Seven Big Myths About Russia

By William Browder
Chief Executive Officer
Hermitage Capital Management

April 2005
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

- Yukos: 228 articles
- Ukraine: 227 articles
- Authoritarianism: 119 articles
- Lack of Reforms: 68 articles
- Economy / Oil Prices: 29 articles
- Russia’s New Holiday Schedule: 12 articles

2.3% of the news

“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.

Share of the Russian Economy Auctioned by the State

<table>
<thead>
<tr>
<th>President Yeltsin</th>
<th>Share</th>
<th>Auction Proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Putin</td>
<td>0.3%</td>
<td>$1.2bn</td>
</tr>
<tr>
<td></td>
<td>30%</td>
<td>$2.8bn</td>
</tr>
</tbody>
</table>

Putin realizes 230 times better yields on sales of state assets than Yeltsin.

Myth 1

“Putin Is Corrupt”

Putin has prioritized debt reduction over debt accumulation

Source: Brunswick UBS, Hermitage.
Myth 2

“Oligarchs = Robber Barons”

The Russian oligarchs’ control of the Russian economy is unprecedented

<table>
<thead>
<tr>
<th># of Owners</th>
<th>% of Economy</th>
</tr>
</thead>
<tbody>
<tr>
<td>22</td>
<td>40%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th># of Owners</th>
<th>% of Economy</th>
</tr>
</thead>
<tbody>
<tr>
<td>750,000</td>
<td>45%</td>
</tr>
</tbody>
</table>

Myth 2

“Oligarchs = Robber Barons”

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)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>% GDP</td>
<td>-9.90%</td>
<td>-9.10%</td>
<td>-7.70%</td>
<td>-7.10%</td>
<td>-3.10%</td>
<td>-1.50%</td>
<td>-0.90%</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Year</th>
<th>1901</th>
<th>1902</th>
<th>1903</th>
<th>1904</th>
<th>1905</th>
<th>1906</th>
<th>1907</th>
</tr>
</thead>
<tbody>
<tr>
<td>% GDP</td>
<td>0.30%</td>
<td>0.35%</td>
<td>0.20%</td>
<td>-0.18%</td>
<td>-0.09%</td>
<td>0.09%</td>
<td>0.30%</td>
</tr>
</tbody>
</table>

Myth 3
“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.

Impact on Yuganskneftegas from Proposed Below-Market Sales
(1997 - 2001)

$bn

$97.8bn

Revenues @ Market Price

$14.5bn

Revenues under Proposed Sales

$83.3bn

Potential Lost Revenue

$83.3 billion in potential lost revenues

Source: Yuganskneftegas filings with the Federal Securities Commission r.e. Interested Party Transactions; Russian Federation Customs Committee Database.
Myth 3
“Khodorkovsky Is an Innocent Victim”

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

1999 Yuganskneftegaz Dilution

- Non-Voting: 25% of Capital
- Minorities: 37% of Capital
- Yukos: 38% of Capital (51% of Voting Shares)
- Three Offshore Entities (17% of Voting)

Yuganskneftegaz as of April 1999

- Non-Voting: 10% of Capital
- Minorities: 15% of Capital
- Three Offshore Entities (17% of Voting)

Yuganskneftegaz after new share issue

146% capital increase

77,863,824 new voting shares
59% of capital
(66% of voting)

131,229,074

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

Similar Dilutions Proposed at Tomskneft and Samaraneftegaz

Offshore Buyers
- Asbury International Inc. (Bahamas)
- Rennington International Associates Ltd. (Ireland)
- Thornton Services Ltd. (Isle of Man)
  - Paul Mellor (30 years old) (50%)
  - David Gellino (24 years old) (50%)
- Brahma Ltd (Isle of Man)
  - Peter Bond (50%)
  - Riggs Valmet IOM Ltd (50%)
  - Menatep (20%)

