

Research

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Comstar-UTS

Target review

Recommendation: BUY

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Bullet moments

Last week Comstar-UTS published its 1H 2008 financial results.

Company's report demonstrated negative trends of efficiency dynamics, due to higher expenses growth rates over income growth rates. This trend especially evident over 1H period. Among the reasons of higher growth rates of expenses are: decreased tariffs of MGTS (Comstar's major subsidiary) and also Comstar's aggressive activities in broadband market segment.

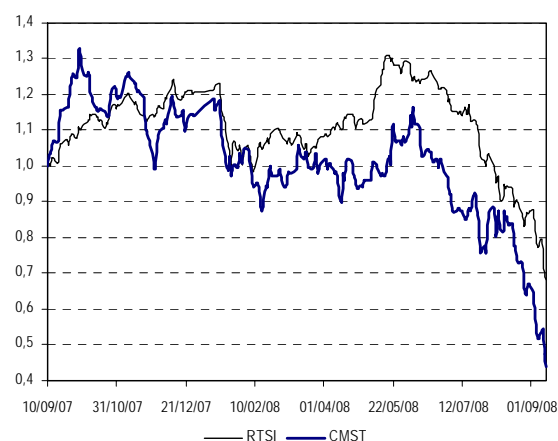
1H 2008 results of the company have met our expectations in general and in accordance to this, we just slightly changed our income and expenses forecasts. The main changes are referred to the fact that Access Industries, implementing put-option, sold 46 mn of shares to Comstar, as a part of the blocking stake purchase deal of Svyazinvest. According to our estimations, strike-price of (weighted average price of LSE per 90 days) the given option forms about 10 USD per Comstar's share, i.e. the whole stake costs – about 462 mn USD. During the deal, the cash assets will be reduced by the same amount, whereas the company receives treasury stocks and free-float decreases on the same value.

Regarding the other estimation factor: the change of fair price of Svyazinvest's blocking stake. The new estimation determines prices fall of all subsidiaries of Svyazinvest. Our previous estimation of the blocking stake formed 1.8 bn USD; today it totals 1.6 bn USD.

Taking into account all described factors, we decreased fair price of share/GDR of Comstar from 13.479 USD to 12.693 USD. In spite of the fall of quotes, company's shares have reached all time lowest, having a significant growth potential to be achieved the fair value. We confirm our "BUY" recommendation on Comstar's securities.

Principal estimates

Company's shares vs. the RTS index



Information about Comstar-UTS

Ticker RTS / LSE	CMST
Market price, USD	4.520
Min / max price during last year, USD	4.520 / 13.710
Fair price at year end, USD	12.693
Upside (downside), %	180.8
Total shares, units ¹	358,224,856
MC, mn USD	1,619
EV, mn USD	1,914

¹ Excl. shares on MGTS-Finance's balance

Financial values (US GAAP)	2007	2008 (F)	2009 (F)
Sales, mn USD	1,562	1,808	1,996
OIBDA, mn USD	663	684	781
Net income, mn USD	44	62	78
OIBDA margin, %	42.5	37.9	39.1
Net income margin, %	2.8	3.4	3.9

Financial coefficients	2007	2008 (F)	2009 (F)
EV / S	1.23	1.06	0.96
EV / OIBDA	2.89	2.80	2.45
P / E	36.90	26.22	20.77
ROIC, %	10.0	7.3	9.5
ROE, %	2.8	3.0	4.6

