



HERMITAGE CAPITAL MANAGEMENT

Seven Big Myths About Russia

By William Browder
Chief Executive Officer
Hermitage Capital Management

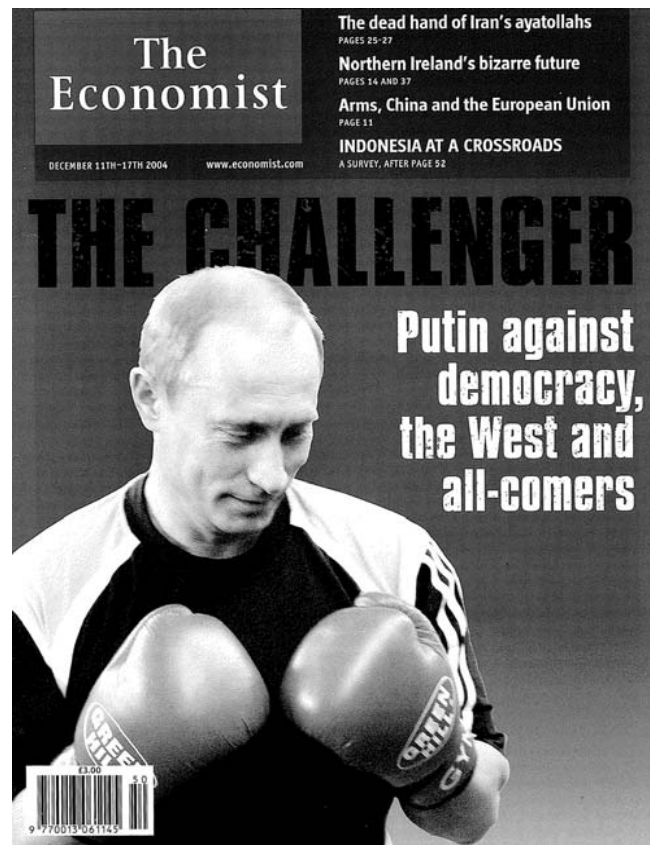
April 2005



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Collapse of Public Opinion

Over the last two years, Western public opinion of President Putin and Russia has collapsed



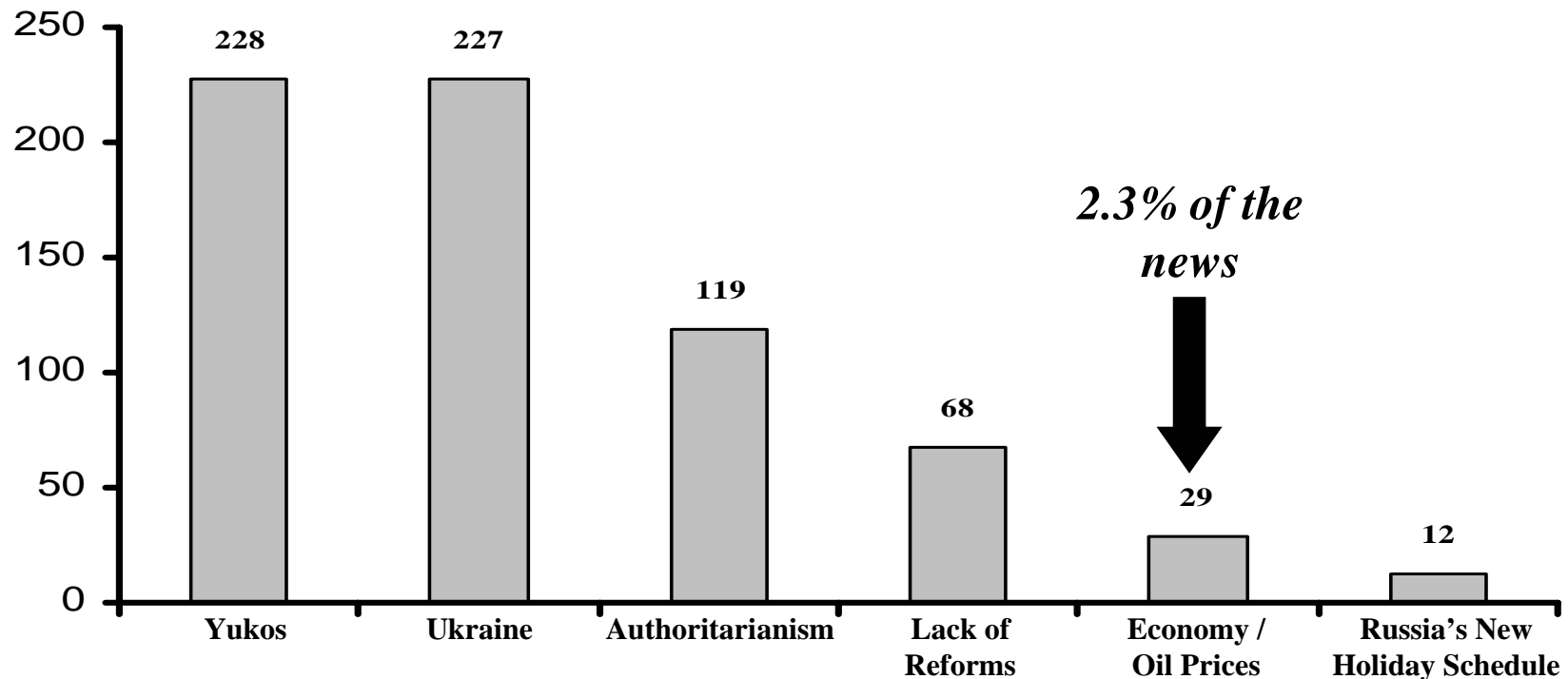
Is this negative view of Russia and the Kremlin based on reality or myth?



Media Onslaught

An analysis of the 1,260 articles published on Russia & Putin in the last five months shows the negative focus of the media coverage

**Number of Articles in Major Western Press,
by topic, December 1, 2004 – April 5, 2005**



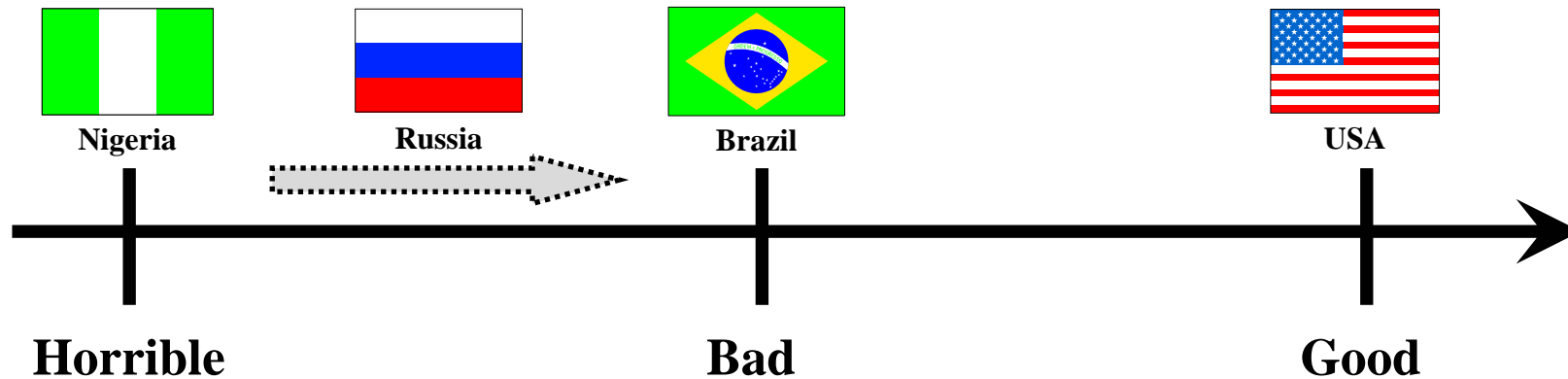


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“Horrible to Bad”

Things in Russia are far from perfect – or even good – but the country is moving in the right direction

Comparative Political and Economic Development



The trend: Russia is a case of moving from horrible to bad



Seven Big Myths About Russia

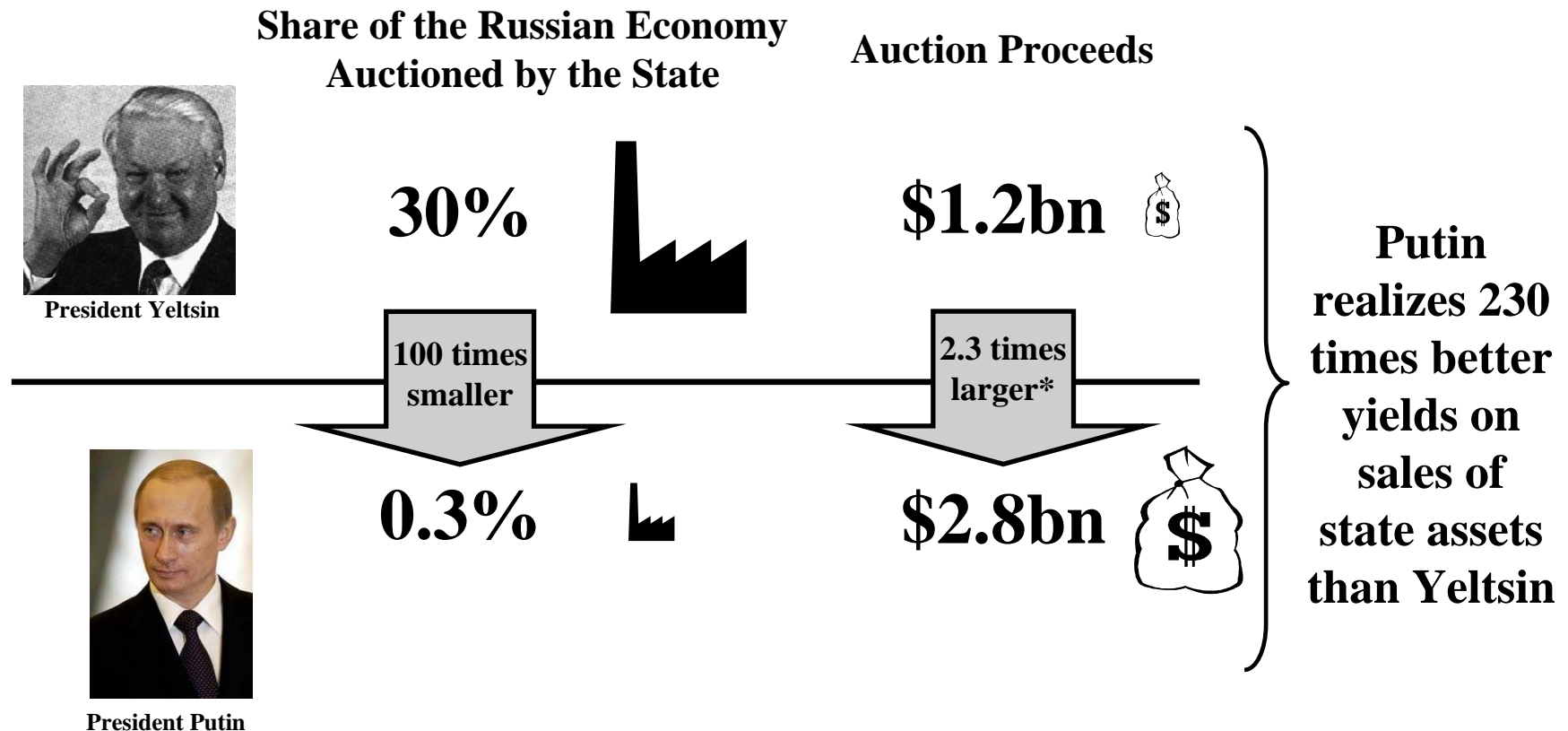
1. “Putin is corrupt and taking money for himself”
2. “Oligarchs are just like the Robber Barons of America in the 1890’s”
3. “Khodorkovsky is an innocent victim”
4. “Putin has destroyed the economy by going after Yukos”
5. “Democracy in Russia died along with regional governors’ elections”
6. “Putin’s Ukraine diplomacy marked the start of a new Cold War”
7. “Reforms are finished in Russia”



Myth 1

“Putin Is Corrupt”

Recent privatizations show that Putin is pursuing what is in Russia’s best interests, rather than his personal interests



Source: Audit Chamber Report 2004; Presidential Decree N 889; Hermitage Estimates, January 2005. Note*: information for Putin taken from 2004; Yeltsin proceeds from loans-for-shares.

