



HERMITAGE CAPITAL MANAGEMENT

A Tale of Two Russia's

*Assessing the current investment climate in
light of Bill Browder's visa problem*

By Bill Browder
Chief Executive Officer
Hermitage Capital Management

May 2006



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Background

In the past, Bill Browder has been one of the biggest advocates of investing in Russia...

FINANCIAL TIMES
MONDAY JULY 14 1997
The Monday Profile: Bill Browder
Russia's true believer



Bill Browder, who may well have been the world's most successful fund manager over the past year, is the seeming embodiment of contrarianism - that most vital of an investor's virtues. In his youth, Browder might have been expected to pursue the radical cause of his grandfather, Earl, a former general secretary of the American Communist Party, who was educated in Stalin's Russia and twice ran for US president. Not a bit of it. After embracing the free market creed at the University of Chicago, Browder entered the citadels of capitalism by working as a management consultant, investment banker, and fund manager. He may have followed in his grandfather's footsteps by moving to Russia last year but it was as a disciple of a very different faith. Browder was convinced there were fortunes to be made from Russia's return to the market. Raising expectations once again, Browder raised \$25m (£14.7m) from private foreign investors and plunged into the Russian stock market in April 1996 - just as everyone else was pulling out, fearing a Communist candidate would win the forthcoming presidential elections. The reward for such boldness has been a staggering 725 per cent return on the initial capital. As a result, his fund, Hermitage, tops just about every performance table, pulling in a flood of new investor money. Hermitage's total net asset value had swollen to \$722m as of July 4. While recounting his personal history, the earnest, 33-year-old Browder betrays barely a flicker of emotion although his family has evidently endured a lot. In matter-of-fact tones he tells how his grandfather started fighting for workers' rights in his home town of Wichita, Kansas, but was subsequently expelled from the Communist party for his "revisionism".

Bill's father, born in Russia, also saw his career as a mathematician temporarily blighted by the suspicions provoked by the McCarthy anti-Communist witch hunt in the 1950s. "Here information is and difficult to obtain it have good information not because you are an simply because you be someone the right op says. Browder says he was by the "incredible" opportunities in Russia working as an investment salesman brothers. After bank in 1992, Browder "the body prize" of Russia to the post of Chairman on a company privatization market crashed the oligarchs [Russia's billionaire tycoons] decided to misbehave like never before," says Browder. "They grabbed and stripped anything they could. It was like they were fighting for their lives. They didn't know what would happen when president Yeltsin finally left office and they had every incentive to do it because they didn't know if they would own any."

FORTUNE February 23, 2004
Billion-dollar bet on Russia
Bill Browder is making a high-stakes wager that energy stocks will continue to boom.



lately, Russia's stock market gained 58% in 2003, outpacing even the 50% rise of the tech-heavy Nasdaq in the U.S. Many individual Russian stocks available to U.S. investors as ADRs did even better. Shares of Norilsk Nickel (NLSY:PK, \$71), the globe's biggest producer of the mineral, nearly tripled, as did those of Gazprom.

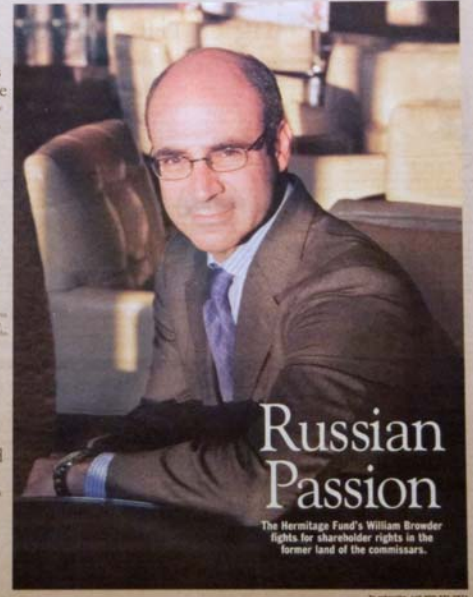
BY JANET GUYON ■ Given that the head of Russia's largest oil company was tossed in a Moscow jail in late October as part of a government power play, Bill Browder has every right to be nervous. It's not because he's likely to be next. It's that as the CEO of the largest public equity fund devoted to investing in Russia, with more than 51 billion parked primarily in just five energy stocks, he's got more than a lot to lose. However, for Browder and other sophisticated investors in Russia, the jitters caused by the plight of Yakov oil baron Mikhail Khodorkovsky served as just another great buying opportunity. And there have been plenty of those since his grandfather was general secretary of the U.S. Communist Party from 1932 until 1945 and his father was born in Moscow, he became hooked on the country's potential while at Salomon Brothers in the early 1990s. A few years later, backed by \$25 million from the late, legendary banker Edmund Safra, Browder started the Hermitage fund. That \$25 million, plus inflowing money, rapidly grew to \$1.1 billion by the end of 1997. But Browder miscalculated by figuring the fix in the Asian markets wouldn't affect Russia. When the Russian market crashed in the summer of 1998, it brought the value of

EMERGING MARKETS FOCUS
Russia's crusader
By Georgina Leslie
MAY 2002
The manager of one of the world's best-performing emerging market equity funds is also Russia's leading shareholder activist. James Schofield charts the rise of Hermitage Capital Management's Bill Browder.