Financial results

Comstar's financial results under US GAAP report, mn USD

	6 mnths 2007	Chg., %	6 mnths 2008	1 Q 2007	Chg., %	2 Q 2007	Chg., %	3 Q 2007	Chg., %	4 Q 2007	Chg., %	1 Q 2008	Chg., %	2 Q 2008
Sales	708	17.8	834	329	15.3	379	-1.9	372	7.9	402	3.9	417	0.1	417
traditional segment	477	6.2	506	216	20.3	260	-5.0	247	5.6	261	-2.6	255	-1.1	252
alternative segment	231	41.8	328	113	5.7	119	4.9	125	12.4	140	15.8	162	2.0	166
Comstar-Direct and Comstar-UTS	208	21.6	253	101	6.3	107	5.2	113	13.5	128	-1.6	126	0.7	127
Regions and international business	23	224.2	75	12	0.0	12	1.7	12	2.5	12	200.0	36	6.3	39
Costs	(480)	26.3	(606)	(236)	3.1	(244)	4.5	(254)	14.3	(291)	1.7	(296)	4.9	(310)
inc. Amortisation	(75)	34.7	(101)	(38)	-0.2	(38)	11.9	(42)	28.0	(54)	-8.9	(49)	6.8	(52)
Operating income	228	0.0	228	93	46.2	136	-13.2	118	-6.0	111	9.6	121	-11.7	107
Operating income margin, %	32.3	-4.9	27.4	28.2	7.6	35.8	-4.1	31.6	-4.1	27.6	1.5	29.1	-3.4	25.7
EBITDA	304	8.6	330	130	32.8	173	-7.8	160	3.0	164	3.6	170	-6.4	159
EBITDA margin, %	42.9	-3.4	39.5	39.6	6.0	45.7	-2.8	42.9	-2.0	40.9	-0.1	40.8	-2.6	38.2
interest payable	(26)	15.8	(31)	(13)	8.2	(14)	-8.9	(13)	n/m	n/d	n/m	(15)	3.6	(16)
Other non-operating income/expense	(13)	n/m	38	22	n/m	(36)	430.8	(190)	n/m	n/d	n/m	21	-22.2	16
Profit before tax	189	24.8	235	102	-15.8	86	n/m	(84)	n/m	n/d	n/m	127	-15.3	108
Profit before tax margin, %	26.6	1.6	28.2	31.1	-8.4	22.7	-45.4	Omp.	n/m	n/m	n/m	30.6	-4.7	25.9
Income tax	(63)	-17.8	(51)	(27)	33.0	(36)	-15.0	(30)	n/m	n/d	n/m	(28)	-15.7	(24)
Minority interest	(66)	51.7	(100)	(33)	2.6	(33)	n/m	44	n/m	n/d	n/m	(45)	20.1	(55)
Affiliates income	1	n/m	0	1	n/m	0	n/m	2	n/m	n/d	n/m	0	n/m	0
Net income	61	38.0	84	44	-60.7	17	n/m	(69)	n/m	52	4.4	54	-44.8	30
Net income margin, %	8.6	1.5	10.1	13.3	-8.8	4.5	n/m	Omp.	n/m	12.9	0.1	13.0	-5.8	7.2

Note: the change of percent estimates is given in percent points

Source: company's data; Estimation: Veles Capital

Financial model

Income and loss statements of Comstar-UTS, mn USD

	2003	2004	2005	2006	2007	2008 (F)	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)
Sales	589	695	908	1,120	1,562	1,808	1,996	2,187	2,410	2,609	2,791
Costs	(427)	(521)	(639)	(885)	(1,077)	(1,370)	(1,484)	(1,574)	(1,682)	(1,780)	(1,943)
Incl. amortization	(73)	(76)	(90)	(131)	(178)	(247)	(269)	(282)	(298)	(318)	(341)
OIBDA	236	250	359	429	663	684	781	895	1,027	1,148	1,189
OIBDA margin, %	40.0	35.9	39.5	38.3	42.5	37.9	39.1	40.9	42.6	44.0	42.6
EBIT	163	174	268	235	485	438	512	613	728	829	848
EBIT margin, %	27.6	25.0	29.6	21.0	31.1	24.2	25.6	28.0	30.2	31.8	30.4
Interest expenses	(19)	(19)	(18)	(22)	(54)	(77)	(68)	(63)	(60)	(60)	0
Non-operating income (losses)	8	6	7	3	3	0	0	0	0	0	0
EBT	152	161	258	216	435	360	444	550	668	769	848
EBT margin, %	25.9	23.1	28.4	19.3	27.8	19.9	22.2	25.1	27.7	29.5	30.4
Income tax	(38)	(41)	(59)	(69)	(116)	(145)	(156)	(173)	(185)	(187)	(203)
Minority interest	(40)	(44)	(93)	(65)	(118)	(166)	(210)	(275)	(352)	(431)	(470)
Loss from discontinued operations	(17)	0	0	0	0	0	0	0	0	0	0
Net income	58	76	106	82	201	49	78	102	130	152	175
Net income margin, %	9.9	11.0	11.7	7.3	12.9	2.7	3.9	4.7	5.4	5.8	6.3

