

SISTEMA

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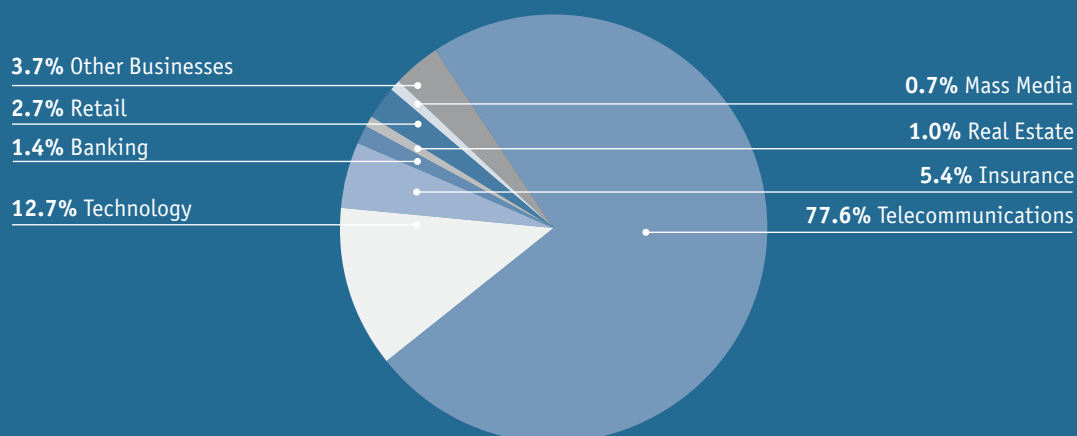
ANNUAL REPORT 2005

## Financial Highlights

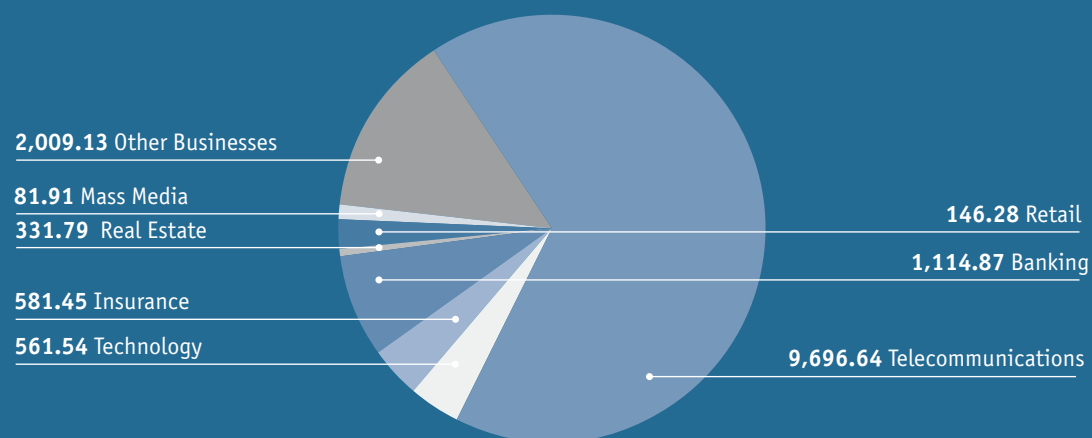
	Revenue (\$, million)	OIBDA* (\$, million)	Net income (\$, million)
2005	<b>7,593.5</b>	<b>2,982.0</b>	<b>534.4</b>
2004	5,733.9	2,462.0	411.2
2003	3,759.9	1,626.7	387.0

	Assets (\$, million)	Shareholders' equity (\$, million)	Earnings per share (\$)
2005	<b>13,090.9</b>	<b>3,233.6</b>	<b>56.4</b>
2004	8,823.3	1,422.2	50.8
2003	6,818.7	989.3	47.8

## Revenue by segments\*\*



## Assets by segments\*\*\* (\$, million)



\* OIBDA represents operating income before depreciation and amortization. OIBDA is not a measure of financial performance under U.S. GAAP.

\*\* Before eliminations of intersegment revenue.

\*\*\* Before intersegment eliminations.

# Sistema's Mission

We create leading businesses in the service sectors, primarily in the field of technology.

Our mission is to serve the interests of both our shareholders and society as a whole.

In order to succeed in its mission, Sistema invests its financial, intellectual and management resources in the development of its businesses and the growth of the Russian economy.

In this Annual Report, we describe how Sistema has worked to fulfill this mission during 2005.

In presenting this Annual Report, we would like to emphasize that Sistema's results should ultimately be judged by how much they have contributed to fulfilling the corporation's stated mission.

Letter from the  
Chairman of the  
Board of Directors



“While we act as a Russian company, we nonetheless understand that we must build the business in an environment of global competition.

But only clear national leadership allows us to go beyond the borders of our country. And only the ability to truly compete in the global marketplace can strengthen our

**national leadership.”**

Vladimir Evtushenkov

Chairman of the Board of Directors

It has been little more than a year since Sistema made its successful debut on the London Stock Exchange. But this was a breakthrough year in every sense for the corporation. The new opportunities and requirements that come along with the status of a public company have significantly changed the nature of our business.

The intense scrutiny of the investment community, careful adherence to international standards of business and alignment with best global practices in management have led us to undertake a thorough revision of our current potential and to more precisely define our strategy. This new outlook and new level of responsibility has allowed us to raise the bar even higher when establishing the goals set before the corporation.

Sistema has always focused on building companies that are leaders in their area of business. Our debut in global capital markets, coupled with the fact that we operate in an open economic environment, means we have changed our very understanding of the term "leadership." Today, in order to be at the forefront, it is no longer enough to maintain consistent organic growth and complete successful M&A deals. One also needs to define new points of growth and foresee the appearance of new breakthrough markets, generate promising ideas and generate synergies. It is just such an approach that has led us to make several large-scale wagers.

We have bet on the INNOVATIVE nature of our development. Sistema has always worked in technology services and developed hi-tech production. But today we are looking at the wider field of innovation: it is no longer just an important component of our businesses, but a business in itself. The scientific and innovative base created within the corporation is dedicated both to stimulating R&D within Sistema's divisions and to the creation of a fully fledged venture investment wing of the corporation. It is our belief that promising, fast-growth sectors will come into being only on a base of innovation. It is these sectors that can become the foundation of the technological leadership of Russia.

We have bet on INTEGRATION. The consolidation of fixed-line operators under the single Comstar-UTS brand was the beginning of this process. The next logical step is the creation, through convergence technology, of a single diversified group on a common technological and management platform within Sistema Telecom. The introduction of a single umbrella telecommunications brand (a first in the Russian marketplace) is an important step down this road. The process of integration will move forward with the further blurring of boundaries between telecommunications and multimedia services.

We have bet on international EXPANSION. The Russian market remains the clear priority for Sistema and we act as a national company. We nonetheless understand that we must build the business in an environment of global competition. Only clear national leadership allows us to go beyond the borders of our country. But only the ability to truly compete in the global marketplace can strengthen our national leadership. Sistema has already moved past the borders of the CIS and entered the markets of Central and Eastern Europe. In addition, we continue to study opportunities in Asia, the Middle East and other attractive markets.

We understand that the trust of investors is the foundation for growing the capitalization of the corporation and we are continuing to perfect our corporate governance practices. We hope that the investment community will fully appreciate the appearance of a new independent director on the Board of Directors. Stephan Newhouse, who was formerly president of investment bank Morgan Stanley, is a person whose authority is difficult to overestimate.

We wish to acknowledge all of those who have accompanied us during this brilliant and fascinating year: our employees, partners, investors and shareholders. We look into the future with optimism. And we hope that we will build the future together with you.

Letter from the  
President



“Leadership is impossible without leaders. Our main trump card and primary resource in the fight for **efficiency** is people.

We take pride in the fact that the corporation has raised a whole generation of managers who have set the highest standards of business in Russia. They are the ones who create value for Sistema.”

Alexander Goncharuk President



Sistema's shareholders have set ambitious goals for the management of the corporation. This latest stage of the corporation's development means the high expectations of investors have been added to these goals.

What do shareholders expect of us?

High rates of business growth — while maintaining profitability.

Entry into new territories — without risking presence in existing areas.

Development of emerging, promising sectors — without a reduction in profitability in mature sectors.

Conquering new markets — without losing established, leading positions in existing markets.

Acquisition of additional assets — while increasing the manageability of the whole asset portfolio.

Sistema's management is doing all that it can to ensure that the expectations of investors are met.

The net profit of the corporation increased by 30.0% in 2005.

Total assets grew by 48.4%.

The capitalization of the corporation grew by more than a third.

How was all of this made possible? Moreover, upon what foundation are we building our future?

I would describe the position of the management in a single word: EFFICIENCY.

The first principle is to "stake" ourselves only on existing and potential LEADERS. We conducted a painstaking analysis of our portfolio and established clear priorities. Subsequently, we concentrated our investment and managerial resources on the most promising business areas. For example, our newly established leadership in the cable television market will provide a base for development in the extremely promising sector of multi-media services.

The second principle is to strictly delimit the criteria for success for our operational companies according to ORGANIC GROWTH and M&A. Thus the consolidated revenues of the corporation attributable to organic growth rose last year by 27.7%. In the Technology division, organic growth accounted for 60% of revenue growth.

The third principle is a BALANCED PORTFOLIO. Sistema is still predominantly a telecommunications corporation. Nonetheless, we are developing other promising areas. Due to the rapid growth in these sectors, the share of revenues from these businesses reached 22.4%, of which 12.7% came from Technology.

The careful MANAGEMENT OF FINANCIAL RESOURCES is the fourth rule. When the timeframe for the privatization of Svyazinvest, for which the company had earmarked funds from the IPO, was again delayed, we made the decision to acquire minority shareholdings in very profitable and highly liquid oil assets in Bashkortostan. Today we are working with our colleagues in Bashkortostan to increase the capitalization of this business by establishing a vertically integrated holding.

The fifth rule is TRANSPARENCY in ownership and management structures. The corporation's preparation for its IPO represents the most significant stage of RESTRUCTURING undertaken by Sistema to date. This received a uniformly high evaluation from the marketplace. The redistribution of authority between the corporate center and the business divisions is the next step in the optimization of the management structure of the corporation.

Finally and most importantly, leadership is not possible without LEADERS. Our trump card and greatest resource in the fight for greater efficiency is people. We take pride in the fact that the corporation has raised a whole generation of managers. These managers possess the highest standards of leadership in the Russian business world. They are the ones who create value for Sistema. It is for them that the corporation has developed a full-range of options programs in MTS and Sitronics.

We do not doubt the ability of our team to succeed and we hope to share this success with our investors.

# BOARD OF DIRECTORS

Board of Directors  
SISTEMA

Board of Directors  
SISTEMA

**Vladimir Evtushenkov**  
Chairman of the Board

**Alexander Goncharuk**  
President

**Vyacheslav Kopicv**  
Deputy Chairman of the Board

**Dmitry Zubov**  
Deputy Chairman of the Board

**Evgeny Novitsky**  
Director

**Sergey Drozdov**  
Senior Vice President,  
Head of the Property Complex

**Alexander Leiviman**  
Director

**Stephan Newhouse**  
Non-Executive Director

**Nikolai Mikhailov**  
Non-Executive Director

**Alexander Gorbatovsky**  
Non-Executive Director

**Ron Sommer**  
Non-Executive Director





# KEY MANAGEMENT



**Alexander Gorbunov**  
Acting First Vice President  
Head of Strategy & Development

**Alexey Buyanov**  
Senior Vice President  
Head of Finance and Investment

**Sergey Drozdov**  
Senior Vice President  
Head of Property

**Denis Muratov**  
Vice President  
Head of Innovation and Science

**Sergey Cheremin**  
Vice President  
Head of External Relations

**Ruslan Almakaev**  
Vice President  
Head of Economic  
and Information Security

Key Management

# 1

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## Strategy

Our strategy:  
The creation of leading  
companies in fast-growing  
markets and the constant  
search for new areas  
of growth.



“Sistema sets the bar high for its businesses, expecting them to occupy leading positions in their sectors through **organic growth** and **M&A** deals. ”

**Alexander Gorbunov**

Acting First Vice President, Head of Strategy & Development

### “THE BUSINESS OF BUILDING BUSINESSES”

The basis of Sistema's strategy is to build market-leading businesses in the most promising service-oriented industries. This “Business of Building Businesses” develops through the skilful combination of organic growth and the effect of mergers and acquisitions (M&A). Through this approach, the corporation continues to grow rapidly, requiring additional investment resources. We were able to successfully attract investment through the IPO and are now working actively to bring the corporation's subsidiary companies to the international capital markets. In February 2006, Comstar-UTS placed its shares on the London Stock Exchange. The placement of Sistema-Hals and Sitronics shares is likely in the near future. Looking forward, the corporation envisions other subsidiary companies trading on international financial markets.

Beginning in 2004, the corporation concentrated its efforts on the development of its key businesses: those that were already market leaders and those with the clear potential to become leaders in their sectors in the foreseeable future. These companies were best positioned to grow together with dynamically evolving markets benefiting from rising consumer purchasing power and the broader growth of the economy. Sistema provides these businesses with the resources needed for development and enables them to become lead-

ers. Other businesses with strong promise that do not yet demonstrate the highest potential expected by Sistema cannot depend on priority financing of investment from the corporation and must fund their development from their internal resources. Areas that do not meet the expectations of shareholders and do not demonstrate signs of future leadership potential are gradually being restructured or sold. This strategy ensures that Sistema's financial and management resources are used with maximum efficiency.

The successful combination of dynamic organic growth and quality M&A deals was reflected in Sistema's strong 2005 financial results. Through organic growth the revenues of Sistema's existing businesses grew by 27.7% or \$1.58 billion. The acquisition of new companies accounted for \$279 million growth in the consolidated revenues of the corporation. After the integration of these businesses, they will strengthen the market positions of the key business areas of the corporation.

The successful IPO on the LSE brought the corporation substantial resources for investment. Sistema gained the ability to undertake a wide range of M&A transactions to strengthen core business areas. But increased deal activity has not changed the fundamental strategic goals. Sistema carefully approaches M&A targets: they must create shareholder value, be well structured and logically integrate within existing company structures. The corporate center provides the general rules in the area of M&A for the business areas. Using these as a framework, each business area carries out its strategy while taking into account the specifics of its industry.

The fruitfulness of the policy of finding the right combination of organic growth and M&A was clearly displayed in 2005 at SITRONICS, which integrates the corporation's high technology businesses in IT and electronics. Following comprehensive restructuring in 2004, the revenues of SITRONICS almost doubled in 2005. Organic growth accounted for 60% of this and, accordingly, 40% was contributed by M&A.

We are actively making deals in businesses in which shifts in strategy are necessary. For example, during 2005, the corporation conducted a comprehensive restructuring in the Media business area. Lower margin businesses in mature sectors, such as newspapers and print distribution, were sold. At the same time, assets were acquired in fast-growth market segments. In particular, UCN, Russia's largest network of regional cable operators, was acquired. The company is capable in the near term of becoming the core for the consolidation of regional cable operators. The corporation is investing to transfer the company to the latest technology platforms. This technology allows the company to provide a wide range of multimedia services to consumers. The corporation anticipates explosive growth in this sector.

During 2005, the restructuring of the corporation's assets in the fixed-line telecommunications sphere was successfully completed. Comstar-UTS was able to raise more than \$1 billion for investment on the London Stock Exchange in a successful IPO in early 2006. The scale of the transaction was the second largest of a Russian company in the international markets to date, after only Sistema's IPO. Sistema's IPO remains the largest IPO in Russian history.

