

Emerging Markets

Brazil vs. Russia: Resilience vs. valuation

Russia's deep discount suggests early outperformance

We are bullish on the upside potential in 2009 of both of the smaller BRICs countries: Brazil and Russia. As re-risking has taken hold in the last month, both markets bounced: Russia (MSCI) up 39% in 30 days, and Brazil up 30%, while the S&P 500 rose just 15%. We think there is more to come, with Russia likely still outperforming Brazil for the next few months. Its valuations are at deep discounts: a forward 12-month P/E of just 7.0X, even in a down year for commodity earnings, versus Brazil's 10.0X with less commodity exposure.

Brazil's longer-term qualities

On the other hand, in the longer run – or for investors with less risk tolerance – Brazil may prove the better story. Its demographics, macro policy framework, strong financial system, relatively benign politics, and reliable investment rules all support equities. Half a trillion dollars' worth of domestic investment is in fixed income, some of which should migrate to equities as Brazil's high interest rates fall.

Trades

Gazprom and Petrobras: The most important trades we recommend for Brazil and Russia are Buys on the flagship energy names in both countries, Gazprom and Petrobras. Both have special access to unique large-scale energy reserves – Russian gas and Brazilian offshore oil and gas – in a world with little new supply development and that should return to energy tightness once global growth resumes. Neither company has demanding valuations. The main risks we see are short-term energy-price corrections.

MTS vs. AMX: We prefer Russia's mobile telephone operator MTS (Buy) to Latin America's AMX (Neutral). MTS is trading at just 4.0X EV/EBITDA 2009E, while AMX trades nearly 50% higher at 5.7X. They have similar (slowing) growth profiles. MTS operates in a less aggressive competitive environment than AMX, overall.

Vale vs. Norilsk Nickel: In the other direction, we prefer Brazil's Vale (Buy) over Russia's Norilsk Nickel (Sell). Vale has high exposure to the iron-ore sector (84% of its 2009E EBITDA), which we think will continue to outperform base metals, due to strong demand from China. Nickel, which is Norilsk's core business, is highly exposed to the OECD economies, where an activity rebound could take longer.

Russian focus ideas

	Rating	Price	Target price	Upside
Gazprom (ADR)	Buy	\$16.7	\$31.3	+87%
Kazmunaigaz	Buy	\$16.1	\$26.0	+61%
Lukoil	Buy	\$42.7	\$60.5	+42%
Mobile Telesystems	Buy	\$35.3	\$45.0	+28%
Novatek	Buy	\$27.7	\$36.1	+30%
Peter Hambro Mining	Buy	457p	1300p	+185%
Sistema JSFC	Buy	\$6.1	\$17.1	+179%

Latin America focus ideas (Brazil stocks only)

	Rating	Price	Target price	Upside
BM&F Bovespa	Buy	R\$7.9	R\$8.4	+6%
Cemig	Buy	R\$35.7	R\$40.7	+14%
Natura	Buy	R\$22.0	R\$25.2	+15%
PDG Realty	Buy	R\$15.4	R\$15.3	-0%
Petrobras (ADR)	Buy	\$34.3	\$40.0	+17%
Redecard	Buy	R\$26.0	R\$32.6	+25%
Suzano	Buy	R\$12.0	R\$12.0	+0%
Telesp	Buy	R\$48.5	R\$52.1	+7%
Usiminas	Buy	R\$28.9	R\$34.0	+18%
Vale (ADR)	Buy	\$14.9	\$18.0	+21%
Vivo PN	Buy	R\$32.5	R\$44.0	+35%
Gerdau (ADR)	Sell	\$6.5	\$4.0	-38%

Source: FactSet, Goldman Sachs Research estimates.

Risks and target methodology

For methodology and risks associated with price targets mentioned, please refer to the analysts' previously published research. Price targets for Russian focus ideas are for a period of 12 months. Price targets for Brazilian focus ideas are for a period of 6 months. Closing prices as of April 3, 2009.

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Brazil set for the long run; Russia set for quicker rebound

After more than a year's equity market outperformance by Brazil over Russia (54% better since both markets began falling in May 2008), our view on the two smaller BRICs is as follows:

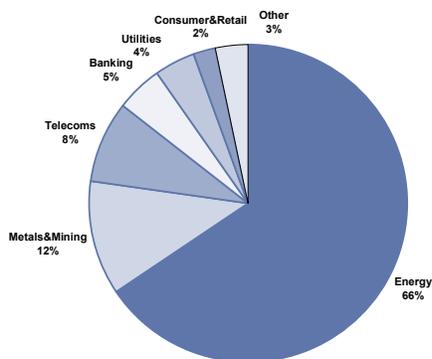
- **We like both markets** for their stories as large emerging economies with above-average growth potential, now at valuations that have overshot developed markets to the downside, even though the underlying financial issues of the global crisis are not core problems for Brazil or Russia. This suggests potential for a rapid and decisive rebound if the current increase in global risk appetite continues.
- **Russian valuations are highly compressed**, at a forward 12-month estimated market P/E of 7.0X, even in a down year for energy earnings. Brazil's P/E is 43% higher, at 10.0X, with less commodity exposure. Corporate-governance issues in Russia explain part of the gap, but we think these are ultimately over-priced.
- **We think Russia is likely to perform better than Brazil** in the next several months, off this exceptionally low base. The view assumes global risk aversion roughly at current levels or improving.
- **However, we think Brazil constitutes a better long-term investment case.** It offers both growth at home and dominance in many export commodities, a demographic boom of young adults, energy self-sufficiency, tested companies in a diversified economy, political stability, clear rules, and undemanding valuations.

Brazil's defensiveness

Brazil has structural aspects that have favored it over Russia in stressful times and that suggest good prospects in the years to come:

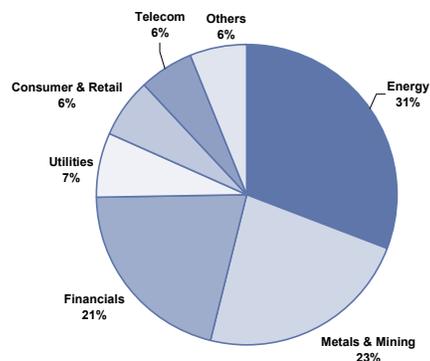
- Its stock market is not concentrated in just a few sectors and is domestically oriented, in contrast to Russia's oil and commodity exports (see Exhibits 1 and 2).

Exhibit 1: Russian market dominated by oil and gas
Market cap by sector



Source: MSCI.

Exhibit 2: Brazil more diversified
Market cap by sector



Source: MSCI.

- Domestic investors are important drivers of performance. Two-thirds of Brazilian equity trading volume in 2009 has been by local investors, about half institutional and half individual. Brazilians have the equivalent of US\$494 bn in domestic fixed income. We think some of this will seek performance in equities as interest rates drop.
- The Brazilian Real floats relatively freely and quickly prices in global conditions without a pressure buildup. As commodity prices fell in the third quarter of 2008, for example, the Real became 33% more competitive against the US dollar within three months. The trade balance has therefore stayed in surplus, and reserves have dropped

only 3% (US\$6 bn) since October. Russia's more managed devaluation cost 35% (US\$210 mn) of reserves.

- Inflation targeting by Brazil's Central Bank has kept consumer inflation below 4% so far in 2009, versus 14% in Russia.
- Brazil's financial system has proven one of the world's more robust in stressed times. Tier 1 capital ratios are high (12%-13% for major banks), as are reserve requirements (30% pre-crisis). Domestic sources provide 96% of bank funding.
- The effects of low commodity prices and a sharp export slowdown have been slow to spread to the broader Brazilian service and consumer economy, revealing surprising domestic strength (retail sales up 6% in January 2009, year on year).
- Brazilian short-term interest rates remain among the world's highest in real terms (about 6.75% now). A solid monetary-policy framework provides ample room for easing, and our economists expect rates to drop to about 4.5% in real terms by July.

Russia's valuation edge

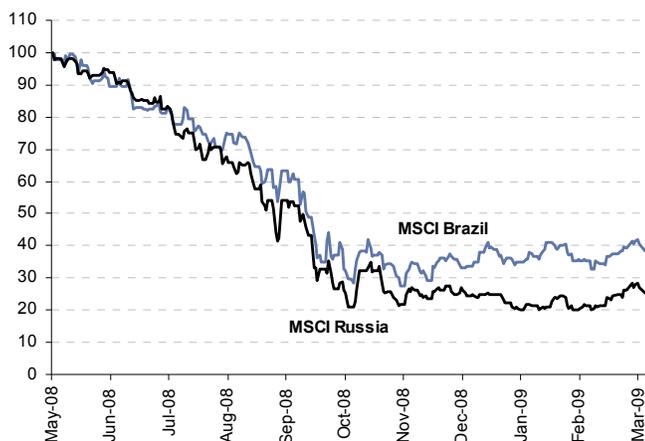
Nevertheless, valuation is distinctly in Russia's favor, as risk aversion eases a bit. Evidence of this is the 39% rally of the MSCI Russia in the past month, outpacing Brazil's 30%. We estimate the Russian market's P/E at about 7.0X, a low number considering the 78% weighting (MSCI) of energy, metals, and mining. Those companies' 2009 earnings are depressed by global commodity prices cycling through a low section of the curve.

Brazil's P/E is 43% higher, at 10.0X. But Brazil's market is only 50% commodities, many of which (oil, gas, ethanol, steel) have not suffered as much from low global prices, as they are sold mostly in Brazil at prices muffled from the global cycle by various mechanisms.

Also in Russia's favor is its fiscal and reserves situation. The government is a net creditor, by 9% of GDP, unusual by any standard, while Brazil's public net debt is 36% of GDP. The Russian Central Bank, even after selling US\$210 mn of reserves, has US\$380 bn, with the ruble strengthening since early February. This is nearly twice the Brazilian level, for an economy of similar size.

The differential in sovereign spreads over ten-year US Treasuries, which went as high as 470 bp for Russia over Brazil in November 2008, has fallen back to 130 basis points. We think this is a leading indicator for equities. It is now clear that the Russian public-sector financial situation is robust even after the massive declines in oil prices and crisis of global financial flows that helped knock the Russian stock market down 72% in dollars since May 2008. Brazil is down only 57% (see Exhibit 3).

Exhibit 3: From May 2008 peaks, Brazil now 55% above Russia



Source: FactSet.

More different than the same?

Russia and Brazil have economies and stock markets that are not very different in magnitude (Exhibit 4). They both tend to be viewed by investors as markets driven by commodities. However, there are fundamental differences.

Exhibit 4: Similar size

	Russia	Brazil
Population	142 million	185 million
GDP (2008)	US\$1.7 trillion	US\$1.6 trillion
Market capitalization	US\$333 billion	US\$451 billion

Source: Goldman Sachs Research.