Myth 1

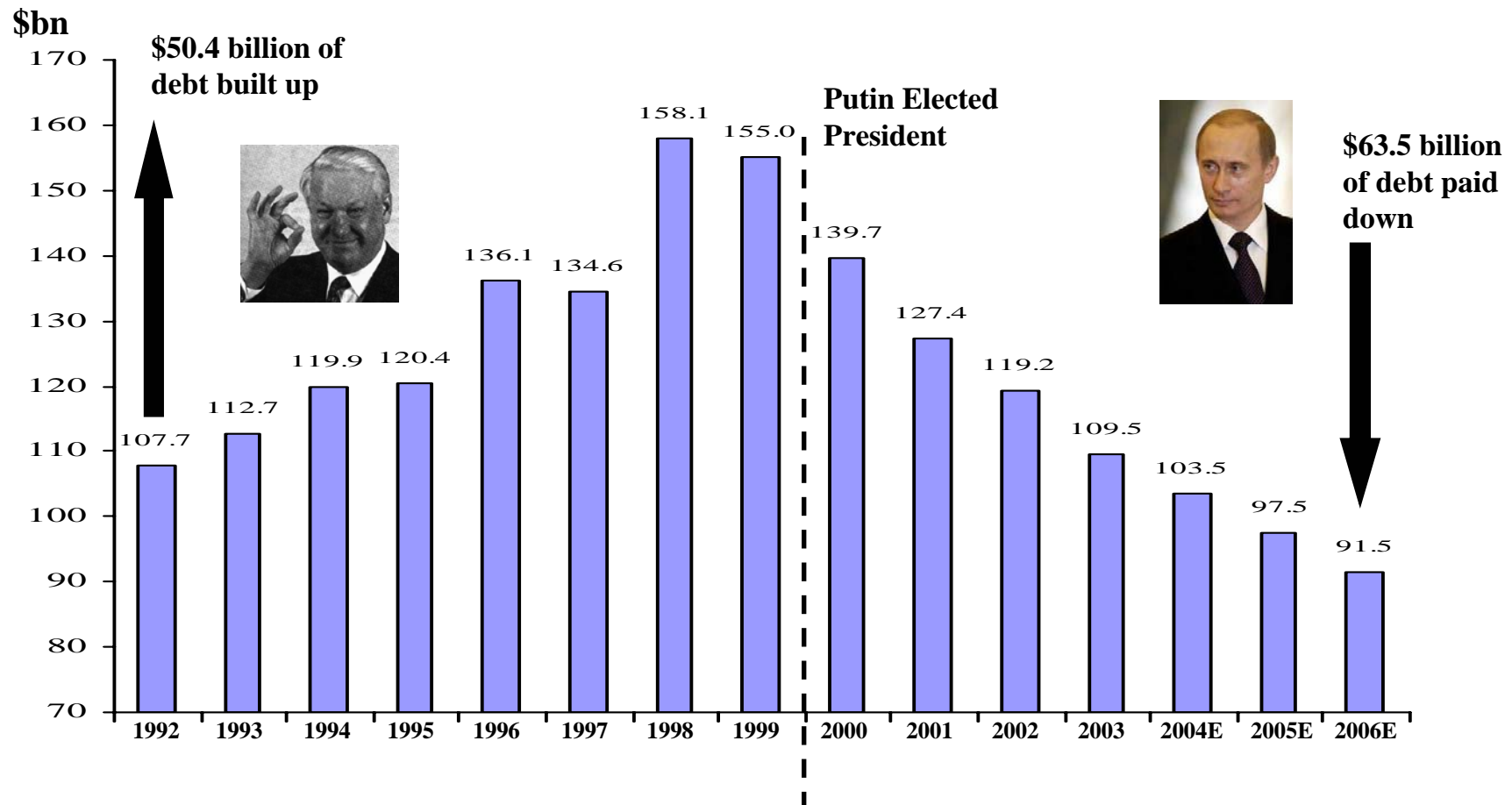
“Putin Is Corrupt”



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Putin has prioritized debt reduction over debt accumulation

Russian Government: External Debt (1992 – 2005E)



Source: Brunswick UBS, Hermitage.

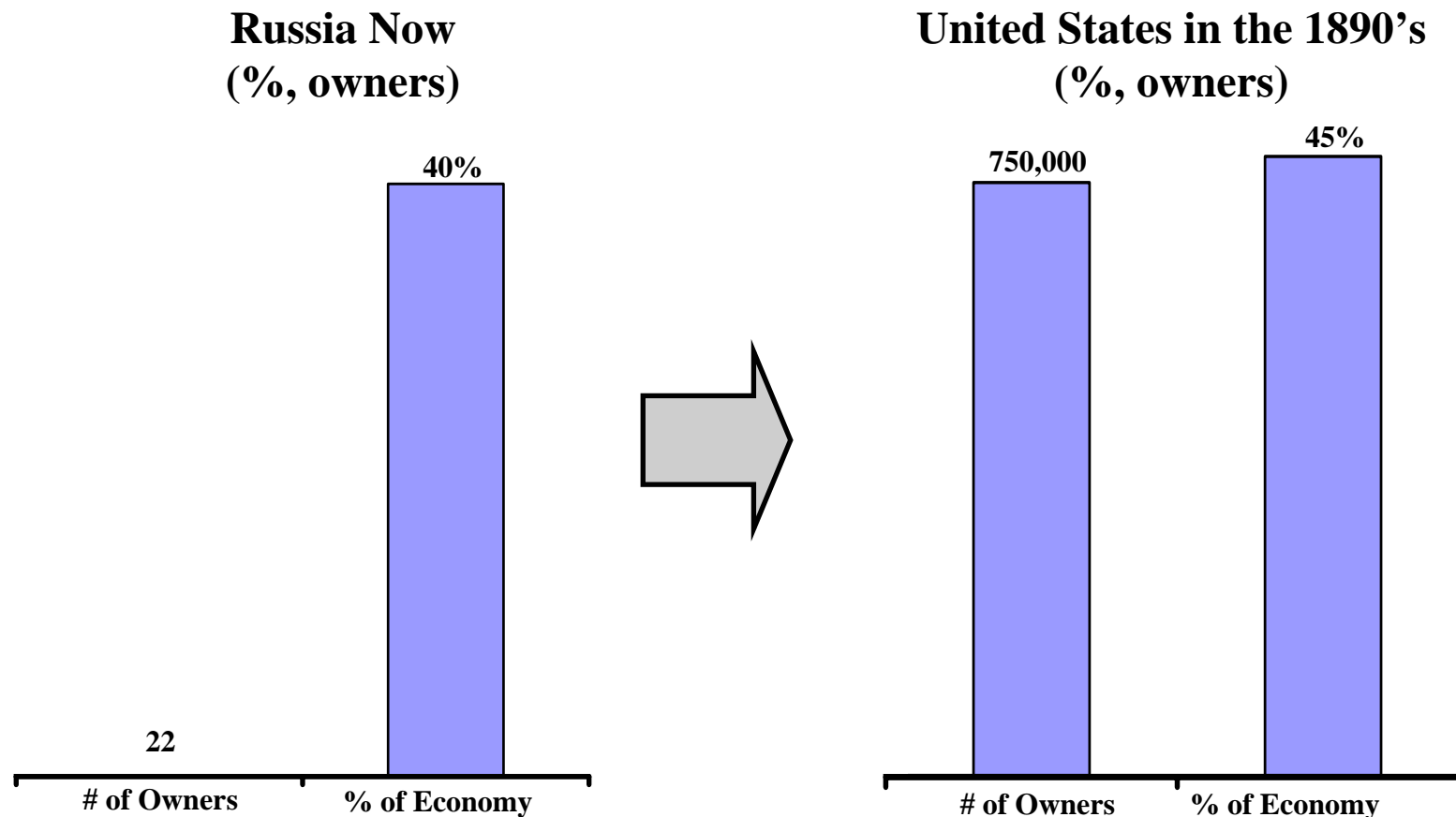
Myth 2

“Oligarchs = Robber Barons”



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The Russian oligarchs’ control of the Russian economy is unprecedented



Source: “Wealth Concentration in the U.S.: Share Held by the Top 1% of Households” in “Robber Barons,” J. Bradford DeLong, January 1, 1998 (Carnegie Endowment publications); Note: United States Population in 1895 estimated to be 75,000,000 (<http://www.demographia.com/db-uspop1900.htm>).

Myth 2

“Oligarchs = Robber Barons”

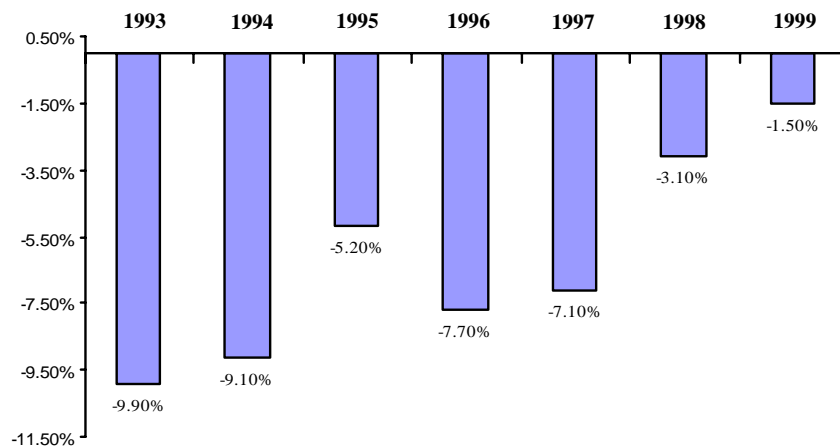


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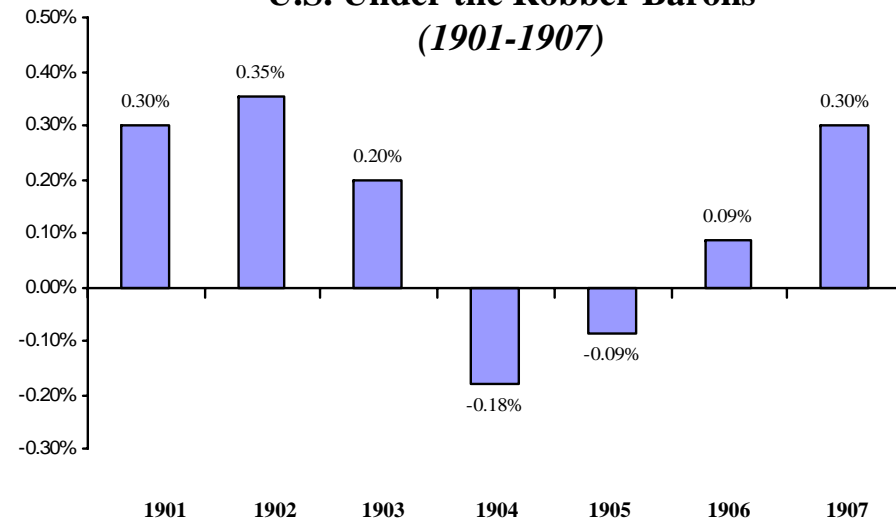
While the Russian oligarchs got rich, the state posted massive losses, differing from the U.S. experience with “Robber Barons”

Nominal Federal Budget Balances (% of GDP)

**Russia Under the Oligarchs
(1993-1999)**



**U.S. Under the Robber Barons
(1901-1907)**



Source: Economic History Services (www.eh.net); U.S. Congress, The Budget for Fiscal Year 2006; “The Tax Smoothing Implications of the Federal Debt Paydown,” *Brookings Papers on Economic Activity*, George J Hall, Stefan Krieger, Benjamin M Friedman, January 1, 2000; UBS Brunswick.