The combination of organic growth and M&A allows Sistema to rapidly grow the scale of its business and capitalization. The strongest business areas are able to go to financial markets independently in order to attract needed investment resources. In turn, the corporation can get a fair price for its assets and can focus on investing in the next wave of leading businesses.



“Financial  
**transparency**  
is the cornerstone of the  
financial policy of the  
corporation.”

Alexey Buyanov

Senior Vice President, Head of Finance and Investment

## FINANCIAL MANAGEMENT FOR LONG-TERM STABILITY

The successful February 2005 initial public offering of the corporation's shares on the London Stock Exchange has created new possibilities for the financial management of the corporation. At the same time, it has presented new challenges. Disciplined and prudent financial management has been a hallmark of the corporation's strategy since it was founded. This approach is strictly applied on both the corporate and subsidiary level. Sistema maintains stringent control over all aspects of financial activity in an effort to ensure the long-term financial stability of the group.

During 2005, the liquid financial resources at the disposal of the corporation increased thanks to the IPO and by high and growing dividends from MTS and other operating companies. In the interests of the shareholders, these funds must be invested profitably. But they must not be diverted over the long term in view of the need to conduct M&A activity. Therefore, the focus of the financial management of the corporation in 2005 was to find a solution for these contradictory goals: to ensure the optimal balance between having liquid funds on hand and making investments in short- and medium-term financial instruments with the highest possible returns. A careful approach to finding such a solution allowed Sistema to strengthen the financial component of its activity. This was recognized by the international ratings agencies. In March, S&P increased its rating on the corporation to BB-. In April, Fitch raised its rating on Sistema to B+.

The achievement of a stable financial position at Sistema is also made possible by the observance of some basic principles in its financial strategy.



### **Sistema's Financial Transparency**

Long before 2005, Sistema had made financial transparency a cornerstone of its financial management. The corporation has prepared consolidated, audited reporting according to US GAAP standards since 1997. The corporation began disclosure of its financial reporting to the investment community in 2003. During the same year a dedicated investor relations department was also created with a highly qualified team of professionals. Sistema disclosed information on its financial results on a semi-annual basis from 2003 to 2005, and began reporting on a quarterly basis during the second half of 2005. During early 2006, the corporation began to transfer financial reporting at its key operating subsidiaries to US GAAP or IFRS standards. A number of these companies already disclose their financial reporting as stand-alone enterprises. There are also plans to increase the number of reporting segments at the corporation during 2006.

### **Debt Management**

To ensure the continued strong financial position of the corporation, Sistema has always paid particular attention to managing the size and structure of its debt obligations. The corporation seeks to maintain an optimal capital structure and ensure continued access to liquid funds on the most attractive possible terms. Between 2002 and 2003, the corporation increased the share of publicly traded debt instruments in the corporation's overall indebtedness from 21% to more than 60%. This ensured more favorable borrowing terms and longer average maturity periods that better corresponded with the average period required to achieve return on investment in the corporation's projects, which varies between three to five years.

### **Control Over Consolidated Borrowing**

Sistema strictly controls the levels of borrowing by its subsidiaries. This has become particularly important because the corporation's subsidiaries increasingly have independent access to loans and subsidiary borrowing has increased significantly in recent years. The corporation has established strict criteria to ensure an optimal structure of consolidated borrowing. For example, the level of consolidated debt should not exceed 3.5 times the consolidated EBITDA.

### **Budgeting and Planning**

Budgeting at the corporation is based on a "bottom-up" approach. The procedure for compiling budgets is the same for all of Sistema's business areas. Each area compiles a yearly budget that goes to the corporate budget commission for approval. Then Sistema consolidates and approves the budget on the corporate level. The corporation carefully tracks the results of each business area and evaluates their success in meeting the strategic goals set before them.

Planning at the corporation is based on one- and five-year time horizons. Beginning in 2005, Sistema has been developing five-year financial economic plans according to US GAAP accounting standards. This has raised financial planning and controls to a qualitatively new level. The corporation's planning takes into account the growing ability of business areas to finance their own development and attract significant financial resources. The February 2006 IPO of Comstar-UTS is one example. Another is the issuance of Eurobonds by SITRONICS. The move of subsidiaries towards independently raising finance will become the key development in financial management and planning in the coming years.



“The formula for effective  
**restructuring:**

maximum volume  
of business with  
minimal number  
of companies and  
structures.”

**Sergey Drozdov**

Senior Vice President, Head of Property

## STRUCTURING ASSETS TO CREATE MARKET LEADERS

The restructuring of assets has been one of the key goals of management throughout the history of the corporation. This goal stems directly from the long-term strategy of Sistema: the concentration of financial and management resources for the development of companies that are market leaders and companies that have a clear leadership potential. The aim of restructuring is to form business units with transparent and efficient vertical ownership and management structures. These units should be able to develop and independently attract funding from the financial markets. The most significant work on restructuring was accomplished during 2004 in preparation for Sistema's IPO. The company identified priority core business areas, consolidated assets within each area and disposed of certain non-core assets. The effect of this restructuring was quickly apparent in the high evaluation by investors, as reflected by Sistema's capitalization.

The IPO did not mark the end of restructuring. This is a constant process and integral to the realization of Sistema's strategy. The activity of each subsidiary is regularly analyzed to identify opportunities for consolidation to extract synergies or create new structures capable of independently borrowing and entering the financial markets in order to fund their own long-term development.

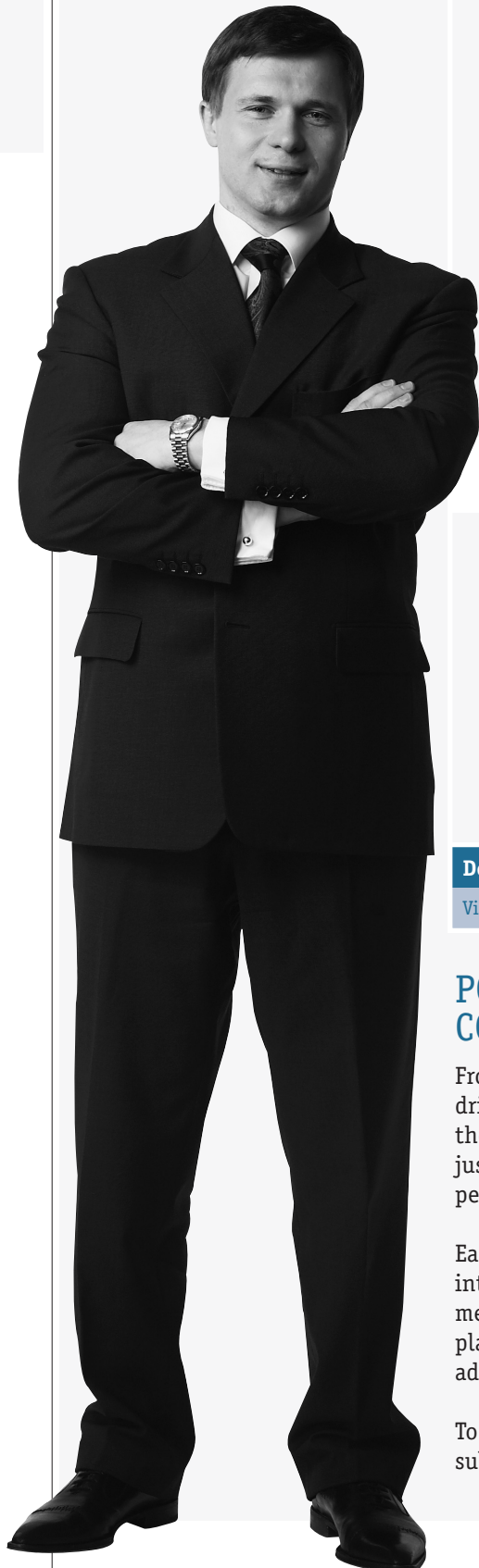
Assets that are acquired through M&A undergo analysis both before and after purchase. In the course of the analysis, it is determined how efficiently new structures can be integrated into existing business areas. Whenever possible, new assets are broken into separate business units and integrated into business areas as affiliated structures. The restructuring of assets must be accompanied by management restructuring to ensure the most efficient use of management resources.

The first aim of restructuring is to maintain the maximum turnover of business with the minimum number of companies. A clear example of this approach is the successful consolidation of all of Sistema's fixed-line telecommunications operators under the aegis of Comstar United TeleSystems. As a result of the consolidation, the structure of the business was simplified while management was centralized and strengthened. This paved the way for the company's IPO in February 2006. A similar process has been completed recently at Sistema-Hals, which has become the head company in the Real Estate business area.

A basic principle of restructuring is strengthening vertical ownership. The corporation uses every opportunity to buy out minority shareholdings and concentrate ownership rights for the companies in its key businesses. Ideally, these companies will all become subsidiary structures of the head company in each business area.

In 2005, Sistema continued to dispose of non-core business areas. The corporation sold its shareholding in Kamov Holding which was 49.5% owned by Kamov OJSC. Also, a number of low-margin media businesses were sold. This freed up additional financial and management resources for strengthening strategic business areas. The process of strengthening and uniting businesses continues. In 2006, Olympic Sistema was integrated into Intourist, the head company in the Tourism business area.

Hand in hand with restructuring is the evolution of a new management model within the corporation. A process of delegating authority from Sistema to the management companies and business areas is underway, in particular in the area of property restructuring. The corporation has set the goal for itself of providing each strategic business area with the management resources and assets needed in order to become independent structures ahead of future debuts in the international financial markets. In the future, each of the business areas will itself engage in the restructuring of assets under its control.



“The unique quality of the corporation consists of the fact that all of our business is, in principle, built through the introduction of **innovation.**”

**Denis Muratov**

Vice President, Head of Innovation and Science

## POLICY OF INNOVATION — SISTEMA'S COMPETITIVE EDGE

From the moment it was founded, innovative technologies have driven the ideas and organization of Sistema. The corporation is the only player in the service sector of Russia and the CIS that not just systematically invests in innovation but views it as an independent business area.

Each of the company's main business areas are in knowledge intensive industries. Innovation as a core principle of development allows Sistema to stay several steps ahead of the marketplace. This spirit of innovation is one of the core competitive advantages of Sistema.

To drive innovative development, the corporation founded a new subdivision called Intellect-Telecom, which performs scientific

research and development in the telecommunications sphere. Intellect-Telecom develops technology for all of Sistema's telecommunications units, including fixed-line and mobile communications, as well as convergent services where traditionally separate telecommunications segments meet. Similar research and development subdivisions are being established in all of Sistema's divisions.

In addition, the goals of the corporation include creation of technology infrastructure to support the management programs of each business area. The research and development subdivisions are also responsible for implementing these goals.

For Russia, a major obstacle to the transition from an economy based on raw materials to an innovation-based economy is the absence of an infrastructure that can turn ideas into finished products. Therefore a major step taken by the corporation to address this need is the decision to create a fully fledged venture investment business area. The Sistema Venture Fund will be fully engaged in identifying the right projects and organizing investment to develop new, innovative technology.

We believe that leadership and profit growth in maturing markets such as mobile telephony require new technology rather than simply new approaches in marketing. New technology developed in-house or acquired through partnerships with international companies offers the potential to create new markets and reshape mature ones.

All of Sistema's subsidiary companies are engaged in the business of innovation. The Technology business area posted 92.8% year-on-year sales growth in 2005. Few companies in the Russian market can boast such a blistering rate of development. The divisions of SITRONICS work in two main directions, both acquiring world-leading technology and developing their own intellectual property.

SITRONICS is integrated into the world-wide network of technology development through joint-venture enterprises established with global companies such as Siemens and Giesecke & Devrient and strategic partnerships with Oracle, Cisco, Intel and Motorola. In 2005, SITRONICS acquired the exclusive rights to manufacture modules using Infineon technology in Russia and the countries of the CIS. As the Center of the Russian microelectronics industry, SITRONICS produces smart-cards together with Giesecke & Devrient, the world's largest maker of such products. Siemens has an interest in SITRONICS's development of security technology through the joint-enterprise Center for Innovative Developments, which was created in 2005.

Sistema's Media business area uses the latest technology to create multi-media content and deliver it to the consumer. The company is implementing a project for broadband ADSL access and IP television, which substantially expands the service offering and number of TV programs offered to the final consumer. Sistema Mass Media is planning the commercial launch of digital mobile technology on the DVB-H platform. Users will be able to tune in television on mobile devices such as telephones, pocket PCs and notebook computers.

One of the most important issues for innovative business areas is training. In August 2005, Sistema signed a strategic agreement with the Lomonosov Moscow State University to create a new Department for Innovative Business. The first group of students will begin classes in the new department in the fall of 2006.





“No fast-growing company can build its strategy in today's environment without taking into account the impact of **globalization.**”

**Sergey Cheremin**

Vice President, Head of External Relations

## INTERNATIONAL COOPERATION AND EXPANSION IN GLOBAL MARKETS

Sistema began its operations in 1993 with a focus on the Russian market. Today, the corporation rightly calls itself the largest consumer services company in the former Soviet Union. In 2005, the corporation confirmed its ambitions as a global player with its IPO on the London Stock Exchange. During that year, the corporation continued its expansion into new markets.

The corporation combines two fundamental principles in its development in overseas markets: partnership and expansion.

Sistema cultivates partnerships with leading Russian and international companies, financial institutions and governments on the national and regional level. These ties, built on "strategic trust," are one of the most important factors in the corporation's success.

Partnerships with leading international players combine Sistema's knowledge of the Russian market and the industrial and management know-how of leading global players. The partnership between Deutsche Telekom (DT) and Mobile TeleSystems (MTS) was one of the factors that turned MTS into the national leader. Cooperation with German company Allianz AG allowed ROSNO insurance company to introduce international standards of conducting business.

The corporation's Technology business area has gained from synergies in SITRONICS' cooperation with Oracle, Cisco, Intel and Motorola.

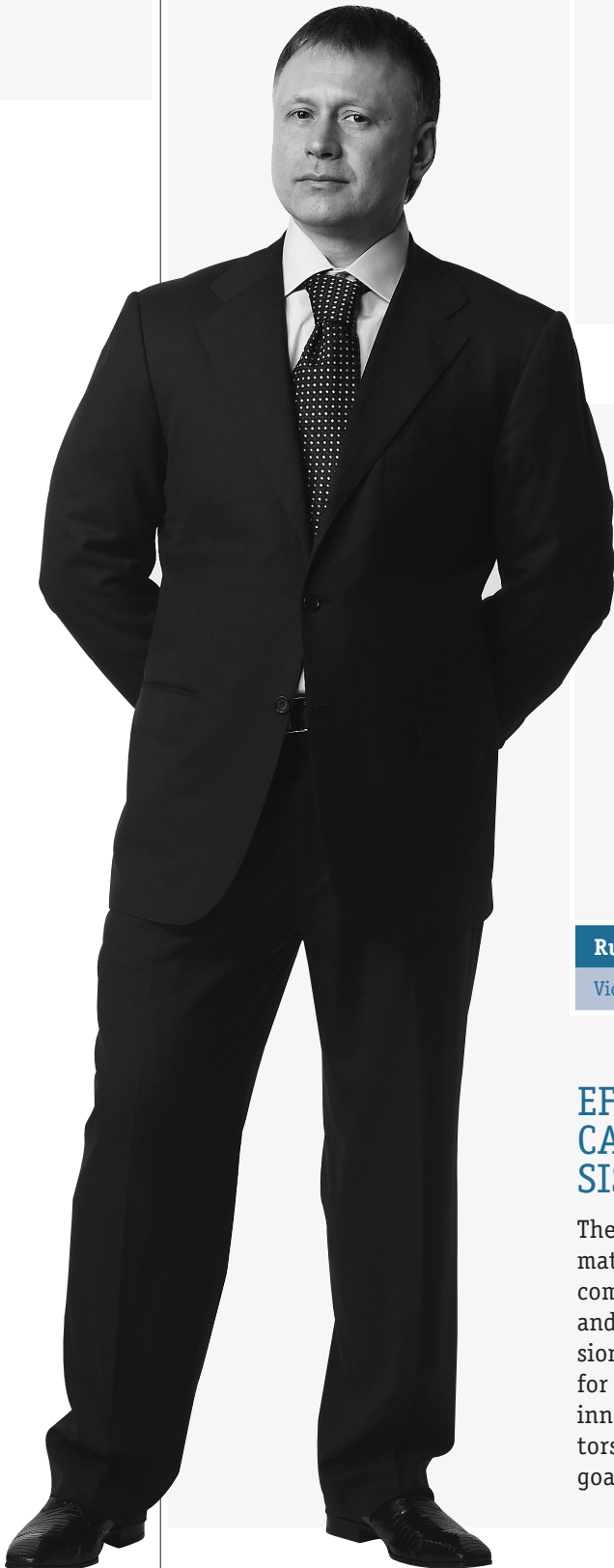
The effectiveness of Sistema's policy of expanding in the markets of the CIS has been confirmed by the development of the mobile communications segment. Mobile TeleSystems's assets in the CIS (including Ukraine, Belarus, Turkmenistan and Uzbekistan) account for around 30% of the company's business.