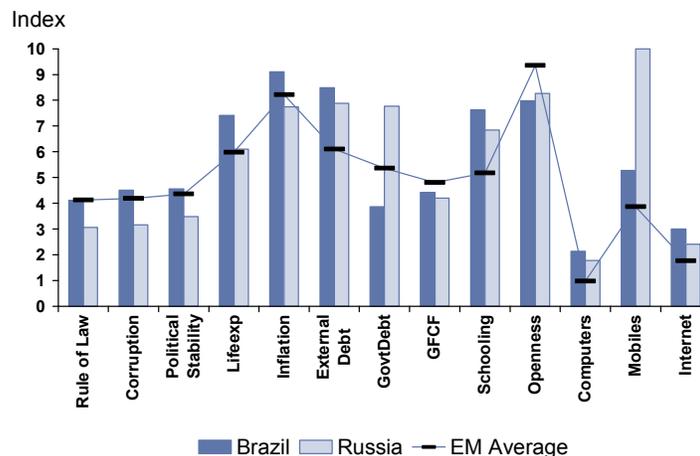
Classic emerging market vs. post-Soviet rearrangement

The most notable is that Brazil is a more closed, domestic, and diversified economy than Russia. Only 13% of GDP is from exports, vs. 30% for Russia. Russia depends on energy for 60% of its exports, while Brazil is a large producer of oil and gas but a net importer. Only 50% of Brazilian exports are commodities at all, mostly processed rather than raw.

Brazil is a classic emerging market, with gradually rising incomes, education and social well-being indicators, off a low base. It moved from an agricultural to a (not very efficient) industrial/service base in the 1960s and 1970s, behind import barriers. It is now becoming more competitive and sophisticated in its services and industry, applying technology to new development efforts in natural resources, one of its true comparative advantages. In contrast, Russia's emergence is from totalitarianism and the command economy of the Soviet Union, with a struggle to fill power vacuums with new institutions and reorder an already industrialized base and educated populace.

Exhibit 5 shows the Growth Environment Scores developed by Goldman Sachs in past reports on the BRIC countries. The key to interpreting the scores is that higher is always better: a higher score for inflation means lower inflation, a higher score for debt implies lower debt, a higher score for corruption implies lower corruption, etc. In most categories – from “rule of law” to “inflation” – Brazil is in front. However, the outsized scores for Russia on government debt (it is a net creditor) and mobile-phone penetration (over 100 per 100 inhabitants) make the average overall score for the two countries the same, 5.6.

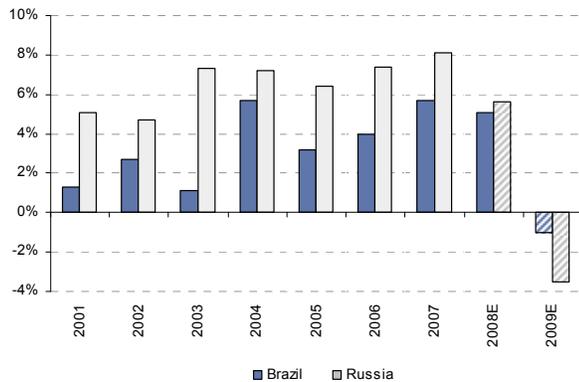
Exhibit 5: 2008 Growth Environment Scores, Russia vs. Brazil



Source: Goldman Sachs Global ECS Research.

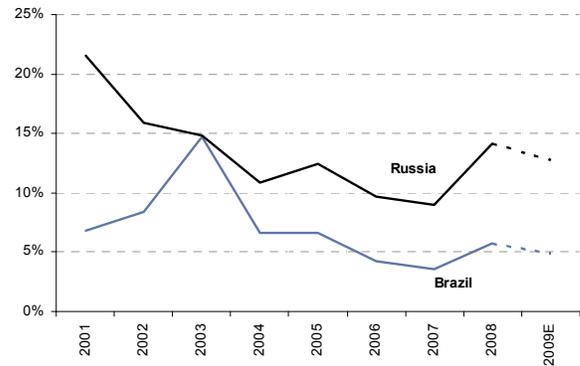
Russia has grown faster than Brazil in every year since 2001, driven by internal stabilization and the commodity cycle. For now, this difference looks ready to reverse, with Brazil's GDP expected to fall 1% in 2009, and Russia's 3.5%. Brazil meanwhile has tighter control of inflation, which is healthy for longer-term growth. (See Exhibits 6 and 7.) Pluses and minuses of the two economies for investors in 2009 are laid out in Exhibit 8.

Exhibit 6: GDP: Russia overshoots Brazil to downside
Year-on-year real GDP growth and forecast



Source: Goldman Sachs Global ECS Research.

Exhibit 7: Inflation: FX drops still not driving prices
Year-on-year consumer price inflation and forecast



Source: Goldman Sachs Global ECS Research.

Exhibit 8: Russia vs. Brazil

Russia

Pluses

- **Oil and gas** = 66% of mkt. cap., so greater exposure if oil/commodities rally
- **Fiscal net assets** (ex-Central Bank reserves) of US\$110bn (9%) of GDP
- Large parts of Russian industry getting more **efficient** as crisis forces market consolidation, restructuring
- **Valuations** at historic lows, among lowest multiples globally, even at low point of commodity cycle (7.0x forward est. P/E)
- Russian **reserves** nearly double Brazil's, at over US\$370bn
- Russian listed corporates relatively **unlevered** vs unlisted firms

Brazil

Pluses

- **Oil and gas** = 31% of mkt cap. Domestically oriented, w/pricing policy that makes sector less exposed to global oil prices.
- **Diversified** domestic consumer, industrial, service economy
- Muffled **global exposure**: exports only 13% of GDP vs. 30% in Russia
- Benign **geopolitical** environment; no significant conflicts.
- Domestic politics, policies **stable**; 2010 presidential election likely low risk.
- Credible **monetary-policy** framework gives more scope for policy easing
- **Inflation** under control (4.5% 09E), allowing interest-rate cuts
- Brazil largely **self-funded**, e.g. 96% of bank funding is in local currency
- Public and private **external-debt** stock is US\$268bn, half that of Russia
- Brazil's **reserves** strong at US\$190bn; minimal pressure so far
- **Corporate governance** has improved
- Well-capitalized and developed **banking system**

Minuses

- Early-stage **institutions** and tense **geopolitics** = political risk
- **State interference** in corp. mgt; other governance issues
- Underdeveloped **banking** system
- Management of the economy can be **unpredictable**
- High **external debt** at shareholder, bank and private-co. levels. Total external debt stock is US\$540bn
- **Inflation** stubbornly high (13% 09E)
- Market extremely susceptible to **foreign fund flows**
- **Highest-beta** mkt. among BRICs, a risk if global stress continues

Minuses

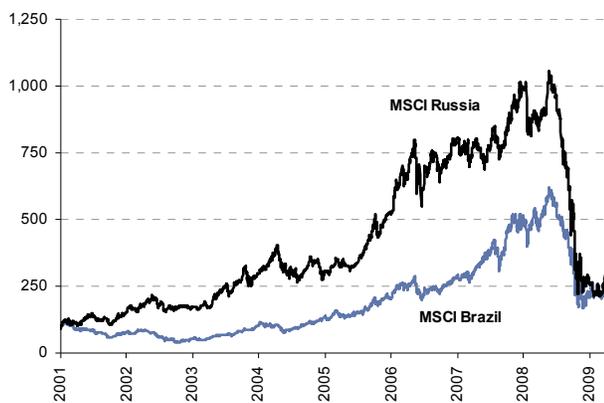
- Mediocre **fiscal discipline**, falling tax receipts may worsen fiscal condition, more public debt, potential loss of IG rating
- Limited ability to push aggressive **counter-cyclical** stimulus efforts
- Brazil is **lower beta**, on more closed economy, a negative factor if commodities rebound
- **Valuations** pricing in safer Brazil (e.g. banks at 2.0x book)
- Stock market dependent in large part on **foreign fund flows**

Source: Goldman Sachs Research.

Why Russia crashed harder

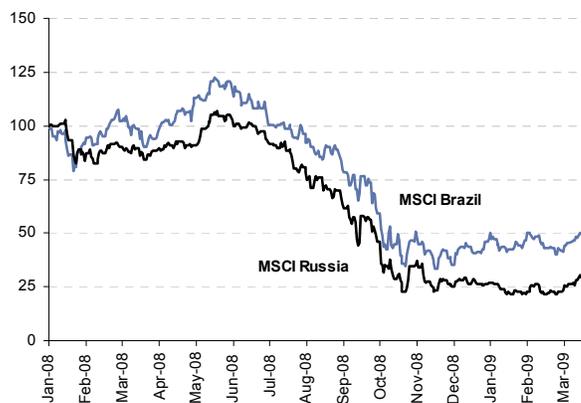
The differences summarized above largely explain why the Russian market dropped more severely than Brazil after global stress began in July 2007 (down 70% from July 2007 to the trough in November 2008, vs. Brazil down 55%), and why Brazil has since rebounded 59% and Russia 33% (see Exhibits 9 and 10).

Exhibit 9: Russian long-term outperformance collapses
Russia vs. Brazil since 2001 (100 = Jan. 2, 2001) (US\$)



Source: Bloomberg.

Exhibit 10: Brazil rallies more since November 2008
Russia vs. Brazil since Jan. 2008 (100 = Jan. 2, 2008) (US\$)



Source: Bloomberg.

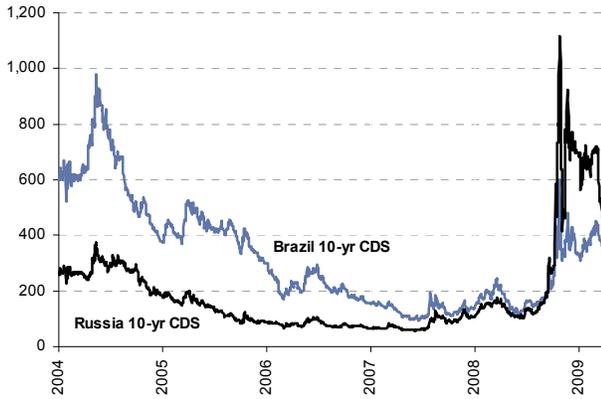
Financial dependency hurt Russia

With global stress squeezing financial liquidity, one important factor helping Brazil has been the relatively robust financial situation of its corporates and banks and low need for external funding. Over 96% of Brazilian bank funding is in local currency, from domestic deposits and investors. Major Brazilian banks entered the global crisis period with over 30% reserve requirements and 12%-13% BIS Tier 1 capital. Russian banks were at about 10.6% Tier 1.