Browder making Russia a better place, as well as making money.

BARRON'S Mutual Funds
FOR THE WEEK NOVEMBER 13 THROUGH NOVEMBER 19, 2004



Managers Recalibrate
What the pros do right to succeed in volatile and uncertain stock markets.

FUND SCORE
Dynamo In The Middle
Hold on your seats! Scores have shot over the high wire in the past 6 months.

SCOREBOARD
Combined Strength
Major asset class took the market.

Russian Passion
The Hermitage Fund's William Browder fights for shareholder rights in the former land of the commissars.

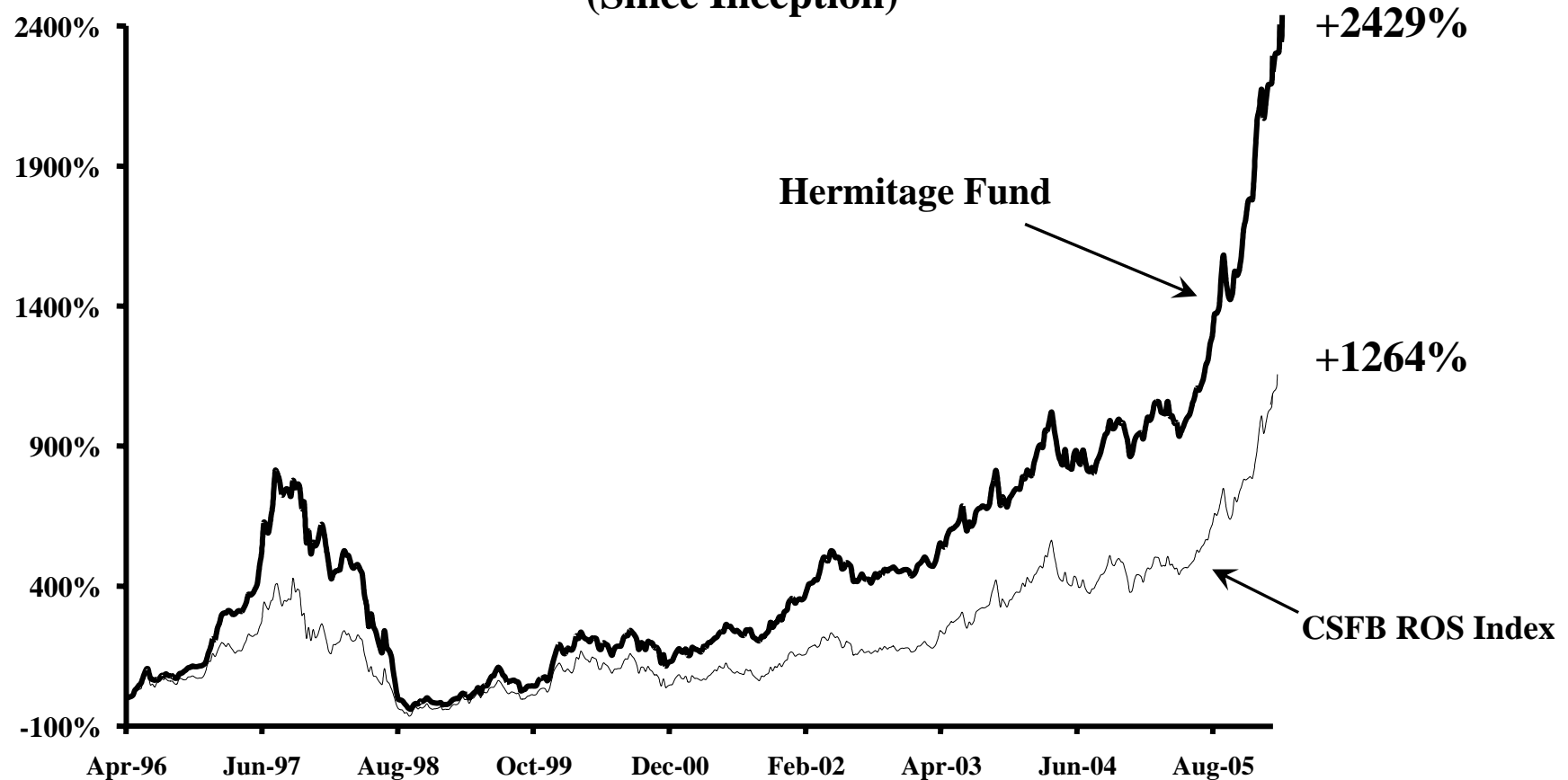
MSCI Russia Index 22699-100
'99 '2000 '01 '02



