



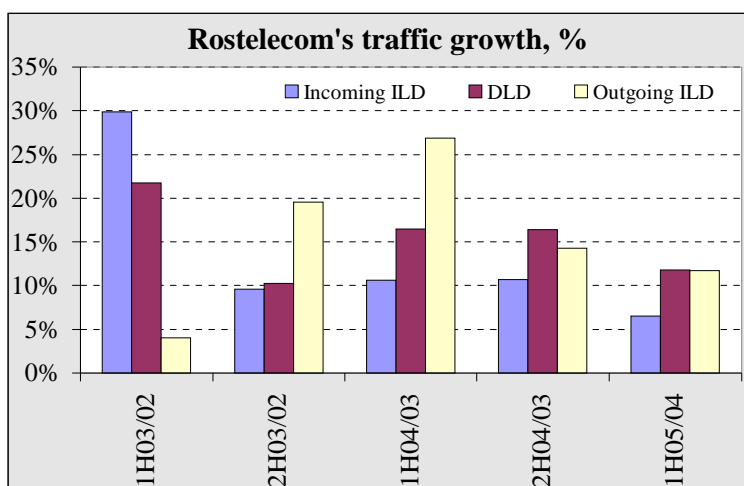
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RESEARCH

Rostelecom: the Market has Estimated the Liberalization

Recently changes in the long-distance (LD) telecommunication market happen with enviable regularity. Institution of new terms for operators' licensing, adoption of new rules of network connection and provision of communication services, issuing first LD-licenses – there were hardly 3 or 4 months between all these events. The Ministry of Information Technologies and Communications started to issue LD-licenses this June. At present such licenses hold, besides Rostelecom, eight companies: Golden Telecom, Centrifocom, Transtelecom, MTT, Equant, MirTeleCom, Info-Plus and LanRusinvest. Later, however, the Government has ruined operators' game and postponed the effectiveness of new connection rules till the beginning of 2006.

Thereupon, the fate of Rostelecom is in the centre of investor's attention, since all these changes were intended to break its monopoly. However, by the highest standards, Rostelecom is not at all a monopolist. On the estimations of the company itself, about one third of LD-traffic passed by Rostelecom networks, and the operator market share continues to decline. This statement may be proved by a significant drop of the traffic growth and Rostelecom revenues, while its competitors are in much better position: in 2004 the revenues of Golden Telecom increased by 62%, Multiregional TransitTelecom (MTT) – by 79%, Transtelecom - twice. The revenue growth of Rostelecom totals 25.2%.



Among operators who have already received LD-licenses real competitors of Rostelecom, on our view, are already mentioned Golden Telecom, MTT, and Transtelecom. Each of these operators is a strong player in his segment of the market. Golden Telecom has many corporate clients, MTT is the leader in the market of transit cellular traffic, and Transtelecom leads the data transfer segment. Delay of the liberalization will allow these companies to determine their strategy of attracting of new subscribers as well as to bring networks into exact line with license requirements. Note, that one of main requirements to LD-operator is the existence of POP (Point of Presence) in all 89 regions of Russia. Golden Telecom, MTT, and Transtelecom are companies among those already licensed operators whose networks practically meet declared standards.

The main competitive advantage of Rostelecom is the scale of its own communication network. It is clear that so far no company can be compared with it on the extension of the backbone network. The nearest pursuer – Transtelecom - has got a network 4 times as short. Golden Telecom has networks in large cities and is just constructing a fiber optic line Moscow – Nizhny Novgorod. MTT has to rent channels at other operators,