The corporation is working actively in European markets. SITRONICS owns Strom Telecom, the largest telecommunications equipment and services provider in Central and Eastern Europe. In June 2006, SITRONICS acquired 51% of the shares of Greek company Intracom Telecom. Strom Telecom has highly competitive product lines in the areas of NGN, billing systems and switching equipment. Intracom Telecom's specialities include wireless networks and data exchange systems. The combined potential of these two companies brings the SITRONICS' business to a qualitatively new level.

The corporation carefully studies the potential of both regional and global markets. Sistema is reviewing possibilities in markets such as China, Egypt, India, Serbia and Vietnam. In the summer of 2006, Sistema opened a representative office in India which provides additional opportunities for the development of business partnerships in that country.

Sistema is implementing its strategy of entering international markets in close cooperation with government institutions and business associations. The corporation is an active member of the Russian Union of Industrialists and Entrepreneurs and the Trade-Industrial Chamber of the Russian Federation as well as bilateral organizations which aim to develop contacts with the business communities of other countries. Sistema is working fruitfully with the Russian-Arabic Business Committee, the Russian-Chinese Business Committee and the Russian-Saudi Business Committee. The corporation is also part of the non-commercial partnership Russian-Indian Business Committee and is part of the Russo-British Chamber of Commerce.





“Today we already know who will be leading the corporation in 10 years. We are seeing the emergence of future **leaders** at every level of the company.”

**Ruslan Almakaev**

Vice President, Head of Economic and Information Security

## EFFECTIVE MANAGEMENT OF HUMAN CAPITAL IS THE FOUNDATION FOR SISTEMA'S SUCCESS

The corporation's achievements directly depend on the approximately 90,000 employees who work at Sistema and its subsidiary companies. The corporation's business relies on the innovative and intellectual potential of people whose knowledge and professionalism underpins its development. Sistema is always looking for talent and develops its personnel to sustain its leadership in innovation. Corporate culture is becoming one of the decisive factors in ensuring the achievement of the the company's commercial goals.

The corporation views investment in the development of personnel at every level as a strategically vital task. In 2005, a new Corporate Coordination Center was created at the corporate level to help the human resource departments of subsidiary companies optimize their work. The Center helps human resources directors find promising employees. The Center is also creating a "personnel reserve," which is a database of future leaders and innovative managers. This greatly simplifies the recruitment of employees for the corporation's business areas.

Sistema's new project, the "Leadership Program for the Employee Reserve," is directed at fostering future leaders. Participants in the program undertake training abroad, test their knowledge through internships and receive professional consultation in career planning. Through these types of programs, the corporation is creating a new generation of leaders able to work effectively in high technology businesses.

In order to develop the potential of its employees, Sistema conducts regular reviews which serve to set goals and aid career planning. The review process also ensures employee feedback and creates a transparent process for evaluating personnel.

The constant development of qualifications is a key factor in increasing the value of the human capital of the corporation. For the last five years, the corporation has run the Educational and Methodology Center. The majority of business areas have their own educational centers. In mid-2006, Sistema signed a long-term agreement with the Lomonosov Moscow State University to create a Faculty for Innovative Business.

In 2005, the corporation launched a program to provide grants for young scientists. Sistema has created committees of young scientists and specialists on the enterprise level. This helps the corporation find the optimal way to divide management and scientific resources between business areas.

Sistema's human resource policy on the corporate and subsidiary level aims to challenge every employee to make full use of their talents and professional qualities to achieve the corporation's goals. Sistema carefully defines what is expected from employees while offering a comprehensive and specific program that provides opportunities for managers and employees to access training and continuing education programs to improve their professional qualifications. Other benefits, including provision of medical insurance and private pension contributions, allow employees to pursue their ambitions while feeling secure about their future.

In 2005, Sistema continued to develop its motivational option programs for employees. These programs exist for managers of the corporation itself as well as in business areas, including MTS and SITRONICS. In mid-2006, Comstar-UTS developed an option scheme for managers that is unprecedented in its scope.

## EVENT OF THE YEAR

### **Sistema's IPO on the London Stock Exchange remains the largest ever Russian placement to date**

On February 9, 2005, Sistema completed the initial public offering (IPO) on the London Stock Exchange of 16.5% of its shares in the form of global depositary receipts (GDRs). The IPO book was 2.6 times oversubscribed and raised \$1.35 billion. Following the exercise of an over-allotment or "greenshoe" option by the global coordinators of the offering, Credit Suisse First Boston and Morgan Stanley, the total free float of the corporation's shares reached 19%, and the total funds raised were \$1.56 billion. Sistema's GDRs are listed under the symbol "SSA."

The IPO was the largest such transaction by a Russian company in history and valued the corporation at \$8.2 billion. The IPO's success provided an endorsement of Sistema's diversified, consumer-oriented businesses by the global investment community. It also silenced skeptics who believed that Russia's investment potential was largely limited to oil, gas and mineral extraction. Going forward, the share price of Sistema's GDRs provide a continuing outside assessment of the corporation's performance and outlook.

In the 15 months between Sistema's IPO and the publication of the Corporation's Financial and Operational Results for the year ending December 31, 2005, the market capitalization of the company grew by 40% from \$8.2 billion to \$11.4 billion.

The IPO marked Sistema's successful transition from a privately held corporation to a public one with a global shareholder base. But the listing also validated a strategy put in place many years before, aimed at preparing the company to meet the strict disclosure requirements necessary to access global debt and equity markets to provide finance growth. These steps included the preparation of consolidated, US GAAP accounts starting in 1997 and the publication of the company's list of shareholders in 2001. The company's transparency allowed Sistema to issue its first Eurobond worth \$350 million in April 2003 and a second Eurobond in January 2004, also worth \$350 million.

The successful IPO of Sistema has started a new chapter in the history of the corporation. The proceeds of the offering provide Sistema with funds for carefully selected mergers and acquisitions. These deals aim to strengthen each of Sistema's core business areas. Other acquisitions provide short- to medium-term opportunities to increase the value of shareholder funds while the corporation prepares for possible future large acquisitions, such as the privatization of the Svyazinvest holding of regional fixed-line companies.

The IPO also confirms Sistema's status as a truly global player. While Russia and the CIS will remain the central focus of the activities of Sistema and its subsidiaries, the corporation's strategy also envisions further expansion of its presence abroad. Sistema, a publicly traded company with a global investor base, has increased its profile on the global stage. As an internationally listed corporation, Sistema's history, accounts and strategy are available for global business and government partners to see.

Sistema's presence in the global capital markets continued to expand in 2006. In early February, the corporation's fixed-line subsidiary Comstar-UTS raised \$1 billion in an IPO on the London Stock Exchange. It was the second largest IPO ever of a Russian company on this trading platform.

At the end of February 2006, another high technology subsidiary of the corporation, SITRONICS, issued a \$200 million Eurobond. These transactions allow the corporation's subsidiaries to raise funds to finance their own growth and benefit from strong demand on behalf of global investors for exposure to fast-growing consumer markets in Russia and the CIS.

Sistema has also linked its future to dynamically developing financial markets in Russia. The corporation was included in the "B" List of the Moscow Stock Exchange (MSE) in November 2004 under the symbol "SIST." Sistema's shares are also included in the "B" list of the Russian Trading System (RTS) under the symbol "AFKS". The trading of ordinary shares on Russian exchanges has enhanced the liquidity of Sistema's shares.

Sistema's successful IPO has also provided new challenges for the corporation. The obligations placed on publicly listed companies continue to evolve. Sistema takes part in a continuous dialogue with the global investment community. The corporation's top management regularly meets with investors and brokerage analysts and these discussions provide an invaluable opportunity to share knowledge and experience.

The IPO challenges Sistema and each subsidiary to meet and exceed their goals over the short-, medium- and long-term. As a publicly listed corporation, Sistema's performance is judged by the global investment community in comparison to other leading global players in the technology and consumer services sector.

Event of the Year

## TARGETS AND GOALS

A careful balancing of quantitative and qualitative targets and goals allows Sistema to efficiently plan the development of the corporation.

### Quantitative Targets

The corporation provides precise quantitative and qualitative targets and goals for each business area and for each employee. The use of key performance indicators (KPIs) provides personnel with a clear-cut understanding of what the corporation expects of them. Sistema undertakes constant monitoring of the performance of the corporation as a whole, as well as the activity of each business area.

For its business units, Sistema uses a measure of performance called the Criteria Base. This system consists of key efficiency indicators that measure the performance of each business unit. These indicators allow the corporation to evaluate how each business unit is progressing toward meeting its targets and goals. These indicators provide detailed measures of the efficiency and growth dynamic in each business area.

Along with the Criteria Base, the activity of the corporation is regulated by the budget, which is the fundamental element of yearly planning. Quantitative goals placed before the business areas are formulated against the most aggressive scenario of development: only in this way is it possible to maintain leadership in fast-growing, highly competitive consumer markets.

### Quantitative Goals

#### *Diversification*

The corporation's goal is to grow the share of non-telecommunications assets in aggregated revenue, OIBDA and profit. Significant progress was made in certain business areas in 2005. The Technology area represented 12.7% of total revenues in 2005, compared to 8.7% in 2004. Retail increased its share year-on-year from 1.4% to 2.7%. This diversification allows greater exposure to fast-growth markets and limits the impact of any future negative developments in the telecommunications segment.

#### *Predictable cash flows*

Sistema's cash flows have been difficult to predict as the corporation has entered fast-growing markets. However, in the last three years, the corporation has undertaken asset restructuring and M&A activity that now permits the prediction of the contribution from each business area with a high degree of precision.

#### *Financial stability*

Sistema's long-term financial stability is built on prudent financial management and tight limits on level of debt. Due to this policy, Sistema has acquired the ability to raise financing on the most attractive terms.

#### *Leadership*

Sistema's mission is the development of market-leading businesses. The corporation has undisputed leadership in its key Telecommunications, Technology, Insurance and Retail business areas. The goal of the corporation is for each remaining business area to achieve leadership in its respective market.

#### *Corporate culture*

The corporation fosters a team-based management culture where key executives share agreed techniques and methodology.

## RISKS

Risks

The consumer sectors of Russia and the CIS, where the corporation conducts its core business, have grown impressively in recent years. Nonetheless, the sector carries with it substantial risks that may affect the pace of development at the corporation's subsidiaries. Therefore, the evaluation and management of these risks is an important element in the strategy of Sistema. This approach allowed Sistema to endure the 1998 Russian financial crisis with minimal losses.

The risks which could affect the corporation's business are diverse. These risks reflect the emergence of processes and factors beyond the control of Sistema.

### A Slowing in Russian Growth Rates

GDP growth rates in Russia and the CIS significantly outpace those in the US and Western Europe. High oil prices on international markets continue to be the largest single factor fuelling Russia's current economic growth. This growth has led to higher real and disposable spending power among Russian consumers and driven demand for the services provided by Sistema's subsidiaries. A substantial fall in world oil prices could cause economic growth to falter. The subsequent drop in consumer spending power could have a negative impact on the corporation's activities.

### Economic Stability in the CIS

As the share of revenues generated by Sistema's activities in the CIS increases, the corporation is also exposed to economic risks in these markets. Market reforms in these countries have been carried out to varying degrees and, like Russia, several CIS economies are exposed to the risk of a decline in world prices for oil and gas.

### Political Risks

Russia still has a number of political groups that do not share the current government's approach to the market economy and current reforms. Should those groups be able to wield greater influence over government policy, this could pose a risk to the economy and the status of private-sector companies. Similar risks exist in other CIS markets.

### Exchange Rate Risks

Sistema faces exchange rate risks linked to changes in the value of the ruble, as well as the hryvnia and the euro, to the US dollar. As a result of inflation in Russia and other markets where it operates, the corporation links its monetary assets and transactions to the US dollar. Also, a significant share of the corporation's capital expenditures and operating and borrowing costs are dominated in US dollars. In Russia and Ukraine, many of the corporation's services are priced in US dollar equivalents.

### Interest Rate and Other Borrowing Risks

Future changes in interest rates in Russia could substantially alter the cost of loans and raising additional capital. Sistema has a number of capital intensive businesses, and therefore changes in the cost of borrowing could have a negative impact on the corporation. Also, if Russia's sovereign debt rating were lowered, the corporate debt ratings of Sistema could be affected, making borrowing in international debt markets more costly.

Investors, partners and other interested persons should consult detailed risk summaries for Sistema contained in the Management's Discussion and Analysis of Financial Condition and Results of Operations.