Background

...and from a stock market perspective, that opinion has been vindicated

**Performance of the Hermitage Fund vs. the Russian Market
(Since Inception)***



* April 27, 1996 - April 21, 2006

Background



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However, on November 13, 2005, Bill Browder was returning to Moscow from a routine business trip and was denied entry into Russia. No reason was given for the denial and his valid Russian visa was not annulled

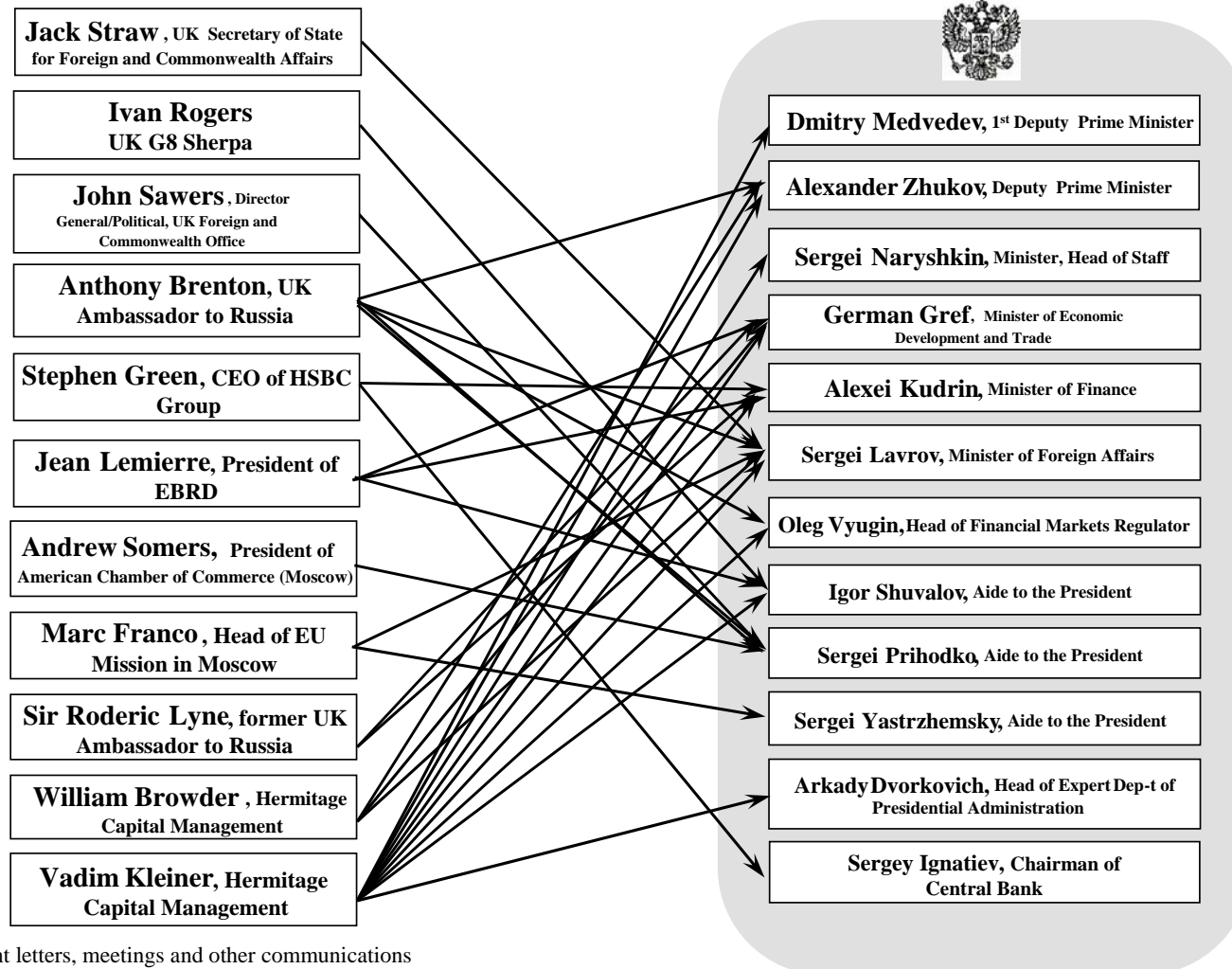
Persona non grata?





Background

There has been an intensive lobbying campaign on his behalf, but the visa has not been restored



Note: Arrows represent letters, meetings and other communications

Background



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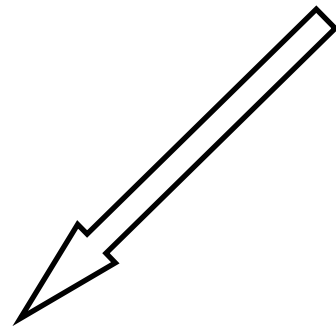
One of the key questions that arises from
this incident is:

“Have I changed my view of Russia?”