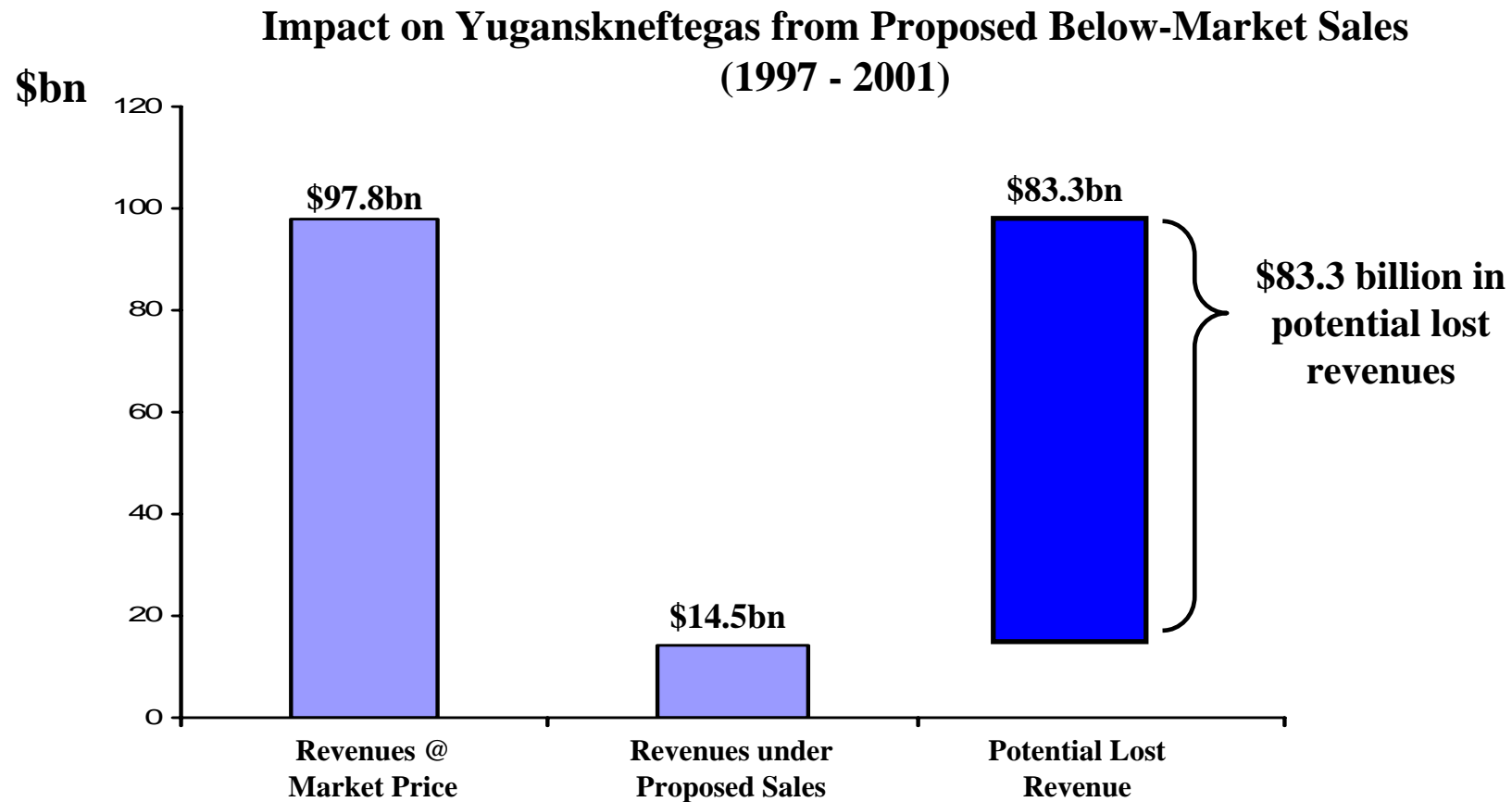
Myth 3



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“Khodorkovsky Is an Innocent Victim”

In 1999, Yukos proposed contracts to sell oil at below-market prices to intermediaries that would take billions from minority shareholders



Source: Yuganskneftegas filings with the Federal Securities Commission r.e. Interested Party Transactions; Russian Federation Customs Committee Database.

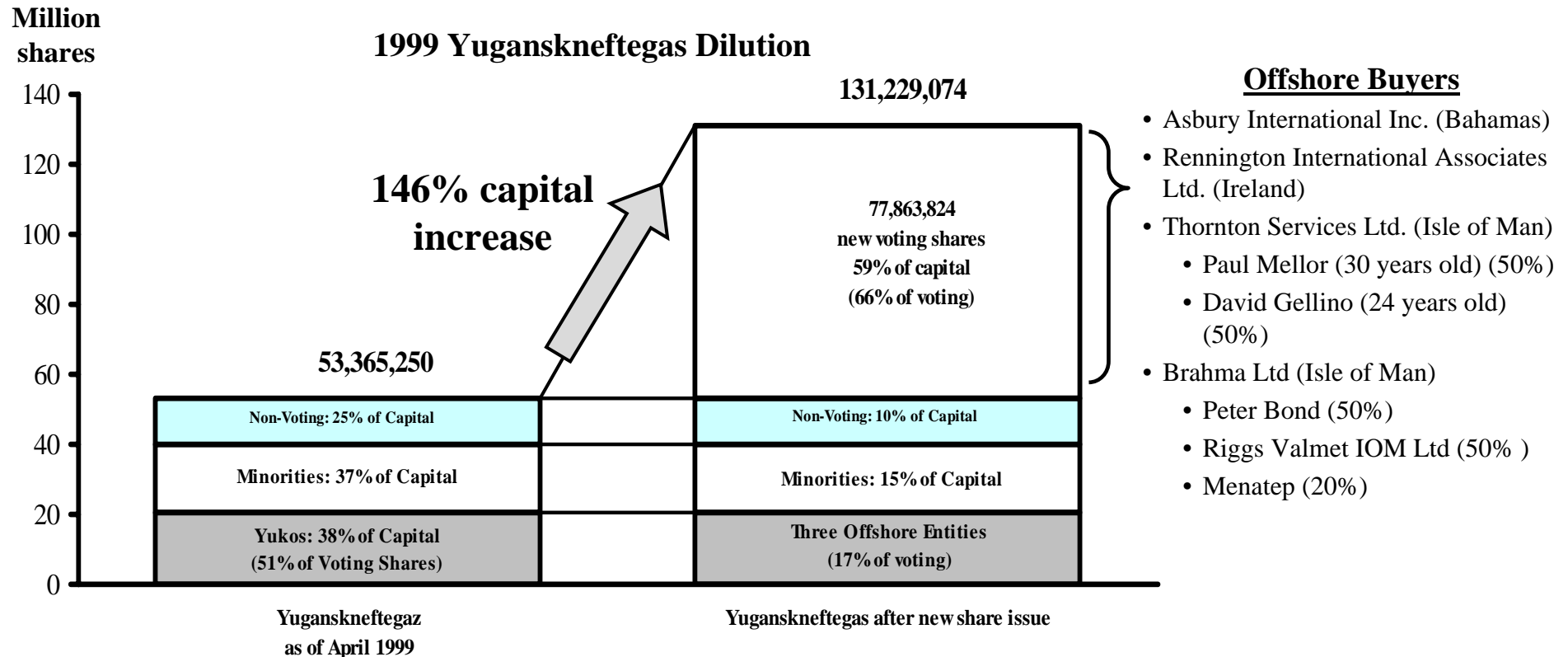
Myth 3



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“Khodorkovsky Is an Innocent Victim”

It also proposed minority shareholder dilutions at all major Yukos production subsidiaries, including Yuganskneftegas



Minorities’ Stake Would Be Diluted from 37% to 15% of Capital

Similar Dilutions Proposed at Tomskneft and Samaraneftegas

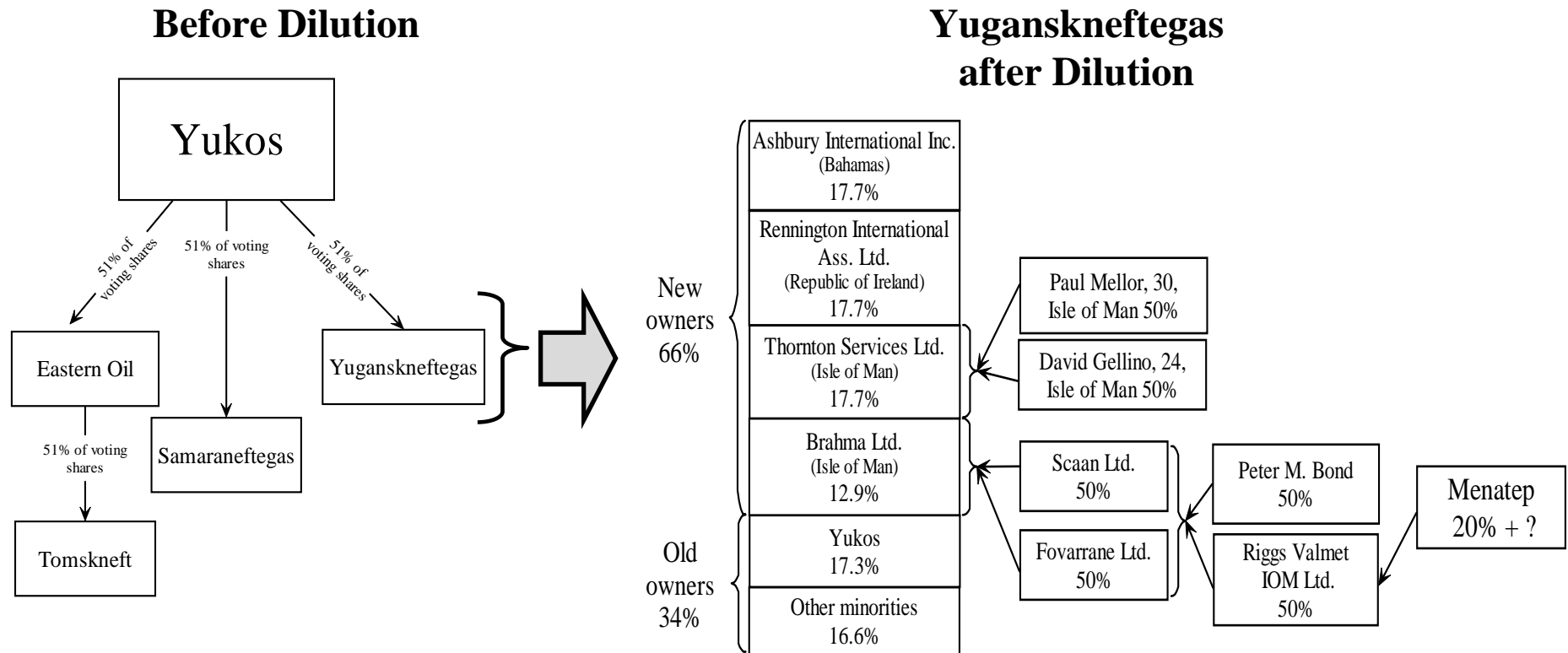
Myth 3



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“Khodorkovsky Is an Innocent Victim”

Offshore companies allegedly close to Khodorkovsky benefited at the cost of shareholders



Myth 3



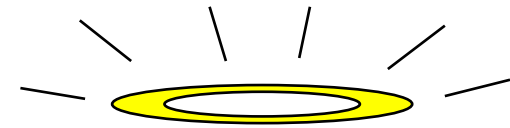
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“Khodorkovsky Is an Innocent Victim”

After an aggressive buy-back program, Khodorkovsky “sees the light” and becomes the poster child of good corporate governance

Yukos Announces:

- Cancellation of all dilutive issues
- Corporate governance charter
- Respectable outside board members
- IAS financial accounts
- Re-listing stock on RTS
- “Changing their ways”