# 2

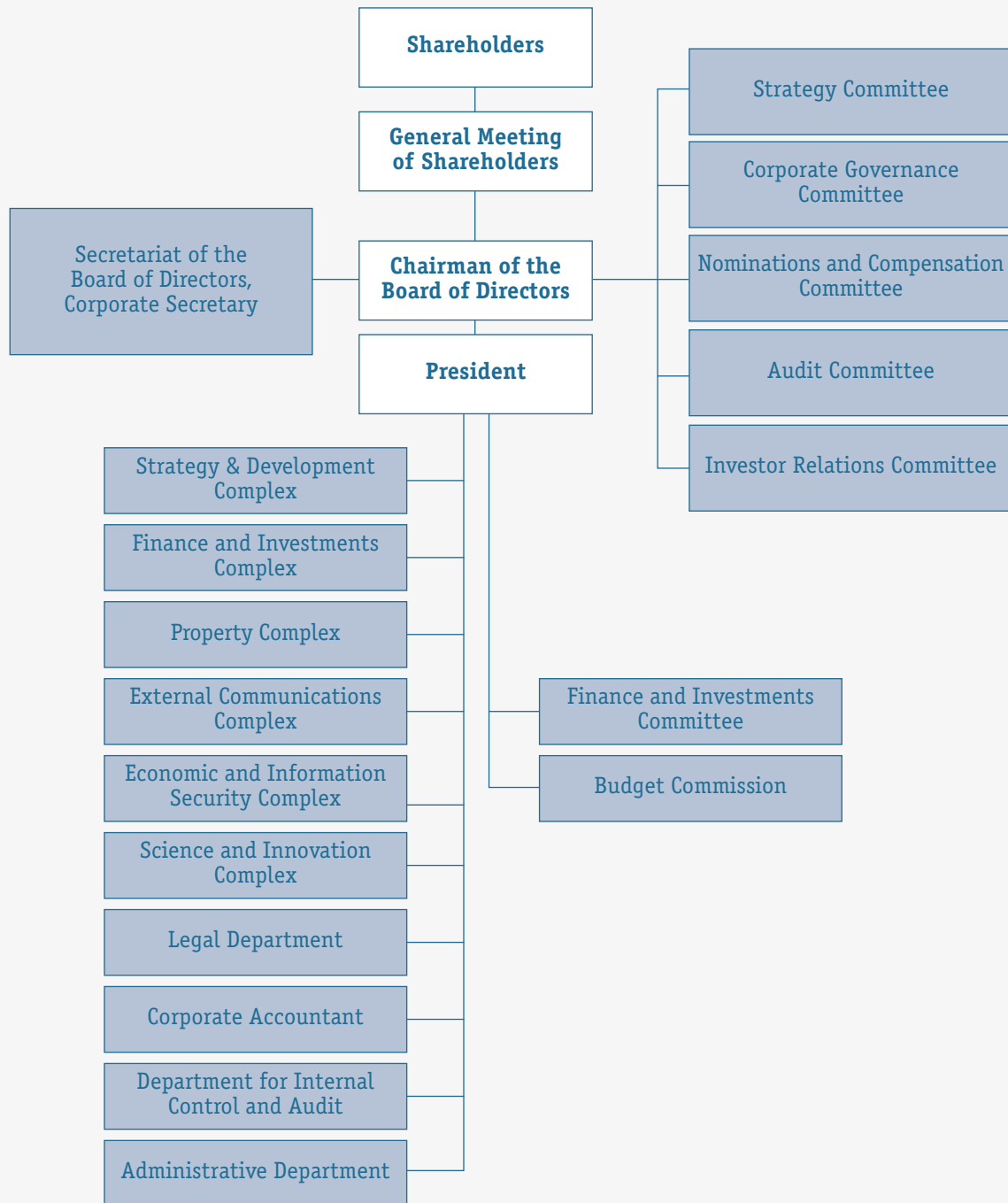
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## CORPORATE GOVERNANCE

The status of public company requires Sistema to observe global standards of corporate governance.



## STRUCTURE OF CORPORATE GOVERNANCE



Sistema's structure of corporate governance is constantly evolving. As the section on "Principles of Corporate Governance" demonstrates, innovation is integral to ensuring the corporation continues to be a leader in the field of corporate governance, business transparency and disclosure about the activity of the corporation. The Board of Directors believed it was vital to codify the essential principles of governance of the corporation and its structure in the Code of Corporate Governance and the Corporate Charter. This ensures that the corporation will continue to observe the highest standards of governance, as managers make decisions in accordance with prescribed rules.

The Code of Corporate Governance was approved by the Board of Directors in July 2004. This Code does not contain general formulas and general ideas. Rather, it concretely and clearly formulates the highest ethical requirements that the corporation has taken upon itself in its dealings with its shareholders, managers, personnel and other key audiences. The full text of the Code is available, along with other key normative documents, in English at [www.sistema.com](http://www.sistema.com).

Sistema has developed and confirmed at the Board of Directors level the rules that establish a basis for all management bodies, including the Annual and Extraordinary General Meetings of Shareholders, the Board of Directors, President, Executive Management and the Audit Commission. In addition, there are clear regulations in effect governing information disclosure, dividend policies, procedures for internal control, the composition of Board-level committees, procedures for meetings of the Board of Directors, management of risks, incentives for managers, procedures for the preparation and contracting of large transactions and corporate events.

The Board of Directors, subordinate to the General Meeting of Shareholders, is the key element in the corporation's corporate governance system. It carries out five primary management functions: the definition of the corporation's development strategy; placing these goals before executive management and ensuring their execution; the efficient management of assets; the appointment of key managers; and the continued improvement of corporate governance.

The development strategy consists of concrete tasks in accordance with precise quantitative and qualitative goals. For example, the corporation's portfolio strategy consists of a detailed list of business areas and ratios which clearly define their level of diversification. The strategic goals of financial management goals are accompanied by qualitative indicators that characterize financial stability.

There is a list of senior management positions in the corporation and subsidiary companies that requires the approval of the Board of Directors in order to receive the appointment.

The Board of Directors closely follows the results of all of Sistema's business areas while also overseeing their internal control and audit functions.

Five committees exist on the Board of Director level for addressing key issues affecting the corporation's development. These committees are: Strategy and Development, Audit, Appointments and Compensation, Corporate Governance and Investor Relations. The Committee for Investor Relations was established in 2005. Its creation reflects the efforts of the corporation to constantly improve the norms and procedures of corporate governance.

Information disclosure is another primary value for Sistema. The corporation aims to disclose information about its activities in a regular and timely manner to all of its stakeholders. The corporation's websites (in both English and Russian) provide the company's latest operational and financial news releases, as well as comprehensive details about the management of the company. At the same time they are posted on the site, news releases are simultaneously disclosed in English and Russian

via the main news information systems and other disclosure systems mandated by stock exchange listing rules. In addition, the corporation aims to ensure that it makes all necessary filings with the relevant organizations regulating the securities markets.

As a result of the IPO on the London Stock Exchange in February 2005, Sistema has acquired a large number of new shareholders in different countries around the world. Because of this, issues of interaction with shareholders have required ever greater attention from the corporation. The corporation aims to create conditions that are conducive for shareholder participation in the management of the company. The corporation uses specialized international and domestic agencies to research the composition and structure of its shareholder base. This allows the corporation to find new ways to keep shareholders informed of the latest developments and is especially important for providing complete information about issues on the agenda of Annual General Meetings. Also, during regular investor "roadshows" following results announcements, management has the opportunity to meet with a number of investors. These meetings are another important way of ensuring continued dialogue between management and current and potential investors.

The dividend policy of the corporation is coordinated with the investment policy so that shareholders can extract maximum profit from increases in the value of the company while Sistema and its businesses are provided with long-term investment.

In 2005, Sistema's Board of Directors approved an Ethical Code which supplements and provides further clarification of the rules described in the Code of Corporate Governance. The corporation is constantly improving its governance structure in accordance with new goals that appear before the business. But the basic principles and values of its fundamental documents are intrinsic parts of Sistema's success story and they will not change.

## PRINCIPLES OF CORPORATE GOVERNANCE

The structure of Sistema's corporate governance, described in the previous section, is defined by the company's charter. But the fundamental principle of corporate governance at Sistema is innovation. Corporate governance is not a static concept. Rather, it evolves along with legislation and is led by the expectations of the Russian and international investment community and changes in Russian legislation. Sistema is committed to transparency and continually improving communications with its investors. Innovation also means regular changes in personnel on both the Board of Directors and in executive management to bring in fresh ideas and practices.

Innovation in corporate governance means that the requirements the corporation sets for itself will always be stricter than accepted practice. Sistema's goal is to set an example for other companies in its field. Corporate governance became an area of considerable attention in the Russian business world about five years ago. Even then, Sistema was a leader in many areas according to many parameters. The corporation introduced high standards of corporate governance in advance of accessing international financial markets. But the main factor was the belief among Sistema's leaders that adherence to the standards of civilized corporate governance increased the efficiency of the company. Openness allowed shareholders, business partners, regulators and employees to offer feedback. This process in turn led to a productive exchange of views which drove further improvements in the structure of governance.

Following the principles of transparency in conducting business, the corporation has prepared consolidated financial reporting according to US GAAP standards since 1997. These accounts are audited by one of the leading international accounting firms, Deloitte & Touche. In 1997, Sistema also appointed its first independent director. In 2001, the Board of Directors created its first oversight committee. The Committee for Strategic Development was required because of the corporation's rapid rate of growth. In 2002, the corporation disclosed the names of its main shareholders. In 2003, Sistema created an International Advisory Council at the Board level, in recognition of the fact that the corporation's innovative business would lead it to develop actively beyond Russia's borders.

All of these moves would eventually be required for the corporation's IPO. Putting these elements into place long before they were required by Russian legislation built trust in the corporation among potential investors and regulators. It also made the preparation for the IPO much more straightforward and required less time. Sistema's efforts in improving its corporate governance received recognition at the beginning of 2005 when the Russian Institute of Directors and Expert RA assigned Sistema a national rating of "B++." At the end of 2005, the corporation's rating was reviewed and raised to the level "A."

In 2005 and 2006, the Board of Directors appointed two new independent directors. In June 2005, Ron Sommer was appointed. He formerly served as Chairman of the Board of Deutsche Telekom, which was a shareholder of Sistema's Mobile TeleSystems subsidiary. Mr. Sommer brings invaluable experience in running a global telecommunications business as well as considerable experience in Russia. Stephan Newhouse, a former president of Morgan Stanley, joined the Board of Directors later that year. Mr. Newhouse brings the very highest level of expertise in preparing, structuring and executing large, cross-border transactions, as well as profound expertise in financial management.

In 2006, Sistema implemented a number of important management changes. These changes reflect the corporation's long-standing practice of appointing and rotating key executives when the company enters a new stage of development.

## Corporate Governance

In February 2006, Vladimir Evtushenkov, who had served as President of the corporation, was elected Chairman of the Board of Directors. Alexander Goncharuk, who served as President of Sistema Telecom and the CEO of SITRONICS from 2003 to 2006, was appointed President of Sistema. In addition, the corporation undertook a number of major appointments in strategic business areas. Sergey Shchebetov was appointed CEO of Sistema Telecom. Alexander Gorbunov was appointed Acting First Vice-President, Head of Strategy and Development of Sistema. Evgeny Utkin was appointed CEO of SITRONICS and Mikhail Dunaev was appointed CEO of Sistema Mass Media.

In April 2006, Mobile TeleSystems appointed Leonid Melamed as MTS' acting President and CEO. Mr. Melamed previously served as General Director of the ROSNO Insurance Group. He has been replaced in that role by Levan Vasadze, previously First Vice President and Head of Strategy and Development at Sistema. Vsevolod Rozanov, who previously served as Chief Financial Officer of Comstar-UTS, was moved over to the same post at MTS. In July 2006, Maxim Entyakov took the post of CEO of Detsky Mir Center.

## CREDIT RATINGS

Sistema conducts a policy of prudent financial management at both the corporate and subsidiary level. This policy ensures the long-term financial stability of the corporation. Such stability is measured by the main international ratings agencies and these ratings play a major role in the corporation's ability to obtain external financing. Ratings agencies consider a number of key factors in determining the financial stability of the corporation, including total debt, current obligations, existing liquidity and future liquidity needs and cash flow. Ratings may also be viewed as an outside evaluation of the corporation's overall strategy and its position versus its rivals in core business areas. Ratings also take into account corporate governance structures in place and protection for minority shareholders.

The following credit ratings had been assigned as of the end of June 2006 for the corporation:

<i>Issuer</i>	<i>Ratings Agency</i>	<i>Date Assigned</i>	<i>Rating</i>	<i>Outlook</i>
Sistema	S&P	24 March 2005	BB-	Stable
Sistema	Fitch	28 April 2006	B+	Positive
Sistema	Moody's	19 November 2003	B1	Stable

In addition, the credit ratings of subsidiary companies also play a major role. They reflect an assessment of the creditworthiness of a subsidiary and the ability of each subsidiary to raise capital.

<i>Issuer</i>	<i>Ratings Agency</i>	<i>Date Assigned</i>	<i>Rating</i>	<i>Outlook</i>
MTS	Moody's	10 November 2001	Ba3	Stable
MTS	S&P	24 March 2005	BB-	Stable
SITRONICS	Fitch	14 February 2006	B-	Stable
SITRONICS	Moody's	16 February 2006	B3	Stable
MGTS	S&P	24 March 2005	BB-	Stable
MGTS	Moody's	20 January 2006	Ba3	Stable
MBRD	Moody's	15 December 2004	B1	Stable
MBRD	Fitch	14 April 2006	B	Stable

# 3

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## CORPORATE INFORMATION

Transparency in  
ownership structure  
and governance is  
a foundation of our  
business.



## GENERAL INFORMATION

Sistema Joint Stock Financial Corporation was registered at the Moscow Registration Chamber on July 16, 1993. The corporation is registered at Prechistenka Street 17/8/9, Building 1, Moscow, 119034, Russian Federation.

The charter capital of the corporation is 868,500,000 rubles and consists of 9,650,000 ordinary shares with a nominal value of 90 rubles.

Sistema's shares are listed on the London Stock Exchange in the form of global depositary receipts (GDRs) under the symbol "SSA." Fifty GDRs represent one ordinary share.

Sistema's shares are included in the "B" List of the Russian Trading System, under the symbol "AFKS." In 2004, Sistema's shares were also included in the "B" list of the Moscow Stock Exchange (MSE) under the ticker "SIST."

As of the end of 2005, a number of debt obligations issued by subsidiaries of the corporation traded on the financial market:

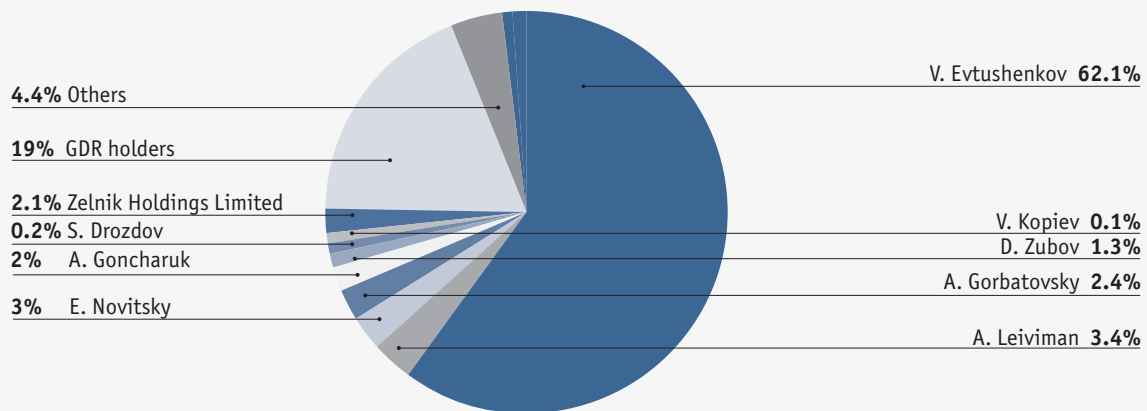
	<i>Currency</i>	<i>Annual interest rate (Actual as of December 31, 2005)</i>	<i>(\$, thousands)</i>	
			<i>2005</i>	<i>2004</i>
Sistema Capital Notes	USD	8.9%	350,000	350,000
Sistema Finance Notes	USD	10.3%	349,285	348,808
MTS Finance Notes due 2012	USD	8%	399,052	–
MTS Finance Notes due 2010	USD	8.4%	400,000	400,000
MTS Finance Notes due 2008	USD	9.8%	400,000	400,000
MBRD Bonds	USD	8.6%	150,000	–
MGTS Bonds	RUR	8.3%–10.0%	104,230	90,094
Detsky Mir Center Bonds	RUR	8.5%	39,954	–
Micron Bonds	RUR	–	–	6,293
<b>Total Corporate Bonds</b>			<b>2,192,521</b>	<b>1,595,195</b>

## SHAREHOLDER STRUCTURE

The graph presented below indicates the shareholding structure of Sistema as of March 30, 2006. At that time, the corporation had 30 registered shareholders, including 25 direct owners and 5 nominees. The identities of the corporation's GDR holders are generally not reported to the corporation. However, the corporation undertakes a regular procedure of researching the identity of its shareholders. This allows Sistema to provide as much information as possible to the largest number of shareholders.