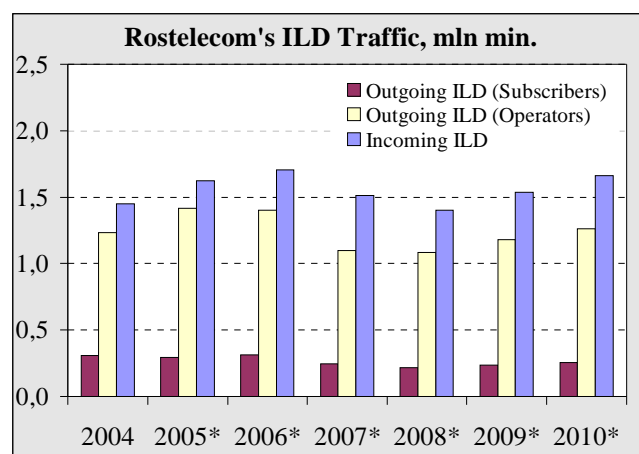
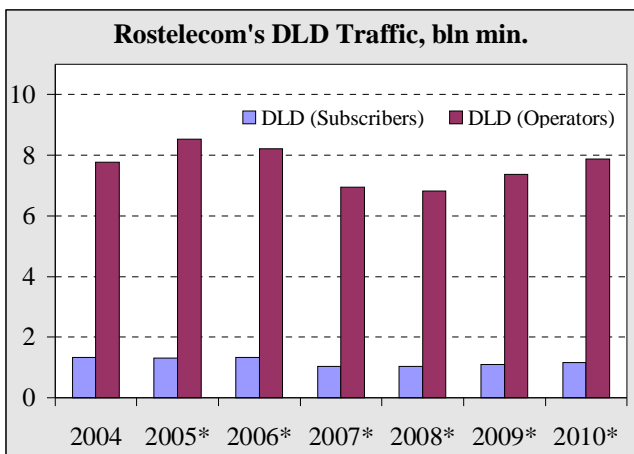
Rostelecom included. As important is the experience of work with subscribers. Rostelecom has got a strong position here too. The company works with end users in Moscow – the most competitive market. At the same time Rostelecom was succeeded in stopping the loss of the market share and to retain it at 45% level. Nevertheless, the situation is not easy: rivals are attacking at all fronts.

Communication services to subscribers. Part of Moscow subscribers of Rostelecom may go to Golden Telecom – one of the largest alternative operators in Russia. It has gained much experience of work with corporate clients – the most promising and profitable. On our estimations, Rostelecom would have to say “goodbye” to about 20% of the market, so finally the company will work with about one fourth part of Moscow subscribers.

Passing traffic between operators. MTT company is a strong player at the market of the transit of cellular traffic. It won't lose the possibility to run through its networks calls from fixed phones as well. The fact that an increasing part of telecommunication traffic goes through cellular networks (that is belongs to MTT) will complicate Rostelecom's life more. Besides, MTT has a real chance to occupy a significant part of the promising segment of traffic from fixed mobile phones. The share of such calls in the whole structure of MTT's traffic has yet grown from 20% in 2003 to 30% in 2004.

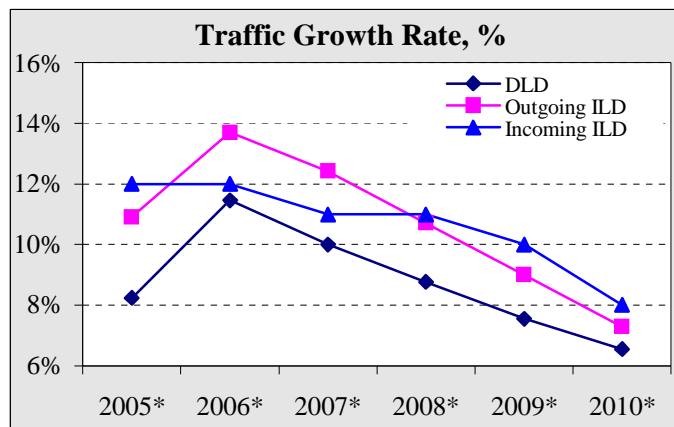
Data transfer services. Recently Rostelecom has lost control of the largest provider of Internet services – RTComm.ru and stopped to consolidate its results in its own accounting statements. Thus Rostelecom has no significant position at rapid-growing market of Internet services. To re-enter this market will be much more difficult, since Transtelecom – affiliate of JSC Russian Railways (RZD) – is increasing its turnover here.

So Rostelecom has very serious competitors, therefore in our model of company's estimation we took in consideration several aspects which will have the negative effect on future revenues of the operator. We suppose that Rostelecom will continue to lose its market share for three years. The peak value of the traffic loss will occur in 2007, when the most part of licensees will start to provide telecommunications services. We suppose that Rostelecom will lose 30% of the domestic LD-traffic (DLD) and outgoing international traffic (ILD) market from operators. At that its absolute value in 2010 would not reach the 2005 level.



