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VSMPO-AVISMA: High Does Not Mean Expensive

BUY

This report is an update of our latest report “VSMPO-AVISMA: demand for titanium is recovering”, which was published on May 23, 2011. We have revised our estimates of the company’s operational and financial results taking into account the latest trends in the global titanium market and also have reviewed our target price and investment recommendation.

Expectations of significant growth in demand for titanium for the aircraft industry are materializing. In 2011 orders for new Boeing and Airbus airplanes increased by 2 times compared 2010r., at the same time orders for wide-body types of airplanes soared by 40% y-o-y, production of such types increased by 12% y-o-y in 2011. It is worth mentioning that in 2011 there was growth in A380 deliveries and production of the Boeing 787 started. Thus, the increase in production of Boeing and Airbus, in our view will be the main driver of demand for titanium for the aircraft industry.

VSMPO-AVISMA is the major beneficiary of growing demand for Boeing and Airbus airplanes. Since the company is a key titanium supplier of Boeing and Airbus, growth in demand for new airplanes will have a direct impact for consumption of VSMPO-AVISMA titanium. In 2012 VSMPO-AVISMA forecasts its titanium production in the range of 30-33 tonnes which is 22-34% higher than volumes in the previous year. We see this forecast as realistic.

Growth in operational results will be the main trigger of an increase in the company financials. We expect VSMPO-AVISMA titanium production to increase by 22 y-o-y in 2012. Thanks to this, the company's EBITDA should grow by 69% y-o-y to USD426 mn, which is close to its financial results in 2007. We note that in 2007 VSMPO-AVISMA stocks were 45-65% higher than the current prices. In our opinion, this fact would be the main reason for a revision of the value of VSMPO-AVISMA stocks by the investment community.

We increase our target price for VSMPO-AVISMA shares by the end of 2012 from USD180 to USD267 per share that implies 37% upside potential and recommendation «BUY».

Ticker MICEX	VSMO
Mcap, USD mn	2 240
EV, USD mn	2 790
Number of common shares, mn.	11.5
Free float	30%

Common shares	Buy
Target price by the end of 2012, USD	267
Current price	194
Upside	37%

Financials, USD mn			
	2011E	2012E	2013E
Revenue	1142	1499	1633
EBITDA	252	426	436
Net profit	92	232	243

Margins, %			
	2011E	2012E	2013E
EBITDA margin	22%	28%	27%
Net profit margin	8%	15%	15%

Multiples			
	2011E	2012E	2013E
EV/S	2.4	1.9	1.7
EV/EBITDA	11.1	6.6	6.4
P/E	24.4	9.7	9.2



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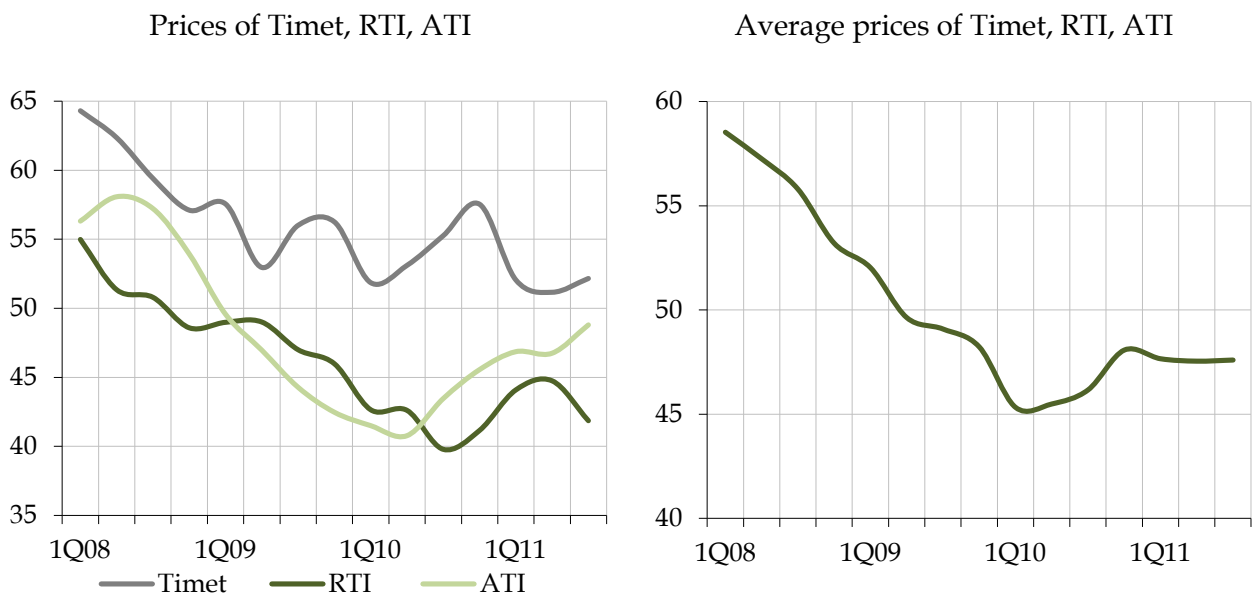
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Last Trends In The Titanium Market For Aerospace Industry Encourages