Source: company's data, Estimation: Veles Capital

Balance sheets of Comstar-UTS, mn USD

	2003	2004	2005	2006	2007	2008 (F)	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)
ASSETS											
Non-current assets											
PPE and intangible assets	861	1,062	1,200	1,569	2,098	2,311	2,441	2,596	2,780	2,983	3,060
Other non-current assets	27	21	37	1,523	1,591	1,591	1,591	1,591	1,591	1,591	1,591
Total non-current assets	889	1,083	1,236	3,092	3,689	3,902	4,032	4,187	4,371	4,574	4,650
Current assets											
Current assets	184	163	199	241	336	389	429	470	518	561	600
Short-term investments	66	105	144	68	426	0	0	18	274	0	362
Cash and equivalents	47	67	62	137	180	43	122	252	277	131	321
Total current assets	297	336	405	445	942	432	551	740	1,069	692	1,283
Total assets	1,186	1,418	1,641	3,538	4,630	4,334	4,583	4,927	5,440	5,266	5,933
LIABILITIES											
Shareholder's equity											
Total shareholder's equity	294	381	479	1,570	2,091	1,689	1,765	1,865	1,994	2,150	2,321
Minority interest	389	451	516	497	765	931	1,141	1,416	1,768	2,199	2,668
Non-current liabilities											
Long-term borrowings	170	217	234	843	1,011	915	851	792	792	1	1
Other non-current liabilities	211	275	281	319	447	447	447	447	447	447	447
Total non-current liabilities	381	491	515	1,161	1,459	1,362	1,298	1,239	1,239	449	449
Current liabilities											
Accounts payable	19	18	29	51	55	64	71	77	85	92	99
Other current liabilities	104	77	102	258	260	287	308	329	354	376	396
Total current liabilities	122	95	131	309	316	351	379	407	439	468	495
Total liabilities	1,186	1,418	1,641	3,538	4,630	4,334	4,583	4,927	5,440	5,266	5,933

Source: company's data, Estimation: Veles Capital

Statements of cash flow of Comstar-UTS, mn USD

	2003	2004	2005	2006	2007	2008 (F)	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)
Cash flows from operating activities											
Net income	58	76	106	82	44	62	78	102	131	160	175
Loss from discontinued operations	17	(0)	0	0	0	0	0	0	0	0	0
Minority interest	40	44	93	65	118	166	210	275	352	431	470
Depreciation and amortization	73	76	90	131	178	247	269	282	298	318	341
Other	7	15	(1)	49	166	0	0	0	0	0	0
Changes in working capital	12	14	(21)	(39)	(18)	(17)	(13)	(13)	(15)	(14)	(13)
Net cash provided by operating activities	207	226	267	288	488	458	544	646	766	895	973
Cash flows from investing activities											
CapEx	(96)	(167)	(183)	(277)	(341)	(460)	(399)	(437)	(482)	(522)	(417)
Other	(48)	(20)	(68)	(1,490)	(519)	426	0	(18)	(256)	274	(362)
Net cash provided by investing activities	(145)	(188)	(251)	(1,767)	(860)	(34)	(399)	(455)	(738)	(248)	(779)
Cash flows from financing activities											
Proceeds from borrowings	92	101	125	1,504	850	3	0	0	0	0	0
Repayments of borrowings	(141)	(111)	(141)	(910)	(730)	(100)	(64)	(59)	0	(790)	0
Other	(7)	(10)	(5)	961	285	(464)	(2)	(2)	(3)	(3)	(4)
Net cash provided by financial activities	(56)	(19)	(20)	1,555	405	(560)	(66)	(61)	(3)	(794)	(4)
Net change of cash	7	18	(4)	76	34	(137)	79	129	26	(146)	190
Cash at the beginning of period	40	47	67	62	137	180	43	122	252	277	131
Cash at the end of period	47	67	62	137	180	43	122	252	277	131	321