Source: Yuganskneftegaz Board of Directors meeting materials, February 26, 1999; Hermitage.
Myth 3
“Khodorkovsky Is an Innocent Victim”

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

Source: Yuganskneftegas Board of Directors meeting materials, February 26, 1999; Hermitage.
Myth 3

“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
“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

Yukos “Turnaround”

Eventually, a 15,000% return for Khodorkovsky

Khodorkovsky & Co. practice rampant shareholder abuse

Khodorkovsky’s “Change of Heart”

Source: AK&M, Reuters Business Briefing.
Myth 4

“Putin Ruined the Economy with Yukos”

Khodorkovsky’s arrest encouraged other oligarchs to pay their taxes

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

- **Sibneft**: 5% (1h 2003), 26% (1h 2004)
- **Lukoil**: 16% (1h 2003), 30% (1h 2004)
- **EvrazHolding**: 11% (1h 2003), 23% (1h 2004)
- **Mechel**: 4% (1h 2003), 28% (1h 2004)
- **TNK-BP***: 7% (1h 2003), 24% (1h 2004)

Myth 4
“Putin Ruined the Economy with Yukos”

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)

Source: Central Bank of Russia.

“Moscow Warns on Impact of Slowing Investment,” Financial Times March 30, 2005
Myth 4

“Putin Ruined the Economy with Yukos”

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

Oil and Condensate Production Growth
1Q 2005 vs. 1Q 2004

- Slavneft: +14.1%
- Surgut: +7.6%
- TNK-BP: +7.6%
- Rosneft ex. Yugansk: +7.3%
- Russia ex. Y&Y: +5.8%
- Gazprom: +5.4%
- Lukoil: +3.6%
- Russia Total: +3.5%
- Tatneft: +1.8%
- Sibneft: 0.9%

Bashneft: -2.0%
Surgut ex. Yugansk: -2.8%
Yukos ex. Yugansk: -11.8%

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

Myth 4
“Putin Ruined the Economy with Yukos”

Foreign direct investment in Russian continues to grow

## Myth 4

**“Putin Ruined the Economy with Yukos”**

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

<table>
<thead>
<tr>
<th>Company</th>
<th>Investment Amount</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>BNP Paribas</td>
<td>$250 m*</td>
<td>(July 31, 2004)</td>
</tr>
<tr>
<td>GE Consumer Finance</td>
<td>$100 m</td>
<td>(August 12, 2004)</td>
</tr>
<tr>
<td>Siemens</td>
<td>$150 m*</td>
<td>(Mid-July, 2004)</td>
</tr>
<tr>
<td>Altadis (Spain)</td>
<td>$186 m</td>
<td>(August 2, 2004)</td>
</tr>
<tr>
<td>ConocoPhillips</td>
<td>$1,998 m</td>
<td>(Sept. 29, 2004)</td>
</tr>
<tr>
<td>Interbrew</td>
<td>$650 m</td>
<td>(August 12, 2004)</td>
</tr>
<tr>
<td>UBS</td>
<td>$200 m*</td>
<td>(August 23, 2004)</td>
</tr>
<tr>
<td>Total</td>
<td>$1,000 m</td>
<td>(Sept. 22, 2004)</td>
</tr>
<tr>
<td>Alcoa</td>
<td>2 mills</td>
<td>(December 2004)</td>
</tr>
<tr>
<td>Sanoma</td>
<td>$186 m</td>
<td>(January 19, 2005)</td>
</tr>
<tr>
<td>Glencore</td>
<td>A grain complex</td>
<td>(Jan. 2005)</td>
</tr>
<tr>
<td>Solvay</td>
<td>A $650m complex</td>
<td>(Feb. 2005)</td>
</tr>
<tr>
<td>Bosch</td>
<td>A $60m factory</td>
<td>(Mar. 2005)</td>
</tr>
<tr>
<td>Coca-Cola</td>
<td>$600m*</td>
<td>(March 15, 2005)</td>
</tr>
</tbody>
</table>

Myth 4
“Putin Ruined the Economy with Yukos”

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

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”

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*

### Myth 5

**“Democracy Died with the Governors”**

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

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”
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”

What happened instead…

- 28,000 people started to freeze
- Schools and nurseries closed
- Hospitals and basic services come to a halt
- Investigators found that employees of heating services had not received salaries for several years
- Sokolovsky was found guilty for abuse of power and convicted to 1.5 years of imprisonment

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.