The titanium market for the aerospace industry is a key market for VSMPO-AVISMA (this market accounts for about 70% of the company`s total sales). As a price indicator in this market, we consider the sales prices of titanium products of Timet, RTI and ATI. We note that for these companies the titanium market for the aerospace industry is also one of the key markets.

As we expected in our previous review, the price bottom in the titanium market for the aerospace industry has been surpassed in 1-3 quarters of 2010. The price level increased by 5-7% from the bottom and was stable in the first three quarters of 2011.

Titanium rolled products prices, th. USD per tonne



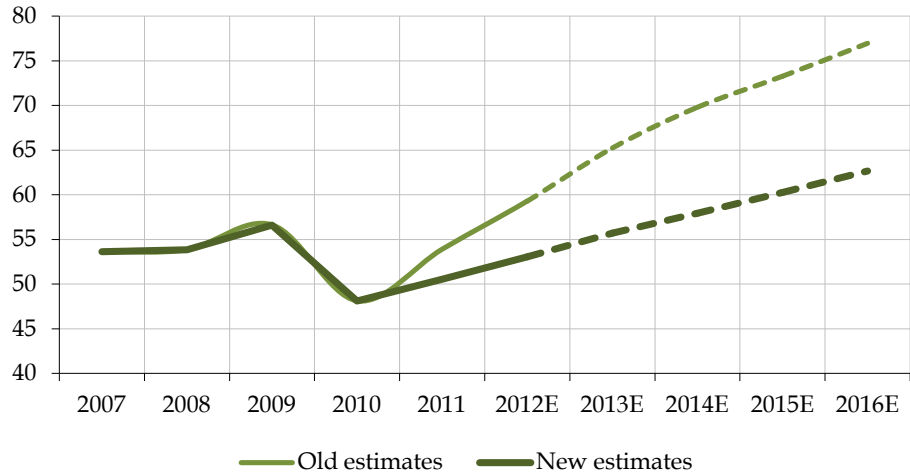
Source: Timet, RTI, ATI, Grandis Capital estimates

Unlike the steel industry, where quotes for rolled products recovered by 30% y-o-y in 2010 after a sharp decline of about 45% y-o-y in 2009, in the titanium market there was a downward trend from 1st quarter of 2008 to the 1st quarter of 2010, resulting in a decrease in titanium products prices of about 20%. From the 2nd to 4th quarters of 2010 titanium prices recovered by 5-7% and in the 1st -3rd quarters of 2011 prices were relatively stable.

Taking into account the latest trends in the titanium market, we have downgraded our forecast for titanium price growth in 2012-2016. In the middle term 2012-2013 annual growth rates of titanium prices were lowered from 10% to 5% and 2014-2016 annual long term rates were downgraded from 5% to 4%.



VSMPO-AVISMA average rolled product prices, old and new forecasts, th. USD per tonne