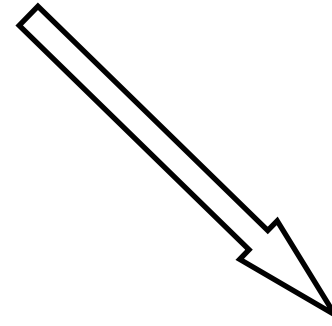
Assessment of the Investment Climate



There are really two Russia's
that exist at the same time



Modernizing Russia



Russia Stuck in the Past

Assessment of the Investment Climate Economic Perspective



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	<i>Modernizing Russia</i>	<i>Russia Stuck in the Past</i>
Integration into Global Economy	<ul style="list-style-type: none"> • G-8 chairmanship and WTO accession 	<ul style="list-style-type: none"> • New legislation reduces foreigners' access to mineral resources; • Foreigners arbitrarily denied entry into Russia
Energy Security	<ul style="list-style-type: none"> • Russia is kicking off G-8 with the theme of energy security 	<ul style="list-style-type: none"> • Russia threatens Europe's gas supplies if Europe doesn't allow Russian acquisitions in the European energy sector
Tax Policy	<ul style="list-style-type: none"> • 13% income tax is the lowest in Europe 	<ul style="list-style-type: none"> • Seemingly arbitrary tax fines ruin Russia's biggest oil company and threaten others
Banking reform	<ul style="list-style-type: none"> • Deposit insurance system introduced; • Cleaning of banking system started 	<ul style="list-style-type: none"> • Most of the country's 1,200 banks are small "pocket" banks; • Foreign banks not allowed to open branches
Corruption	<ul style="list-style-type: none"> • "Our plans do not include handing over the country to the inefficient rule of a corrupted bureaucracy" (President Putin, Annual Address to the Federal Assembly, April 25, 2005) 	<ul style="list-style-type: none"> • Between 2002 and 2005, Russia slid from 74th to 128th place in the global corruption index

Assessment of the Investment Climate Hermitage Perspective



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	<i>Modernizing Russia</i>	<i>Russia Stuck in the Past</i>
UES Restructuring	Hermitage worked with the Presidential Administration to re-write the UES Charter to eliminate risk of asset-stripping at the company	UES management publicly portrayed Bill Browder as “against reform” for trying to stop the fire-sale of UES assets
Sberbank	Hermitage worked with the Duma to add amendments to the Joint Stock Company Law to prevent share dilution at Sberbank and other companies	Sberbank sues Hermitage’s Head of Research and Vedomosti newspaper for defamation for saying that “by cutting costs, Sberbank would increase profits”
Dividends	Hermitage and other shareholders worked with the government to amend laws on dividend payouts to improve preferred share dividends	Transneft (a state-controlled company) pays 90% less than preferred shareholders expected based on the new law
Gas Prices	Hermitage and BCG assisted the Minister of Energy with a gas price analysis to estimate the impact of higher domestic tariffs on inflation	Gazprom votes down government-sponsored corporate governance code that was proposed by Hermitage at 2004 AGM