Brazilian corporates had strong balance sheets and low FX exposure, outside of exporters (see *Latin America's (mostly) robust corporates*, October 5, 2008). Today we estimate that 20% of Brazilian corporate debt is due within 12 months, much of it at companies with large cash positions. About 32% of Russian corporate debt is due in the same period. (See Exhibit 15.) Russia's foreign debt had risen 110% from 2005 to now, to US\$490 bn, while Brazil's rose a more modest 43%, to US\$268 bn.

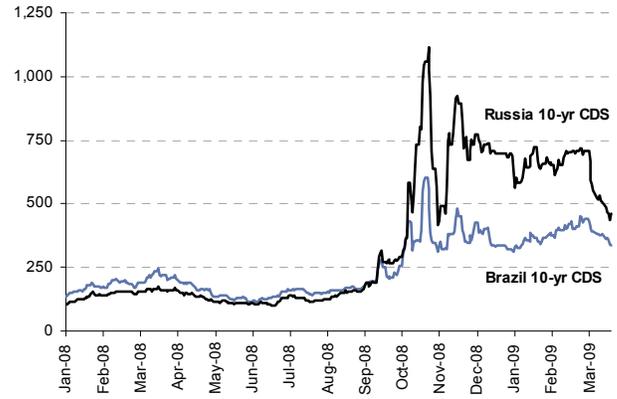
On the risk front, sovereign bond spreads (Exhibits 11 and 12) had been priced on a converging path since 2004 as the Brazilian government of President Luis Inacio Lula da Silva continued on the economic-management path that stabilized Brazil under President Fernando Henrique Cardoso in 1994-2002. Russian spreads were also falling as oil prices rose and President Vladimir Putin presided over a major economic expansion. By August 2008, CDS spreads were virtually identical, less than 200 bp over ten-year US Treasuries for each. However, Russian risk then spiked much more than Brazil's, to as high as 1,060 bp, when Brazil was at 600 bp. Spreads have recently begun converging again, with Russian ten-year sovereign bonds priced now at 460 bp spreads, vs. Brazil's 330 bp.

Exhibit 11: Brazil and Russia risk converging since 2004
Sovereign CDS spreads vs. US Treasuries



Source: FactSet.

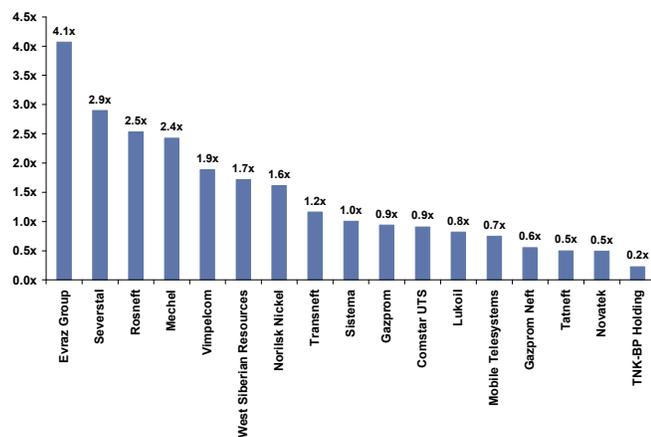
Exhibit 12: Russia risk exceeds Brazil after August 2008
Sovereign CDS spreads vs. US Treasuries



Source: FactSet.

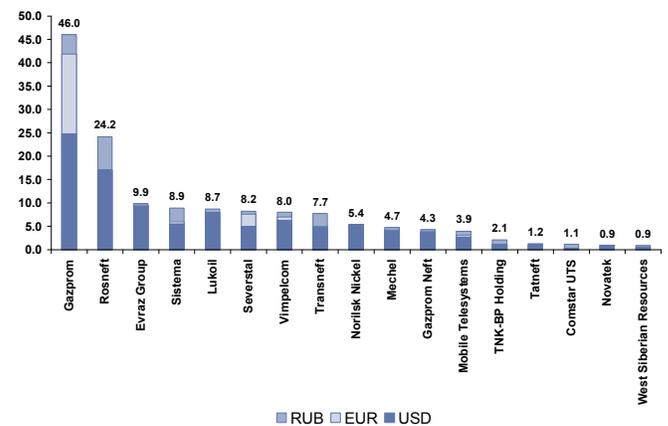
It is worth noting that of Russia's total external private-sector debt stock, only roughly US\$130 bn is attributable to listed Russian companies. The rest is lending to unlisted banks, other private companies, shareholder vehicles, private-equity investors, etc. For the universe of listed companies specifically, debt is not a very serious issue, with the average debt-to-EBITDA ratio of our Russia coverage at 1.2X (Exhibit 13). Still, a large proportion of this debt is US dollar- or euro-denominated (Exhibit 14). With the virtual shutdown of the debt refinancing markets for companies with currency mismatches, valuations of domestic stocks with forex debt exposure took a severe beating at the beginning of 2009.

Exhibit 13: Modest Russia gearing
Net debt/EBITDA 2009E



Source: Goldman Sachs Research estimates.

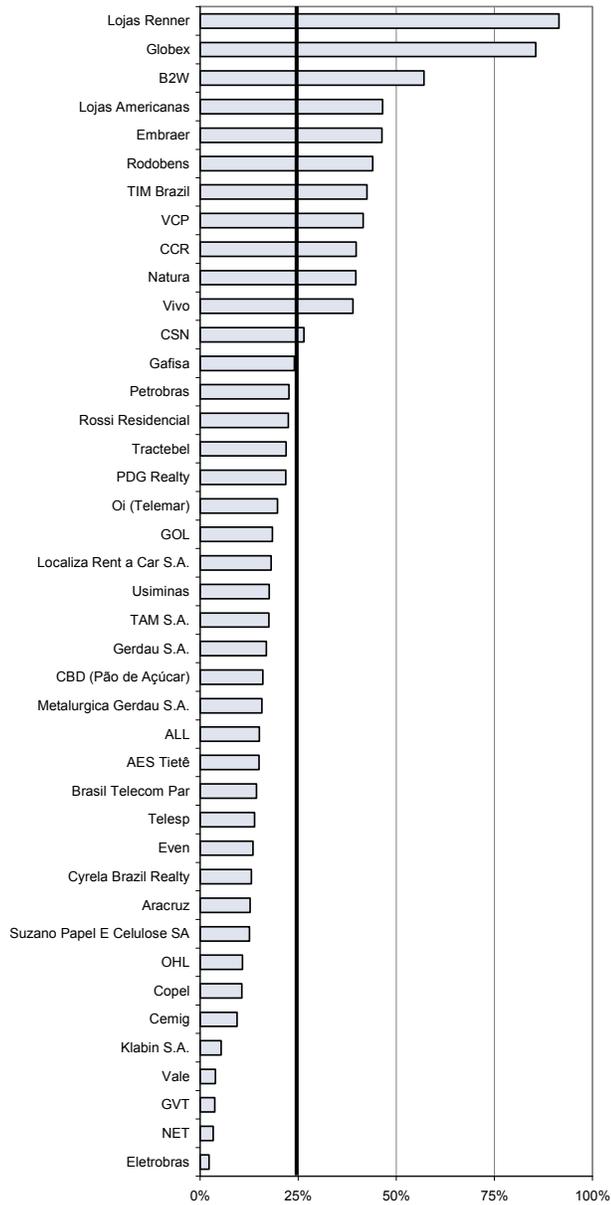
Exhibit 14: Most Russian loans are USD-denominated
Currency split of Russian corporate borrowings



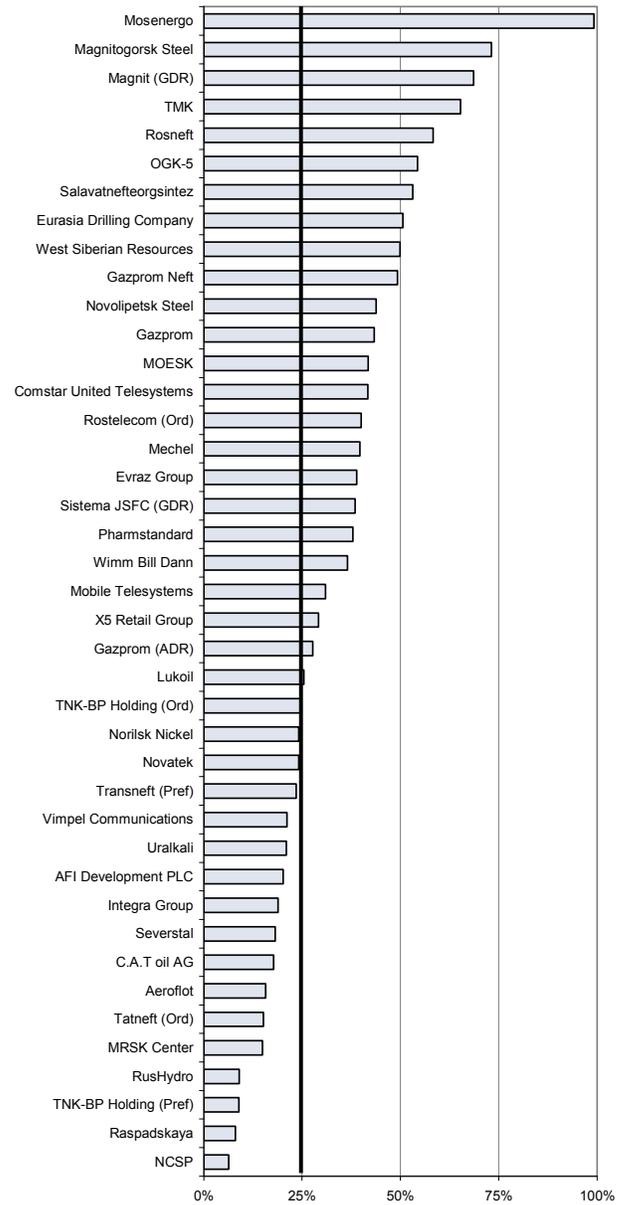
Source: Company reports, Goldman Sachs Research.

Exhibit 15: Greater weighting of short-term corporate debt in Russia

Select Brazil corporates: short term debt as % of total debt



Select Russian corporates: short term debt as % of total debt



Source: Company reports, Goldman Sachs Research.

Russia's turn?

The question now is whether a reversal or leveling of commodity-price and risk-aversion trends will reverse the relative performance of Brazil vs. Russia. A pro-Russia view may be premature, and we do have a bullish view on Brazil vs. developed markets. **But we think Russian valuation discounts are now so severe that there is an excellent chance Russia will outperform.** Exhibit 20 shows that many large Russian stocks are at much lower EV/EBITDA multiples than Brazilian peers. Bond markets have already switched to pricing in greater confidence in Russia's levels of foreign reserves. Sovereign risk spreads are now only 130 bp above Brazil's. We think stock valuations have lagged. Considering that 2009 stock multiples already take into account the low commodity prices of 2009 itself, we think Russian stocks are priced relatively too low.

