

Tenge devaluation: Not the end of the story

Kazakhmys, ENRC, KMG should benefit the most

- **The National Bank of Kazakhstan (NBK) has devalued the tenge by 18% to KZT150/\$**, dropping its nearly 1.5-year-long support for the currency. We see the move as largely a result of the country's slowing economy and rapidly deteriorating current account. However, the trigger was the effective nationalization of a significant part of the local banking system. Given the state's control of the local financial system, we expect the tenge to remain stable at the new support level, at least for the near term.

- **We see potential for further devaluation from the current level**, as the tenge still has some room to catch up with other commodity-exposed peers. Additionally, escalating problems with bank asset quality and oil price weakness, which could trigger another devaluation step. Additionally, current forward rates imply close to KZT175/\$ in 2009 aop. Thus, we believe the market might start to price in an even larger devaluation. Exporters' stocks were up 5%-15% today, but we would expect a further market reaction due to the potential for further devaluation.

- **As a result, we suggest investors continue to focus on companies that have already benefited from devaluation.** We see major benefits for the metals and mining sector, and to a lesser extent the oil and gas industry and gold producers. Our top picks are **Kazakhmys**, **ENRC** and **KazMunaiGaz E&P**. However, domestic economy stocks, especially banks like **KKB** and **HSBK**, might suffer from the effects of the falling FX value of domestic demand which could also marginally affect **Vimpelcom**, which operates on the local market.

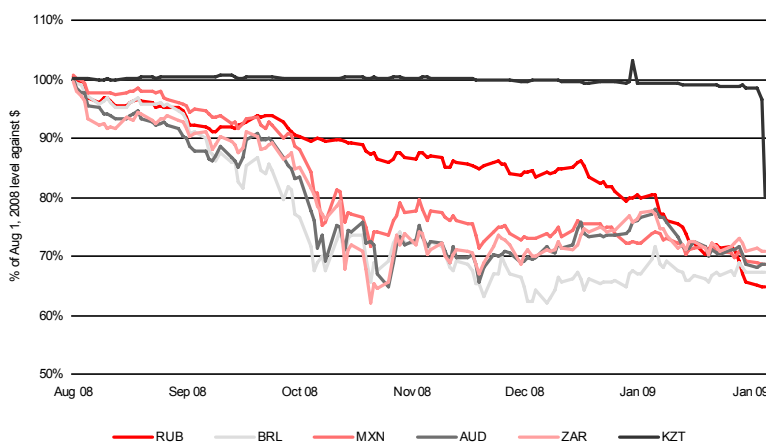
DEVALUATION BOOSTS EXPORTERS, BUT UNDERMINES THE VALUE OF LOCAL DEMAND

Implied change to 2009F EBITDA	KZT150/\$	KZT170/\$
KazMunaiGaz E&P	14%	19%
Kazakhmys	52%	92%
KazakhGold	15%	27%
ENRC	35%	61%
Steppe Cement	-39%	-57%
Kazakhtelecom	-31%	-55%

Implied change to 2009F net income	KZT150/\$	KZT170/\$
KazMunaiGaz E&P	15%	19%
Kazakhmys	237%	419%
KazakhGold	47%	83%
ENRC	83%	146%
Steppe Cement	-47%	-70%
Kazakhtelecom	-43%	-76%

Source: UniCredit Research estimates

THE TENGE HAS CORRECTED, BUT STILL HAS ROOM FOR ANOTHER DROP



Source: Bloomberg

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Tenge finally bows to economic reality

The NBK announced that it will let the tenge support level fall to KZT150/\$ starting February 4, and allow it to fluctuate within a 3% band. The statement quickly brought the tenge-dollar rate to the new support level, bringing the currency down 18% from yesterday's KZT123/\$.

The move followed a carefully choreographed sequence of events, suggesting bank assets were the prime concern. First the NBK Governor was replaced. Then on January 29 bank provisioning requirements were raised. Next the government announced the effective takeover of the two largest banks and extended support to others. Now the NBK has allowed the tenge to devalue. This sequence suggests deteriorating bank asset quality was the main reason for the NBK's continued support of the tenge.