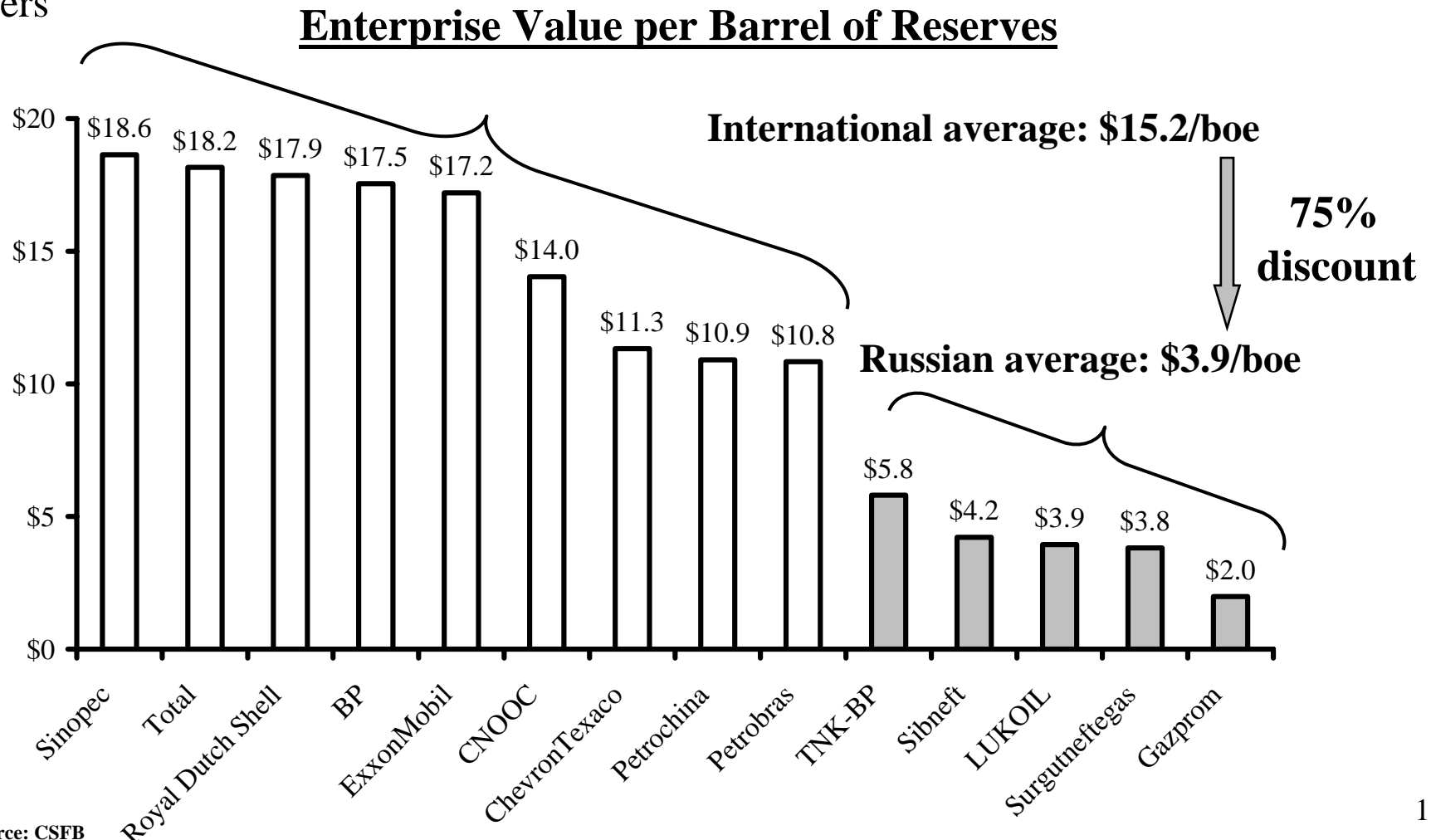
Assessment of the Investment Climate

Russian Oil Companies Still Cheaper



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As a result of the conflict between the past and the future in Russia, the assets of Russian companies trade at an enormous discount to Western and emerging market peers



Source: CSFB

Assessment of the Investment Climate

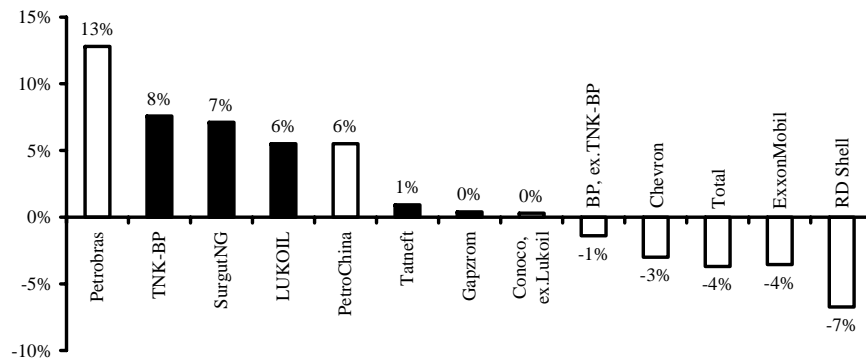
Russian Oil Companies Stand Out



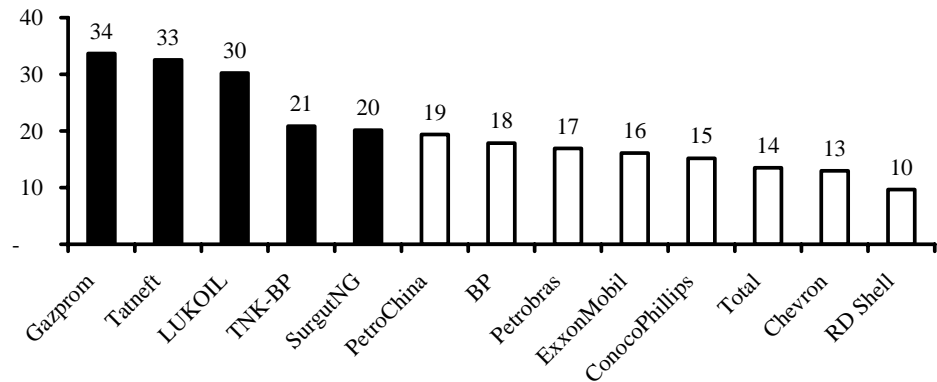
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Even though Russian oil companies are better in many ways