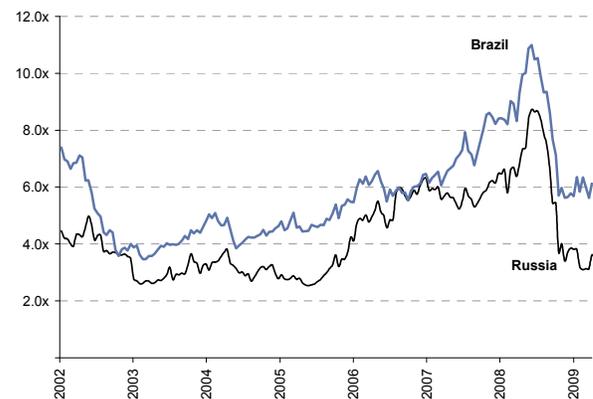
Exhibits 16-18 show that the Brazilian valuation premium over Russia is wider than at most points in the last seven years. This is partly explained by expected returns on equity at Brazilian companies in 2009 around 15%, 50% higher than the Russians' 10% (Exhibit 19). But that is related to oil prices, which affect over 70% of the earnings of listed Russian firms, by our estimate. If oil prices rise, Russian ROEs should too. The biggest risk to a valuation case for Russia might be a revival of corporate-governance issues.

Exhibit 16: Russia at deep P/E discount to Brazil ...
12-month forward P/E multiple estimate



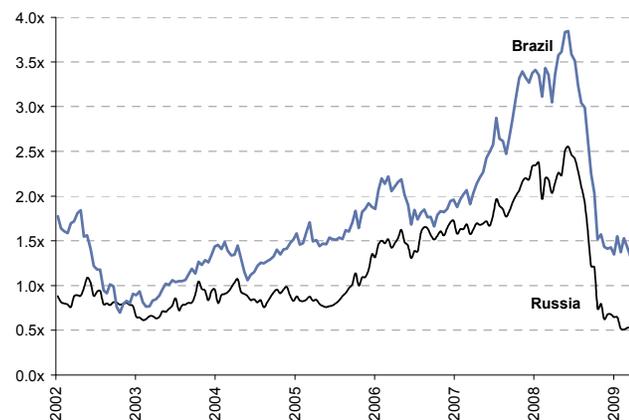
Source: Goldman Sachs Research estimates.

Exhibit 17: ... and EV/EBITDA.
12-month forward EV/EBITDA multiple estimate



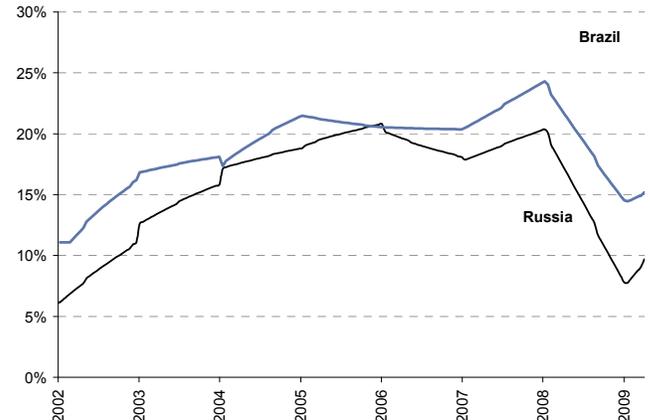
Source: Goldman Sachs Research estimates.

Exhibit 18: Russia cheaper than Brazil on P/BV ...
12-month forward P/BV multiple estimate



Source: Goldman Sachs Research estimates.

Exhibit 19: ... but justified by higher ROE
Return-on-equity estimate



Source: Goldman Sachs Research estimates.

Russian stocks at lower multiples than Brazilian

Exhibit 20: Brazil and Russia equities – recommendations, ratings, and valuations

Prices as of April 3, 2009. Largest Brazilian and Russian stocks, filtered by market caps above US\$2 bn.

	Country	Ticker/ADR	Mkt cap US\$ m	Rating	Price	Target Price	Time Frame	Upside/ down.	EV/EBITDA 2009E	P/E 2009E	Div yield 2009E
BASIC MATERIALS											
Companhia Siderurgica Nacional	Brazil	SID	13,050	Neutral	\$16.96	\$17.00	6m	+0%	6.3x	11.2x	8.1%
Gerdau	Brazil	GGB	9,398	Sell	\$6.61	\$4.00	6m	-39%	6.6x	21.7x	1.5%
Klabin	Brazil	KLBN4.SA	1,242	Neutral	R\$3.04	R\$2.90	6m	-5%	7.1x	27.7x	6.0%
Metalurgica Gerdau S.A.	Brazil	GOAU4.SA	3,679	Sell	R\$19.10	R\$19.00	6m	-1%	5.6x	9.4x	9.7%
Usiminas	Brazil	USIM3.SA	6,640	Buy	R\$29.73	R\$34.00	6m	+14%	4.7x	11.8x	5.1%
Vale (Ord)	Brazil	RIO	80,970	Buy	\$15.34	\$18.00	6m	+17%	7.8x	13.1x	3.1%
Vale (Pref)	Brazil	RIO_P	69,991	Buy	\$13.26	\$16.00	6m	+21%	6.8x	11.3x	3.6%
Volorantim Celulose e Papel (ADR)	Brazil	VCP	2,867	Neutral	\$5.84	\$4.90	6m	-16%	12.5x	39.2x	0.0%
Brazil average								+13%	7.2x	13.1x	3.7%
Evraz Group	Russia	HK1q.L	3,223	Neutral	\$8.77	\$10.10	12m	+15%	5.3x	12.2x	0.0%
Magnitogorsk Steel	Russia	MAGNq.L	3,137	Buy	\$3.65	\$6.30	12m	+73%	0.8x	5.4x	2.8%
Norilsk Nickel	Russia	NKELyq.L	12,477	Sell	\$6.83	\$6.30	12m	-8%	8.1x	34.2x	0.9%
Novolipetsk Steel	Russia	NLMKq.L	7,911	Neutral	\$13.20	\$16.10	12m	+22%	3.1x	6.5x	5.7%
Severstal	Russia	CHMFq.L	3,890	Neutral	\$3.86	\$3.70	12m	-4%	3.9x	36.4x	0.7%
Uralkali	Russia	URKAq.L	5,251	Neutral	\$12.36	\$13.00	12m	+5%	4.3x	5.7x	0.0%
Russia average								+10%	5.1x	19.7x	1.9%
CONSUMER & RETAIL											
CBD (Pão de Açúcar)	Brazil	PCAR4.SA	3,459	Buy	R\$32.49	R\$39.70	6m	+22%	5.4x	16.3x	0.8%
Lojas Americanas	Brazil	LAME4.SA	2,432	Neutral	R\$7.10	R\$7.50	6m	+6%	6.7x	33.9x	0.6%
Natura	Brazil	NATU3.SA	4,319	Buy	R\$22.25	R\$25.20	6m	+13%	10.4x	15.7x	4.2%
Brazil average								+14%	7.9x	20.2x	2.2%
Magnit (GDR)	Russia	MGNTq.L	2,626	Neutral	\$6.31	\$7.20	12m	+14%	8.5x	16.1x	0.0%
X5 Retail Group	Russia	PJPq.L	2,974	Buy	\$10.95	\$15.90	12m	+45%	7.2x	14.6x	0.0%
Russia average								+31%	7.8x	15.3x	0.0%
ENERGY											
Petroleo Brasileiro (Ord)	Brazil	PBR	153,985	Buy	\$35.10	\$40.00	6m	+14%	8.4x	14.7x	2.4%
Petroleo Brasileiro (Pref)	Brazil	PBR_A	121,565	Buy	\$27.71	\$32.00	6m	+15%	6.9x	11.6x	3.1%
Brazil average								+15%	7.7x	13.4x	2.7%
Gazprom (ADR)	Russia	GAZPq.L	98,148	Buy	\$16.63	\$31.30	12m	+88%	4.0x	6.9x	1.5%
Gazprom Neft	Russia	SIBN.RTS	10,431	Neutral	\$2.20	\$3.40	12m	+55%	3.5x	9.9x	2.4%
Lukoil	Russia	LKOH.RTS	34,332	Buy	\$41.50	\$60.50	12m	+46%	4.5x	9.8x	1.4%
Novatek	Russia	NVTKq.L	8,207	Buy	\$27.03	\$36.10	12m	+34%	9.9x	16.6x	2.1%
Rosneft	Russia	ROSN.RTS	48,952	Sell	\$5.10	\$4.10	12m	-20%	7.7x	18.3x	0.5%
Tatneft (Ord)	Russia	TATN.RTS	5,405	Neutral	\$2.55	\$3.20	12m	+25%	4.8x	12.7x	2.1%
TNK-BP Holding (Ord)	Russia	TNBPI.RTS	14,163	Neutral	\$0.88	\$0.98	12m	+11%	2.3x	5.5x	7.1%
TNK-BP Holding (Pref)	Russia	TNBPI_p.RTS	14,163	Neutral	\$0.66	\$0.54	12m	-18%	2.3x	4.3x	9.4%
Russia average								+43%	4.8x	10.1x	2.2%
FINANCIALS											
Banco Bradesco	Brazil	BBD4.SA	34,727	Neutral	R\$25.00	R\$23.60	6m	-6%	na	11.2x	3.0%
Banco do Brasil	Brazil	BBAS3.SA	22,171	Buy	R\$19.10	R\$18.30	6m	-4%	na	7.8x	4.7%
Banco Itau	Brazil	ITAU4.SA	51,905	Neutral	R\$28.00	R\$27.10	6m	-3%	na	12.5x	3.6%
BM&F Bovespa SA	Brazil	BVMF3.SA	7,390	Buy	R\$7.99	R\$8.40	6m	+5%	14.4x	14.4x	4.9%
Redecard	Brazil	RDCD3.SA	8,039	Buy	R\$26.40	R\$32.60	6m	+23%	9.0x	14.3x	6.3%
Brazil average								-2%	11.6x	11.5x	3.9%
TELECOM											
NET	Brazil	NETC4.SA	2,719	Buy	R\$17.72	R\$18.00	6m	+2%	5.9x	29.4x	0.0%
Oi (Telemar)	Brazil	TNLP4.SA	5,931	Neutral	R\$34.30	R\$32.70	6m	-5%	3.8x	8.8x	6.0%
Telesp	Brazil	TLPP4.SA	11,281	Buy	R\$49.25	R\$52.10	6m	+6%	4.0x	9.1x	9.9%
TIM Brazil	Brazil	TCSL4.SA	2,783	Neutral	R\$2.64	R\$3.70	6m	+40%	2.2x	31.1x	1.9%
Vivo	Brazil	VIVO4.SA	5,163	Buy	R\$31.00	R\$44.00	6m	+42%	3.0x	13.2x	3.5%
Brazil average								+13%	3.8x	13.9x	6.1%
Mobile Telesystems	Russia	MBT	13,332	Buy	\$35.25	\$45.00	12m	+28%	4.0x	10.7x	5.6%
Rostelecom (Ord)	Russia	RTKM.RTS	6,263	Sell	\$8.31	\$1.60	12m	-81%	15.7x	47.8x	0.4%
Sistema JSCF (GDR)	Russia	SSAq.L	2,895	Buy	\$6.00	\$17.10	12m	+185%	6.1x	3.0x	3.0%
Vimpel Communications	Russia	VIP	8,324	Buy	\$8.15	\$12.00	12m	+47%	3.9x	nm	0.0%
Russia average								+26%	6.5x	20.0x	2.8%
TRANSPORTATION											
ALL	Brazil	ALL11.SA	2,923	Neutral	R\$11.20	R\$10.40	6m	-7%	8.3x	21.2x	1.2%
CCR	Brazil	CCRO3.SA	4,186	Neutral	R\$22.95	R\$30.50	6m	+33%	6.3x	12.9x	3.7%
Embraer	Brazil	ERJ	2,835	Neutral	\$15.62	\$11.90	6m	-24%	3.4x	7.2x	5.6%
Brazil average								+5%	6.1x	13.7x	3.5%
UTILITIES											
AES Tietê	Brazil	GETI4.SA	3,197	Neutral	R\$18.53	R\$18.90	6m	+2%	5.9x	9.6x	10.4%
Cemig	Brazil	CMIG4.SA	8,305	Buy	R\$36.98	R\$40.70	6m	+10%	5.9x	11.0x	4.5%
Copel	Brazil	CPLE6.SA	3,137	Neutral	R\$25.33	R\$27.80	6m	+10%	4.2x	7.9x	3.2%
Eletrobras	Brazil	ELET3.SA	14,291	Neutral	R\$27.89	R\$31.30	6m	+12%	na	6.7x	3.6%
Tractebel	Brazil	TBLE3.SA	5,435	Buy	R\$18.40	R\$24.70	6m	+34%	7.8x	12.9x	5.1%
Brazil average								+14%	6.1x	9.1x	4.7%
RusHydro	Russia	HYDR.RTS	5,905	Neutral	\$0.02	\$0.03	12m	+12%	4.7x	7.6x	0.7%