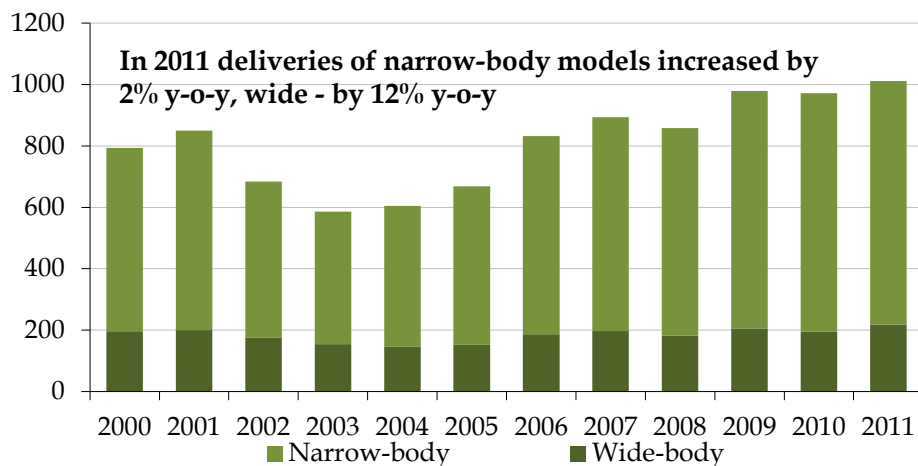
Source: VSMPO-AVISMA, Grandis Capital estimates

In our view, the main driver of growth in demand for titanium for the aerospace industry is an increase in the rate of production for new wide-body types of aircrafts models such as Boeing 787 and A380. In construction of such types of airplanes specific titanium usage is higher than in the construction of narrow-body ones.

In 2011 wide-body airplanes production increased by 12% y-o-y

In 2011 Airbus delivered 26 A380 airplanes – that is 44% more than in 2010. Last year Boeing launched its Boeing 787 deliveries sending 3 aircrafts to customers. As a result Boeing and Airbus increased wide-body airplanes production by 12% y-o-y in 2011, while production of narrow-bode models increased only by 2% y-o-y.

Boeing and Airbus new airplanes deliveries



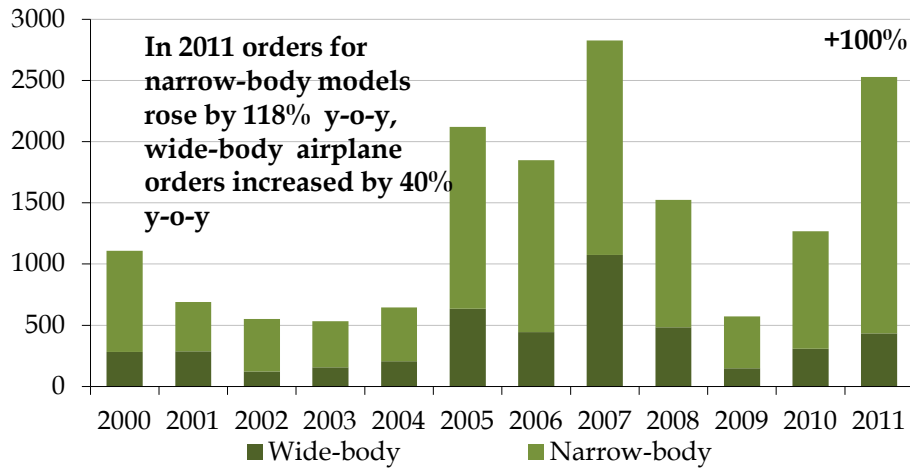
Source: Boeing, Airbus, Grandis Capital estimates



In 2011 total orders for new airplanes doubled y-o-y

We note that in 2011 there was a significant growth in orders for new Boeing and Airbus planes, resulting in 2500 orders, which is 2 times higher than the number of orders taken in 2010. Orders for narrow-body models increased by 118% y-o-y, orders for wide-body models were up 40% y-o-y.

Boeing and Airbus new airplane orders



Source: Boeing, Airbus, Grandis Capital estimates

A significant increase in the number of new orders for Boeing and Airbus in 2011, as well as the fact that in 2011 it produced the highest number of new aircraft since 2000, allows us to maintain an optimistic view on the prospects of growth in the titanium market for the aerospace industry in the medium and long term.

Because of VSMPO-AVISMA is a key supplier of titanium for Boeing and Airbus, the growth of production of new aircraft, in our opinion, will have a positive impact on the dynamics of the company's operating performance.

VSMPO-AVISMA: titanium production estimates are upgraded

This year the company plans to increase its titanium production by 22-33% y-o-y

At the end of 2011 and beginning of 2012 various statements related to production plans for 2012 appeared in the media. For example at the end of September 2011 Maxim Santalov, Adviser to the CEO on the improvement of operational efficiency, announced VSMPO-AVISMA plans to produce more than 30 tonnes of titanium products in 2012. In mid-January of this year, the Interfax news agency reported that in 2012 VSMPO-AVISMA plans to produce 32.7 thousand tonnes of titanium, which is 33% more than in 2011.