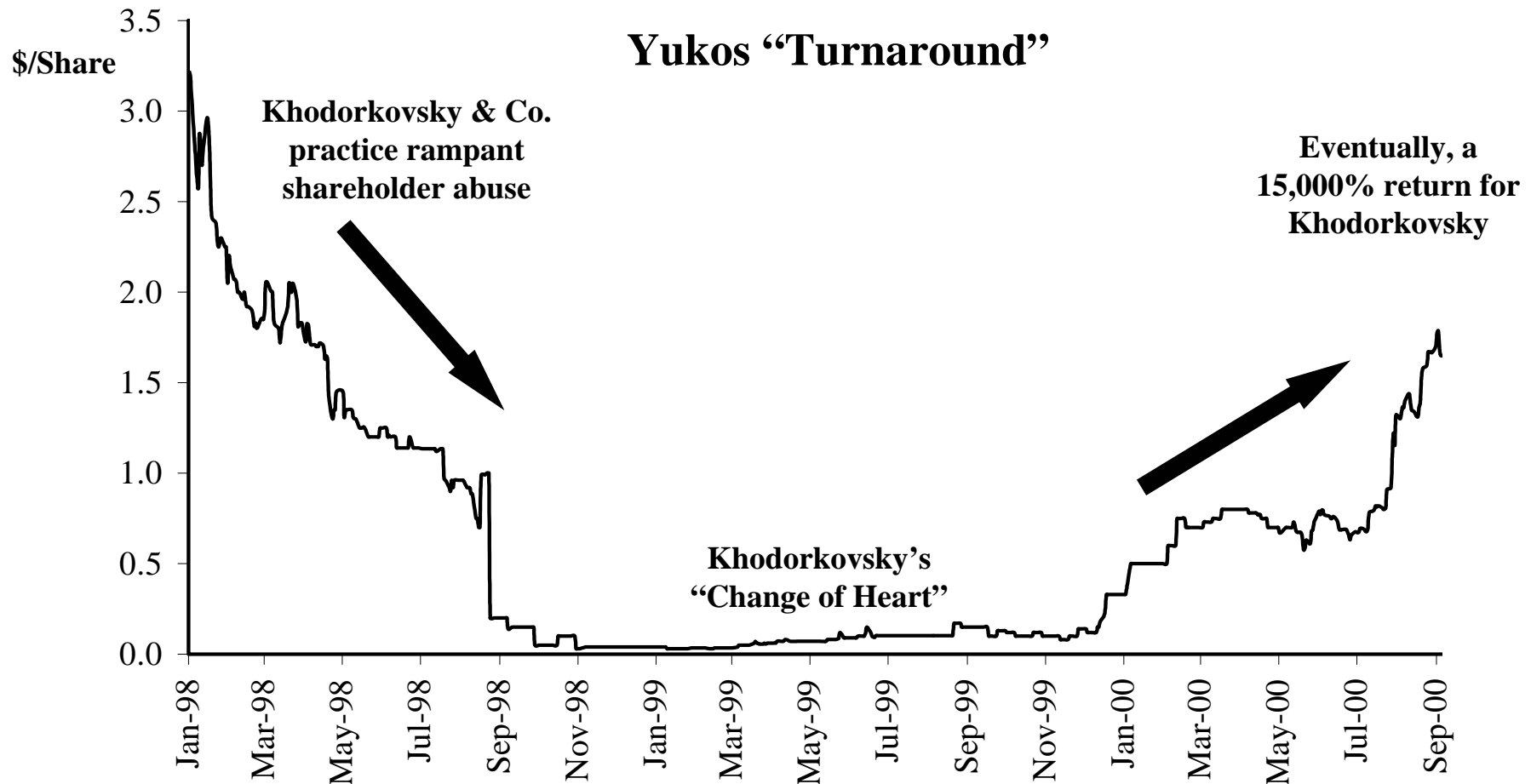
Myth 3



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“Khodorkovsky Is an Innocent Victim”

After all of the shareholders had fled and sold their stakes to Khodorkovsky, it was time to get really rich



Source: AK&M, Reuters Business Briefing.

Myth 4

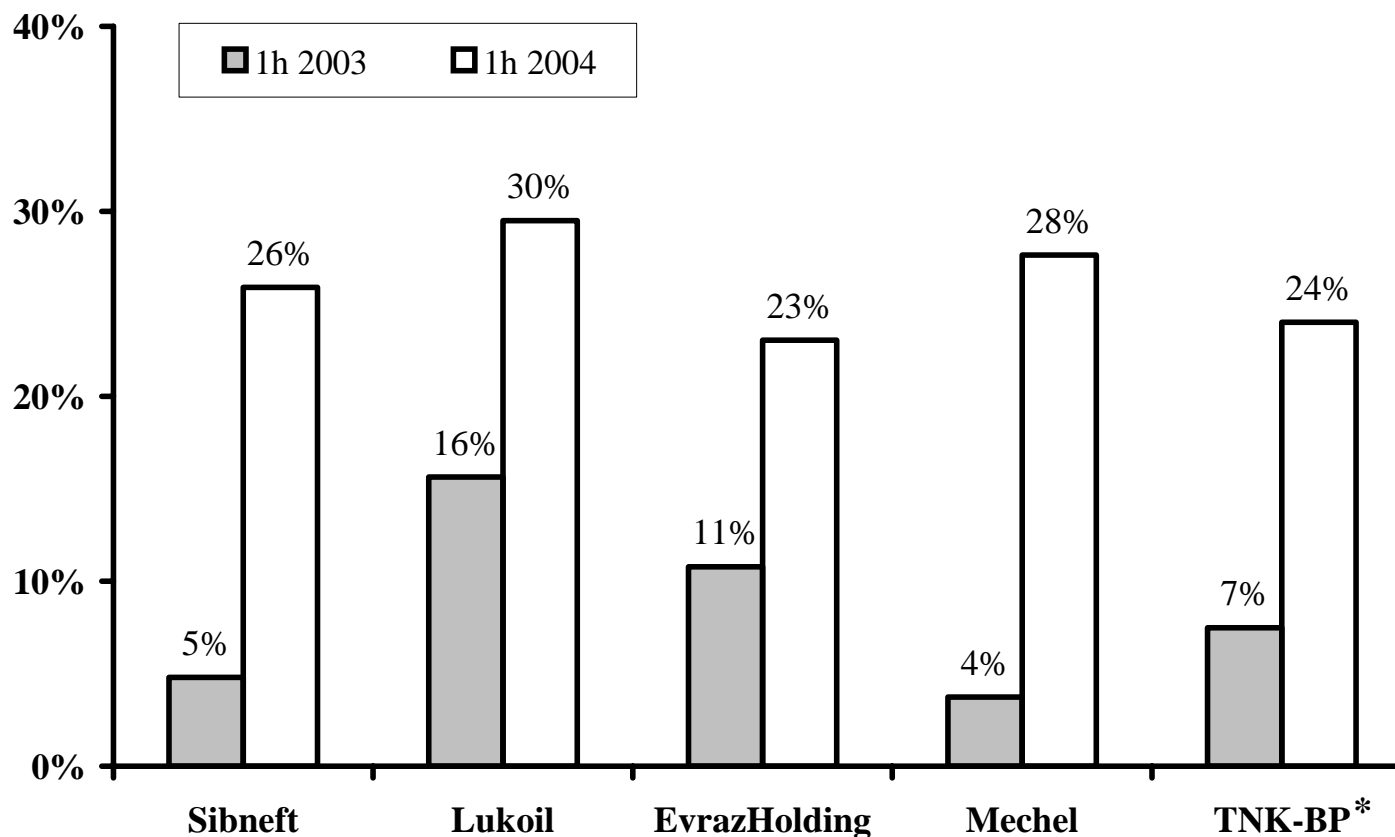


“Putin Ruined the Economy with Yukos”

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Khodorkovsky’s arrest encouraged other oligarchs to pay their taxes

Effective Tax Rates, 1h 2003 vs. 1h 2004



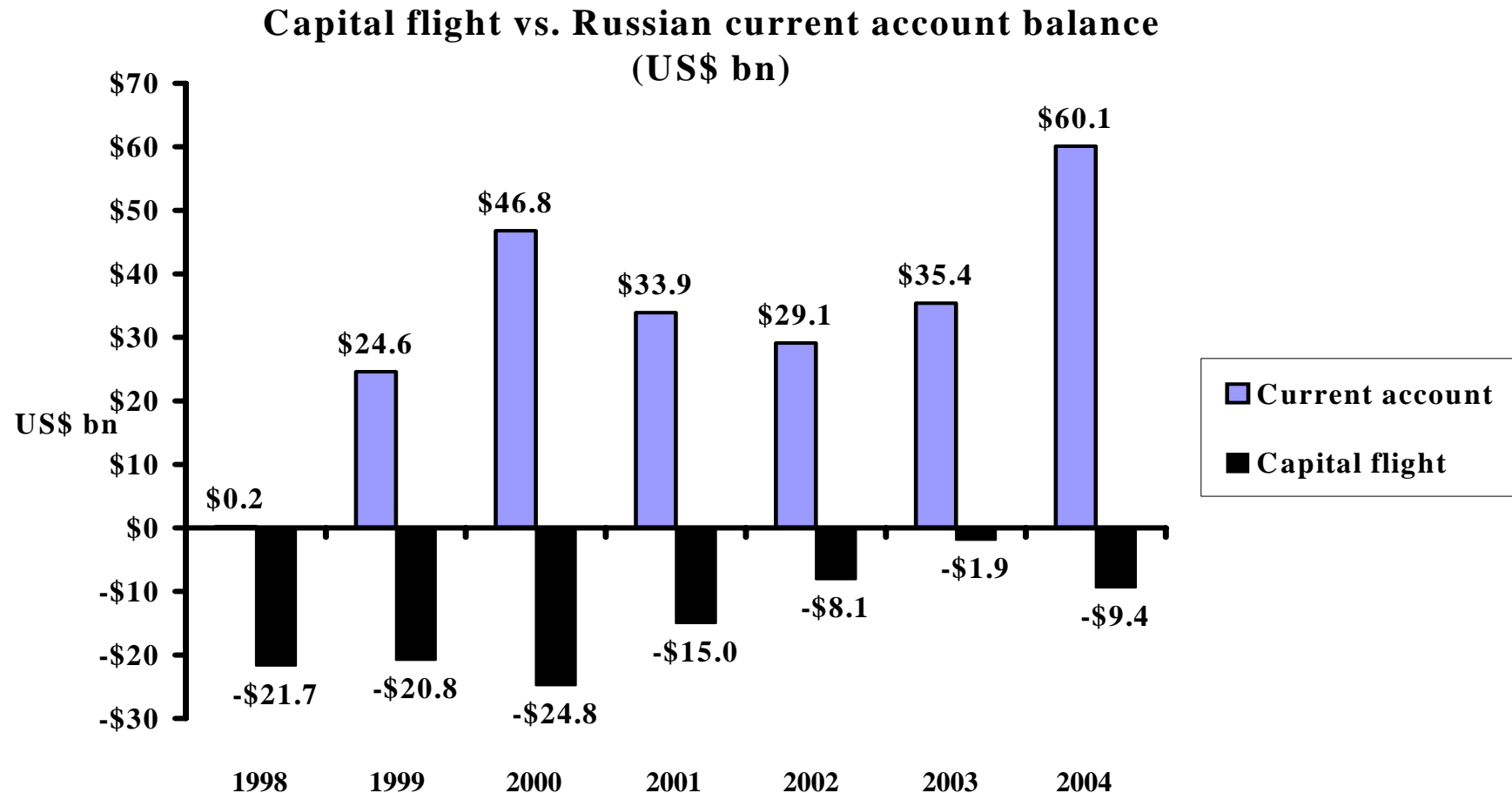
* TNK-BP’s 2004 results / based on a company visit. Source: Hermitage estimates, Companies’ financials. Data for Mechel is for 2003 vs. 2002.

Myth 4



“Putin Ruined the Economy with Yukos” HERMITAGE CAPITAL MANAGEMENT

Everyone talks about capital flight, but no one mentions the booming current account



Source: Central Bank of Russia.