Shareholder Structure

### Shareholder Structure



## SHARE PRICE PERFORMANCE

On February 9, 2005, Sistema completed the initial public offering (IPO) on the London Stock Exchange of 16.5% of its shares in the form of 79.6 million global depository receipts (GDRs). The IPO book was 2.6 times oversubscribed and raised \$1.35 billion. Sistema's GDRs are listed on the London Stock Exchange under the symbol "SSA." Fifty GDRs represent one ordinary share.

Following the exercise of an overallotment option by Credit Suisse First Boston and Morgan Stanley, the global coordinators of the offering, for the sale of 11,945,000 additional shares, or an additional 2.5% of Sistema's shares, the total free float of the corporation's shares reached 19%, and the total funds raised were \$1.56 billion.

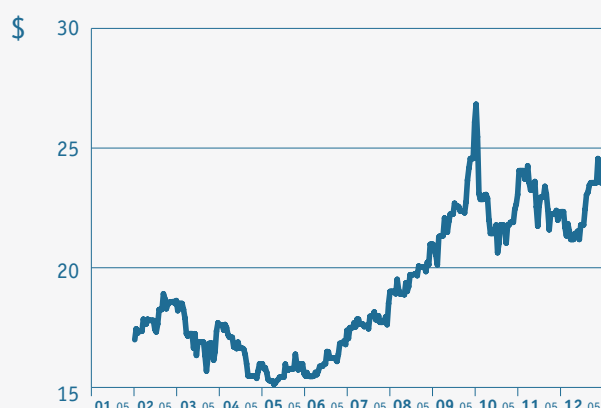
Previously, in October 2004, the Russian Federal Securities Market Commission had approved the inclusion of Sistema's ordinary shares on the quoted lists of the RTS and the Moscow Stock Exchange (MSE). Sistema's shares were included in the "B" List of the Russian Trading System at the end of October, under the symbol "AFKS." In November 2004, Sistema's shares were included in the "B" list of the Moscow Stock Exchange (MSE) under the ticker "SIST." Until mid-2005, however, trading liquidity was relatively limited on Russian exchanges. Following the start of active trading in June 2005, Sistema's ordinary shares were included in the MSE index.

In May 2005, Morgan Stanley Capital Investment (MSCI), a leading investor in international capital markets and provider of financial market ratings, announced the inclusion of Sistema's GDRs and Mobile TeleSystems's American depository receipts (ADRs) in its index.

On February 9, 2005, the first day of trading, Sistema's GDRs shares closed at \$17.45. On the last day of trading of the year, the shares closed at \$23.50. The shares reached a yearly high of \$26.75 on October 4, 2005. The shares followed a strong upward dynamic over the course of the year, linked to both the company's performance and broader optimism about the Russian economy. Sistema, as one of the few internationally listed Russian consumer sector entities, has seen its share price fluctuate in response to broader political and economic news regarding the country.

The corporation is covered by analysts from a number of Russian and international investment banks. A list of covering analysts, including contact details, is published on [www.sistema.com](http://www.sistema.com) and regularly updated.

### Sistema GDR price performance



## ASSET STRUCTURE

The table below outlines Sistema's participation in the capital of its largest subsidiary and affiliated structures and its voting interests as of December 31, 2005. The corporation's asset structure has changed significantly in recent years in line with Sistema's strategy of restructuring and consolidating its ownership in key subsidiaries. The table reflects the completion of restructuring at SITRONICS in the Technology segment at the end of 2005. It should be noted that Sistema's beneficial ownership and voting interest in Comstar-UTS, following the IPO of Comstar-UTS on the London Stock Exchange in February 2006, fell to 59%.

<i>Segment</i>	<i>Company</i>	<i>Beneficial Ownership</i>	<i>Voting Interest</i>
<b>Main Business Areas</b>			
Telecommunications	MTS and subsidiaries	53%	53%
	Comstar-UTS and subsidiaries	100%	100%
	Sky Link	50%	50%
	MTT	43%	50%
Technology	SITRONICS and subsidiaries	78%	78%
Insurance	ROSNO and subsidiaries	49%	51%
Banking	MBRD	95%	99%
	East-West United Bank	49%	49%
Real Estate	Sistema-Hals and subsidiaries	100%	100%
Retail	Detsky Mir	75%	75%
	Detsky Mir Center and subsidiaries	100%	100%
Media	Sistema Mass Media and subsidiaries	100%	100%
Tourism	Intourist and subsidiaries	72%	72%
Radio and Space Technology	RTI Systems and subsidiaries	100%	100%
<b>Other Businesses</b>			
Pharmaceuticals and Biotechnology	Medical Technological Holding	67%	67%
Medical Services	MEDSI	69%	74%
<b>Financial Investments</b>			
Oil Business	Bashneft	21%	25%
	Ufimsky NPZ	22%	26%
	Novoil	26%	28%
	Ufaneftekhim	18%	22%
	Ufaorgsintez	22%	25%
	Bashnefteproduct	17%	19%

# 4

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## SOCIAL RESPONSIBILITY

We see the creation of a  
new quality of life as our  
responsibility to society.

## PRINCIPLES OF SOCIAL RESPONSIBILITY

The principles of social responsibility are central to Sistema's business. This year, the corporation is publishing its first-ever comprehensive Social Responsibility Report. This section represents a brief overview of Sistema's important ongoing work in this area.

We believe that the most effective social investment depends on the harmonious combination of the interests of business and society. Sistema links its social activities with the goals of the corporation, its mission and business strategy. The main social programs of Sistema rely on technological leadership and are directed toward the creation of a new quality of life.

We invest resources in science-led projects and invest funds in science and education, innovative structures and the introduction of new technologies. The activity of the corporation enables the transition of the Russian economy from one based on raw materials to one based on services. This leads to qualitative changes in the standard of living for society as a whole and for each citizen.

Consequently, Sistema integrates the principles of corporate social responsibility into its practices. Sistema understands corporate social responsibility as its position on a range of economic and social issues facing Russia and the world today. Social responsibility, in the broadest understanding of the term, means fulfilling obligations before its customers, business partners, employees and the citizens of the towns, regions and countries where the corporation does business.

Social responsibility toward employees means, in particular, providing them with additional benefits. Voluntary pension contributions and medical insurance provide employees and their families with faith in the future. The responsibility of the corporation to its partners is reflected in the observance of the highest principles of business ethics. Working with Sistema, representatives of the international business and investment communities see a Russian partner demonstrating the highest levels of business conduct.

The corporation takes the impact of its activities on the surrounding communities and environment into account and is constantly working on appropriate procedures to deal with these aspects of its business. Sistema is convinced that new technology is crucial in dealing with the many issues surrounding Russia's economic growth in an efficient and ecologically friendly way. The creation of efficient Russian technologies also creates the opportunity to develop new industries and export the country's know-how.

At Sistema, particular attention is paid to supporting education and scientific research in Russia. This is part of the company's strategy for developing innovation. The activities of the corporation contribute to the diversification of the Russian economy and reduce dependence on the oil and gas sectors. Sistema is working in cooperation with government and charitable and private-sector organizations to create an environment for innovation and to ensure Russia's participation in global technological development. At the corporate level, this means an increase in the number of skilled workers as well as the introduction of technologies that will create new businesses and consumer markets for Sistema's products.

Sistema has adopted internationally recognized principles of sustainable development and corporate social responsibility and integrates them into its business practices. In 2002, the corporation became one of the first companies in Russia to sign the Global Compact of the United Nations (UN-GC).

In 2003, Sistema joined the World Business Council for Sustainable Development (WBCSD). As with other WBCSD members, the corporation has committed itself to maintain a high level of transparency and responsibility in all aspects of its business. Within Russia, Sistema works in partnership with government bodies to develop procedures and standards in a range of areas, from human resources to providing a helping hand to the less fortunate.

The directors and management of Sistema invite readers to read carefully through the corporation's Social Responsibility Report to learn more about the company's strategy in this area, its achievements in 2005 and its plans for the future.



# 5

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## BUSINESSES

The core assets of Sistema are concentrated in dynamically developing sectors of the economy.



**Sergey Schebetov**

CEO, Sistema Telecom

## DYNAMIC

The consolidated revenues of the Sistema Telecom business area grew by 27.6% to \$5.89 billion in 2005, outpacing the market for the fifth year in a row.

MTS remains number one mobile telephony provider in Russia and the CIS. Its number of subscribers grew by 24 million in 2005.

## FOCUS OF THE YEAR

Comstar UTS concluded the consolidation of assets and occupied the leading position in the fixed-line market.

## TELECOMMUNICATIONS

### Marketplace

The telecommunications market remains one of the most dynamic sectors in the Russian economy. The sector's significant growth potential is apparent in all key sectors of the telecommunications business. For example, Russian mobile telephony penetration in 2005 stood at 78% compared to 96% in Western Europe. Fixed-line penetration was 24% compared to the Western European level of 47%. Internet penetration stood at just 8% compared to 52% in Western Europe and broadband penetration was 2% compared to 29%<sup>1</sup>.

According to data from the Russian Ministry of Information Technologies and Communications, the total volume of the Russian telecommunications market grew 24% in 2005 to \$23.3 billion. Markets in the CIS countries are also creating new prospects for development in an environment of rapid economic growth and relatively low penetration of telephony services. However, the market continues to see strong competition in both the wireless and fixed-line sectors and continuous innovation is required to win and retain market leadership.

### Business

Sistema's strategy is focused on long-term leadership in the telecommunications market. Sistema Telecom, the management company in the Telecommunications business area, is developing businesses in all of the main segments of the communications market: fixed and mobile telephony, internet, data exchange and transit traffic.

#### *Wireless Communications*

Mobile TeleSystems (MTS) is Sistema's largest asset in the wireless communications market and the leading cellular operator in Eastern Europe. MTS is one of the top-10 companies in the world in terms of subscriber numbers. The company is present in Russia (its share in value terms is 35%<sup>2</sup>) Turkmenistan, Ukraine and Uzbekistan. At the end of 2005, MTS had a consolidated subscriber base of 58.2 million, 24 million of which were new subscribers added during 2005. 17.7 million of these subscribers were added in Russia.

Sistema is MTS's largest shareholder, with 52.8% of its shares. The company is listed on the New York Stock Exchange and has a freefloat of 46.7% of its shares. Deutsche Telekom, formerly one of the largest shareholders of the company, sold its remaining 10.1% shareholding in 2005. The move has enhanced the liquidity of MTS's shares in Russia.

#### *Fixed-Line*

Comstar-UTS is Sistema Telecom's integrated holding which manages the fixed-line business area of Sistema. In addition, following the merger of a number of Moscow-based alternative fixed-line operators controlled by Sistema, these carriers now operate under the Comstar-UTS brand.

At the end of 2005, Sistema restructured its assets in the fixed-line segment. As a result of this restructuring, Comstar-UTS gained a controlling stake in Moscow City Telephone Network (MGTS) and MTU Intel. Following the restructuring, Comstar-UTS became the market leader in the fixed-line segment, providing a full range of telecommunications services. MGTS provides fixed-line services

<sup>1</sup> Source: Pyramid research; mobile and fixed-line figures for September 2005, Internet and broadband figures for 1H 2005

<sup>2</sup> Source: AK&M, as of end of Q3 2005

## Businesses

and a line of high-value residential services is being developed under the Stream brand and Comstar-UTS services corporate clients.

MGTS is the largest operator in Moscow with a number capacity of more than 4.3 million. It is one of the largest fixed-line operators in Europe. The company operates in an environment of regulated tariffs (which grew 17% in 2005) and MGTS is continually upgrading its network infrastructure.

MTU-Intel is a provider of broadband multi-service networks and pay TV. The broadband internet access business has more than 283,000 clients and 14,000 television subscribers. The company launched an in-house entertainment offering under the Stream brand in mid-2005, with more than 100 television channels, pay-per-view, gaming and other options.

### Results

Consolidated revenues in the Telecommunications segment grew by 27.6% to \$5.89 billion in 2005. The level of sales growth outpaced the overall rate of the telecommunications market for the fifth year in a row. To further strengthen this capacity, the corporation undertook a wide-scale restructuring of its fixed-line assets, turning Comstar-UTS into the market leader. The restructuring allowed Comstar-UTS to undertake a successful initial public offering on the London Stock Exchange in February 2006, raising \$1 billion for the further development of the company.

At MTS, dynamic revenue and earnings growth, international expansion and maintenance of market share were accompanied by ongoing restructuring aimed at buying out minority shareholders in subsidiaries and transformation of subsidiaries into affiliates.

MTS was the primary contributor to revenue growth in the Telecommunications segment of Sistema. Subscriber growth in Russia and the CIS was the main revenue driver. Total subscriber numbers grew from 34.2 million at the end of 2004 to 58.2 million at the end 2005. MTS's consolidated revenues increased by 28% year-on-year to \$5.01 billion, compared to \$3.92 billion in 2004. Net income increased by 14% to \$1.13 billion in 2005. In May 2005, the company announced a dividend recommendation of 5.75 rubles per ordinary share (approximately \$1.03 per ADR) or approximately 40% of its 2004 net profit under US GAAP.

Comstar-UTS's consolidated revenues increased by 31% year-on-year to \$907.6 million for the full year, compared to \$695.1 million in 2004. This growth was primarily organic, with businesses acquired during the year contributing \$32.6 million to revenues in 2005. Net income increased by 39% year-on-year to \$105.9 million. At the end of 2005, Comstar-UTS had a 28.6% share of the Moscow telecom market, serving 4.8 million lines and 41% of the Moscow residential broadband market.

The corporation sees the growth of the share of non-telecommunications assets as a long-term strategy. However, in order to diversify exposure to a range of fast-growth consumer segments, the Telecommunications business area remains a vital part of the corporation. The segment's share of the corporation's aggregated revenues decreased to 77.6% in 2005 from 80.5% in 2004. This was due to accelerated organic growth and significant acquisitions in other business areas.

The accomplishments of 2005 and early 2006 set the stage for the rollout of a new brand identity uniting Sistema's telecommunications businesses. The new brand is aimed at all target audiences, including clients, employees and investors. The graphic symbol of the brand is an egg, symbolizing unity and universality, hope, trust, growth and innovation. The brand is intended to create a single

face for the telecommunications area of Sistema and ensure that it is clearly identifiable in the marketplace. The brand should become a symbol of quality of service in the eyes of consumers, personnel and the investment community.

