	(93)	(195)	(232)	(305)	(500)	(665)	(898)
Net profit	208	511	1,179	1,514	1,584	2,106	2,843
Net profit excluding minority interest	205	499	1,137	1,480	1,551	2,062	2,784

Source: Company data, SOVLINK estimates



Financial ratios

	2005	2006	2007	2008E	2009E	2010E
P/E	51.7	22.7	17.0	16.3	12.2	9.1
P/BV	5.25	3.91	1.5	1.4	1.3	1.2
ROE	13.2%	19.7%	12.4%	9.3%	11.4%	14.0%
ROA	1.8%	2.6%	2.1%	1.5%	1.6%	1.7%
Operating costs/ assets	2.7%	3.1%	2.7%	2.8%	2.7%	2.5%
Fee & commission / operating income	11.0%	12.6%	13%	15%	18%	21%
Net interest income (after interest-bearing asset impairment provision) / operating income	53.0%	45.8%	54%	66%	67%	67%
Earnings asset yield	7.8%	9.4%	9.6%	10.0%	9.8%	9.7%
Cost of liabilities	-4.0%	-5.0%	-5.1%	-6.1%	-5.9%	-5.8%
Net interest spread	3.8%	4.4%	4.4%	3.8%	3.9%	3.9%
Net interest margin	3.9%	4.5%	4.5%	4.3%	4.4%	4.3%
Cost / Income	45%	42.5%	46%	50%	49%	45%

Source: Company data, SOVLINK estimates



STOCK RATING POLICY

STRONG BUY:	Upside over 25%; confidence level – high / upside over 100%; confidence level - low
BUY:	Upside between 15 and 25%; confidence level – high / upside between 25% and 100%; confidence level – low
HOLD:	Upside of less than 15%; confidence level – high / upside of less than 25%; confidence level – low
SELL:	Target price at or below current price levels

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