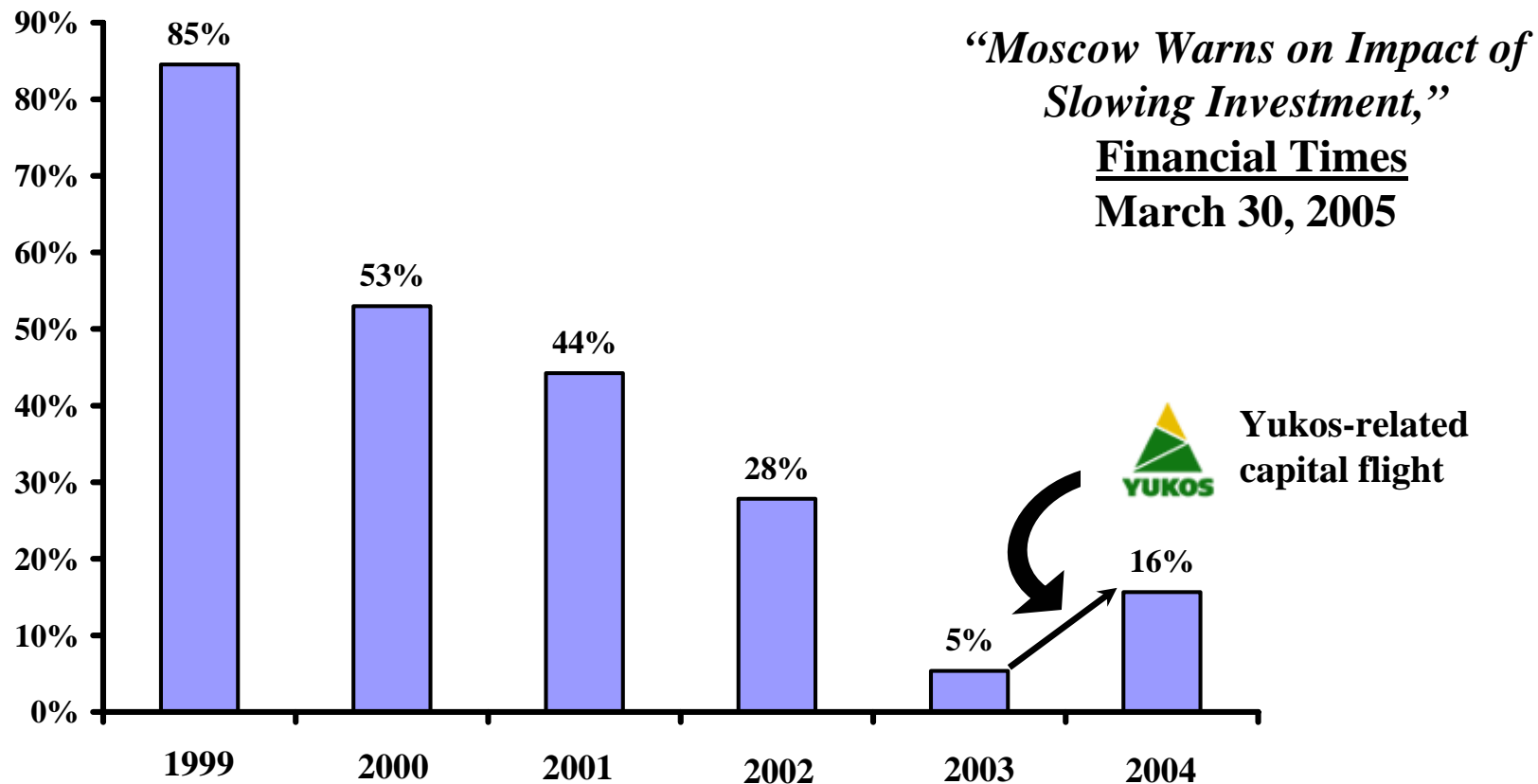


Myth 4

“Putin Ruined the Economy with Yukos”

With the exception of a Yukos–related uptick in 2004, capital flight as a percent of Russia’s current account has fallen annually since 1999

Capital flight as percentage of Russian current account
(1999-2004)

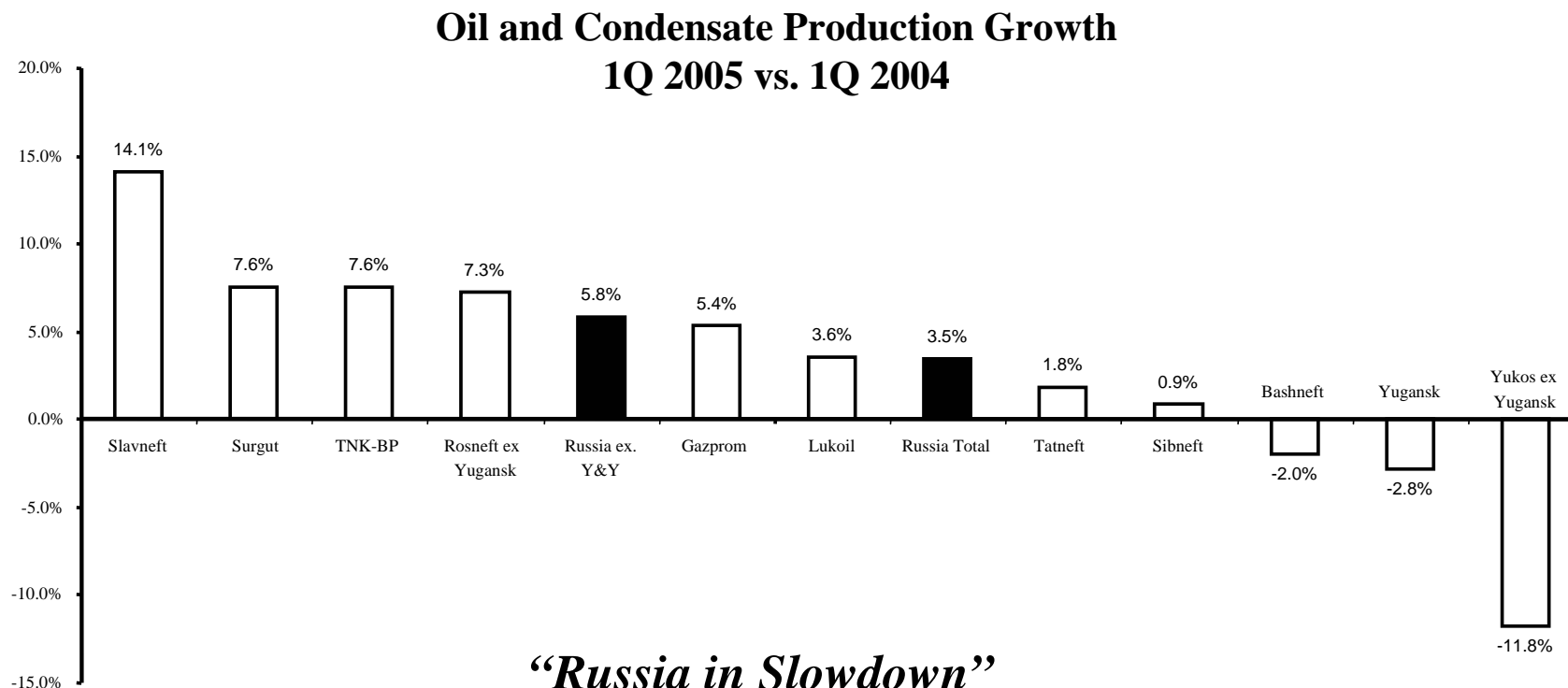


Myth 4



“Putin Ruined the Economy with Yukos”^{HERMITAGE CAPITAL MANAGEMENT}

With the exception of Bashneft and Yukos entities, Russian oil production is up across the board



“Russia in Slowdown”
The Courier Mail, April 6, 2005

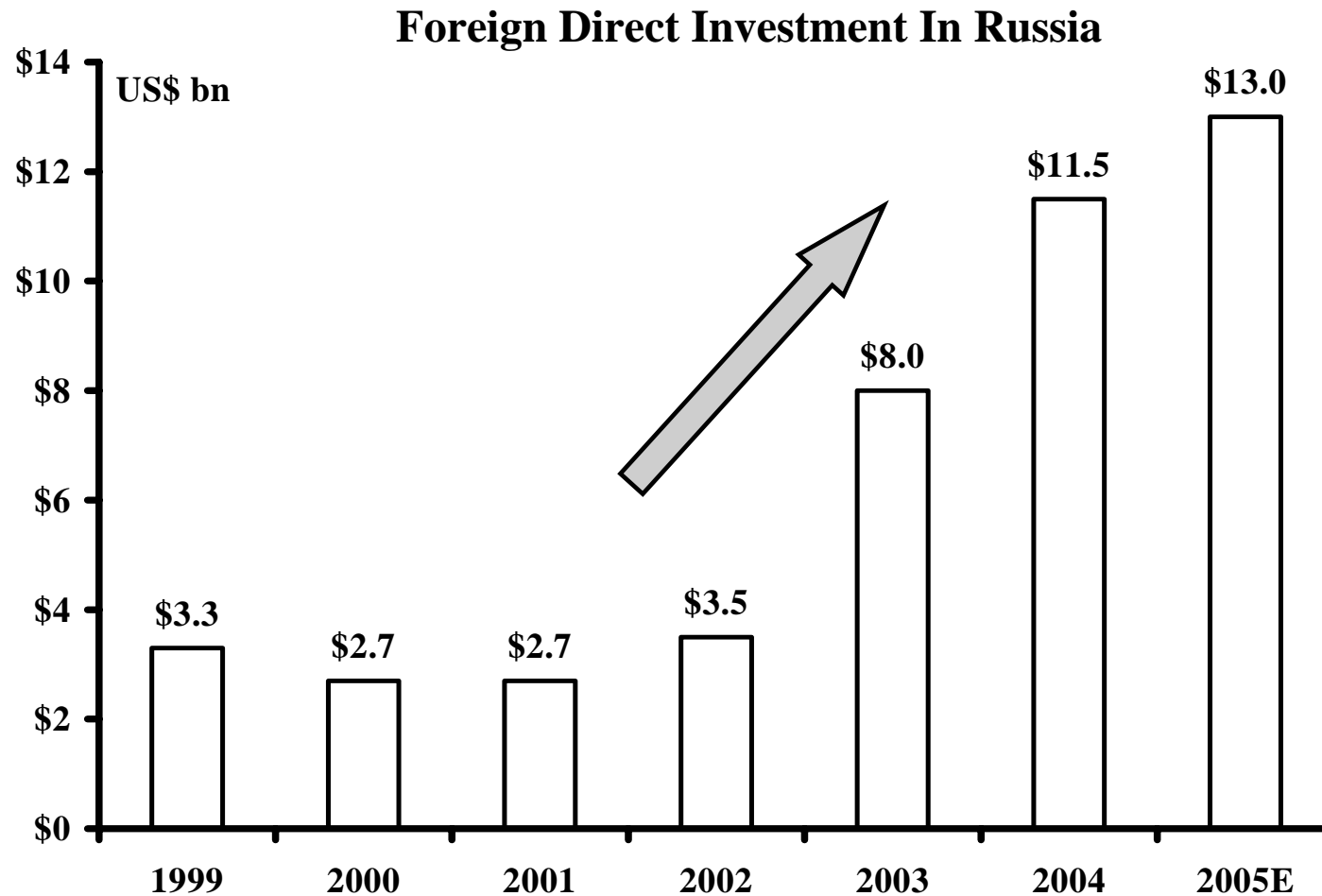
Myth 4



“Putin Ruined the Economy with Yukos”

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Foreign direct investment in Russia continues to grow



Myth 4



“Putin Ruined the Economy with Yukos” HERMITAGE CAPITAL MANAGEMENT

Deals continue to close, with over \$6.1 billion invested since July 2004

BNP Paribas		\$250 m* (July 31, 2004)	Bank Russian Standard	
GE Consumer Finance		\$100 m (August 12, 2004)	Deltabank	
Siemens		\$150 m* (Mid-July, 2004)	Power Machines	
Altadis (Spain)		\$186 m (August 2, 2004)	Balkan Star / Tobacco	
ConocoPhillips		\$1,998 m (Sept. 29, 2004)	Lukoil	
Interbrew		\$650 m (August 12, 2004)	SUN Group / Brewery	
UBS		\$200 m* (August 23, 2004)	Brunswick UBS	
Total		\$1,000 m (Sept. 22, 2004)	Novatek	
Alcoa		2 mills (December 2004)	Rusal	
Sanoma		\$186 m (January 19, 2005)	Independent Media	
Glencore		A grain complex (Jan. 2005)	Alfa-Eco	
Solvay		A \$650m complex (Feb. 2005)	Kaustik (Nikos Group)	
Bosch		A \$60m factory (Mar. 2005)	City of St.-Petersburg	
Coca-Cola		\$600m* (March 15, 2005)	Multon Juice	

* Estimates. Source: Reuters, Bloomberg, Hermitage Estimates, March 2005.