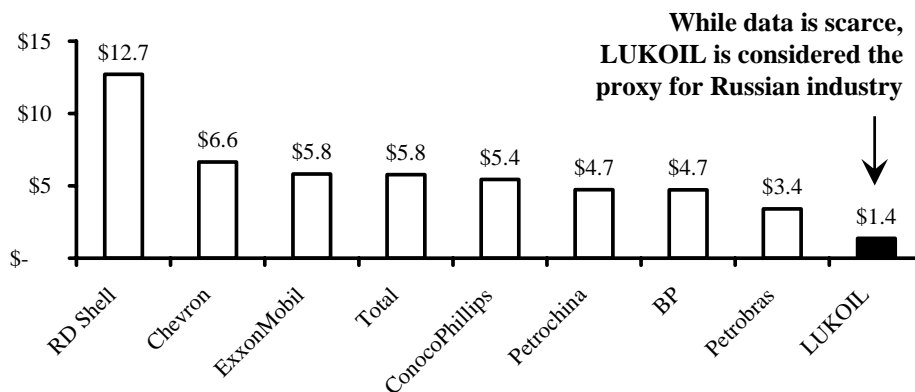
2005 Production Growth



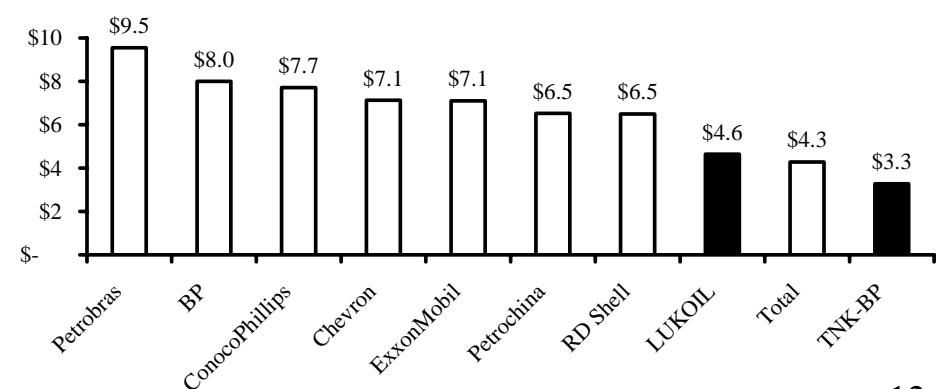
Reserve Life (in years)



Finding Costs (US\$/bbl, 3-year average)



Operating Costs (US\$/bbl, 3-year average)