### Key Figures

#### Revenues

\$5,892.9 million

#### Operating Income

\$1,933.3 million

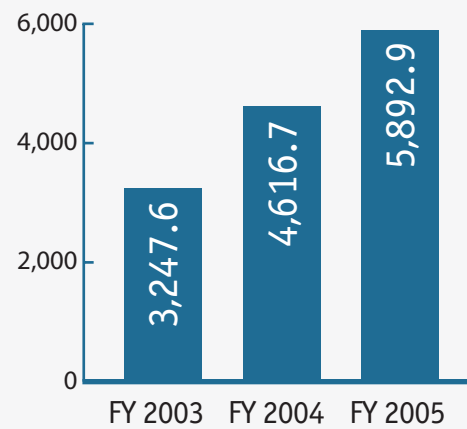
#### Assets

\$9,696.6 million

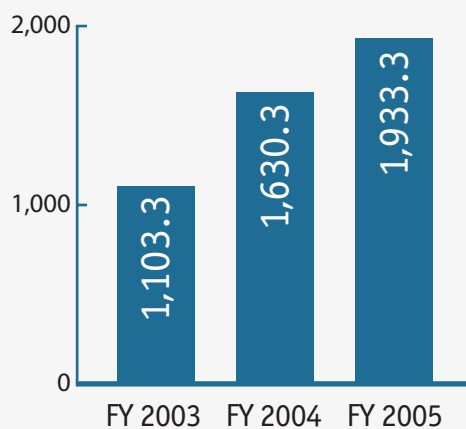
#### Employees<sup>1</sup>

47,500

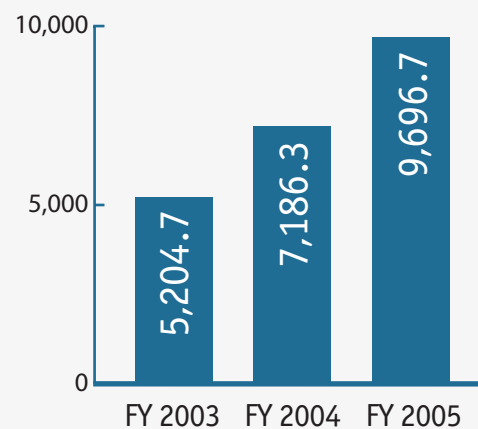
### Revenues



### Operating Income



### Assets



<sup>1</sup> Source: DirectInfo, Comstar-UTS



**Evgeny Utkin**

President, SITRONICS

## DYNAMIC

Revenues in the Technology business area increased by 93% year-on-year, reaching \$961.1 million.

## FOCUS OF THE YEAR

The Technology business area expanded its presence in the global marketplace, with operations distributed across Central and Eastern Europe.

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SITRONICS consolidated its ownership in key subsidiaries.

## TECHNOLOGY

Technology

### Marketplace

Sistema's Technology business is represented by SITRONICS, which is decisively moving into fast-growing markets for high-tech products and solutions. During 2004 and 2005, these segments experienced dynamic growth, demonstrating their considerable potential.

#### *Telecommunications Equipment*

The volume of the Russian market for telecommunications equipment was \$3.35 billion in 2004, according to research by consultancy J'son and Partners. This amount includes only equipment and assemblies for telecommunications operators and excludes sales to other businesses and end users. Sales of equipment to wireless communications providers accounted for 58% of the market and the remainder was accounted for by sales of equipment for fixed-line and OSS/billing.

#### *Information Technology*

Russia's information technology (IT) market was estimated to have grown by 35.2% to \$9.57 billion in 2004, according to market research group IDC. IDC also estimates that the average annual growth rate of the IT-services market will be 24.5% between 2005 and 2009, growing to \$5.7 billion.

#### *Microelectronic Components*

The global market for microelectronics continues to recover from the sharp fall in sales in the sector seen in 2001 and 2002. According to data collected by World Semiconductor Trade Statistics, the world market for semi-conductors grew by 28% in 2004 to \$213 billion, compared to \$166 billion in 2003. Evaluations published by Electronics Publishing House show that the Russian market for microelectronics continues to outpace global growth rates, posting annual growth of 18% to 20%. The largest consumers of micro-electronic components in the Russian market are producers of industrial electronics, communications equipment makers and the defense industry.

#### *Consumer electronics*

International research and consulting company Strategy Analytics estimates that global demand for flat-screen televisions increased by 66% to 17.5 million units in 2005. According to Russian research group IT Research, sales of LCD televisions in Russia reached 102,800 units in Q2 2005 and 164,000 units in Q3 2005, worth \$102.2 million and \$167.0 million in value terms respectively.

Sales of plasma televisions in Q2 2005 were 20,600 units and 35,000 units in Q3 2005, worth \$72.9 million and \$109.9 million in value terms respectively.

Looking at the market for GSM and CDMA devices, Russian market research company RosBusinessConsulting estimates the Russian market was worth \$5.5 billion in 2005. Marketing group Sotovik calculates that the volume of the GSM market surpassed 36 million units in 2005, with a value of \$5.7 billion.

### Business

SITRONICS' goal is to become the largest high-technology enterprise in Russia, the CIS and Eastern Europe. It seeks to do this through both organic growth and strategic mergers and acquisitions. The optimal combination of these two tactics will strengthen its position in Russia while driving expansion in international markets. In order to achieve its long-term goals, SITRONICS has concentrated its efforts on four key business areas: the development of solutions for New Generation Networks (NGN)



## Businesses

for telecommunications operators, systems integration, the production of smartcards and microchips and the further development of its SITRONICS umbrella brand for consumer electronics.

The development of telecommunications hardware and software solutions takes place under the Strom Telecom brand and it accounts for around 25% of sales in the Technology business of Sistema. The corporation is developing this area further through acquisitions and strategic alliances with leading international equipment manufacturers. SITRONICS is also concentrating on the expansion of its sales beyond Russia. The development of its products in Russia and Eastern Europe give it a major competitive advantage due to lower production costs and proximity to consumers of service infrastructure.

SITRONICS's systems integration business is built around the base of the Ukrainian group Kvazar-Micro, 51% of which was acquired by the corporation in 2004. Kvazar-Micro has operations in several Central and Eastern European countries. The company has solid potential for building strong market share in the systems integration business in Russia, the CIS and Eastern Europe. SITRONICS aims to turn Kvazar-Micro into the leading IT company in Central and Eastern Europe with a focus on high-margin services such as systems integration and consulting.

The microelectronics division of SITRONICS is based in Zelenograd, where production capacity and skilled engineering and technical personnel are concentrated. SITRONICS is strengthening its position in the domestic market as a leading supplier of solutions for the defense industry and other sectors. SITRONICS is strengthening its position in the Russian Smart-Card market, with the aim of diversification of production and increasing profitability.

In the consumer electronics field, SITRONICS has made considerable progress in cutting production costs and increasing the price competitiveness of its products. However, its business is not just about cost competition and it continues to enhance its R&D capacity in this division. Strategic partnerships with outside electronics producers provide another way to combine a competitive advantage in price with leading-edge global technology.

### Results

In 2005, corporation dramatically demonstrated its ability to restructure and integrate newly acquired assets into an existing business to create a market leader in an innovation-driven business environment. The Technology segment was one of Sistema's fastest growing business areas in 2005. Revenues grew 92.8% year-on-year to \$961.1 million in 2005 compared to \$498.4 million in 2004 with OIBDA more than tripling year-on-year to \$155.6 million.

Systems integration accounted for 49.1% of revenue in the Technology segment during 2005. The volume of IT services rose 60.1% to \$472.0 million in 2005 from \$293.5 million a year earlier. The Consumer Electronics subdivision saw turnover more than triple to \$188.0 million in 2005 from \$51.6 million in 2004. The microelectronic solutions business reported 10.6% year-on-year revenue growth to \$59.6 million. Revenues from the info-communications business of SITRONICS grew by 105.5% in 2005 and amounted to \$246.6 million.

Outside of its core business areas, SITRONICS continued to develop its promising Integrated Security Systems division. The division includes Videofon, which contributed \$6.4 million in revenues to the Technology segment.

During 2005, the corporation strengthened its ownership in key Technology divisions as part of its strategy of buying out minority interests and strengthening vertical ownership and management structures in its core businesses. Sistema increased its shareholding in Strom Telecom to 100% during the year. Sistema also purchased a further 53% equity stake in Kvant, a personal computer and components maker, concentrating 88% of the shares in the enterprise in its hands.

**Key Figures**

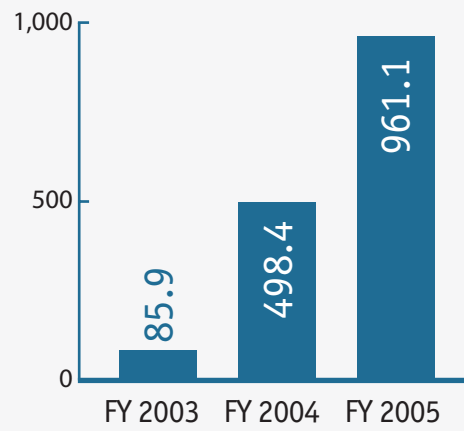
**Revenues**  
\$961.1 million

**Operating Income**  
\$143.5 million

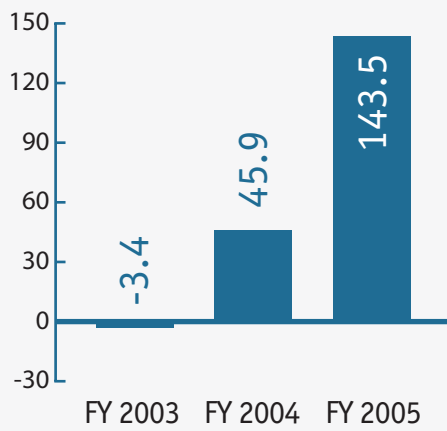
**Assets**  
\$561.5 million

**Employees<sup>1</sup>**  
10,500

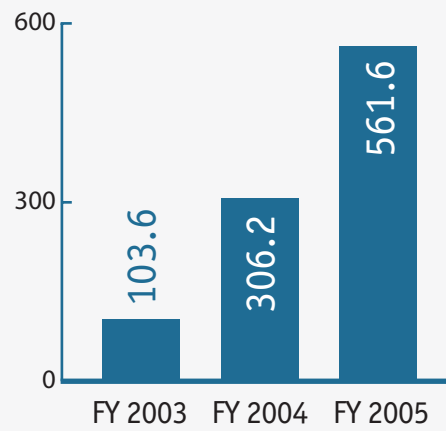
**Revenues**



**Operating Income**



**Assets**



<sup>1</sup> As of August 1, 2006



Levan Vasadze

CEO, ROSNO

## DYNAMIC

In 2005, revenues in the Insurance business area grew by 36.2%, reaching \$408.9 million.

The volume of non-life premiums grew by more than 40% during 2005.

In 2005, ROSNO delivered growth at twice the rate of the market as a whole.

## FOCUS OF THE YEAR

ROSNO was the first company in the Russian market to offer its clients full accompaniment on third-party liability insurance (OSAGO).

## INSURANCE

### Marketplace

Insurance has been one of the fastest growing sectors of the Russian economy in recent years. Between 2003 and 2005, total premiums grew to \$17.33 billion from \$14.14 billion, according to data from the Russian Federal Service for Insurance Oversight (FSIO). Today the insurance industry accounts for approximately 3.0-3.5% of Russia's gross domestic product. Compared to ratios in Central and Eastern European markets, as well as to Western Europe, the market has enormous further potential. Russia's rapid economic growth is stimulating demand from companies and organizations for a wide range of insurance products. At the same time, the retail sale of policies to individuals is also growing rapidly. Still, it is difficult to precisely measure the size of the insurance market because of the presence of "pseudo-insurance" schemes that are aimed at optimizing tax payments and not actually presenting insurers with any actuary risk.

In 2005, the insurance market began to consolidate, as regulators imposed a tighter legal framework and revoked licenses from companies that did not meet charter capital requirements. Currently, 1,073 insurance companies are active in the market. Ten companies accounted for 57% of all premiums, excluding mandatory medical insurance, according to FSIO data for 2005.

### Business

ROSNO represents the business of the corporation in the insurance sphere and is one of the largest players in the market. As a market leader, it can only benefit from the consolidation process. ROSNO's regional network is made up of 100 affiliates united by 10 territorial directorates. More than seven million people and more than 50,000 enterprises and organizations use ROSNO insurance products. For the last several years, the company has consistently been one of the leaders of the insurance market. Voluntary medical insurance, mandatory automobile and KASKO insurance and property insurance historically have been the largest contributors to gross premiums written.

ROSNO provides more than 100 types of obligatory and voluntary insurance. The company's strategy envisions the further strengthening of its leading position and an increase in the company's share of the insurance market by providing clients with high-quality service. ROSNO is a successful example of international partnership for Sistema. Allianz AG, a leading German insurer, holds 47.2% of ROSNO's shares. In 2004, Allianz and Sistema launched two new joint projects: Allianz ROSNO Asset Management and Allianz ROSNO Life Insurance.

ROSNO has extensive mandatory reinsurance protection in place to manage risks. Partners of the company in reinsurance include Allianz, Hannover Re, SCOR, Munich Re, Swiss Re and Russia's largest reinsurance companies. ROSNO also works with the broking agents of Lloyd's corporation. Russia's Expert RA rating agency has awarded ROSNO the top A++ rating for four consecutive years.

### Results

In 2005, the Insurance segment's main financial and operational indicators confirmed ROSNO's strong position in the insurance market. Company revenues increased by 36.2% year-on-year to \$408.9 million in 2005, from \$281.6 million (this excludes the operations of subsidiary company Leader, which was sold in December 2005). Gross premiums jumped 26.1% year-on-year to \$463.4 million, from \$367.6 million. ROSNO's net premiums earned increased by 31.5% year-on-year to \$364.8 million, from \$277.5 million.

## Businesses

Growth during 2005 was driven primarily by the non-life business, continued expansion and diversification of the customer base and expanded service offerings. Growth in non-life premiums (excluding re-insurance) was over 40%, nearly twice the growth rate of the market as a whole. In order to further diversify its premium portfolio, ROSNO focused on sales of policies to individuals, which accounted for 32% of premiums in 2005. The company successfully placed investment funds in Allianz ROSNO Asset Management. The segment's share of Sistema group revenues was approximately 5%.

ROSNO continued to upgrade its customer service quality across the board with continued training and assessment. In November 2005, the company launched a new call center which enables most clients to find needed information or to be connected with the right staff member within just 30 seconds.

The company received the "Gold Brand of the Year/EFFIE" in 2005. The company also won the "National Brand" award for the Insurance Company segment in 2005 for a second time.

### Key Figures

#### Revenues

\$408.9 million

#### Operating Income

\$28.4 million

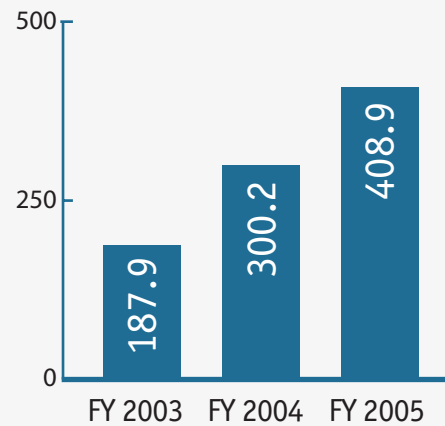
#### Assets

\$581.5 million

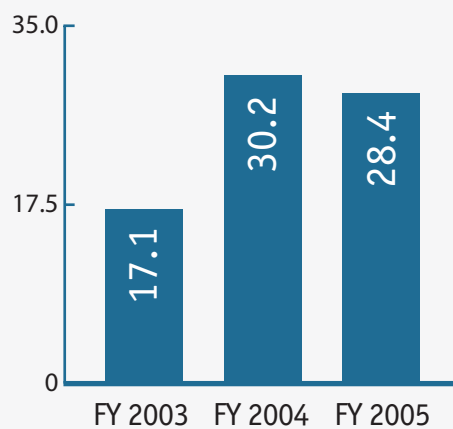
#### Employees<sup>1</sup>

3,564

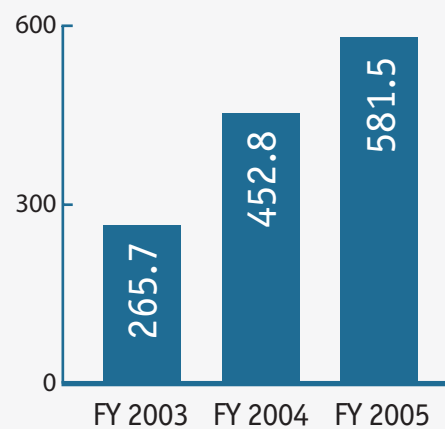
### Revenues



### Operating Income



### Assets



<sup>1</sup> As of August 1, 2006

Businesses



**Felix Evtushenkov**

President, Sistema-Hals

## **DYNAMIC**

The value of Real Estate project portfolio increased nearly three-fold to \$709 million.