The Domestic and CIS markets account for more than 30% of VSMPO-AVISMA total titanium sales. In late November 2011 the Interfax news agency, citing official materials of VSMPO-AVISMA, reported that in 2012 the company plans to ship to Russian and CIS customers about 11 thousand tonnes of titanium products, which is 38% higher than in the previous year.

Mikhail Voevodin, CEO of VSMPO-AVISMA, declared recently that about half of Russian and CIS orders for 2012 are already paid in advance, and that in the beginning of 2012 the company will receive more than 70% payment in advance from its Russian customers.

Because most of VSMPO-AVISMA titanium shipments are based on long term agreements we share the company optimism regarding the production plans for 2012.

Nevertheless, we use a conservative scenario and in 2012 expect the titanium output growth of VSMPO-AVISMA to be 22% y-o-y to 30 thousand tonnes, which is close to the bottom of the range of 30-33 tonnes the company declared.

In 2012 we expect the titanium output growth of VSMPO-AVISMA to be 22% y-o-y

VSMPO-AVISMA: titanium production and estimates, th. tonnes



Source: VSMPO-AVISMA, Grandis Capital estimates

We have reviewed our estimates of VSMPO-AVISMA production results due to heightened expectations in the current year. As a result we have increased our mid-term estimates by 7% and long-term estimates by 6%

VSMPO-AVISMA: titanium production old and new estimates

Th.tonnes	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E	2016E
Old estimates	28	26	20	21	25	28	29	30	31	31
New estimates	28	26	20	21	25	30	31	32	33	33
change, %				0%	-2%	7%	7%	7%	6%	6%

Source: VSMPO-AVISMA, Grandis Capital estimates

VSMPO-AVISMA: financials continue to rise

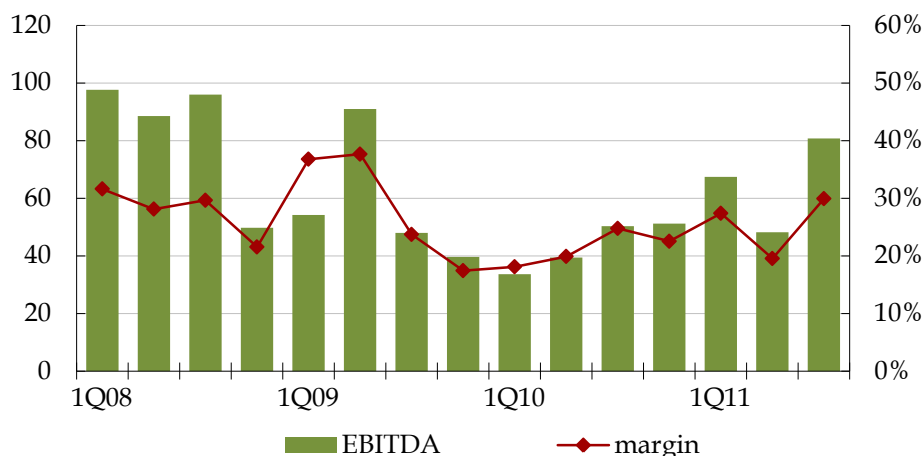
For the first nine months of 2011 the company's EBITDA under RAS grew by 59% y-o-y

Due to the fact that VSMPO-AVISMA publishes its IFRS financial results with a substantial delay (at this time 2010 IFRS results are still not published), to evaluate IFRS financials we propose using financial results under Russian accounting standards (RAS) which have historically been a good indicator of revenue and EBITDA under IFRS.

For the first nine months of 2011 the company's EBITDA under RAS grew by 59% y-o-y, while EBITDA margin accounted for 26%.

In the graph below it is shown that the minimum in EBITDA was surpassed in the 1st quarter 2010, and from 1Q10 to 3Q11 there was an uptrend - RAS EBITDA in the 3rd quarter 2011 was 2 times higher than 1Q10 EBITDA. We also note that 3Q11 EBITDA is 10-15% below pre-crisis level.

VSMPO-AVISMA: dynamics of RAS EBITDA and margin, USD mn.