Note: For methodology and risks associated with price targets, please refer to the analysts' previously published research.

Source: FactSet, Goldman Sachs Research estimates.

Beyond multiples and commodity prices

Russian risk

Factors in Russia's underperformance in the past year go beyond corporate basics, in our view. In 2008/2009 Russia reignited past investor fears on various fronts. These fears have dominated the discussions over the valuations of the Russian assets over the last nine months. However, we believe the risks have been generally overstated relative to valuations.

Politics. The war in Georgia in August 2008 and the Ukraine-Russia gas prices dispute in January 2009 have dented Western perception of risk in Russia. We estimate that the Russian implied equity risk premium increased by 100 basis points on average with the war. The fall-out from the gas dispute was more severe, with the implied Russian equity risk premium adding 400 bp during the month of January 2009 on our estimates, although it is difficult to separate the impact of the row from the overall deterioration in the global macro environment and sentiment in the beginning of 2009.

Probably not coincidentally, as the political climate surrounding Russia has improved, culminating in the conversations between Presidents Obama and Medvedev in London in April 2009, the implied equity risk premium of the Russian market has declined by 200 basis points. Again, this cannot be cleanly separated from the overall improvement in global sentiment in the last month.

Government interference in the economy. The government in 2008 became increasingly involved in specific corporate situations. In May 2008, investors sold stocks on perceived government pressure on TNK-BP. In July, official pressure on Mechel – one of the leading Russian coal and steel companies – pushed stock prices down again. In December, the government reopened an investigation into Uralkali, the leading Russian potash producer, for environmental damage. This was widely perceived as further state-sponsored intervention aimed at a commodity-related corporate. Also, situations where the government agency VEB has assumed the collateral and refinanced shareholders of listed companies – such as VimpelCom, Evraz, and Rusal – have raised concerns about possible nationalizations and untransparent change of ownership, government intervention and even stock overhang.

Management of the economy. Investors had also been increasingly concerned about the adequacy of the Russian government response to the global crisis. The policy of gradual ruble devaluation cost a US\$210bn loss of reserves over a six-month period. Uncertainty about medium-term oil prices, and perception of a government bail-out of indebted corporates as well as banks, has led to concerns that Russia could lose a considerable chunk of reserves if commodity prices do not bounce back before long. However, we no longer view this as a serious risk.

Recent stabilization of oil prices has alleviated pressure on the currency and restored some confidence in the government's ability to keep the ruble within the 26-41 band to the dual-currency basket. The managed depreciation has achieved its goal of avoiding sudden traumatic stress on much of the Russian economy.

Lack of clarity on corporate/shareholder structures: A large part of Russian corporate debt sits at holding company/shareholder levels as opposed to listed-subsidary levels. The collateral is typically an equity stake in an underlying company. Consequently, the rapid unwinding of the equity market caused a loss of value of the collateral, with margin calls and forced liquidations. With many corporate structures not transparent, the scale of the problem was not known before October 2008, but now appears priced in.

Corporate governance: Corporate governance in Russia is under new pressure as stock prices have fallen. Over the last six months the market has been concerned that minority shareholders might be disadvantaged at companies such as Norilsk Nickel and Sibir Energy. Most recently, investor focus shifted towards corporate disputes involving Russian shareholders and foreign partners in joint ventures – such as TNK/BP in mid-2008 and the more recent Telenor/Altimo situation, where a strategic investor could end up potentially forfeiting its stake after falling out with its Russian partner and losing in the local courts.

Brazilian stability

Although we consider Russian risk over-priced by many investors, on most of these counts Brazil tends to look safer than Russia and better today than in the past.

Politics: Brazil is benign in geopolitical/ideological risk. It has engaged in no armed conflicts with neighbors in over a century. There are minimal internal ethnic or religious tensions. Terrorist episodes affecting many countries, including Russia, in this decade have spared Brazil. Street and white-collar crime are the main Brazilian security issues.

The key political event on Brazil's agenda is the 2010 presidential election. This is shaping up as a low-risk event by emerging-market or Brazilian historical standards. The choice is widely seen as being between continuity of a relatively market-friendly Workers' Party administration under Lula's chief of staff Dilma Rousseff, or a switch to one of two leading centrist opposition candidates – governors José Serra or Aécio Neves. Investors tend to view both as good public administrators, reformers, and even more market-oriented than Lula's government.

Management of the economy: The core economic-management problem of Brazil's Lula administration, in our view, has been insufficient fiscal discipline. With the economy having slowed sharply and the government pushing counter-cyclical stimulus efforts even as tax receipts fall, there is new risk of fiscal deterioration, higher public-debt issuance, and potential risk of a negative outlook on investment-grade ratings from credit agencies that were only recently won. The balance of trade is also under pressure as the positive shocks from high commodity prices are gone.

Nevertheless, the fiscal risks are still only latent, while the agility of the public-sector response to the economic crisis since October 2008 has encouraged markets. Credit-sensitive markets such as automobiles and construction have responded well to tax breaks and directed lending. The float of the exchange rate has kept the trade balance in surplus, despite severe drops in export volumes and prices. Conservative bank regulation before the global crisis has allowed a margin for safe loosening of bank lending restrictions now. Overall we expect the Brazilian economy to shrink 1% in 2009, a benign result by low global standards for the year, or compared to our Russia forecast of -3.5%.

Corporate governance: Historically, the Brazilian equity market suffered from poor protection of minority shareholders. Issues remain in tender requirements and rights of non-voting shareholders, but Brazil is today viewed as a safer market than before. The development of the "Novo Mercado" segment, with all voting shares and other requirements is one key, along with the gradual strengthening of the Brazilian Securities Commission. The government has generally taken the side of protecting the investing public, and although not always effectual, it has not been threatening. This does not mean there are no other dangers on corporate balance sheets after an initial round of damage in late 2008 from FX derivatives gone wrong.

Sector by sector: Buy and Sell recommendations

Comparative valuations of the most important sectors in Russia and Brazil – oil and gas, metals and mining, telecoms, financials, and utilities – have shown similar dynamics over the last six months: diverging valuations, with the advantage to Brazil. Under stressed market conditions this seems largely justified, and yet may set up Russia for outperformance when conditions improve.

Our stock recommendations are formed independently for Russia and Brazil and relate specifically to expected performance within each analyst’s stock-coverage group. Nevertheless, we see positions that can be taken across borders to capture potential performance differences between Russian and Brazilian names or versus global sectors.

Oil and gas: Buy Gazprom and Petrobras

Among our core views are Buy recommendations on each market’s leading energy name: Petrobras in Brazil and Gazprom in Russia. In 2009, if as we believe, energy prices are in the early stages of a rebound, Gazprom may outperform. Exhibits 21 and 22 show the gaps that have opened up in valuations and stock prices. Petrobras trades at 8.4X EV/EBITDA 2009E, not demanding considering it is based on the low energy prices of 2009. But Gazprom trades at an especially low multiple of 4.0X. We think the gaps will narrow if markets settle down and energy prices rally.

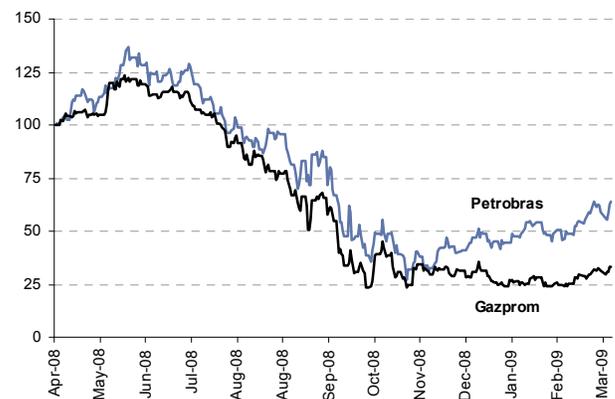
In any case, both companies have dominance over unique energy resources – Russian gas and Brazilian offshore oil and gas – in a world that we believe will be tight for energy again when global growth resumes. Expansion costs for both are competitive over other marginal sources of hydrocarbons. Our global energy teams favor both names over most other energy stocks around the world.

Exhibit 21: Brazil oil and gas multiple far above Russia’s
12-month forward EV/EBITDA estimate



Source: Goldman Sachs Research estimates.