We note that Kazakhstani policymakers have seemingly carried out a model devaluation. Prior to the devaluation officials took care of the banking sector by nationalizing the weakest players and extending major support to others, which has largely minimized the risk of larger destabilization of the sector as a whole. Most importantly, the devaluation came in one large step, which allowed policymakers to minimize FX reserve losses. The latter distinguishes the Kazakhstani action Russia's gradual devaluation, which has lost over \$200bn of FX reserves since August 2008 to major capital flight and the de-dollarization of the economy.

The new KZT150/\$ level brings the tenge closer to other commodity-exposed currencies, thus making the new support level easier to maintain. As a result, we expect the exchange rate to stabilize around the support level for the near term. The Kazakhstani authorities also have much greater power to keep the local financial system under control, as local financial markets are much shallower than in other countries such as Russia, which limits the potential for speculative attacks against the tenge. Moreover, following the recent takeover or expanded control of the four largest banks in the country, the government has extensive administrative powers to keep the FX market under control.

We note that there are strong economic reasons for the substantial correction of the exchange rate. The Kazakhstani economy seems to have entered a recession in late 2008. In 2009 we expect the country's economy to contract by 1.3%, which, in our view, calls for looser monetary policy. Additionally, at the previous exchange rate the country is likely to face a significant current account deficit of about 7.7% of GDP in 2009F, down from a surplus of over 6% in 2008, mostly due the oil price collapse. Under these circumstances a meaningful devaluation of the tenge might help boost GDP expansion, as it could improve the trade balance, and may help stabilize the balance of payments.

The market may discount further devaluation, as it cannot be ruled out

Despite the sharp drop, the tenge still has room to catch up with other commodity-exposed peers. Even following the 18% correction the tenge has still outperformed its commodity-exposed peers by 15%-20%, especially the ruble, which might spur a further correction, possibly later this year. Although we believe the NBK will do its best to defend the tenge at KZT150/\$, we see several risks that could force it to change its stance.

We see problems in the local banking system and a further fall in oil prices as the major risks to tenge stability at KZT150/\$. Following the state's nationalization and increased control over the nation's largest banks, continued deterioration of bank asset quality could trigger another round of capital flight and bank runs, similar to the one in late 2007. The latter could result in fresh liquidity infusions into local money markets, which could intensify pressure on NBK reserves and the tenge. Additionally, a further decline in oil prices could further

undermine country's trade balance and current account, resulting in devaluation pressures on the tenge.

We believe that even with the exchange rate stable at the new level, the equity market will likely continue to price in further tenge devaluation, as another decline cannot be completely ruled out yet. Moreover, even with the stabilization of the exchange rate, the corporate sector has yet to account for the full effect of the 20% tenge decline.

Tenge correction boosts exporters, but full effect has yet to be priced in

The tenge devaluation should be positive for all export-oriented industries, such as oil and gas and metals and mining. Following the news of devaluation, major commodities stocks have already rallied by some 5%-15%. However, given the risk of a deeper devaluation, we expect the potential for further rally is not over yet.

The metals and mining sector is set to benefit the most from devaluation, as nearly all of Kazakhstani miners' costs are incurred in tenge, while the export duties, which were introduced from January 1, 2009, are to be cut significantly. Thus, tenge devaluation should support falling profits due to the collapse in commodities prices. KazakhGold is also set to benefit, although we expect the stock to be driven mainly by news about the potential merger with Polyus Gold, rather than the devaluation.