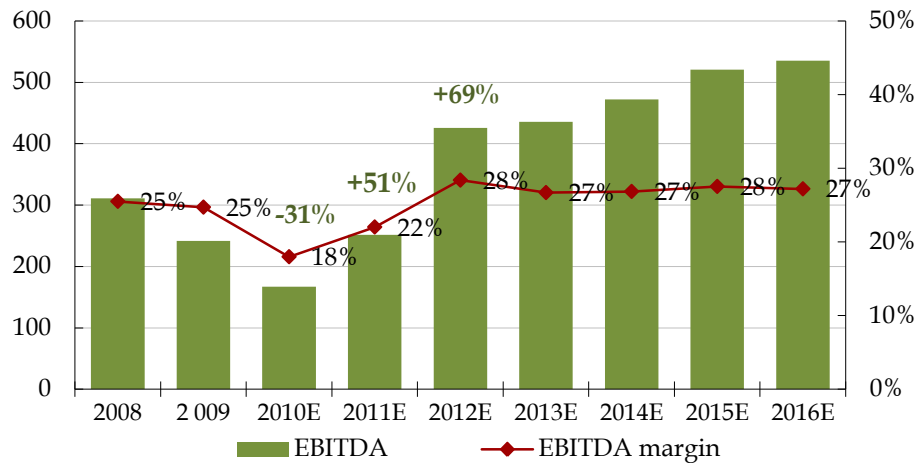


Source: VSMPO-AVISMA, Grandis Capital estimates

This year we expect EBITDA to grow by 69% y-o-y to USD426 mn

We maintain our positive outlook on the company's IFRS financials results in 2011 and 2012. We estimate EBITDA to increase by 51% y-o-y to USD252 mn in 2011. This estimate was downgraded by 16% compared with the previous forecast due to moderate titanium price growth in 2011.

Regarding the current year, our EBITDA forecast was not revised - we expect EBITDA to increase by 69% y-o-y to USD426 mn. On the one hand we have downgraded our forecast on titanium selling prices, on the other - this decline was fully offset by a more optimistic outlook on operating results in 2012.

**VSMPO-AVISMA: IFRS EBITDA and forecasts, USD mn**

Source: VSMPO-AVISMA, Grandis Capital estimates

Our mid-term EBITDA forecast for 2012-2013 is USD 420-440 mn, our long-term EBITDA estimate is USD470-520 mn with EBITDA margin at 27-28%.

VSMPO-AVISMA: old and new EBITDA estimates

USD mn	2007	2008	2009	2010	2011E	2012E	2013E	2014E	2015E
Old estimates	423	311	242	154	299	429	470	468	523
New estimates	423	311	242	167	252	426	436	472	521
change, %				8%	-16%	-1%	-7%	1%	0%

Source: VSMPO-AVISMA, Grandis Capital estimates



Valuation

We estimate the fair value of VSMPO-AVISMA shares as an average between estimates made by discounted cash flows (DCF) and multiples methods.

Multiples valuation

Target level of leading
EV/EBITDA – 10X

As a basic multiplier, we propose using the leading EV/EBITDA (EBITDA is an estimate of RAS EBITDA of the first fiscal year). The first fiscal year RAS EBITDA estimate is carried out by the way of presenting actual quarterly data in annual terms.

VSMPO-AVISMA: leading EV/EBITDA estimates



Source: VSMPO-AVISMA, Bloomberg, Grandis Capital estimates

The pre-crisis level of the company's leading EV/EBITDA multiple was in the range of 9-10X, in the post-crisis period this multiple ranged between 10-11X.

Valuation on EV/EBITDA2012
multiple implies USD321 per
share by the end of 2012

We view the fair value of VSMPO-AVISMA's leading EV/EBITDA multiple on the level of 10X.

Based on the leading EV/EBITDA 10X multiple and our EBITDA forecast in 2012 of USD426 mn we view VSMPO-AVISMA's fair enterprise value of USD4.26 bn.

At the end of 2011 we estimate the level of VSMPO-AVISMA Net Debt at USD550 mn, thus we view the fair capitalization of the company based on multiples method at USD3.7 bn, or USD321 per share.