Exhibit 22: Gazprom lags Petrobras and World Energy
Stock prices and index levels, March 30, 2008 = 100



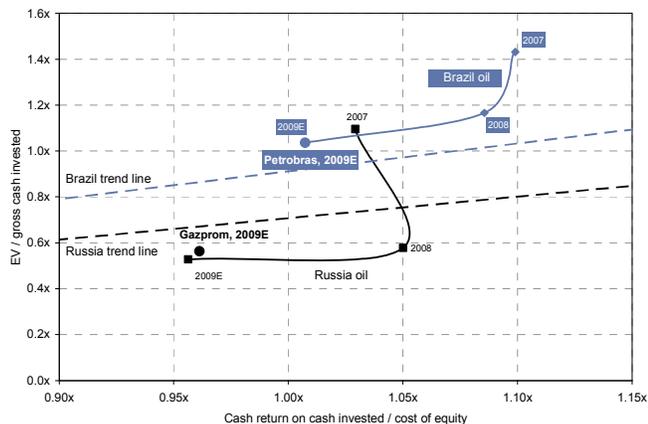
Source: FactSet.

Exhibit 23 shows that cash returns on cash invested (CROCI) vs. cost of equity for both sectors have deteriorated in 2009, as risk premia rose while oil prices fell. Multiples (in this case Enterprise Value/Gross Cash Invested, which is an Enterprise-Value form of Price/Book Value multiple) also fell.

The dotted lines, however, are the regression lines formed by the last seven years of data points on EV/GCI vs. CROCI/Cost of Equity for each company. They show that Gazprom at

the moment is below its recent historic valuation on this risk-adjusted and return-adjusted basis. Petrobras, in contrast, is priced above its recent history. This favors a potential rebound of Gazprom vs. Petrobras in the short term. (For more details on this valuation approach, see for instance "Screening for Alpha – Director's Cut and the Reward for Sustainable Advantage," October 2, 2008.)

Exhibit 23: Gazprom at discount, Petrobras at premium to historic risk-adjusted & return-adjusted multiples
EV/gross cash invested vs. (cash return on cash invested/(cost of equity))



Source: Goldman Sachs Research estimates.

Exhibit 24: Petrobras earns more per barrel
Net income per barrel estimate: Russia, Brazil, China

2009 @ US\$50/bbl Brent	CNOOC	Petrobras	Russian oils
Brent price	50.0	50.0	50.0
Quality discount	-3.5	-10.0	-2.0
Realized price	46.5	40.0	48.0
Opex and transportation	-8.3	-10.0	-9.7
SG&A	-2.4	-1.0	-0.9
Exploration	-2.2	-2.0	-0.5
DD&A	-7.4	-4.0	-4.2
Production taxes	-1.6	-10.0	-7.2
Export duties	na	na	-18.9
Other taxes	-1.1	na	na
PBT	23.5	13.0	6.6
Income tax	-5.3	-4.55	-1.6
Net Income	18.2	8.5	5.0

Source: Goldman Sachs Research estimates.

Less taxation on Petrobras

Nevertheless, we think Petrobras may be the better medium-term story. In the past 24 months it has presided over a series of large, new offshore Brazilian oil discoveries that our global oils team believes makes it the best positioned major in the world for the next major oil-price upcycle. A number of global majors are active in Brazil, but almost invariably in partnership with Petrobras. This means it has more favorable medium-term growth prospects (the first significant pre-salt production will be in 2010) than Gazprom.

Furthermore, Exhibit 24 above, with a \$50-per-barrel example, shows that vs. other oil companies, Petrobras generates more cash per barrel. That reflects mainly a more advantageous Brazilian tax regime.

That highlights another factor, which is less political and geopolitical risk in Brazil than in Russia. There is a growing view among many investors that Gazprom effectively represents the Russian State, including use of the company as a foreign-policy instrument. Petrobras also is managed with national-policy goals in mind, such as domestic sourcing of capital equipment, but to a less intense degree.

Gazprom, is nevertheless not only our key Russian oil and gas sector recommendation, but our strongest Russian idea overall. Besides its resource base, it also benefits from an on-going restructuring program which should result in domestic Russian gas-price liberalization in the medium term. And its valuation is extremely undemanding.

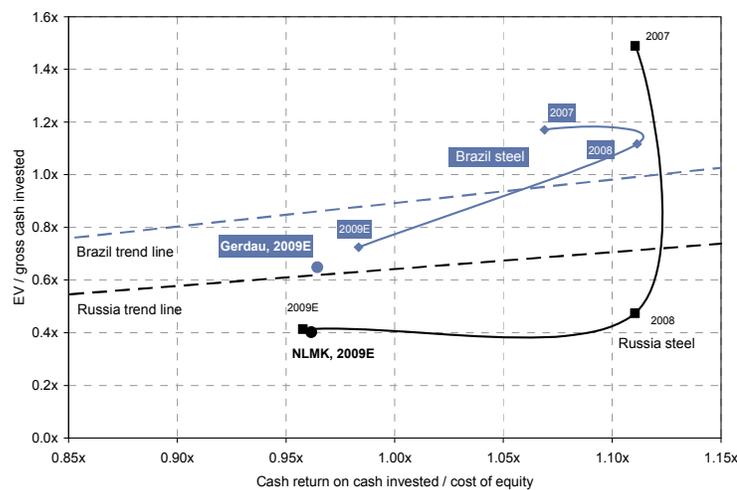
Of course, the major risk to both Petrobras and Gazprom is the global commodity price curve. There are also extensive operating/technology risks with both companies.

Steel: Prefer Novolipetsk (Neutral) to Gerdau (Sell)

We see a significant valuation discount for the Russian steelmaker Novolipetsk (NLMK) vs. Brazilian steelmaker Gerdau, considering NLMK's clean balance sheet versus a deterioration in the production profile and debt burden for the Brazilian steelmaker. Gerdau is currently trading at 6.6X 2009E EV/EBITDA or a 113% premium to Novolipetsk (NLMK) and 15% premium to the Latin American steel average.

Exhibit 25 shows that both Brazilian and Russian steel sectors are below their historic trend lines in risk- and return-adjusted valuation, but Gerdau is currently priced 58% higher than NLMK on this basis. Note also that unlike other Brazilian steelmakers that are domestically oriented, Gerdau has 40% of its revenues coming from the depressed US market, where we expect steel demand to drop 15% in 2009.

Exhibit 25: Brazil steel vs Russian steel, and Gerdau vs. NLMK
EV/gross cash invested vs. cash return on cash invested/cost of equity



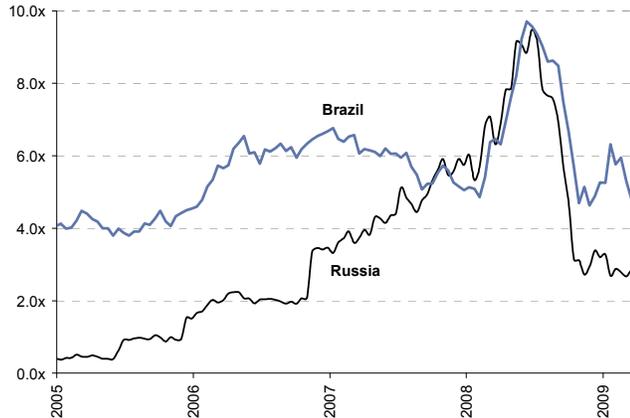
Source: Goldman Sachs Research estimates.

In general, a large valuation gap of Brazilian over Russian steels has opened up, with Brazilian steels at 5.0X expected 12-month forward EV/EBITDA, and Russians at 2.9X (Exhibit 26). As with other elements of Brazil vs. Russia recommendations, we think the Russians could outperform in the short run to narrow the gap. This could occur merely as an effect of markets stepping back from extreme risk aversion.

Brazilian steels have held up in part because the structure of the industry supports domestic prices (Exhibit 27), while Russia is highly exposed to international export prices and import competition. The flip side, of course, is that any sign of recovery of international prices is likely to benefit the Russians more.

Exhibit 26: Brazil steel sector at 66% premium

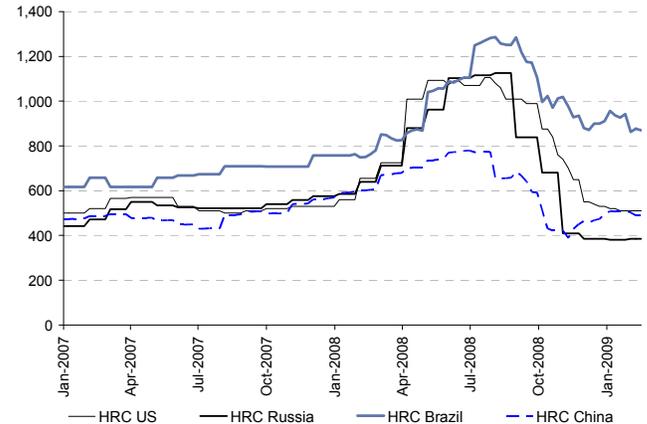
Avg. 12-mo. fwd. EV/EBITDA multiple, covered steel stocks



Source: Goldman Sachs Research estimates.

Exhibit 27: Brazil prices less sensitive to global prices

Hot rolled coil steel price per ton (US\$)



Source: Goldman Sachs Research.

Some Brazil premium justified

Our NLMK-vs.-Gerdau call does not mean we think Russian steel should necessarily trade in general at the same multiples as Brazilian steel. Both are global cost leaders (on an FOB basis) and should therefore be valued at a premium to global steelmakers, as long-term industry winners. However, there are disadvantages that Russian steelmakers have versus Brazilians, at least in the short term.

- First, Brazil is a more closed market than Russia, with a steel industry aimed over 85% at domestic sales and insulated from imports by logistics costs, tariffs and market structure. This allows domestic steel prices in Brazil to stay at a significant premium to prices in Russia.
- Second, steel demand in Russia collapsed 28% in the August to January period and remains at subdued levels today. Steel consumption in Brazil was resilient for longer, fell sharply only in November 2008, and has shown signs of a rebound already in February and March 2009, on recovering auto sales. This should result in lower capacity-utilization rates for Russian steelmakers this year, despite the recent growth in Russian steel shipments to Asia (which we think may reverse).
- Lower selling prices and lower utilization rates for Russian steels means they will generate lower returns this year – we forecast CROCI of 8% for Russian steels and 11% for LatAm steels on average (before adjustments for coking-coal costs). Russian steels' valuation advantage also looks less appealing if earnings of Brazilian steels are adjusted for the expected sharp decline in coking-coal costs after July 2009.
- Finally, along with higher governance and country risk, some Russian steels (particularly Evraz and Mechel) also face greater balance-sheet stress than their Brazilian peers.

Different markets and cost structures

Although both markets have concentrated supply structures, competition among steel companies in Russia is more intense than in Brazil. There are only three major Brazilian producers in flat steel (CSN, Usiminas and ArcelorMittal) and two in long steel (Gerdau and ArcelorMittal). Imports have provided only minimal pricing pressure. The steelmakers themselves control close to 60% of the steel service centers in Brazil. The rest are small, which limits their ability to gain the import scale that could compete with large mills.