Source: company's data, Estimation: Veles Capital

Share price estimation

Discount rate (WACC) of Comstar-UTS, %

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Cost of equity (k_e)	10.86	10.91	10.77	11.02	10.96	10.99	10.91	10.83	10.79	10.29
Risk-free rate	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2
Stock market risk	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Coefficient β	0.7	0.7	0.7	0.8	0.8	0.8	0.7	0.7	0.7	0.6
Corporate risk	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Share of equity, %	80.1	79.3	81.0	71.0	73.8	74.1	77.4	80.6	82.6	100.0
Cost of debt (k_d)	7.49	7.49	7.49	7.49	7.49	7.49	7.49	7.49	7.49	7.49
Risk-free rate	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2
Debt premium	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Tax rate	25.6	23.0	33.5	42.6	38.9	35.2	31.5	27.7	24.0	24.0
Share of debt, %	19.9	20.7	19.0	29.0	26.2	25.9	22.6	19.4	17.4	0.0
WACC	9.81	9.85	9.67	9.07	9.29	9.40	9.60	9.78	9.90	10.29

Estimation: Veles Capital

Cash flows of Comstar-UTS, mn USD

	2003	2004	2005	2006	2007	2008 (F)	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)
Net income (corr.)	133	139	217	229	361	305	362	445	549	657	644
Depreciation and amortization	73	76	90	131	178	247	269	282	298	318	341
CapEx	(96)	(167)	(216)	(277)	(341)	(460)	(399)	(437)	(482)	(522)	(417)
Changes in working capital	12	14	(21)	(39)	(18)	(17)	(13)	(13)	(15)	(14)	(13)
Free cash flow	122	62	70	44	181	75	219	277	350	440	555
Discount rate, %						9.3	9.4	9.6	9.8	9.9	10.3
Discount coefficient						1.00	0.91	0.83	0.76	0.69	0.63
Discounted cash flow						75	200	231	266	304	348

Source: company's data, Estimation: Veles Capital

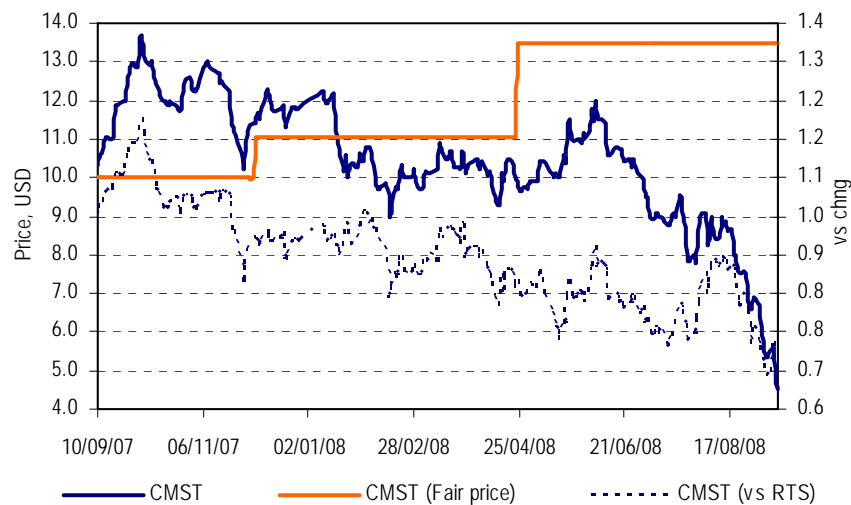
Comstar-UTS's shares/GDRs valuation

TGR, %	3.0
Sum of cash flows, mn USD	2,160
Terminal value, mn USD	9,725
Discounted terminal value, mn USD	4,443
Enterprise value, mn USD	6,603
Net debt, mn USD	1,180
Fair value of 25%+1share of Svyazinvest, mn USD	1,631
Shareholder's equity (incl. minority interest), mn USD	7,054
Minority interest, mn USD	2,507
Shareholder's equity, mn USD	4,547
Number of shares, mn units	358
Fair value of stock/GDR at the year end, USD	12.69
Upside (downside), %	180.8