The exclusion will be the incoming ILD Rostelecom traffic, which volume, as we think, in 2010 will a little exceed the 2005 level. It is stipulated, first, by constantly high rate of incoming traffic growth, second, by the possibility to expand the operator's presence at the transit market of Europe-Asia direction.

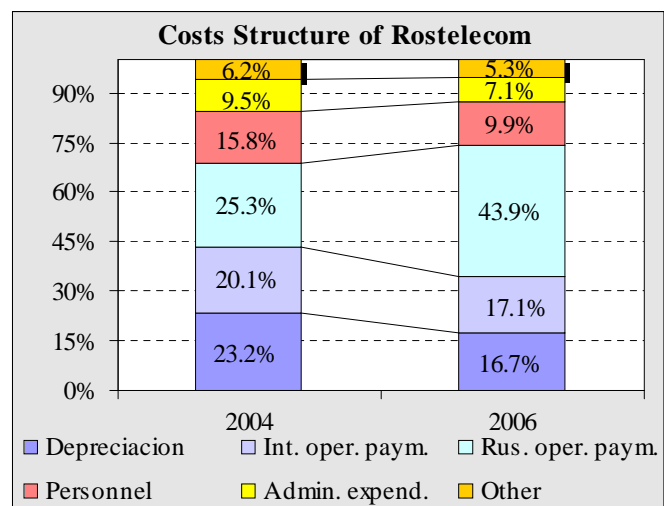
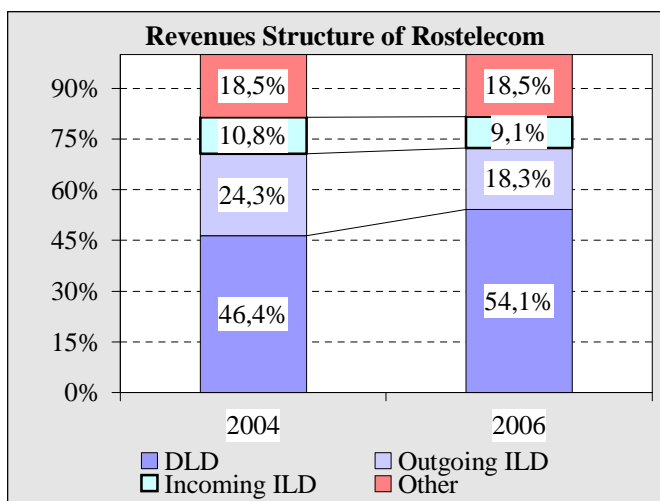
As about Moscow market of end users, Rostelecom, as we have mentioned already, will lose 30% of it. The loss will be smaller as compared with other segments, since at present Rostelecom continues to work under high competition conditions in Moscow. Our model of estimation contains various rates of growth of telecommunication traffic. So the growth of DLD traffic will slow down from 12% in 2005 to 6.5% in 2010. Outgoing ILD traffic will decrease its growth rate from 15% to 7%, incoming ILD traffic will decline from 12% to 8%.



Besides the loss of a market share Rostelecom will have to deflate tariffs to be in line of market conditions. This point is also considered in our model of company estimation. At that tariffs for the traffic pass will decrease in 2007 and 2008 - the time of the hardest competition, after that the tariffs will become stabilize. Tariffs for Moscow subscribers will permanently deflate – by 5% a year in average. Our forecast of Rostelecom’s tariffs change is presented in the table.