In the oil and gas sector, the devaluation may breathe in new life into KazMunaiGaz E&P's valuation, acting as a short-term trigger for the company. With more than 85% of the company's revenues denominated in dollars and the rest closely tied to the dollar price of crude, we expect noticeable improvements in the company's financial position. We estimate that up to 50% of the company's expenses are denominated in tenge (primarily transportation, personnel expenses and local repair and maintenance work) and hence should be directly affected by the devaluation. The other 50% of expenses are made up of income taxes, which are tied to oil prices and hence hardly affected by devaluation; imports, which should rise in price; and works performed by international sub-contractors, which are also largely tied to the dollar. Combined, the three to some extent lessen the positive effect of tenge devaluation for the company. We calculate KMG E&P's net income would improve 15% at KZT150/\$ and 19% at KZT170/\$. We see costs contracting 10% and 13% respectively, in dollar terms. We do not include one-off items such as FX gains in our net income calculation; however, our assessment of the potential effect shows gains of \$600mn at KZT150/\$ and almost \$900mn at KZT170/\$, assuming the currency structure and amounts of deposits remain constant throughout the year.

DEVALUATION HELPS EXPORTERS, BUT UNDERMINES THE VALUE OF LOCAL DEMAND

	2009F EBITDA \$ mn			Implied change to 2009F EBITDA	
	KZT130/\$	KZT150/\$	KZT170/\$	KZT150/\$	KZT170/\$
KazMunaiGaz E&P	872	997	1,042	14%	19%
Kazakmys	399	607	766	52%	92%
KazakhGold	186	215	236	15%	27%
ENRC	1,000	1,347	1,612	35%	61%
Steppe Cement	109	67	47	-39%	-57%
Kazakhtelecom	412	284	186	-31%	-55%

Source: UniCredit Research estimates

FX INTEREST PAYMENTS FAIL TO OFFSET BENEFITS TO EXPORTERS, BUT WORSEN OUTLOOK FOR DOMESTIC ECONOMY STOCKS

	2009F net income \$ mn			Implied change to 2009F net income	
	KZT130/\$	KZT150/\$	KZT170/\$	KZT150/\$	KZT170/\$
KazMunaiGaz E&P	530	612	631	15%	19%
Kazakmys	154	519	799	237%	419%
KazakhGold	88	130	161	47%	83%
ENRC	500	913	1,229	83%	146%
Steppe Cement	79	42	24	-47%	-70%
Kazakhtelecom	222	126	53	-43%	-76%

Source: UniCredit Research estimates

Devaluation should have a negative effect on Kazakhstani banks, which will likely be its main victims. The major problem is the likely continued deterioration of asset quality. Banks' customers with loans in hard currencies (close to 25% of total loans outstanding) will likely find it increasingly difficult to service their debts. The construction industry, one of the largest borrowers in the country and one of the main victims of devaluation, should add a great deal to banks' delinquent loans. On the other hand, most of the banks manage their asset/liability currency exposure relatively well, matching both sides of the balance sheet, which lessens the direct negative impact of devaluation.

Worsening loan quality should lead to further jumps in provisioning, and likely to the capital deterioration of Kazakhstani banks. The Kazakhstani government has already effectively nationalized Bank TuranAlem and Alliance Bank, two banks of the country's top four banks (although both banks and the regulator claim that they were not technically nationalizations). Moreover, the government intends to recapitalize the two other top-four banks: KKB and Halyk Bank. Smaller banks might simply disappear if the government decides not to bail them out. In any case, we believe the implications of the developments for minority shareholders are negative.

The falling value of the tenge undermines the value of sectors exposed to domestic consumer demand, such as telecoms and construction materials. We expect Kazakhtelecom and Steppe Cement to be among the company's adversely affected.

Tenge devaluation might also marginally affect Vimpelcom, which has considerable exposure to the local market. Our current valuation of the company is based on KZT130.5/\$ 2009 aop, whereas we now expect the year-average rate to be as much as 15% lower. However, we see the potential downside risk to our target price as negligible given Kazakhstani revenues contributed only 7% to Vimpelcom's consolidated total in 3Q08. Thus, at KZT150/\$ the downside risk to our current projections for Vimpelcom in 2009 is 1% at the top line level, and less than half of a percent at the net income. If the tenge devalues to KZT170/\$, the downside risk to revenue is 2% and below 1% for net income.

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