¹ Expecting shares outstanding at end of 2008

Source: company's data, Estimation: Veles Capital

History of fair estimations



Public comparables

Our recommendations

Share	Ticker	Current price, USD	Target for year end, USD	Current growth potential, %	Recommendation	Date of recommendation revision	Investment idea
Traditional telephony							
Volgatelecom, cs	NNSI	1.9500	5.0428	158.6	BUY	9/5/2008	High effectiveness and low debt make company into an attractive subject for investing
Volgatelecom, ps	NNSIP	1.3000	3.7821	190.9	BUY	9/5/2008	
Dalsvyaz, cs	ESPK	2.4000	6.6357	176.5	BUY	9/1/2008	Prospects of improving the effectiveness of activity due to the new services
Dalsvyaz, ps	ESPKP	2.3000	4.9768	116.4	BUY	9/1/2008	
NWT, cs	SPTL	0.6300	1.3503	114.3	BUY	8/27/2008	Company's management gets maximum out of regulated services, however a growth potential can be seen after the fall
NWT, ps	SPTLP	0.5835	1.0127	73.6	BUY	8/27/2008	
Sibirtelecom, cs	ENCO	0.0430	0.0902	109.7	BUY	8/18/2008	The drop of quotes earlier this year, allows to hope for a significant growth potential
Sibirtelecom, ps	ENCOP	0.0255	0.0676	165.2	BUY	8/18/2008	
Uralsvyazinform, cs	URSI	0.0230	0.0459	99.6	BUY	9/10/2008	A fall of quotes over the year makes company's stocks attractive, in spite of aggressive investment program
Uralsvyazinform, ps	URSIP	0.0140	0.0344	145.7	BUY	9/10/2008	
Centrtelecom, cs	ESMO	0.4000	1.0463	161.6	BUY	8/27/2008	The fall of quotes, in spite of aggressive investment program, makes company's shares attractive.
Centrtelecom, ps	ESMOP	0.2100	0.7847	273.7	BUY	8/27/2008	
STC, cs	KUBN	0.0670	0.2917	335.4	BUY	8/27/2008	Significant fall of quotes after year's start intends a growth potential up to fair price
STC, ps	KUBNP	0.0700	0.2188	212.5	BUY	8/27/2008	
Alternative telephony							
Comstar-UTS	CMST	5.1000	12.9690	154.3	BUY	9/12/2008	Growth potential due to development of regional markets
Long-distance communication							
Rostelecom, cs	RTKM	10.5000	4.4800	-57.3	SELL	7/21/2008	An extremely high market price, resulted from buyup of shares, yet unsupported by fundamental factors
Rostelecom, ps	RTKMP	0.9900	3.3600	239.4	BUY	7/21/2008	
Cellular communication							
Vimpelcom	VIMP	20.52	35.64	73.7	BUY	9/1/2008	GT consolidation, strong fall early the year
MTS	MTSS	9.25	19.59	111.8	BUY	8/13/2008	Sound financial results, prospects of 3G technology use, fundamental underestimation of shares
Media							
CTC Media	CTCM	16.35	32.60	99.4	BUY	7/30/2008	Growth of ad market, prices and spread business, due to merger with other companies
RBC	RBCI	5.95	9.86	65.7	BUY	10/2/2007	Separation of IT business and improvement of primary business' effectiveness
Other							
Sitronics	SITR	0.0970	0.0814	-16.1	HOLD	9/11/2008	Company demonstrates low efficiency, determining its low fundamental value

Data: Bloomberg; Estimation: Veles Capital

Brief investor's guide

Methods, used for company's share evaluation				
Income approach			Comparables approach	Expenses approach
	DCF method	EVA method	Multiplicative method	Net assets method
Concept of evaluating the unified object (EV) *	FCFF discounting	EVA discounting		
Shareholders' value direct calculation (SV) **	FCFE discounting	EVA for shareholders discounting (Edwards-Bell-Ohlson method)		

*

Debt cost is calculated separately and then subtracted from the sum total cost of business (target EV), formed considering the cash flows/ economic profits of firm.

**

Debt is accounted integrated -via annual coverage. So the fair cost of shareholders' value (target SV) is formed directly - considering the cash flow / economic profits for holders.