## **FOCUS OF THE YEAR**

The successful completion of restructuring Sistema's real estate holdings into single vertically integrated structure.

In 2005, Sistema-Hals developed the concept of the super-regional mall "Hals-Mart" and won 2005 HYPERSTATE Awards prize for this project.

## REAL ESTATE

Real Estate

### Marketplace

Sistema has been present in Russia's construction and property sector since the mid-1990s. The corporation's commitment to consolidate its presence in this market has paid off. In 2005, the market continued to boom, not only in Moscow but in a large number of regional cities. Changes in the legal environment for development have created favorable business conditions. In particular, the issues surrounding the ownership of land underneath properties have been resolved. Economic growth is driving demand in a number of property market segments. Russian and international companies require world-class office space. The middle class is prepared to invest money in modern housing with modern infrastructure and families are increasingly seeking ecologically cleaner areas outside of cities.

Despite the ongoing boom, however, the market still has room to grow. Modern shopping space per capita in Moscow was just 50% the level in London in 2005, according to research by Jones Lang LaSalle. Average residential values rose 233% between 2000 and 2005. The level of empty office space in Moscow in 2004 and 2005 was practically zero and leasing prices were higher than in Western Europe. Sistema's superior project management experience and access to capital has allowed it to gain maximum benefit from a growing market.

### Business

Sistema-Hals is Sistema's vertically integrated subsidiary in the Real Estate sector. Commercial real estate was one of the first areas of investment for Sistema. As part of asset restructuring during 2004 and 2005, the corporation's real estate portfolio was transferred to Sistema-Hals, which had previously operated as a developer of commercial property and elite housing. Now operating as the legal owner of the corporation's property portfolio as well as a project management company, Sistema-Hals has considerably increased its capitalization and ability to attract finance for development. The ability to successfully manage its own property as well as conduct deals for acquisition and sale of assets has significantly increased the value of the project portfolio of the company.

The company's major competitive advantage in Russia's real-estate sector is its ability to manage projects across practically every market segment, including construction of high-quality office property and business-class housing, large multi-functional centers and transportation infrastructure facilities. It has completed more than 20 major projects, with past clients including Dresdner, Daimler-Chrysler and Samsung. While Sistema's projects have been concentrated in the Moscow market, the company is prepared to expand its presence in Russia's regions.

### Results

In April 2006, Sistema announced the results of the regular valuation of its portfolio in the Property business area, which was conducted by Cushman & Wakefield Stiles & Riabokobylko. The report indicated that the value of Sistema's real estate portfolio had increased nearly three-fold to \$709.2 million in 2005, compared to \$238.5 million in 2004.

A large portion of the segment's development projects were not yet completed at the end of the year, and therefore revenues in the real estate business were down 32.0% from \$115.3 million in 2004 to \$78.4 million in 2005. Consequently, operating income for the period declined to \$10.4 million from \$23.5 million in 2004.

In 2005, Sistema-Hals moved forward on the construction of the Pokrovskie Gates Class-A office and hotel complex in central Moscow. The total floor space of the project is more than 24,000 square meters,



## Businesses

with office space accounting for 14,772 square meters. This project is unique in Moscow in that two physically separate spaces, an office complex and hotel, will be managed as a single object.

The office building under development at Nastasinsky Pereulok in the center of Moscow has a floorspace of around 8,000 square meters. The new Class-A office complex is targeted at major Russian and international companies. Since the building is located in a historic part of Moscow, the project has been designed to fully fit into the surrounding architectural landscape.

In July 2005, construction began on a new business-class living complex in Moscow called Izumrudnaya Dolina (Emerald Valley). The project will see the construction of two 19-story towers with a common parking area. The planned total floorspace of the complex is 29,910 square meters. The project is planned to be completed in Q2 2007.

In August 2005, Sistema-Hals completed and handed over all 89 houses in a new cottage development called ForestVille in the Moscow Region. The 15 hectare village is located 22 kilometers from the Moscow Ring Road. Its infrastructure includes a shop, a cafe-bar, playgrounds, a sauna and a pharmacy.

**Key Figures****Revenues**

\$78.4 million

**Operating Income**

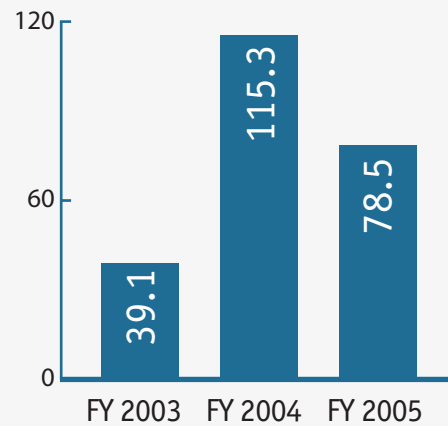
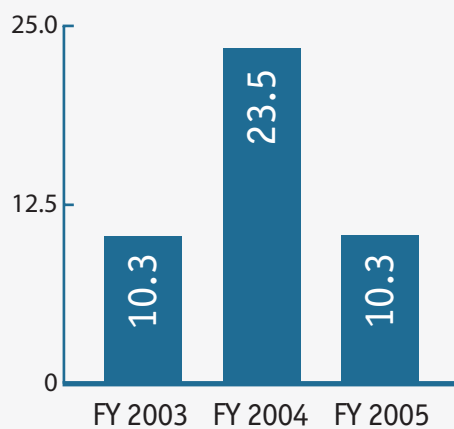
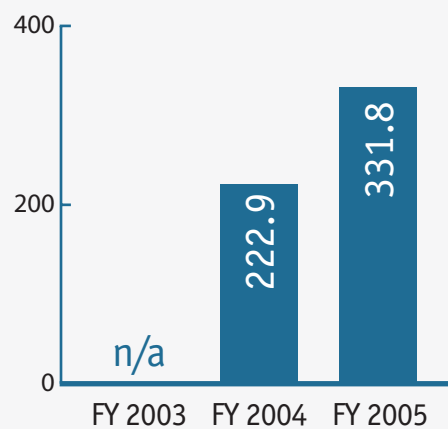
\$10.3 million

**Assets**

\$331.7 million

**Employees<sup>1</sup>**

1,000

**Revenues****Operating Income****Assets**<sup>1</sup> As of August 1, 2006

Businesses



**Maxim Entyakov**

CEO, Detsky Mir Center

## **DYNAMIC**

Revenues in the Retail business area grew more than 2.5 times to \$208 million.

The division began active development of small retail stores based on a new format.

## **FOCUS OF THE YEAR**

The number of Detsky Mir stores doubled in 2005.

A \$40 million bond placement was conducted at the end of 2005.

## RETAIL

Retail

### Marketplace

Sistema's retail business is operated through Detsky Mir Center and owns the leading retailer of children's goods in Russia, which operates under the same name. Detsky Mir, which means Children's World, is one of Russia's oldest, most recognized and most trusted retail brands, with a 50-year history.

The growth in demand for children's products is driven by Russia's continued economic growth and the steady improvement in household disposable income. In 2005, the market for children's goods was worth \$7 billion and is projected to grow to \$11 billion by 2008. Children under 14 years of age represent 18.1% of Russia's population.

Patterns of purchasing children's products depend on the level of income enjoyed by a particular family. For wealthier parents, representing 20% to 25% of the population, time is at a premium. Parents seek a one-stop shopping experience offering high levels of service, comfort and the availability of a wide choice of products from well-known companies. Children in this segment have significant pocket money and are crucial in dictating shopping decisions and have a high level of brand awareness. Consumers on more limited incomes represent 45% to 60% of the population. They are price sensitive and their demand is limited to a narrower range of necessary goods.

Expectant parents are another distinct consumer category. Research demonstrates that they formulate purchasing preferences ahead of the arrival of their first child.

### Business

Sistema became a shareholder in Detsky Mir in 1996 and runs the business through Detsky Mir Center. While the chain struggled during the 1990s due to the restructuring of the economy, Sistema has spearheaded an aggressive expansion of the chain and established consistent revenue and earnings growth. Detsky Mir's flagship store in Moscow is located in central Lubyanka Square, on the same site it has occupied since 1957.

As of December 31, 2005, the corporation operated 22 stores in Moscow and 23 stores in the regions, with total retail space of more than 58,000 square meters. Stores are located in high-traffic locations and popular shopping centers that are accessible by public transportation. This is an important consideration as the level of automobile ownership in Russia continues to trail levels in Central and Eastern Europe. Store leases are generally negotiated on a five- to ten-year basis.

Sistema is planning the further expansion of Detsky Mir. It is opening new stores in Moscow and other cities, and the building housing the central store at Lubyanka will be modernized. The strategic goal of the company is to expand to the countries of the CIS. The corporation is also reviewing the possibility of expansion of the network through franchising.

As Russia's most trusted retailer of children's goods, the Detsky Mir group of companies continues to develop an ever more satisfying shopping experience across the chain with the refurbishment of existing stores and development of improved shopping formats. Due to its increased size and the backing of Sistema, Detsky Mir Center has been able to move away from intermediaries and enter into direct relationships with international suppliers. As a result, this allows Detsky Mir to offer a more attractive pricing proposition to its shoppers while at the same time expanding the number of products available at each store.

## Results

In 2005, Detsky Mir Center grew rapidly through store openings and acquisitions. Revenues more than doubled year-on-year to \$208.0 million from \$79.3 million in 2004. Detsky Mir opened 25 new retail outlets during 2005. Total retail space exceeded 58,000 square meters. The company made a number of acquisitions, including Chudo-Ostrov, Vyrastai-ka and S-Toys businesses, with revenues of \$10.0 million, \$0.9 million and \$53.7 million respectively.

The Detsky Mir group of companies undertook a range of marketing initiatives during 2005 and the number of shoppers entering the chain's stores reached 1 million per year. The majority of these shoppers were regular customers of the chain. During 2005, the company created a new small format chain called Vyrastai-ka.

Detsky Mir constantly works to improve customer service on the store and company level. In 2005 the chain completed a program aimed at creating a universally high and consistent level of service across all of its stores. An integrated Call Center was also put into operation in 2005. This permits customers to get information on the hours and product assortment at any store. In addition, a new consumer internet portal for parents and children was launched at [www.detmir.ru](http://www.detmir.ru).

Logistics remained a key focus in 2005, reflecting the major expansion in store numbers in the Moscow area and Russia's regions as well as the significantly greater number of suppliers. Detsky Mir undertook a wide-ranging re-engineering of its Distribution Center. The personnel composition was changed and training programs were introduced. Storage and processing times were significantly reduced to reflect the new demands and the number of Just-in-Time deliveries increased. Further expansion of the Distribution Center is planned for 2006 as Detsky Mir intends to continue new store openings.

In December 2005, Detsky Mir Center placed ruble denominated bonds on the Moscow Interbank Currency Exchange (MICEX), raising 1,150 million rubles (approximately \$40 million) with a term of 9.5 years and a coupon of 8.5%. Around a quarter of the funds raised will be directed to refinancing debt on more favorable terms. The remainder of the funds will be directed toward continued expansion of the chain, including new acquisition and leases.

### Key Figures

#### Revenues

\$208.0 million

#### Operating Income

\$10.4 million

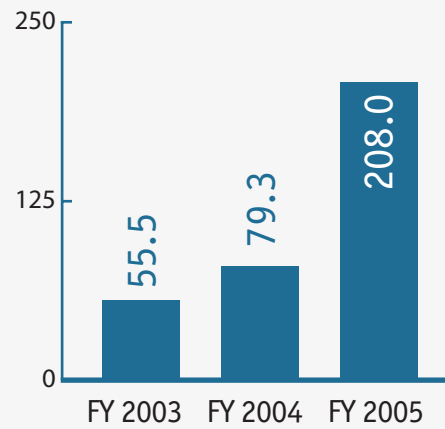
#### Assets

\$146.3 million

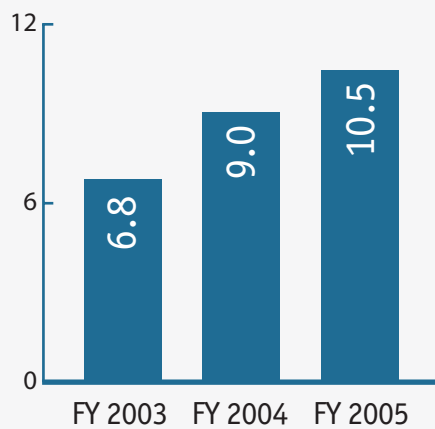
#### Employees<sup>1</sup>

4,115

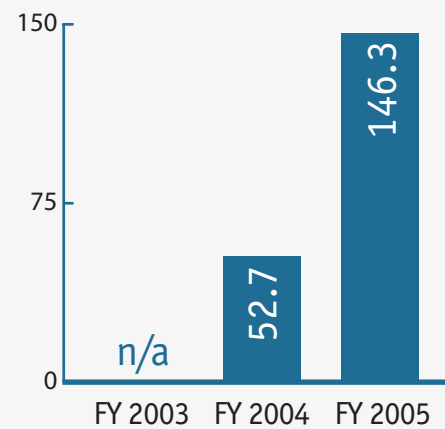
### Revenues



### Operating Income



### Assets



<sup>1</sup> As of August 1, 2006



Sergey Zaitsev

CEO, MBRD

## DYNAMIC

Revenues in the Banking business area grew by 62% to \$106.8 million in 2005.

The number of retail customers exceeded 90,000 and corporate clients numbered over 6,000.

## FOCUS OF THE YEAR

Sistema consolidated 99% of the shares of the Moscow Bank for Reconstruction and Development.

The successful roll-out of retail banking business in 2005, with banking divisions opened in seven regions.

## BANKING

### Marketplace

Since 2004, Sistema's banking business, the Moscow Bank for Reconstruction and Development, has aggressively expanded into the country's fast-growing retail banking sector. Russia's macroeconomic growth has fostered the development of both the corporate and retail banking sectors. At the same time, Russia's banking sector remains extremely fragmented, with a large number of small banks and "treasury" banks.

In 2005, the Central Bank of the Russian Federation, acting as the regulator of the sector, developed and implemented a deposit guarantee program for individual clients at banks that had completed a special certification process. The law "On Credit Histories" came into effect on June 1, 2005 and gave further momentum for the development of the sector. This legislation allows the development of consumer credit for consumers at lower interest rates, including mortgages, automobile finance and lending.

Russia's banking sector still has considerable room to grow when measured against peers in Central and Eastern Europe. In 2005, total deposits in Russia were equal to 7% of gross domestic product (GDP), one of the lowest rates in the region. According to international investment bank Nomura, the comparable figure in Romania is 19%, 39% in Hungary, 44% in Turkey, 74% in Slovenia and 120% in the European Union. The market for corporate lending has also not reached the limits of its growth potential. The volume of loans to GDP in Russia was 11%, compared to 18% in Bulgaria and Romania, 19% in Poland, 34% in Turkey, 52% in Czech Republic and 102% in the European Union.

### Business

Sistema's primary finance and banking business is MBRD. Previously, the MBRD acted primarily as an in-house treasury function for Sistema. Today, however, MBRD is a full-fledged universal bank, offering a full range of services to corporate and consumer clients.