Brazil steel faces limited competition

The largest buyer of Brazilian steel (27% in 2008) is the domestic auto industry, which is itself protected from imports and has longstanding direct relationships with mills for custom supply, cutting and logistics. Auto executives say domestic prices would have to be at a premium to imports of close to 50% on a sustainable basis to justify importing steel.

In Russia, more than 80% of supply is concentrated among the top six players, but generally the market is open to imports (from Turkey, Ukraine, and Asia). Russian antitrust authorities have tended to show greater care for buyers of steel by making sure that domestic prices are not substantially higher than prices in export markets.

Direct comparison between Brazilian and Russian steel companies must also take into account the different impact of iron-ore and coking-coal prices on earnings and multiples. Some of the Russian companies are self-sufficient or have a surplus of coking coal. However, Brazilian flat-steel makers must import this input, which is the largest single component of their costs. New contracted coal prices should be agreed upon in the next 1-2 months, and our expectation is for a 60% decline by July, to US\$120/ton. Multiples based on 2009 profitability will therefore include 7-8 months of the year with coking coal at very high cost (US\$250-300/ton), and 4-5 months at much lower cost.

If Brazilian steel companies' multiples were adjusted to the new coal prices for the full year 2009, they would be much lower than the headline multiple. On our numbers, Usiminas (a flat-steel producer), for example, would fall from 4.9X 2009E EV/EBITDA to 3.5X. For the Russians there is no similar impact. The expected decline in coking-coal prices affects earnings for all of 2009 at non-integrated names like MMK and NLMK, while the impact is neutral at Severstal and Evraz, which produce their own coking coal.

Mining: Vale (Buy) vs. Norilsk Nickel (Sell)

While both Brazil's Vale and Russia's Norilsk Nickel are fully exposed to the global commodity-price cycle, including nickel prices specifically, the Russian mining stock's valuation is likely to continue to suffer from concerns over corporate governance and control issues. These are not particular issues with Vale. The Brazilian giant also has a strong balance sheet, at 0.8X 2009E net debt to EBITDA, versus 2.6X for Norilsk.

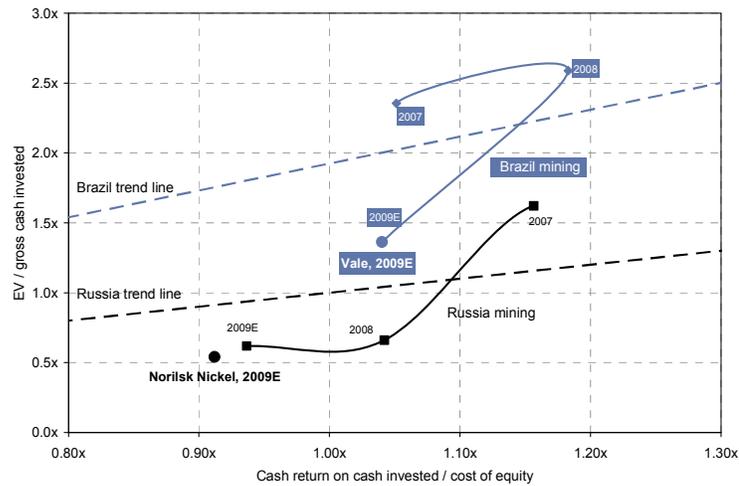
Vale has high exposure to the iron-ore sector (84% of its 2009E EBITDA), which we think will continue to outperform base metals, due to strong demand from China. Nickel, which is over 50% of Norilsk's business, is used in stainless steel, which goes into high-end consumer and other products, where an activity rebound could take longer.

Brazilian iron ore exports in February 2009 were down 20% year on year, but rose 16% month on month in terms of shipments per working day. The year-on-year performance of monthly shipments is clearly on an upward trend, coming from -40% in December 2008 to -29% in January 2009 and most recently -20% in February 2009. We are confident that Vale will deliver 1Q2009 iron sales volume of at least the 50mn mt the company has guided for. In our view, the risk to the shipments forecast is now to the upside. We estimate that Vale will sell 250mn tons (including domestic sales) in all of 2009, which would represent a decline of 15% yoy.

As shown in Exhibit 28, Vale trades at a higher risk- and return-adjusted multiple than Norilsk, but is now farther below its own historical trend than Norilsk. With additional adjustment for political and corporate-governance risk that may not be fully captured in Norilsk's cost of capital, we see Vale as the better alternative.

Exhibit 28: Vale vs. Norilsk

EV/gross cash invested vs. cash return on cash invested/cost of equity



Source: Goldman Sachs Research estimates.

Telecoms: Prefer Mobile Telesystems, MTS (Buy) to América Móvil, AMX (Neutral, price as of April 3: \$30.91)

This call is not a perfect Russia vs. Brazil trade, but rather a CIS vs. Latin America trade, since both companies operate regionally. Among other things, this means AMX is only 20% exposed to the relatively resilient expected performance of Brazil’s economy this year, but 40% to the more severely affected Mexican economy.

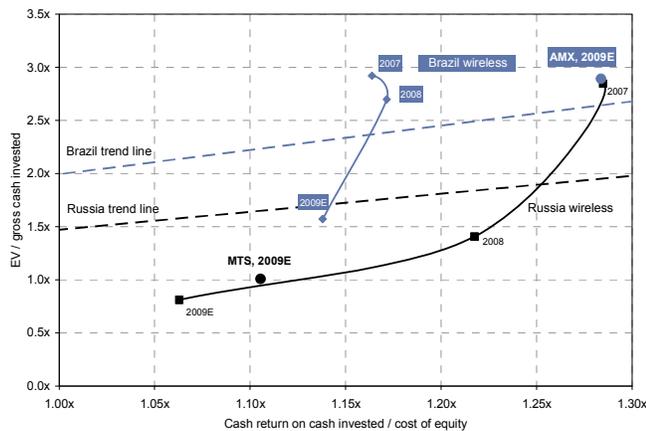
MTS is trading at just 4.0X 2009E EV/EBITDA, despite a benign competitive environment. Part of the discount is due to shareholder structure – MTS’s main shareholder is the holding company Sistema. The market has been concerned that Sistema’s liquidity position – the short-term debt of the holding company alone is US\$1.9 bn in 2009 – may push it to use MTS to upstream cash to the parent company via value-destructive intra-group acquisitions. In our view, these concerns are exaggerated – Sistema is a listed company and derives the majority of its value from its stake in MTS, hence majority and minority shareholders are in the same boat. Consequently we expect MTS’s discount to emerging markets wireless companies and AMX specifically to narrow.

AMX operates in a mix of less competitive (Mexico) and more competitive (Brazil, Argentina, Colombia, Chile) markets, and trades at 5.7X, nearly 50% above MTS’s multiple. AMX is a solid, dominant business, one of the five largest mobile operators in the world. As its growth slows, it now generates heavy free cash flow (10.6% yield expected in 2009). Nevertheless, we believe its premium (about 20% over the average of global peers on EV/EBITDA, while many telcos have higher FCF yields) reflects expectations of a growth premium for AMX that are no longer realistic, as Latin America’s markets are near saturation with mobile phones.

We think ruble stabilization alone can help substantially in restoring sentiment on Russia’s MTS, since it fell sharply on fears surrounding its non-ruble debt. This movement has been visible already in the rally of the past few weeks.

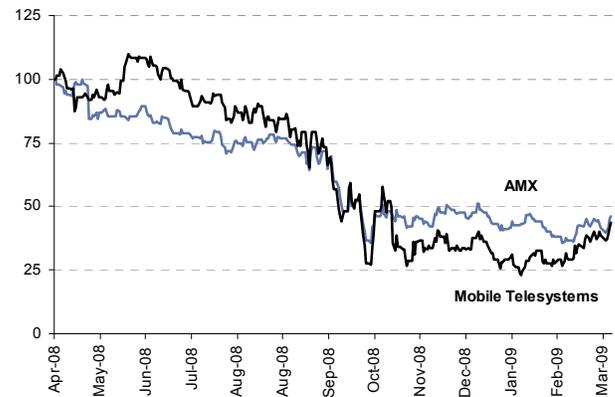
Exhibit 29 shows how MTS is now about 50% below its seven-year trend line of EV/Gross Cash Invested vs. CROCI/Cost of Equity, that is a risk- and return-adjusted valuation multiple. AMX in contrast is above its own trend line.

Exhibit 29: MTS below valuation trend line, AMX above EV/gross cash invested vs. cash return on cash invested/cost of equity



Source: Goldman Sachs Research estimates.

Exhibit 30: AMX in line with MTS over 12 months
Relative stock-price performance, US\$, April 3, 2008 = 100%



Source: FactSet.

As for Brazil itself, it is a more competitive market than Russia for telephony, particularly mobile telephony. Russia is a three-player market characterized by broad pricing discipline. In contrast, Brazil has five national mobile operators (including Nextel, or NIHD), the largest of which (Vivo) has just 26% market share. The Brazilian sector is also heavily taxed, at about 40% of revenues.

On the fixed-line side, there are two regional Brazilian incumbents, but even they compete with Embratel and others for long distance and with cable companies (NET) and alternative carriers (GVT) for voice telephony and broadband. Furthermore, all listed Brazilian telcos except GVT (and LatAm multinationals AMX and NIHD) operate under the split ON/PN share structure that creates potential conflicts of interest between controlling and public shareholders.

Because of less competition, Russian mobile telcos' EBITDA margins have been in the region of 50%, compared to Brazilian mobile margins at best in the 30s, but at times as low as the teens. Fundamental changes in the competitive regime in Russia are unlikely in our view, so we believe the Russian wireless consolidated margins will move no lower than the mid-40s range in the medium term. We believe that both MTS and VimpelCom can defend their core margins at close to 50%.

In our view, the move to a premium by Brazilian telcos in the last two months largely reflects investor unease about the Russian operators' forex-denominated debt in the face of sharp ruble devaluation. In contrast, about 85% of Brazilian telecom operators' debt is local-currency denominated. With the ruble stabilizing, and with Russian companies making efforts to swap debt into rubles, we expect Russian telecoms valuations to start returning to historical averages.

Banks: Brazil premium valuations supported by better near-term fundamentals

Russian bank valuations have collapsed since 2008, to just 0.5X book value on average today (Exhibit 31). This was driven primarily by a rapid deterioration in credit quality, as economic growth nearly halted in 4Q2008, as well as by expectations of a sharp increase in credit costs. The CEOs of state-controlled banks Sberbank and VTB have said that non-performing loans (NPLs) could reach 10% in 2009-10 from 1.7% and 3.8% respectively in 2008, while the market has been concerned about potentially much higher numbers. Deterioration in the operating environment has led to concerns about the potential need for capital raising.