Discounted cash flow (DCF) valuation

DCF valuation implies USD212 per share by the end of 2012

We construct our DCF model to 2016. We assume the terminal growth rate to be 3% and the discount rate WACC to be 13.3%. (in the previous report on DCF valuation we used WACC 14.8%, which was reduced due to lower sensitivity of VSMPO-AVISMA shares to fluctuations in the market). Using the DCF method we estimate the fair value price of VSMPO-AVISMA shares by the end of 2012 to be USD212 per share.

VSMPO-AVISMA: Discount Cash Flow Model (DCF)

USD mn	2010	2011E	2012E	2013E	2014E	2015E	2016E
Revenue	929	1142	1499	1633	1759	1892	1968
EBITDA	167	252	426	436	472	521	535
margin %	18%	22%	28%	27%	27%	28%	27%
EBIT	88	173	347	357	393	442	456
Taxes	18	35	69	71	79	88	91
NOPAT	70	138	278	286	315	353	365
+ Depreciation	79	79	78	78	79	79	80
- CAPEX	-120	-69	-75	-80	-83	-86	-89
Change in working capital	25	5	-70	-27	-55	-33	-35
FCF	54	153	212	257	255	314	320

WACC Calculation	
Terminal growth rate	3.0%
Cost of Equity	16.8%
After tax cost of debt	8.0%
Debt/(Debt+Equity)	40%
WACC	13.3%
DCF	1048
Terminal value	3213
Discounted terminal value	1952
Total DCF	3000
Net Debt of 31/12/11	550
Equity value (common shares)	2450
Number of common shares, mn	11.5
Target price, \$	212

Sensitivity analysis							
Discount rate (WACC)							
	11.8%	12.3%	12.8%	13.3%	13.8%	14.3%	14.8%
Terminal growth rate (%)							
4.5%	302	280	261	244	229	216	204
4.0%	284	265	248	233	219	207	196
3.5%	268	251	236	222	210	198	188
3.0%	255	239	225	212	201	191	181
2.5%	242	228	215	204	193	184	175
2.0%	231	218	207	196	186	177	169
1.5%	222	210	199	189	180	171	163

Source: VSMPO-AVISMA, Grandis Capital estimates

Final valuation

Taking into account our estimates of the VSMPO-AVISMA fair value made by the multiples and DCF methods our target price for the company's stock at the end of 2012 is USD267 per share - that implies a 37% upside potential to the current price.

Final valuation – an average between estimates made by DCF and multiples methods implies USD267 per share by the end of 2012

Multiples valuation EV/EBITDA 10X, USD per share	Weight 0.5	321
DCF valuation, USD per share	Weight 0.5	212
Fair value, USD per share		267
Upside, %		37%

Source: Grandis Capital estimates

VSMPO-AVISMA multiples vs. main peers

The three main peers of VSMPO-AVISMA are Timet, RTI and ATI. In terms of business model we view Timet and RTI as the closest counterparts to VSMPO-AVISMA.

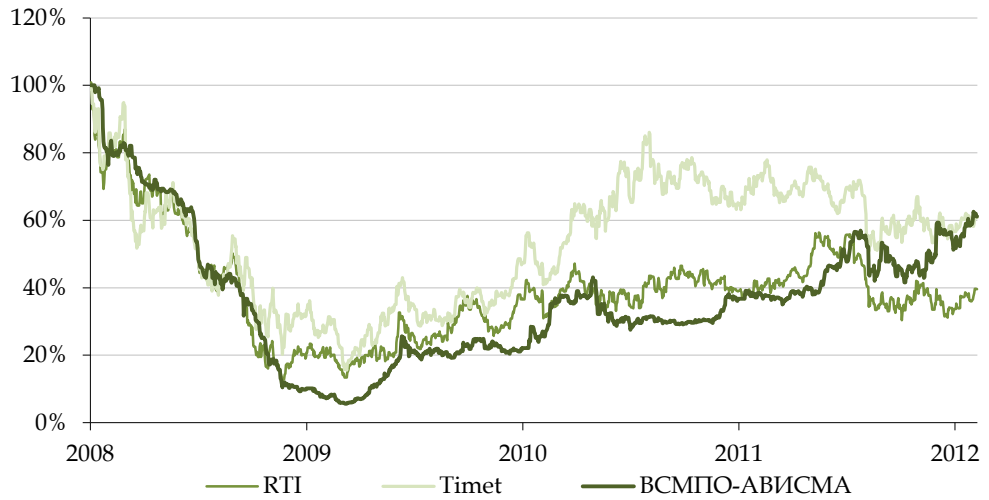
Company	Ticker	MCap USD mn	EV USD mn	P/E			EV/EBITDA			EV/Sales		
				2011E	2012E	2013E	2011E	2012E	2013E	2011E	2012E	2013E
RTI	rti us	824	604	96.4	31.0	21.2	11.3	6.4	5.9	1.1	0.9	0.7
Timet	tie us	2813	2530	25.4	21.5	21.3	11.6	10.0	9.7	2.4	2.1	1.7
Allegheny Tech.	ati us	5148	6277	21.0	15.7	10.9	9.0	7.1	5.9	1.2	1.1	1.0
Average				47.6	22.7	17.8	10.6	7.8	7.1	1.6	1.3	1.1
VSMPO-AVISMA	vsmo rx	2242	2792	24.4	9.7	9.2	11.1	6.6	6.4	2.4	1.9	1.7
(discount)/ premium				-49%	-57%	-48%	4%	-16%	-10%	55%	38%	50%