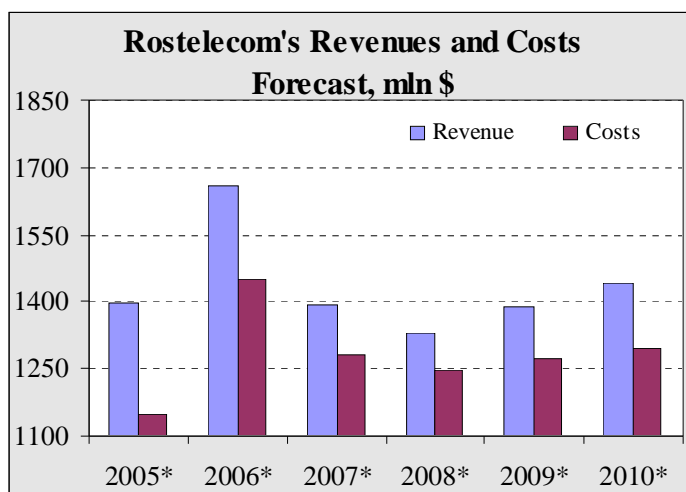
Traffic	Average price per minute, \$						
	2004	2005*	2006*	2007*	2008*	2009*	2010*
DLD, operators	0.023	0.023	0.022	0.021	0.02	0.02	0.02
Outgoing ILD, operators	0.173	0.170	0.166	0.158	0.150	0.146	0.14
DLD, subscribers	0.10	0.096	0.091	0.086	0.082	0.078	0.075
Outgoing ILD, subscribers	0.320	0.317	0.301	0.283	0.266	0.253	0.24
Incoming ILD	0.096	0.094	0.091	0.087	0.082	0.078	0.076

Finally, one more factor to lower equally revenues and costs of Rostelecom are new rules of settlements between operators for LD-traffic which will come into effect at the beginning of 2006. Their introduction will significantly change the structure of revenues and costs of Rostelecom in the direction of increase the share of items concerning LD-traffic transit.



So change of Rostelecom revenues will be simultaneously effected by three main factors acting in different directions, that is the loss of the market share, deflate of tariffs and introduction of a new system of settlements for LD- traffic. 2007 and 2008 will be the hardest years for Rostelecom: revenues will down by

15% in 2007 and by 4.5% in 2008. Up to 2010 Rostelecom will almost completely recover from the consequences of the LD-market share loss. The revenues will start to increase in 2009 exceeding 2005 level.



Note that a significant loss of revenues will not restrict necessary capital investments; moreover, we think that Rostelecom will be able to manage without borrowings. To the start of the liberalization Rostelecom has already finished the construction and modernization of its networks. High net income allowed the operator to reduce the level of debt almost to zero (in 2004 the consolidated debt amounted just \$6.5 mln.). It favorably distinguishes Rostelecom from its competitors who will have to spend money for networks development in future.

Calculations of free cash flows of Rostelecom based on conservative forecasts of traffic volume and tariff rates showed that market participants are ready for losses of Rostelecom's revenues and have already considered the consequences of the loss of monopolistic market position in the market price of company's shares.

Calculation of free cash flow of Rostelecom, \$ mln

	2005*	2006*	2007*	2008*	2009*	2010*
Revenues	1428	1737	1468	1402	1482	1554
Russian Operators	886	1207	1018	998	1069	1137
DLD	522	846	708	690	745	797
Outgoing ILD	246	233	173	163	172	180
Foreign Operators	172	173	149	133	140	144
Incoming ILD	154	155	131	115	122	126
Subscribers	325	313	260	233	236	238
DLD	145	138	108	93	93	93
Outgoing ILD	112	107	84	72	75	77
Costs	1155	1500	1332	1306	1356	1403
Depreciation	253	251	241	232	218	207
International operators payments	259	257	203	198	215	231
Russian operators payments	318	658	557	546	590	631
Personnel	145	148	151	152	151	151
Administrative expenditures	106	106	106	106	106	106
OIBDA	527	488	377	328	344	358
Net profit	236	196	119	88	111	131
Depreciation	253	251	241	232	218	207
Capital investments	230	150	150	100	100	100
FCFF	249	276	209	220	219	212



Fair value of Rostelecom totals \$2.28 bln. This figure includes market price of 11% Golden Telecom shares, which at present amounts \$120 mln, or 5% of Rostelecom capitalization. In our model of Rostelecom estimation we consider that a preference share must be traded to an common one with a 20% discount, where 10% is the discount for the liquidity loss and the other 10% goes for the loss of vote on the share. Thus fair price of a common share is \$2.47, the one of a preference - \$1.98. The downside of a common share is 2.8%, the upside of a preference - 7.2%, recommendation for both types of shares is **Hold**.

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