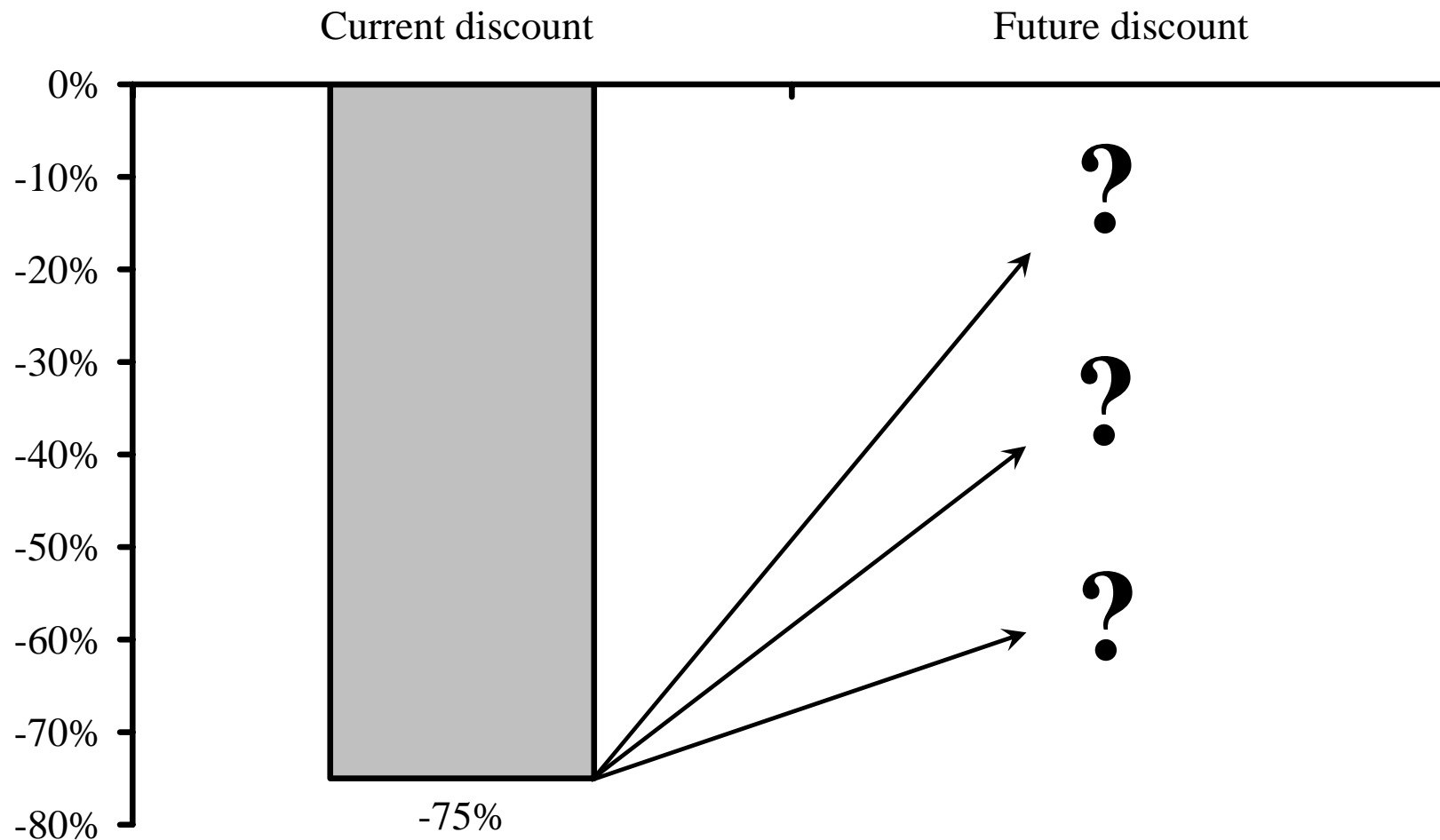
Assessment of the Investment Climate

How Quick Will They Catch Up?



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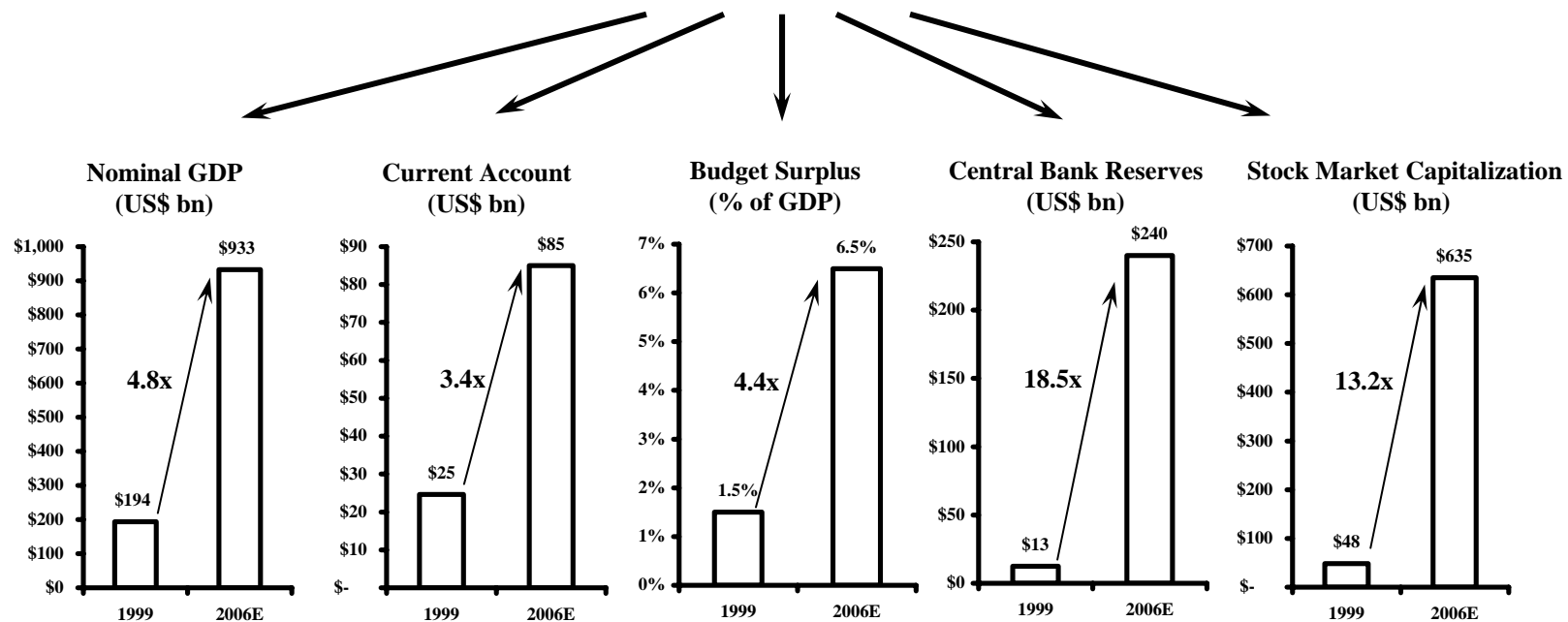
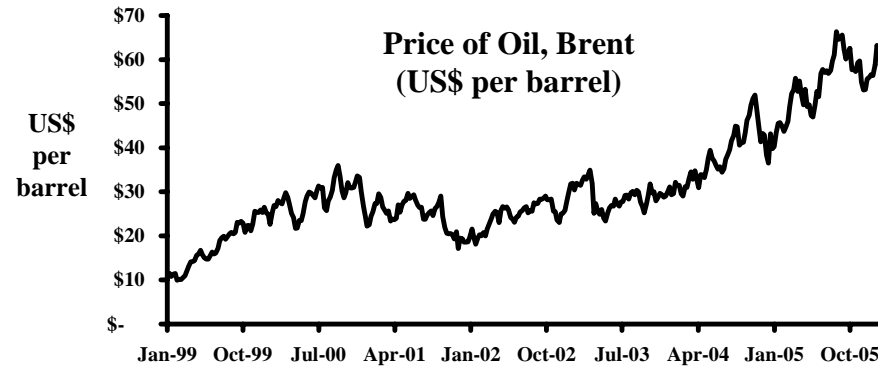
This discount will shrink in the future, but the speed and magnitude of that process depends on the perception and resolution of Russian risks