Source: Bloomberg, Grandis Capital estimates

In terms of 2012 and 2013 EV/EBITDA multiples VSMPO-AVISMA trades at a slight discount of 4-11% to its main peers. In terms of P/E multiples discount is more significant and ranges from 49-57%.



VSMPO-AVISMA and main peers relative price dynamics from the beginning of 2008



Source: Bloomberg, Grandis Capital estimates

From the beginning of 2008 to mid 2011 VSMPO-AVISMA shares underperformed its main peers, however, over the past six months, the company's shares showed very strong dynamics and are close now to 60% of its value of the beginning 2008.

VSMPO-AVISMA share price dynamics, USD per share



Source: Bloomberg, Grandis Capital estimates

Risks

We see the following risks, which if realized could lead to a decrease in the stock price of VSMPO-AVISMA shares:

- **Decline in the world demand for new aircraft and as a consequence, a reduction in demand for titanium for the aircraft industry.** We see possible risks related to the worsening debt crisis in European countries, recession in U.S. or a significant slowdown in the Chinese economy that could lead to a significant slowdown in global economic growth. This fact may have a negative impact on demand from airlines for new aircraft around the world.
- **Increased political instability in Russia during the presidential elections.** Political instability is perceived negatively by investors, and could significantly reduce the attractiveness of the Russian stock market, in particular, VSMPO-AVISMA shares.
- **Worsening relations between Russia and the United States.** Sales to the United States account for about one-third of total VSMPO-AVISMA titanium deliveries. The company delivers its titanium to a strategic sector of the U.S. economy. Growing political tensions between Russia and the United States could have a negative impact on VSMPO-AVISMA sales to this market one that is key to the company.
- **The low level of corporate transparency for minority shareholders.** Given the fact that VSMPO-AVISMA publishes its IFRS financial statements with a significant delay it is quite difficult to judge the real financial situation in the company. This fact increases the investment risk for minority shareholders. In addition to low financial transparency, VSMPO-AVISMA maintains a high level of financial investments. The company does not disclose the structure of those investments. At the end of the third quarter of 2011 the value of financial investments under RAS amounted to about USD360 mn (approximately 65% of the estimated current net debt). We see a high risk for possible losses in those financial investments and that is negative for minority shareholders.

Conclusions and Recommendations

VSMPO-AVISMA is a world leader in the sector of titanium for the aerospace industry. The company is a key supplier to Boeing and Airbus, providing more than a half of these aircraft manufacturers' needs in titanium. In recent years, VSMPO-AVISMA has taken a number of successful steps, allowing it to strengthen its business ties with leading aircraft manufacturers and to increase the proportion of high value-added products in the company's shipments.

Latest trends in the aerospace market are encouraging - in 2011 orders for new Boeing and Airbus airplanes increased by 2 times compared 2010. At the same time orders for wide-body types of airplanes soared by 40% y-o-y while production of such types increased by 12% y-o-y in 2011. At the moment there is an increase in production of Airbus A380 and Boeing 787 that, in our opinion, will be the main driver of demand for titanium for the aircraft industry. These trends allow us to maintain an optimistic view of the prospects for growth in the titanium market for the aerospace industry in the medium and long term.

Positive trends are already reflected in the VSMPO-AVISMA financials - for the first nine months of 2011 the company's EBITDA under RAS grew by 59% y-o-y, while EBITDA margin accounted for 26%.