Yanukovich vs. Yushchenko

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)

Rinat Akhmetov
- Azovstal (metals)
- Krivovozhstal (metals)
- Ukrmetallurgtrans (transport)
- Central GOK (iron ore mining)
- Severny GOK (iron ore mining)
- Krasnodon Coal
- Dobropolski Coal
- Kharziski Pipe
- Azovmash (machinery)
- Markokhim (coal)
- Sarmat Brewery

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 an 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

Myth 7

“Reforms are Finished”

Although some specific efforts have recently stalled, reform is continuing

<table>
<thead>
<tr>
<th>Done in 2004</th>
<th>Incomplete or Stalled</th>
<th>Expected in 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social Welfare Reform (“monetization” of benefits)</td>
<td>Electricity Sector Reform (UES) Restructuring</td>
<td>Privatization of Svyazinvest</td>
</tr>
<tr>
<td>Stabilization Fund (created and funded to US$19bn)</td>
<td>Gas Sector Reform</td>
<td>Liberalization of Gazprom shares</td>
</tr>
<tr>
<td>Payroll Tax Reform</td>
<td>Further Banking Reform</td>
<td>Tax Reform: VAT to be reduced</td>
</tr>
<tr>
<td>Heathcare Reform: medical insurance introduced</td>
<td>Military Reform</td>
<td>Continued progress to WTO Membership</td>
</tr>
<tr>
<td>Mortgage Reform: laws facilitating mortgage lending</td>
<td></td>
<td>Educational Reform</td>
</tr>
<tr>
<td>Banking Reform: deposit insurance introduced; “Strategy for Development of the Banking System” (2004-08)</td>
<td></td>
<td>Creation of Special Economic Zones to stimulate investment in high-tech</td>
</tr>
<tr>
<td>Constitutional and Electoral Reform</td>
<td></td>
<td>Break-up of local electricity monopolies</td>
</tr>
<tr>
<td>Administrative Reform: streamlining of ministries and consolidation of responsibilities</td>
<td></td>
<td>Banking: cleansing to continue; rules facilitating mergers to be adopted</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Communal Services Restructuring</td>
</tr>
</tbody>
</table>

Although some specific efforts have recently stalled, reform is continuing.

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

- 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*

**Putin v. Bush Approval Rating (%)**

- Putin Approval Rating: 66%
- Bush Approval Rating: 48%

Perception versus Reality

These myths have had a dramatic impact on Russian equities

Russian Macroeconomics

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

<table>
<thead>
<tr>
<th>Country</th>
<th>Price/Earnings Ratio (12-Month Forward)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chile</td>
<td>16.3</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>14.6</td>
</tr>
<tr>
<td>Israel</td>
<td>13.5</td>
</tr>
<tr>
<td>India</td>
<td>12.4</td>
</tr>
<tr>
<td>Indonesia</td>
<td>12.0</td>
</tr>
<tr>
<td>Korea</td>
<td>11.7</td>
</tr>
<tr>
<td>Malaysia</td>
<td>10.2</td>
</tr>
<tr>
<td>Mexico</td>
<td>10.9</td>
</tr>
<tr>
<td>Philippines</td>
<td>10.0</td>
</tr>
<tr>
<td>Poland</td>
<td>10.1</td>
</tr>
<tr>
<td>Russia</td>
<td>8.1</td>
</tr>
</tbody>
</table>

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

Hermitage Fund
+1016%

CSFB ROS Index
+472%
Disclaimer

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