Assessment of the Investment Climate

In the short term, the cynics who are stuck in the past will say that oil outweighs everything, but it will not always be the case



Source: Bloomberg, UBS, Hermitage Estimates, January 2006

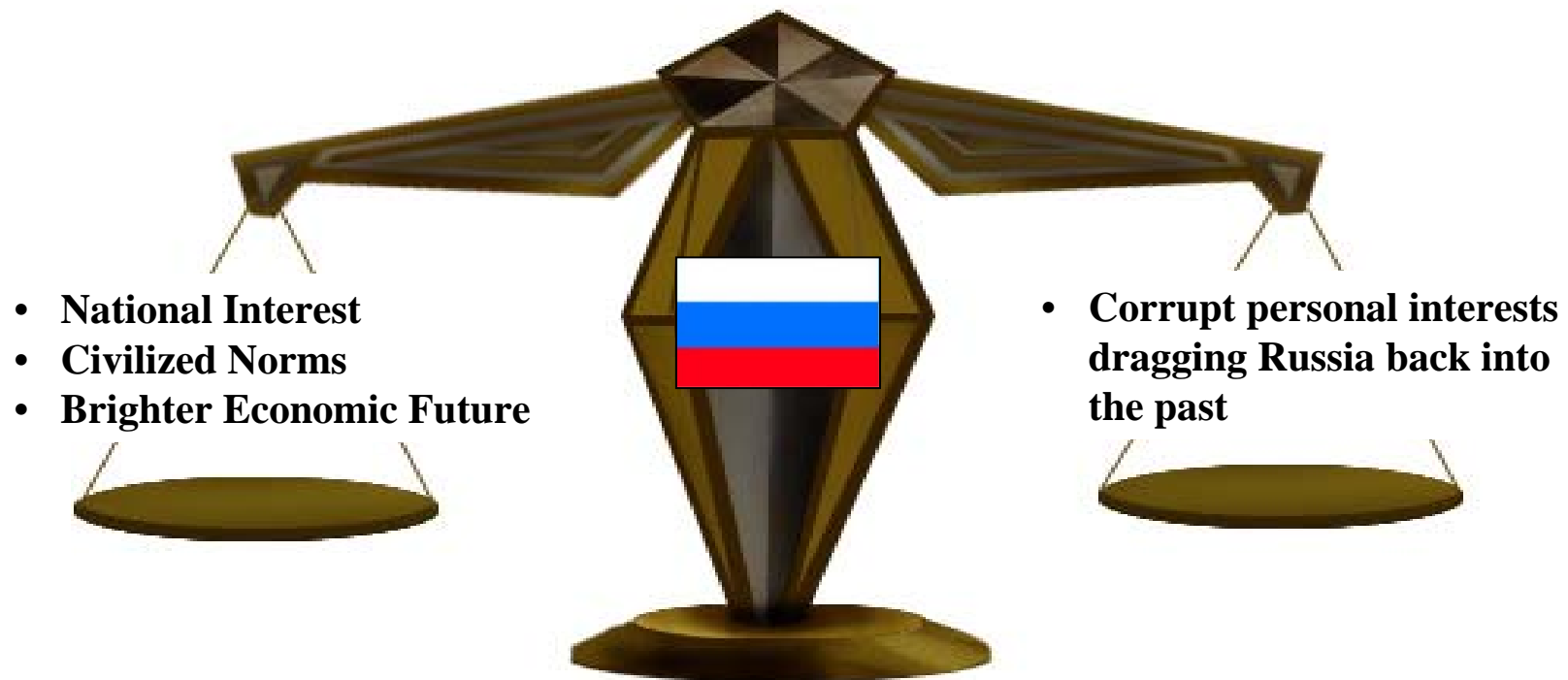
Assessment of the Investment Climate

In the Long Term, the Answer Is Still Unclear



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The Bill Browder visa scandal is an important litmus test for who wins in the struggle between reforms and corruption in Russia. The outcome of this struggle will ultimately determine whether Russia will be considered modern and civilized place to do business





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