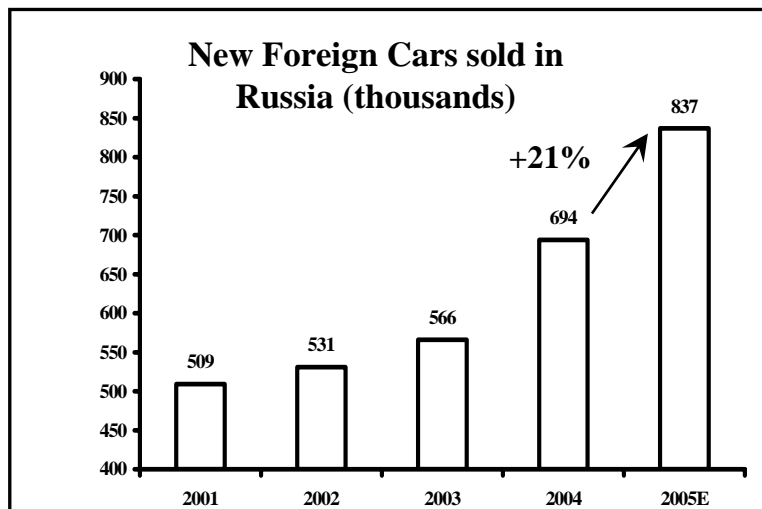
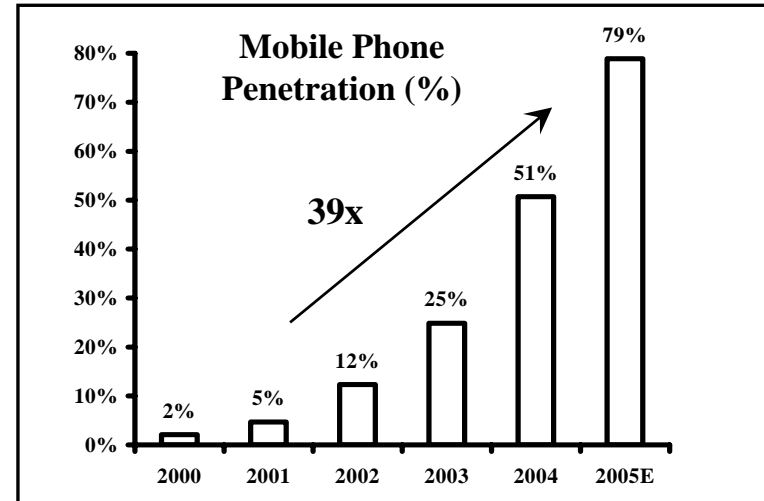
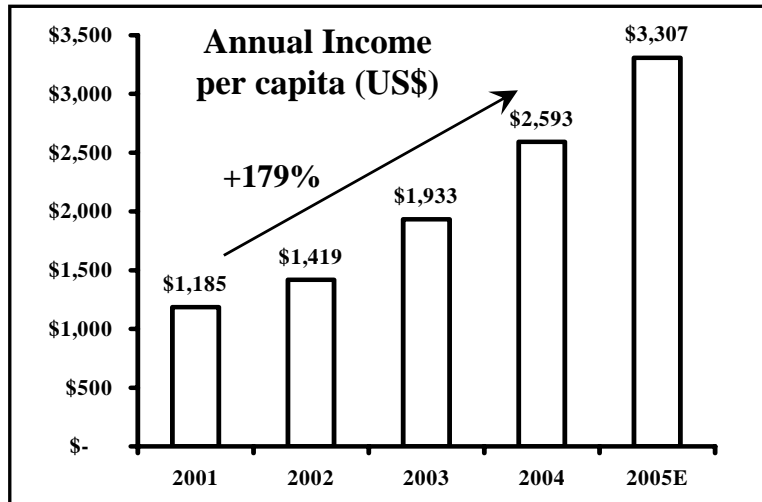
Myth 4



“Putin Ruined the Economy with Yukos”

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And the booming economy can be seen at nearly every level of Russian life



Source: Renaissance Capital, Aton, Hermitage Estimates, April 2005.

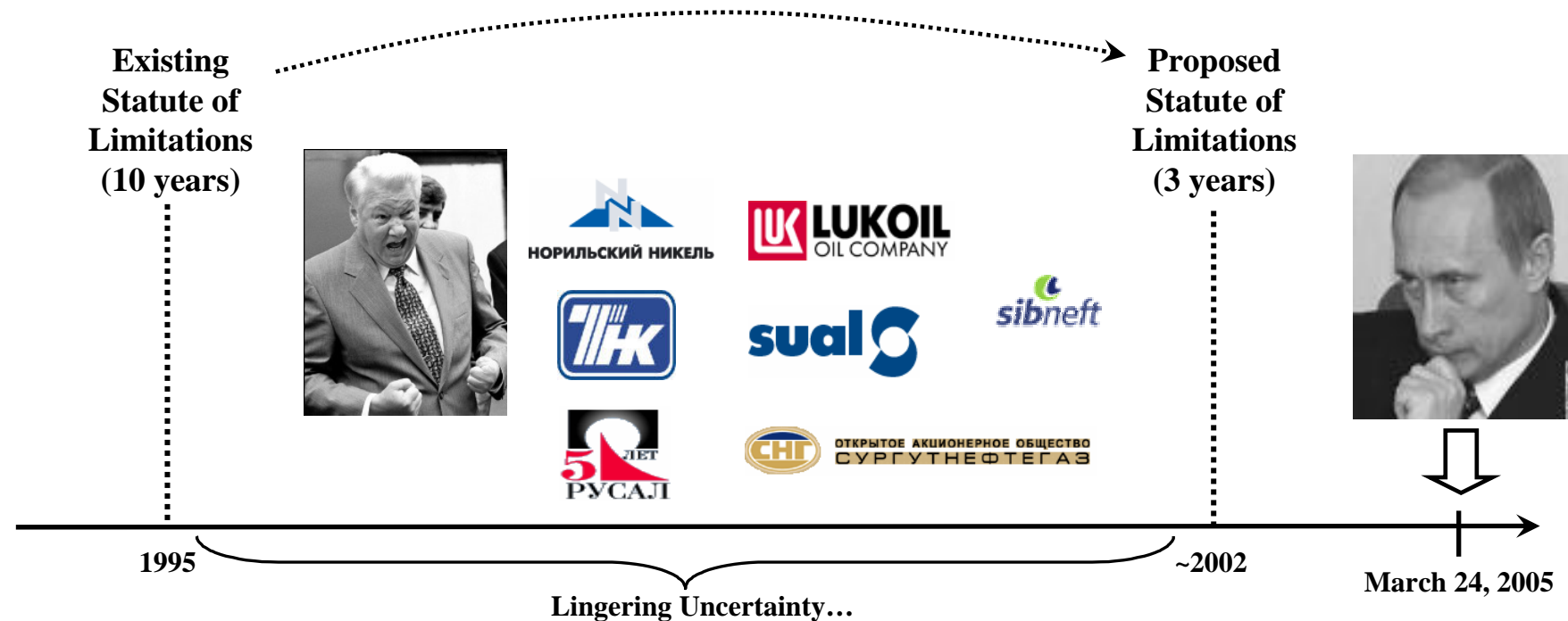


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Myth 4

“Putin Ruined the Economy with Yukos”

On March 24, 2005, in order to restore investor confidence in Russia, Putin announced his support for a general amnesty on all privatizations conducted more than three years ago



“This will help the business community look to the future with greater certainty ... and I hope reassure entrepreneurs on the security of property rights.”

President Putin, March 24, 2005

Myth 5

“Democracy Died with the Governors”

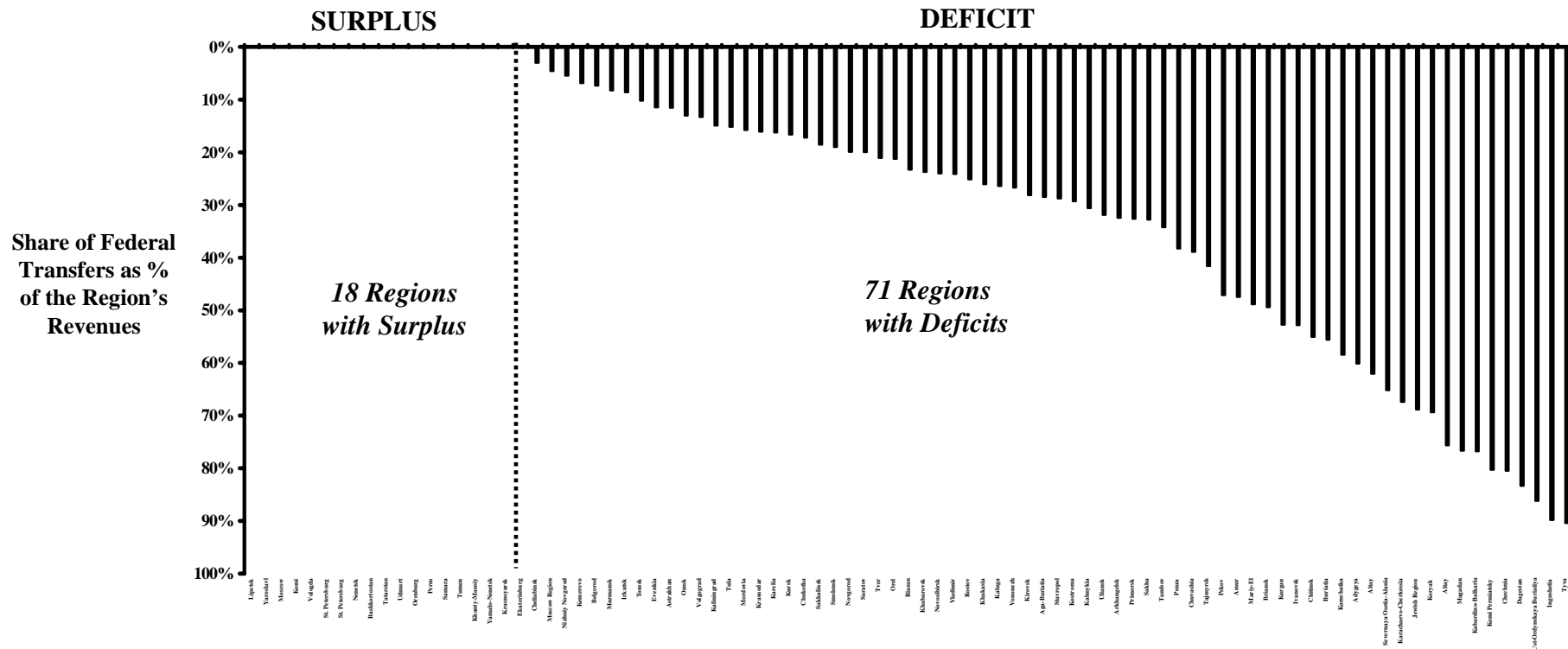


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The vast majority of the Russian regions are run extremely inefficiently and represent a serious drain on the federal budget

Russian Regions: Surplus vs. Deficit

Share of Federal Transfers in the Region's Revenues (%), October 2004



Source: Russian Ministry of Finance (www.minfin.ru).

Myth 5

“Democracy Died with the Governors”



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	Governor	Region	Year*	Accusations	Current status**
	Loginov	Koryakia	2004-5	Vice-Governor found guilty of abuse of power; Loginov fired for alleged theft of winter heating oil	Under criminal investigation
	Ayatskov	Saratov	2004	Misappropriation of government's funds; Illegal benefits in favor of crony companies	Under criminal investigation
	Rutskoi	Kursk	2003	Abuse of power; Illegal borrowing of \$6m to buy equipment overpriced by \$1.8m	Retired
	Nazdratenko	Far East	2000	Mismanagement; Blackouts and heating disruptions	Deputy Head of Security Council
	Lisitsin	Yaroslavl	2004	Abuse of power; Illegal issuance of below-market loans resulting in a \$50m loss	Under house arrest
	Mashkovtsev	Kamchatka	2004	Abuse of power; Illegal issuance of fishing licenses	Under criminal investigation
	Titov	Samara	2004	Abuse of power; Illegal issuance of \$10m loan which was not repaid	Under criminal investigation
	Yakovlev	St. Petersburg	2002	Several deputies accused of graft	Held positions of Vice-PM & Head of South District
	Gorbenko	Kaliningrad	2003	Illegal \$10m guarantee issued in favor of a crony company, which didn't repay loans	Director of fishing port
	Butov	Yamal-Nenetsk	2002 2003	Fraud Physical assault	Under criminal investigation

Notes: * Year in which charges were brought against the governor; **According to available media reports; Sources: Izvestia.ru 17.05.04, Kommersant 01.10.03; RBC 06.12.00, Gazeta.ru 23.08.04, Lenta.ru 30.08.04, Russkiy Kurier 11.01.05, ORT 23.05.02, Vremya Novostei 05.08.03, Izvestia 11.01.05, Kommersant 28.06.02