This year the company plans to produce 30-33 tonnes of titanium an amount that is 22-34% higher than in the previous year. Because most of VSMPO-AVISMA's titanium shipments are based on long term agreements we share the company's optimism regarding its production plans for 2012. Nevertheless, we use a conservative scenario and expect VSMPO-AVISMA's growth in output in 2012 to be 22% y-o-y to 30 thousand tonnes, which is close to the bottom of the range the company declared.

Given a positive production outlook for 2012 we estimate the company's revenue to increase by 31% y-o-y to USD1.14 bn, while EBITDA should grow by 69% y-o-y to USD426 mn, and net profit to rise by 153% y-o-y to USD232 mn. Thus the 2012 financials would be close to the financial results of 2007. We note that in 2007 VSMPO-AVISMA stocks were 45-65% higher than the current prices. In our opinion, this fact would be the main reason for a revision of the value of VSMPO-AVISMA stocks by the investment community.

We increase our target price for VSMPO-AVISMA shares by the end of 2012 from USD180 to USD267 per share. This 37% upside potential and recommendation «BUY».

VSMPO-AVISMA: IFRS financials and estimates, USD mn.

P&L	2007	2008	2009	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Sales	1311	1219	978	929	1142	1499	1633	1759	1892	1968
Operational expences	887	909	736	762	891	1074	1197	1287	1371	1433
Depreciation&Amortization	47	91	77	79	79	78	78	79	79	80
Operating profit	376	220	165	88	173	347	357	393	442	456
EBITDA	423	311	242	167	252	426	436	472	521	535
Net interest expences	21	50	41	52	57	54	50	44	39	32
Other expences (income)	-8	33	87	0	0	0	0	0	0	0
Profit before taxes	363	136	36	36	116	293	308	349	403	424
Profit tax	128	37	10	7	23	59	62	70	81	85
Minority interest	1	1	0	0	1	3	3	3	4	4
Net profit	235	99	26	29	92	232	243	276	319	335
BS	2007	2008	2009	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Cash and cash equivalents	78	39	72	94	205	371	574	777	1040	1312
Accounts receivable	395	343	287	273	286	333	363	391	420	437
Inventories	552	600	438	448	445	488	499	536	549	573
Other current assets	12	150	192	191	194	218	229	246	257	268
Property, plant and equipment	757	821	809	850	841	837	839	843	851	860
Other non-current assets	178	160	166	175	173	172	172	173	175	177
Total assets	1971	2112	1964	2031	2143	2419	2675	2966	3292	3627
Accounts payable	101	152	64	85	99	119	133	143	152	159
Short-term debt	387	650	411	417	420	424	428	432	436	441
Other current liabilities	76	77	92	98	99	116	126	140	151	163
Long-term debt	166	134	325	331	334	338	342	346	351	355
Other non-current liabilities	53	43	43	46	46	54	59	66	71	76
Equity	1188	1055	1029	1055	1144	1367	1587	1839	2130	2433
Total liabilities and equity	1971	2112	1964	2031	2143	2419	2675	2966	3292	3627
Cash flow statement	2007	2008	2009	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Operating profit	370	220	165	88	173	347	357	393	442	456
Income tax expense	128	37	10	7	23	59	62	70	81	85
Depreciation and amortization	47	91	77	79	79	78	78	79	79	80
Change NWC	-221	56	129	25	5	-70	-27	-55	-33	-35
Interest expences	21	50	41	52	57	54	50	44	39	32
Other operating cash outflow	3	53	26	0	0	0	0	0	0	0
Operating CF	45	226	293	133	176	243	298	302	369	384
CAPEX	-280	-543	-210	-120	-69	-75	-80	-83	-86	-89
Other investing CF	-65	112	29	0	0	0	0	0	0	0
Investing CF	-345	-431	-182	-120	-69	-75	-80	-83	-86	-89
Operating CF net of Investing CF	-300	-205	111	13	107	168	218	219	282	295
Change in total debt inflow	317	232	-49	12	7	7	8	8	9	9
Dividends	6	1	18	3	3	9	23	24	28	32
Other financing outflow	13	28	12	0	0	0	0	0	0	0
Free CF	-1	-2	32	22	111	167	202	203	263	272

Source: VSMPO-AVISMA, Grandis Capital estimates



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