In contrast, we do not believe listed large-cap private-sector banks in Brazil (Itaú-Unibanco and Bradesco) will need to raise capital, even if NPLs are higher and the economic downturn deeper than we expect. Bradesco and Itaú-Unibanco have BIS ratios of 16% (Tier 1 of 13%). Nevertheless, we have a Neutral coverage view on Latin American banks overall, and Neutral ratings on Itaú-Unibanco shares and Bradesco, because their strength is already reflected in premium valuations. Price/book value on 2008 is 2.4X for Itaú-Unibanco and 2.0X for Bradesco (or 1.9X and 1.8X on a forward 12-month basis).

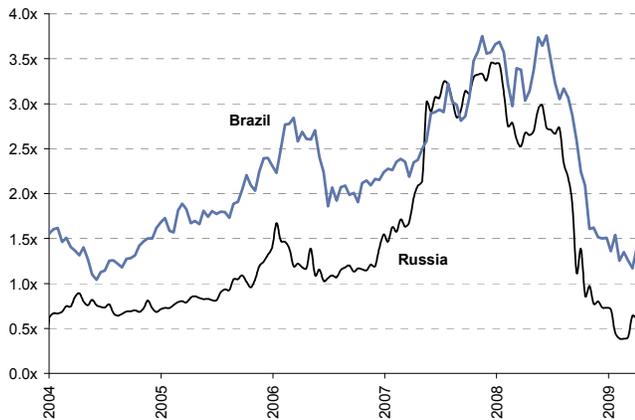
Banco do Brasil, which is controlled by the federal government, is our only Buy-rated Brazilian bank. It has a weaker capital position than the other two, although still robust at 11% Tier 1. Its valuation is much lower, at 1.3X price/book (or 1.2X forward 12 months). This is a stark difference from a year ago, when private-sector and public-sector banks traded at similar levels.

The drop for Banco do Brasil reflects the market's concern, at least partly justified in our view, that the government will use the bank's balance sheet in stimulus programs to help the Brazilian economy during the global crisis. It also reflects the public bank's exposure to agriculture (30% of the loan book) in an environment of low commodity prices and drought in southern Brazil. The fear of governmental pressure is similar to fears surrounding Russia's state-controlled Sberbank and VTB, which may be valid, although such pressure has not materialized yet.

The current credit-quality problems at Russian banks can mainly be attributed to a deterioration of corporate loans, which comprise about 80% of their loan books. This compares with about 65% for the banks we follow in Brazil (including the agribusiness lending at Banco do Brasil). Foreign currency lending is a non-issue for Brazilian banks, since they are allowed to lend domestically only in local currency and have minimal loans abroad.

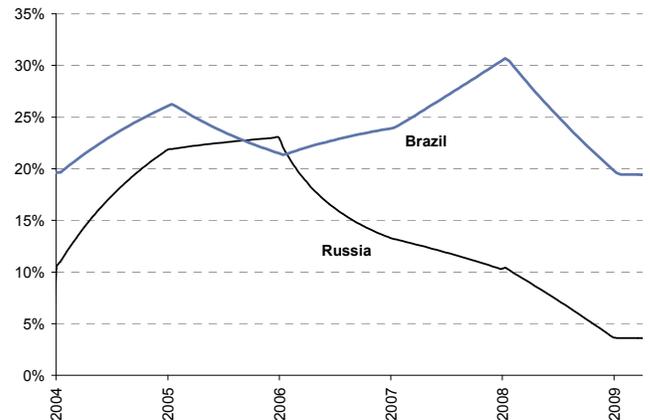
Although mortgage lending is not large for either Russian or Brazilian banks, mortgages do account for 9% of Sberbank's loan portfolio and 8% of VTB's. This is higher than for the Brazilians (3% at Itaú-Unibanco, 1% at Bradesco and close to zero at Banco do Brasil). Brazilian banks do not extend mortgages in foreign currency, while about 18% of the mortgages at Sberbank and VTB are in euros or dollars, stressing some borrowers when the ruble fell.

Exhibit 31: Brazilian banks valuation premium is justified by a substantially higher ROE
12-month forward P/BV multiple



Source: Goldman Sachs Research estimates.

Exhibit 32: Brazilian banks enjoy some of the highest ROEs globally
Avg. return on equity, covered banks



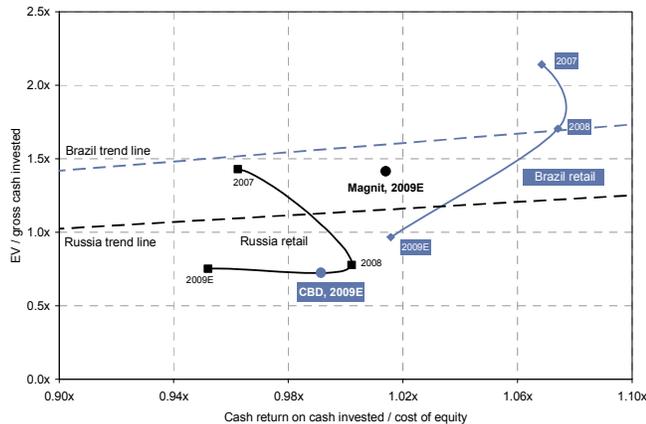
Source: Goldman Sachs Research estimates.

Retail: CBD (Buy) vs. Magnit (Neutral)

The high multiples of Russian retailer Magnit (2009E EV/EBITDA of 8.5X) are hard to justify in light of a significant deterioration in the operating environment for domestically oriented consumer companies. Brazil's CBD is priced lower, at just 5.4X our 2009 EBITDA estimates, even with Brazilian retail sales still holding up nicely (up 6% year on year in January 2009). CBD is the second largest food retailer in Brazil (i.e. defensive in the expected 2009 slowdown) and is in the middle of a corporate turnaround that has shown early results in margin expansion. We think this will continue on track into 2010.

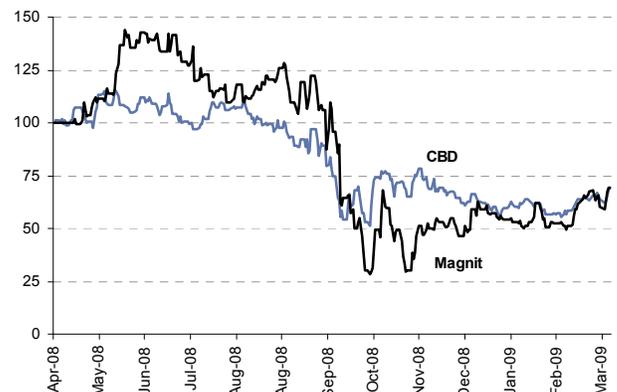
With CBD and Magnit having traded in line in the past year – both fell 31% (Exhibit 34) – we believe CBD looks better value. Adjusted for risk captured in cost of equity for returns on capital expected in 2009, CBD is trading at less half the level of its seven-year trend line, while Magnit is trading about 17% above its trend (Exhibit 33).

Exhibit 33: Magnit valuation premium over CBD in 2009 appears unjustified given similar returns
EV/gross cash invested vs. cash return on cash invested/cost of equity



Source: Goldman Sachs Research estimates.

Exhibit 34: CBD should start outperforming Magnit
Relative stock-price performance, US\$, April 3, 2008 = 100%



Source: FactSet.

Utilities: Cemig (Buy) vs. RusHydro (Neutral)

Among major power generation companies, we expect the valuation discount of RusHydro to Cemig to remain in place or widen in 2009 – RusHydro trades at 4.7X 2009E EBITDA, compared to 5.9X for Cemig. As shown in Exhibit 35, both companies have been struggling to return their cost of capital. However Cemig's returns look set to rise, while RusHydro's may drop in the next few years.

In general, Russian generators are trading at a substantial discount both to the global sector – 3.7X average EV/EBITDA 2009E vs. 7.7X on average for global utilities – and relative to Brazilian utilities, which trade at an average of 6.1X EBITDA 2009E. However, the Russians have massive capex commitments to the government, and we think most of the investment projects dilute value in the current environment. There are also material regulatory risks, with low visibility on prospective returns and no sign yet of recovery of liberalized electricity prices since they collapsed in late 2008. We believe the downside pressure on Russian stock prices will continue until there is more clarity on regulation.

All this contrasts with Brazil, where we see generation tariffs for Cemig and other producers rising in the next five years to R\$130/MWh on average, in today's purchasing power vs. current prices at R\$75-85/MWh. Moreover, the committed capex for new generation plants in Brazil has high visibility of earnings, from locked-in long-term contracts. The electricity rates are defined, with inflation adjustments, in free-market auctions before construction commitments are made.

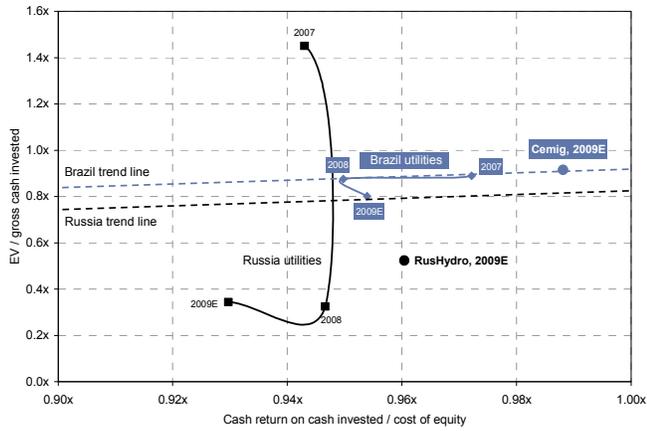
Distribution offers better Russian risk/reward balance than generation

As for power distribution companies, the Russian distributors are trading at especially distressed valuations of 0.2-0.3X P/BV 2009E and at 85%-90% discounts to their expected regulatory-asset-base (RAB) values. In contrast to generators, we are looking positively at the Russian distribution subsector and see very significant upside potential from these valuations. However, we do not expect decisive share-price recovery until we see more regions transitioning to RAB regulation.

In Brazil the regulatory framework for power distribution is well established, after two rounds of tariff reviews (2001 and 2008/9). Most distributors trade at an enterprise value above the official value (RAB) assigned to their assets by the regulator. This implies that the market believes management at present is producing returns higher than the regulator originally assumed. We agree with this view, and although the bar is reset by the regulator every four years we think Brazilian distributors will continue improving above the official bar. Dividend yields (Bloomberg consensus) for 2009 are as high as 7% (CPFL), 17% (Coelce), and 12% (Eletropaulo).

Exhibit 35: Cemig and RusHydro struggle vs. cost of capital

EV/gross cash invested vs. cash return on cash invested/cost of equity



Source: Goldman Sachs Research estimates.

Exhibit 36: Cemig outperformance relative to Rushydro is justified in our view

Relative stock-price performance, US\$, April 3, 2008 = 100



Source: FactSet.

Reg AC

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