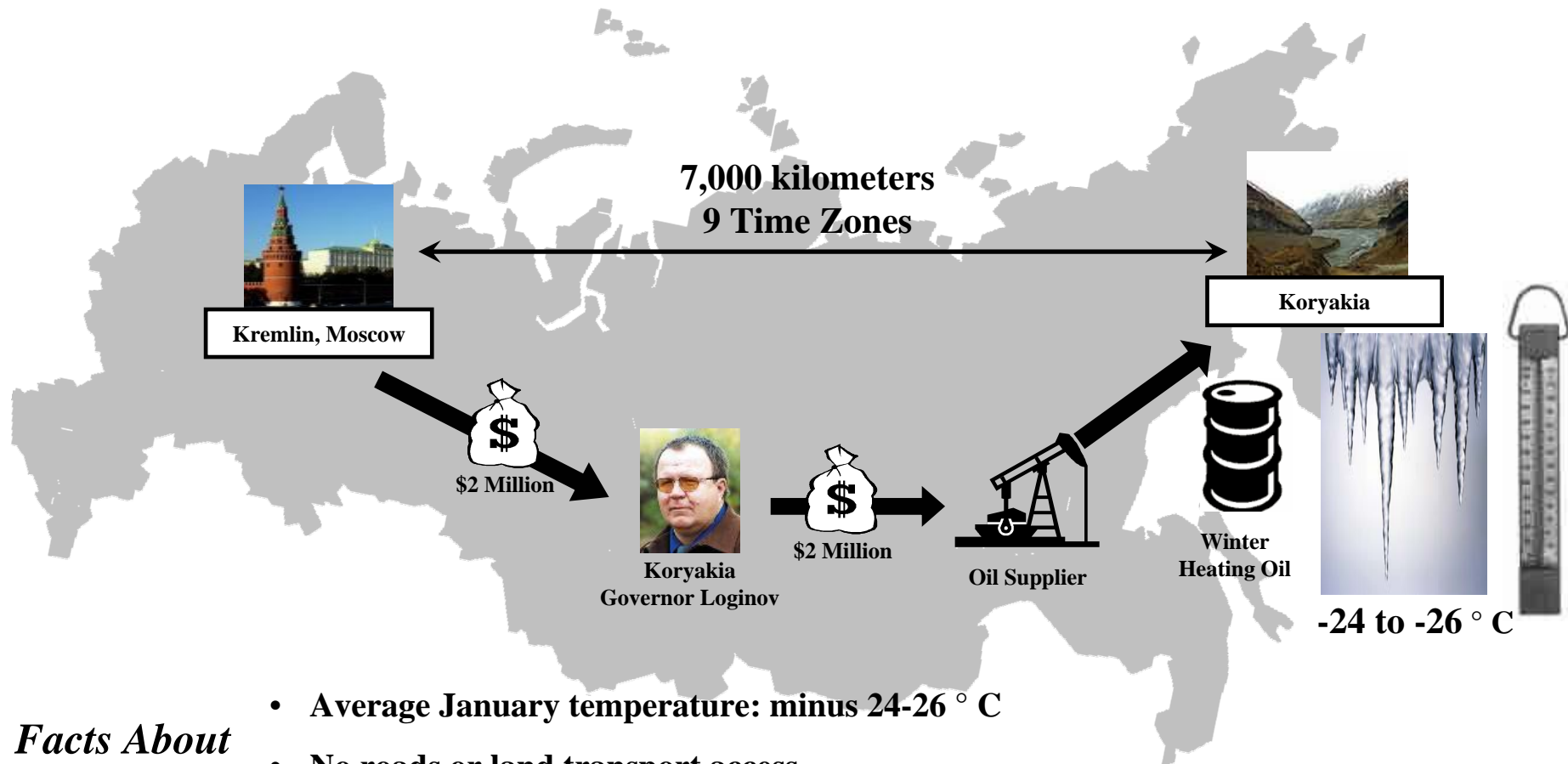
Myth 5

“Democracy Died with the Governors”



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What should have happened last winter in Koryakia...



Facts About Koryakia

- Average January temperature: minus 24-26 ° C
- No roads or land transport access
- Fully dependent upon Moscow for winter heating fuel subsidy & supply

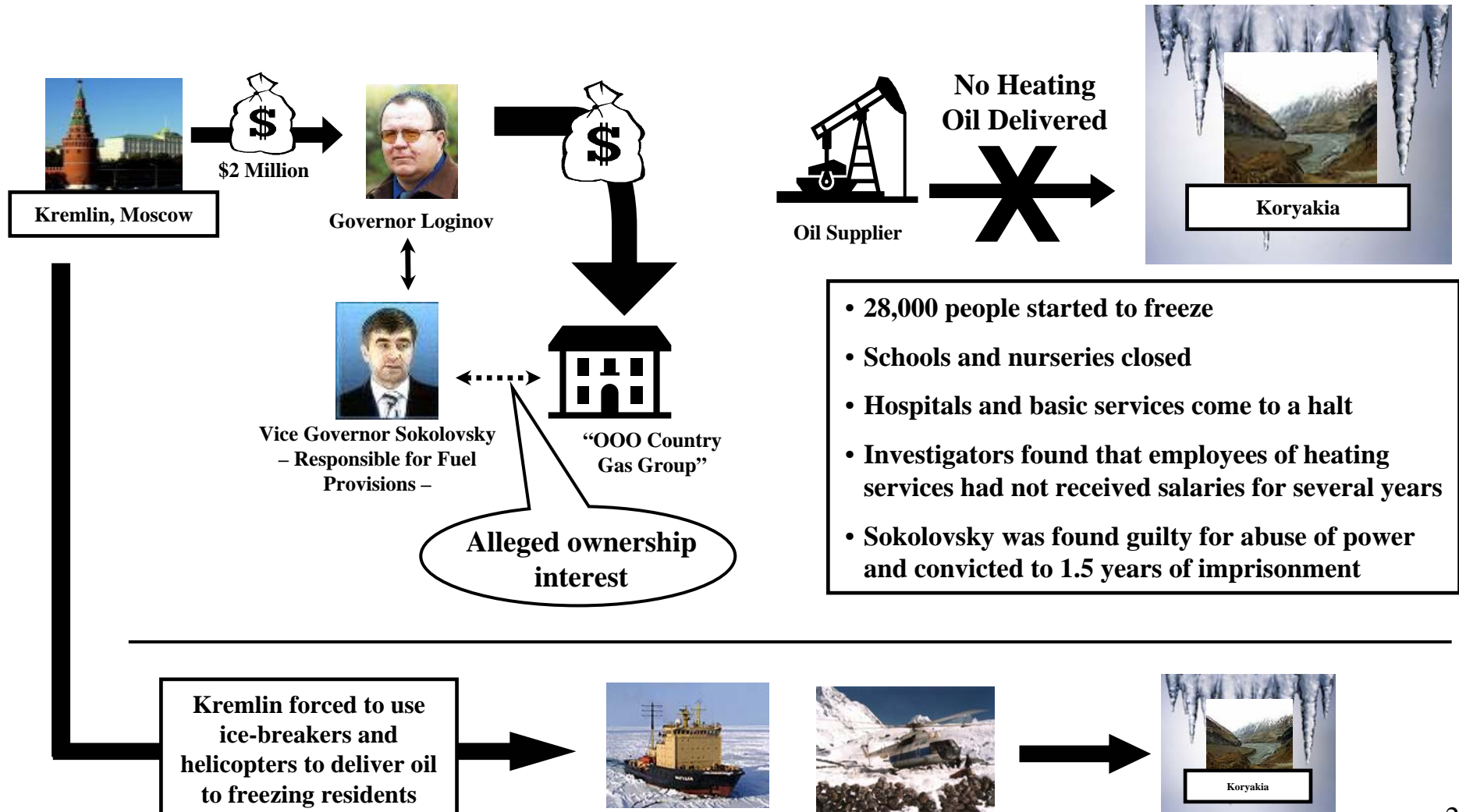
Myth 5

“Democracy Died with the Governors”



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What happened instead...



Source: Moscow Prosecutor General’s Office, Rossiiskaya Gazeta, Komsomolskaya Pravda.



Myth 6

A New Cold War in Ukraine?

The Ukrainian elections were never a simple fight between good and evil, but rather one between two compromised candidates supported by powerful oligarchs

Yanukovych vs. Yushchenko



Rinat Akhmetov

- Azovstal (metals)
- Krivorozhstal (metals)
- Urkrmetallurgtrans (transport)
- Central GOK (iron ore mining)
- Severny GOK (iron ore mining)
- Krasnodon Coal
- Dobropolie Coal
- Kharziski Pipe
- Azovmash (machinery)
- Markokhim (coal)
- Sarmat Brewery



Yanukovich:

- Two prison sentences
- Privatized Krivorozhstal (a metal plant) to Akhmetov and Pinchuk, Kuchma's son-in-law

Yushchenko:

- Led the Ukrainian Central Bank when it systematically overstated the country's reserve position to the IMF, causing over \$200m in additional funds to be disbursed; \$600m of IMF funds later embezzled (PWC Audit)

Julia Timoshenko

- Former CEO of Unified Energy Systems of Ukraine, aka the "Gas Princess", controlling a monopoly on the import and distribution of Russian gas in Ukraine
- Allegedly bribed former Ukrainian Prime Minister Pavel Lazarenko to arrange a national monopoly on natural gas distribution in Ukraine
- Lazarenko later indicted by a U.S. Grand Jury, charged with laundering \$114 million
- Timoshenko on the Interpol detention list, November 2004 (later removed)
- Husband Olexandr jailed on charges of corruption and theft of state property

Source: "Release of PricewaterhouseCoopers Report on the National Bank of Ukraine," <http://www.imf.org/external/np/sec/nb/2000/nb0015.htm>, "The Eleven Billion Dollar Woman," *Casino Moscow* (2002), Matthew Brzezinski, pp. 119-144; "Lazarenko Says New President of Ukraine Could Clear Him," *Associated Press*, January 13, 2005; "The Yushchenko Mythos," Raimondo, Justin, November 29, 2004, Interpol Can Detain Former Ukrainian Deputy PM, Pravda.ru/RBC, September 29, 2004; "Interpol Can Detain Former Ukrainian Deputy PM," *RosBusinessConsulting*, September 29, 2004; www.ukrwe.ekly.com/Archive/2000/2003.shtml; www.imf.org/external/country/UKR/auth/2000/eng/letter.htm, www.imf.org/external/np/sec/dec/2000/eng/ebm0091.htm; <http://www.imf.org/external/country/ukr/pwc/2000/index.htm>, <http://www.ukrpravda.com/ru/archive/2004/may/14/4.shtml>, <http://www.krivorozhstal.ru/opinions.php?id=73>, http://www.mirtv.ru/cgi-bin/sanitarium2/view.cgi?id=6192&ca_t_id=2&print=1, <http://www.sta.gov.ua/news.php3?166>; <http://ru.obkom.net.ua/news/2004-09-24/1932.shtml>, <http://intertv.kiev.ua/print/economy/2004/07/19/134281.html>, <http://www.economicua.info/modules.php?name=News&file=article&sid=511>.

Myth 7

“Reforms are Finished”



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Although some specific efforts have recently stalled, reform is continuing

Done in 2004

- Social Welfare Reform (“monetization” of benefits)
- Stabilization Fund (created and funded to US\$19bn)
- Payroll Tax Reform
- Healthcare Reform: medical insurance introduced
- Mortgage Reform: laws facilitating mortgage lending
- Banking Reform: deposit insurance introduced; “Strategy for Development of the Banking System” (2004-08)
- Constitutional and Electoral Reform
- Administrative Reform: streamlining of ministries and consolidation of responsibilities

Incomplete or Stalled

- Electricity Sector Reform (UES) Restructuring
- Gas Sector Reform
- Further Banking Reform
- Military Reform

Expected in 2005

- Privatization of Svyazinvest
- Liberalization of Gazprom shares
- Tax Reform: VAT to be reduced
- Continued progress to WTO Membership
- Educational Reform
- Creation of Special Economic Zones to stimulate investment in high-tech
- Break-up of local electricity monopolies
- Banking: cleansing to continue; rules facilitating mergers to be adopted
- Communal Services Restructuring