Note:

DCF methods differ from the methods of economic profit by the way of investments calculation. The methods of unified object evaluation concept differ from these methods of direct calculation of shareholders' value costs - by the way of accounting cost and maintenance of debt liabilities.

Cost calculation within the frames of income approach:

	Business cost calculation (EV) within the frames of united object cost evaluation	Shareholders' capital value calculation (SV)
DCF method (FCFF)	$EV = \sum_{i=1}^n \frac{FCFF_i}{(1+WACC_i)^i} + \frac{TV}{(1+WACC_i)^n} + NA$	$SV = EV - D$
DCF method (FCFE)		$SV = \sum_{i=1}^n \frac{FCFE_i}{(1+k_{sj})^i} + \frac{TV}{(1+k_{sj})^n} + \text{Cash} + NA$
EVA method	$EV = IC_1 + \sum_{i=1}^n \frac{EVA_i}{(1+WACC_i)^i} + \frac{TV}{(1+WACC_i)^n} + NA$	$SV = EV - D$
EBO method		$SV = BV_1 + \sum_{i=1}^n \frac{SVA_i}{(1+k_{sj})^i} + \frac{TV}{(1+k_{sj})^n} + \text{Cash} + NA$

Signs:

EV	- Enterprise Value
SV	- Shareholders Value
TV	- Terminal Value
Cagr	- development rates within the target period
BV, E	- Balance Value, Equity
EBIT	- operational profit from selling, profit before payments of credit interest and income tax
EBITDA	- operational profit before payment of credit interest, income tax and amortization
EBT	- Earnings Before Tax
EAT	- Earnings After Tax
EPS	- Earnings Per Share
NOPAT	- net operational profit, free from effects of debt financing $NOPAT = EBIT * (1 - \text{income tax effective rate})$
FCFF	- Free Cash Flow to Firm $FCFF = \text{gross cash flow} - \text{gross investments}$ $\text{Gross cash flow} = NOPAT + \text{amortization}$
FCFE	- Free Cash Flow to Equity $FCFE = \text{gross shareholders' cash flow} - \text{gross investments}$ $\text{Gross shareholders' cash flow} = \text{EAT of operational profit (including interest payoffs)} - \text{annual debt coverage} + \text{attracted borrowed assets} + \text{amortization}$
EVA	- Economic Value Added $EVA = \text{economic profit spread} * IC = (ROIC - WACC) * IC$
SVA	- Shareholders Value Added $SVA = \text{spread} * E = (ROE - k_s) * E$
WACC	- Weighted Average Cost of Capital
k_s	- required shareholders' yield
D	- fair (market) cost of net debt
Cash	- cash assets, along with market securities on thee balance
NA	- non-operational assets
IC	- Invested Capital
ROIC	- Return on Invested Capital $ROIC = \frac{NOPAT}{IC}$
ROE	- Return on Equity
ROA	- Return on Assets

Information disclosure

The statement of an analyst and confirmation of the responsibility withdrawal

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The principle of recommendation assignment

The investment recommendations are given based on the evaluation of the company's share yield. The basis for the calculation of the expected company's cost is the evaluation by the discounted cash flows method (DCF). In some estimations the method of comparable coefficients, and also the mixed estimation (by DCF method and by comparable coefficients method) are applied. All recommendations are assigned based on the determined by us the fair cost of the shares within the nearest 12 months.

At the present moment the investment scale of the Investment Company Veles Capital is the following:

BUY – corresponds to the growth potential of the shares within the nearest 12 months by 15% or more.

ACCUMULATE – corresponds to the growth potential of the shares within the nearest 12 months for 5-15%.

HOLD – corresponds to the growth (reduction) potential of the shares within the nearest 12 months from -5% to 5%.

REDUCE – corresponds to the reduction potential of the shares within the nearest 12 months from 15% to 5%.

SELL – corresponds to the reduction potential of the shares within the nearest 12 months by 15% or more.

In some cases the deviations from the evaluation scale given above, based on which the recommendations are assigned, are possible. That fact relates to the high volatility of some securities in particular, and market in the whole, and also to the individual characteristics of one or another issuer.

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