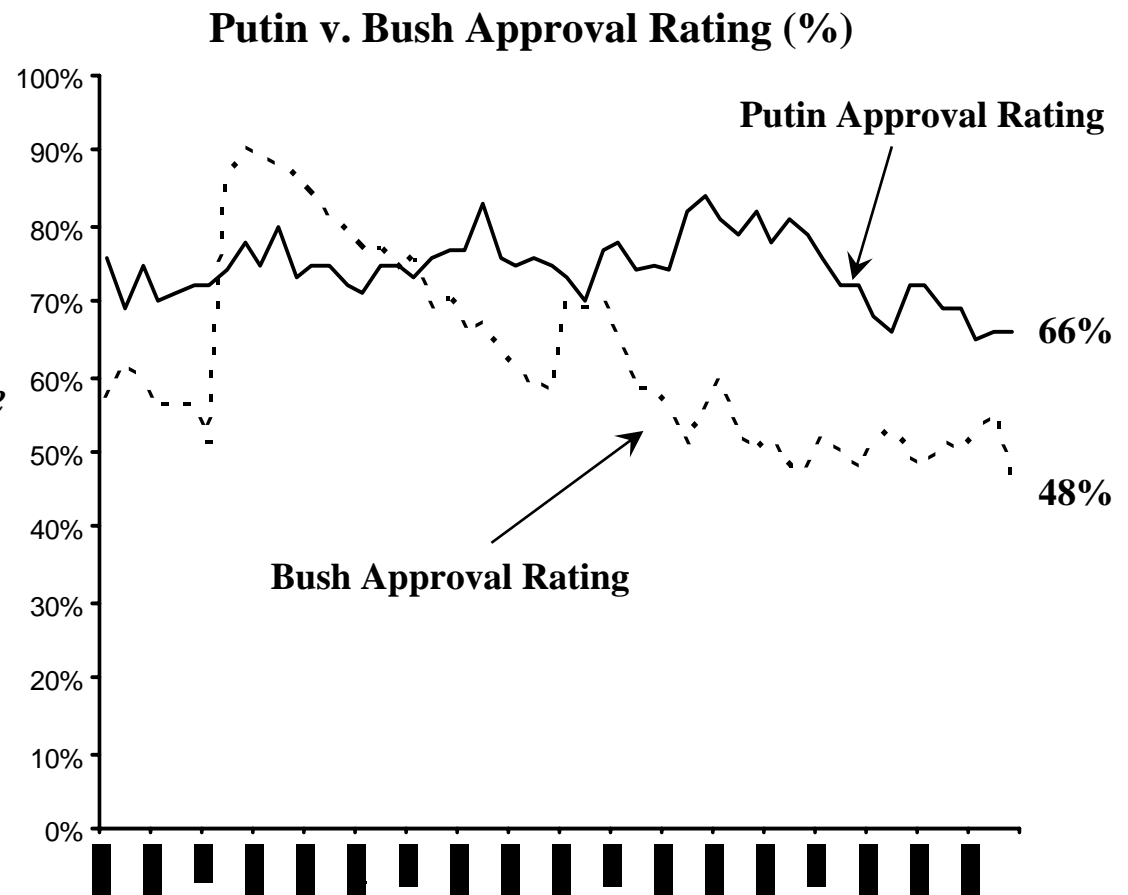


Putin's Mandate

Whatever the foreign criticism, Putin's agenda has been met with genuine support at home on an absolute and relative basis

Putin's Mandate

- 1. Establish law and order*
- 2. Restore the power of Russia in the world*
- 3. Eliminate oligarchs' influence*
- 4. End poverty and fiscal responsibility*

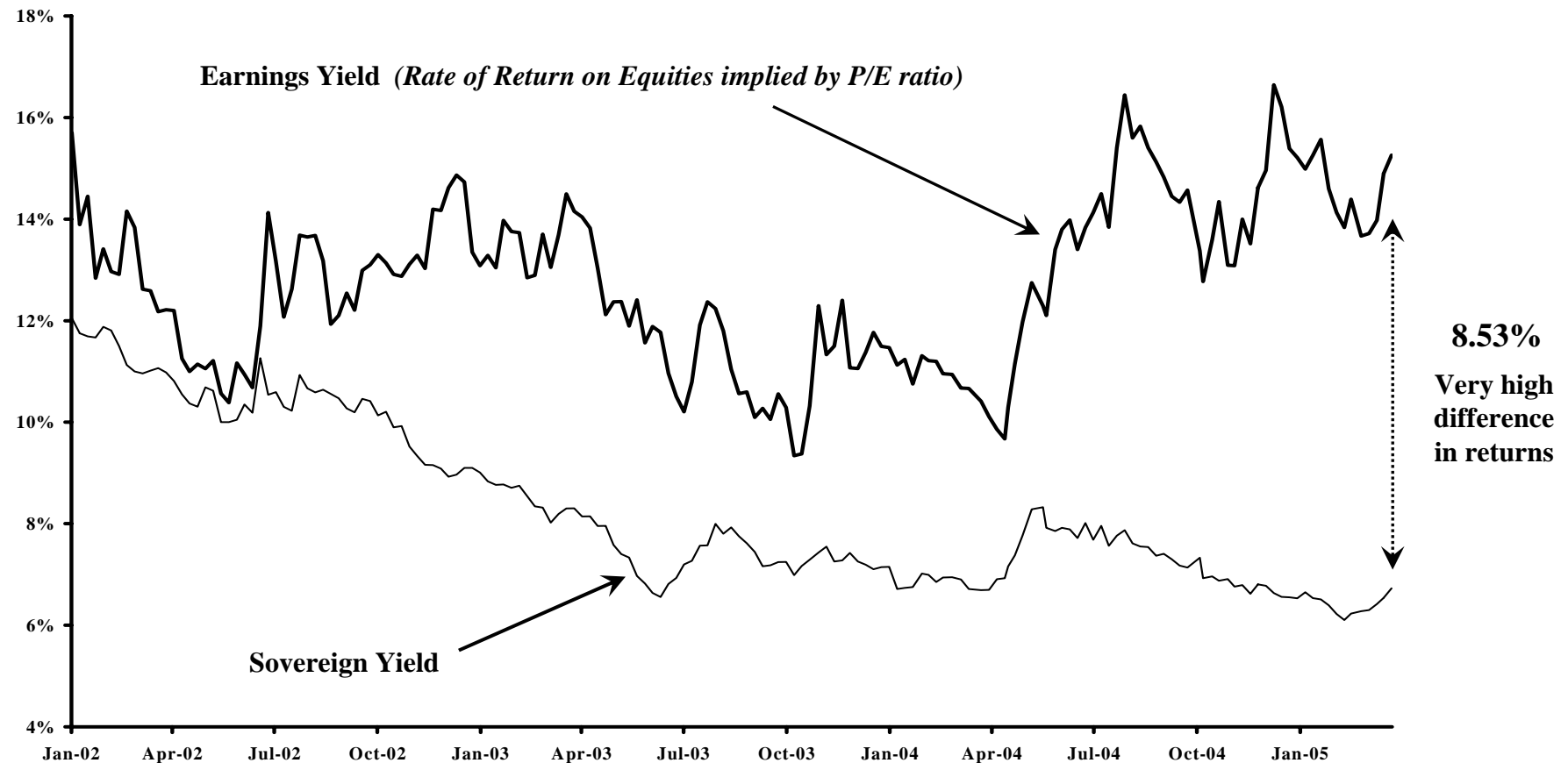




Perception versus Reality

These myths have had a dramatic impact on Russian equities

Russian Bond Yields vs. Earnings Yield (%)



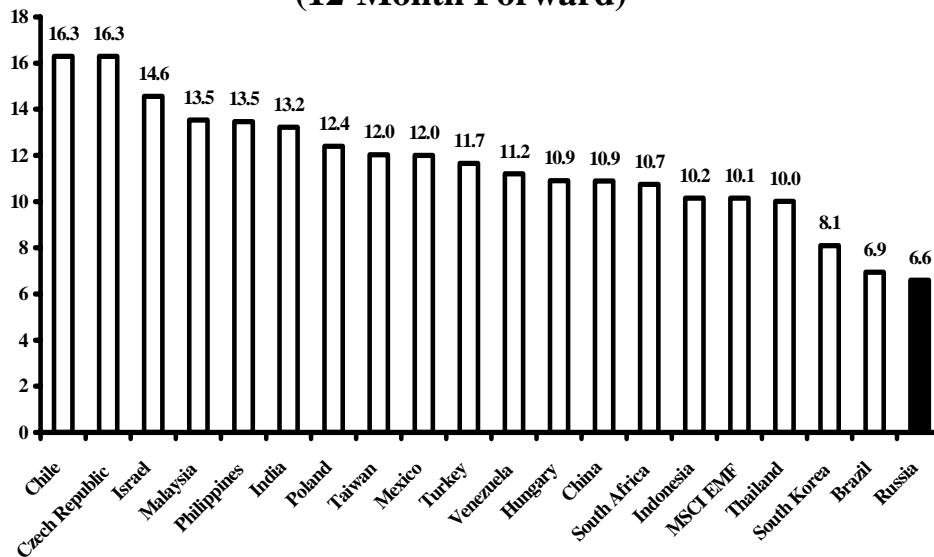
Source: HSBC, Bloomberg, Hermitage Estimates, March 2005.



Russian Macroeconomics

The Russian stock market remains the cheapest in the emerging market universe

**PE of Russia vs. Other GEM Countries
(12-Month Forward)**



**Price/Earnings Ratio of Russia
(12-Month Forward)**

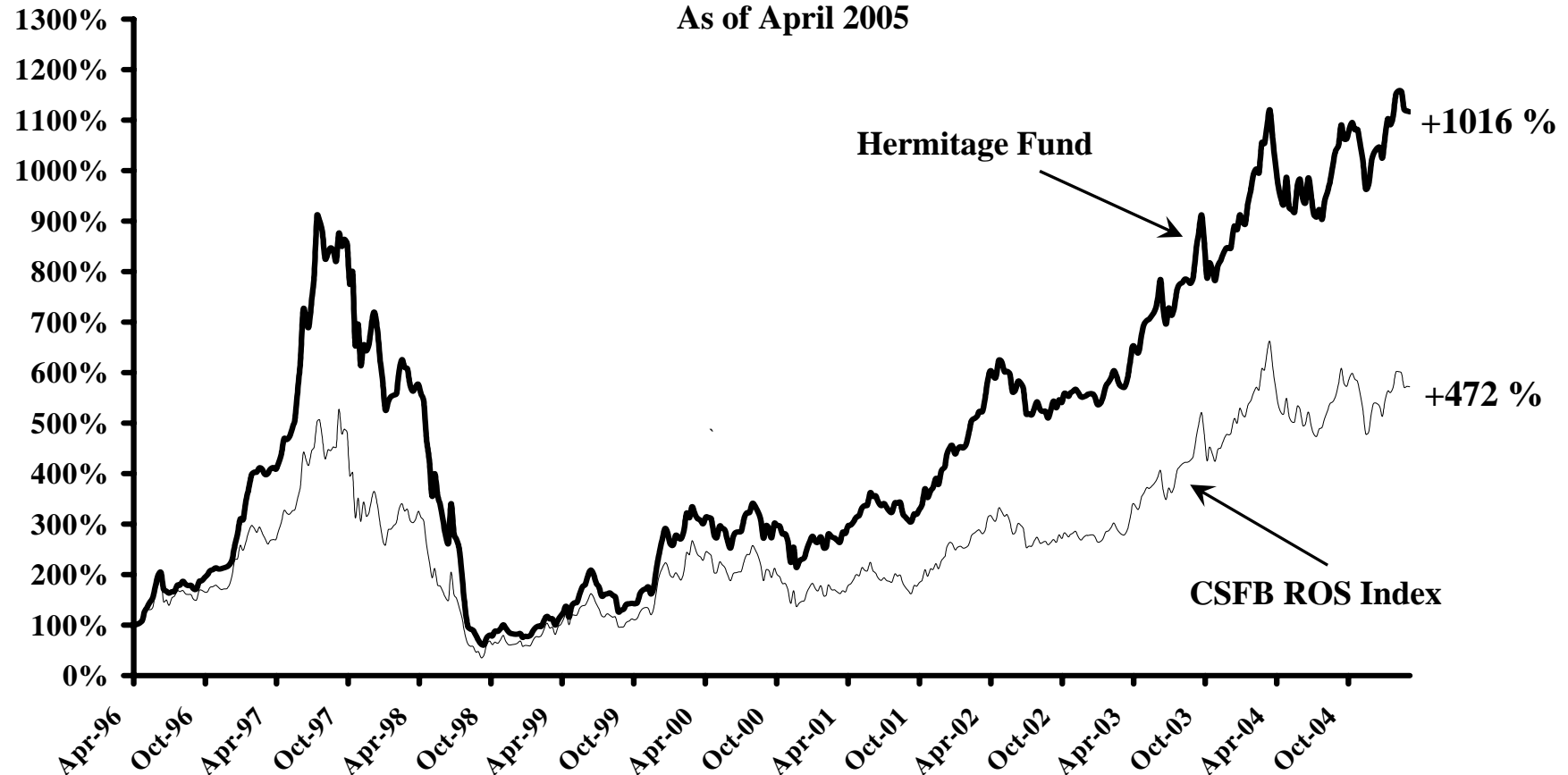




Hermitage Performance

We have spent the last nine years trying to convince people that many myths about Russia are untrue

Performance of the Hermitage Fund vs. the Russian Market
As of April 2005





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Disclaimer

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