In 2004, MBRD launched a program for the development of its retail banking business, using a business model developed with the participation of international consulting firm Deloitte & Touche CIS. During that year, the MBRD opened its first retail outlets in Moscow and created its first affiliates in the Russian cities of Krasnodar and Yekaterinburg. By the end of 2005, the bank operated in Moscow and seven Russian regions. The volume of revenues from intra-group operations dropped throughout the year. The total number of retail customers exceeded 90,000 and the number of corporate clients exceeded 6,000.

MBRD offers another opportunity for Sistema to develop consumer services across its business areas and to gain access to the more than 60 million customers served by the corporation. Sistema is developing internet and mobile access for customers and offers a range of banking services to existing clients in other business areas. The SMS BankInfo service, launched in 2004, allows customers to obtain information about credit and debit card transactions and bank balances via mobile phone.

### Results

The Banking business area demonstrated strong revenue growth of 62.4% year-on-year to \$106.8 million from \$65.7 million in 2004. Growth during 2005 was due to the strong growth in corporate lending and the aggressive expansion of the new retail business. As of year end, MBRD's retail network included 12 branches and 41 sub-branches in Moscow and Russia's regions.



## Businesses

Loans issued to retail customers increased seven-fold during the year. Operating costs also increased due to the costs of the retail expansion, and the operating margin consequently fell from 17.8% to 11.9%.

During 2005, Sistema acquired a further 13.0% stake in MBRD for a total consideration of \$10 million, increasing its voting power in the bank to 99%. In March 2005, MBRD completed an issue of Loan Participation Notes for the first time for a total of \$150 million. The issue was organized via Dresdner Bank AG, which issued to MBRD a credit for the entire amount. These notes reach maturity in three years. In March 2006, MBRD issued \$60.0 million 8.9% Loan Participation Notes to finance a subordinated loan. The notes mature in March 2016 and are listed on the Luxembourg Stock Exchange.

## Key Figures

**Revenues**

\$106.7 million

**Operating Income**

\$12.7 million

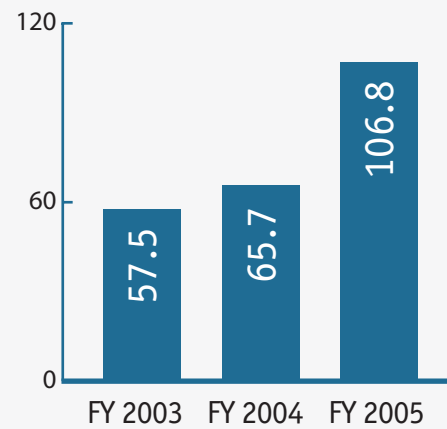
**Assets**

\$1,114.8 million

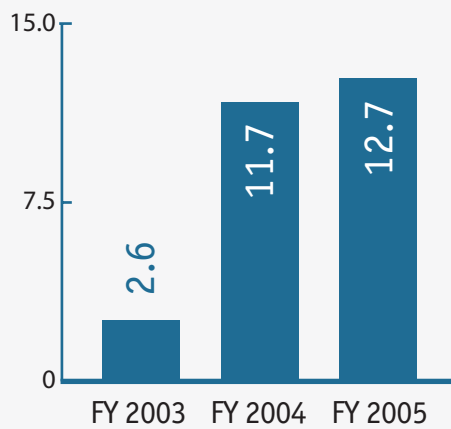
**Employees<sup>1</sup>**

1,585

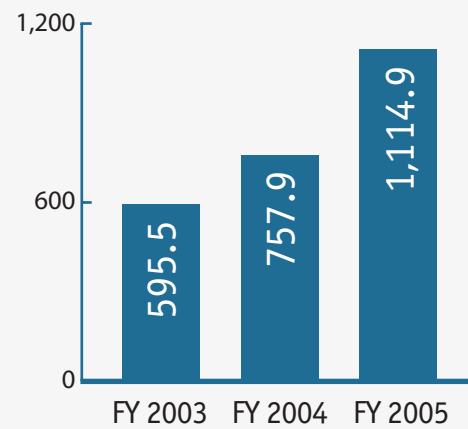
## Revenues



## Operating Income



## Assets

<sup>1</sup> As of August 1, 2006



**Mikhail Dunaev**

CEO, Sistema Mass Media

## DYNAMIC

In 2005, revenues from the Media business area grew by 45%.

## FOCUS OF THE YEAR

In 2005, Sistema Mass Media took the leading position in the Russian market for pay TV.

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The film *Match Point*, produced by Thema Productions in 2005, was nominated for an Oscar.

## MEDIA

### Marketplace

Today, the corporation's Media business segment area operates in the pay TV and multi-media services sectors, including cable television. This is a new and fast-developing market in Russia. The total volume of the pay TV market was estimated in May 2006 to be 4.6 million households. During 2005, this number was estimated at 2.5 to 3.0 million households, with a market volume of \$300 million per year. Pay TV penetration is 8.8% of the population, compared to the Central and Eastern European average of 65%.

Cable television operators and content providers have forecast that the Russian cable television market will grow by more than 30% per year. Today, the market is segmented in the following manner. A number of cable operators are "Social Package" providers linked to municipal TV networks and providing only a basic package of five to 15 channels and average revenue per user (ARPU) of only around \$1 per month. Commercial providers offer a "Basic Package" of 20-60 channels and have ARPU of \$3.5 per month. There is the potential for growing ARPU in this segment closer to the average Central and Eastern European level of \$10.5 per month. Russian premium providers are aiming for ARPU levels of \$25.0 per month. Against the background of sustained growth in the Moscow market, regional markets are also showing significant growth in demand for cable and satellite television with a wide choice of channels and services.

### Business

The corporation manages its media businesses through the Sistema Mass Media (SMM) holding company. Until 2005, SMM was active in advertising and print distribution, and was also engaged in publishing, film production and news services. In 2005, in accordance with the strategy of asset restructuring, a number of low margin businesses were sold. The decision was made to focus primarily on high-revenue, high technology areas in the media business, such as the development of infrastructure and content for pay-TV and multi-media services.

SMM is not confining its distribution and content operations to the Moscow market. At the end of 2005 and early 2006, the holding acquired the regional operators United Cable Networks (UCN) and Regional Cable Networks (RCN). These acquisitions made SMM the leader in the Russian market for regional cable television.

In 2005, SMM also entered the segment for mobile television with the acquisition of 74.0% of the company Tsifrovoe Teleradioveshanie (Digital Television and Radio Broadcasting). Mobile television is still a market in the early stages of development, both in Russia and globally. Nonetheless, it offers potential for synergies between Sistema's Media and Telecommunications business segments.

One of SMM's key areas of development is film production. SMM owns a 75% stake in Thema Production, which produces films for the international market that feature internationally acclaimed actors.

Sistema also owns an advertising and public relations agency called Maxima. Russia's advertising market has been one of the fastest growing in the world in recent years. The corporation continues to study the possibilities for expanding its business into other fast-growth media market segments.

### Results

Consolidated revenues from the Media business area grew by 44.8% to \$52.4 million in 2005, compared to \$36.2 million in 2004. Operating income was \$7.1 million in 2005, compared to an operat-

## Businesses

ing loss of \$0.9 million in 2004. Revenue growth was driven primarily by the addition of the newly acquired regional cable networks.

During 2005, Sistema undertook a wide-scale asset restructuring in the business area. The corporation conducted a range of deals for the sale of a number of print and distribution assets, including Nasha Pressa, Stolichnaya Pressa, Concern Radio Center, Credo Service and Gloros Stolitsa. The acquisition of the Esta cable television business and CTV, a digital television broadcasting company, contributed \$7.2 million to the Media segment's revenue. Esta brought SMM 217,000 cable subscribers in three Russian regions. Its business includes 40,000 Moscow pay TV subscribers under the Kosmos-TV brand.

In May 2005, Sistema launched STREAM-TV, the first ADSL-based in-house entertainment offering ever launched in Russia. The STREAM-TV package offers customers access to over 80 Russian and international television channels, four specialty channels (Drive, Hunting and Fishing, Health and Wellbeing and Retro), pay-per-view and video-on-demand services as well as internet, networked games and digital radio. The company has made a range of subscription options available starting at \$9.95 per month, with the flexibility to add new channels individually or in packages for time periods ranging from a day to a month. This flexibility, along with the option for consumers to pay for the equipment package upfront or by installment plan over three years, makes STREAM-TV attractive to millions of Russian consumers seeking digital multimedia content. It creates scope for ARPU growth by allowing consumers to add content on a flexible basis.

STREAM-TV is a joint project between SMM and Comstar-UTS, Sistema's primary fixed-line telecommunications business. It demonstrates the scope for synergized brands across the corporation. SMM's focus in 2005 on fast-growth segments demonstrates the ability of Sistema to effectively restructure assets. Acquisitions in the Media business area have enabled SMM to build a market-leading business in the Pay-TV sector in Russia.

**Key Figures**

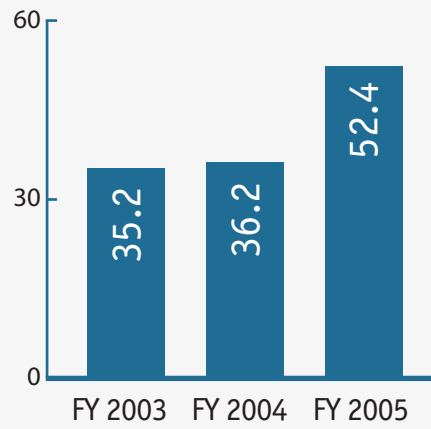
**Revenues**  
\$52.4 million

**Operating Income**  
\$7.1 million

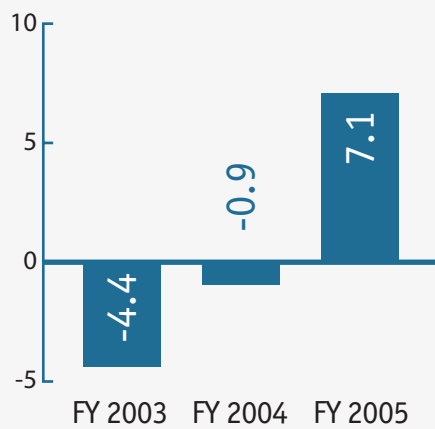
**Assets**  
\$81.9 million

**Employees<sup>1</sup>**  
1,657

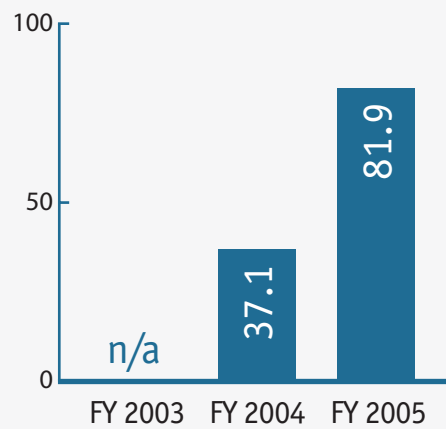
**Revenues**



**Operating Income**



**Assets**



<sup>1</sup> As of August 1, 2006



**Alexander Arutyunov**

President, Intourist

## **DYNAMIC**

Assets in the Tourism business area grew by more than 3.5 times to \$90.27 million in 2005.

## **FOCUS OF THE YEAR**

In 2005 Intourist moved forward in its goal to become a universal tour operator.

The acquisition of Megapolyus Aviacharter has expanded the capability of Intourist to provide logistics and transport services.

## TOURISM

Tourism

### Marketplace

Sistema is represented in the tourism market by Intourist. The company conducts its activity across the tourist business: the organization of overseas tours for Russian citizens, the reception of foreign tourists and domestic tourism within Russia. While related, each segment is subject to its own development dynamic. Overall, the tourism industry in Russia continues to boom. Expert forecasts suggest the value of the market will grow at an average annual rate of 15% annually through 2010.

Growth in per capita disposable income is a major factor encouraging Russians to travel domestically and abroad. Competition on domestic airline routes has made domestic travel both more affordable and flexible, and has influenced the price of travel on Russia's railways as well. World class hotels and resorts are being built in traditional domestic destinations such as the Black Sea coast. For Russians traveling abroad, the number of tour operators has multiplied in recent years, offering greater choice and price competition.

At the same time, Russia's political and economical stability has encouraged inbound tourism attracted by Russia's rich historical and cultural legacy. Still, the growth in inbound tourism has been limited by a lack of modern tourism infrastructure, such as international quality hotels, in many Russian regions. In Russia's most modern cities and popular destinations, Moscow and St Petersburg, a number of hotels in the mid-market segment have been closed in the last few years. A very limited supply of rooms has led to a rise in prices. Despite these challenges, the inbound segment grew on average by 19% between 2001 and 2004. A new tourist infrastructure development plan has been put into place by the Russian government and the country has stepped up international campaigns promoting tourism in the country.

### Business

Intourist was founded in 1929. In Soviet times, it was the monopoly provider of tourist services. In 1992, the assets of Intourist were restructured, which resulted in the company retaining only its international and domestic tour operators. All of the other assets, including hotels and tour buses, were put under the control of the Russian government.

Today, Intourist aims to turn the company into a universal operator on the tourist market, offering clients a full range of services. The activity of the company comprises three key areas. The first is tour operating services, including both inbound and outbound tourism, and corporate services. Intourist serves more than 400,000 foreign and Russian tourists annually and is actively developing a network of tour product sales offices. Currently, the company has six affiliate companies overseas, 15 sales offices in Moscow, 46 affiliate companies in Russia's regions and 25 franchised agencies. In the future, these numbers will continue to grow.

A second key area is the hotel business. The development of a hotel network in Russia and abroad is being managed by the Intourist Hotel Group. This company is acquiring and taking over management of hotels across the country. This is part of fulfilling a strategic goal set by the shareholders. The hotel segment will develop as an independent business area within the framework of Intourist.

The third area is transportation services. Auto transportation is operated by the company Inturautoservice. Charter programs are operated by the company Megapolyus Aviacharter, which was acquired at the end of 2005. Each of these areas has considerable growth potential.



## Businesses

In an environment of ever increasing competition, the company stands out by offering the highest level of service. At the same time, Intourist strives to maintain the highest standards of financial and operational transparency.

In 2005, Sistema undertook the restructuring of Intourist with the goal of consolidating ownership and creating an efficient, vertically integrated structure. In January 2005, Intourist announced issue of new stock to its existing shareholders. The Moscow City Government purchased the first tranche of 3,120,516,875 shares in exchange for a 40% stake in Kosmos Hotel, a 1,000-room hotel complex situated in Moscow, with a fair value of the contributed ownership interest of \$20.1 million. In April 2005, Sistema paid the equivalent of \$47.7 million for the remaining 6,961,052,632 additional shares of Intourist.

Sistema and its affiliated companies control over 71.58% of the Group. GAO Moskva, the second principal shareholder, is owned by the Moscow City Government and is focused on the development of Moscow hospitality infrastructure, including hotels and historic places.

### Results

Intourist served 421,000 clients in 2005. The group posted 1.5% revenue growth in 2005, with revenues growing to \$98.04 million in 2005 compared to \$96.59 million in 2004. The slowing in revenue growth was due to a 4% reduction in revenues from the domestic tourism area. The outbound segment, by contrast, grew by 5%.

During 2005, Intourist underwent a significant restructuring program aimed at improving its manageability and increasing the efficiency of its activity. A number of unprofitable regional operating offices were closed. This restructuring work continues in 2006. It is planned that over 40 regional subsidiary structures will be converted into affiliates.

Intourist won a tender in 2005 to provide travel services for the Russian-Arab Business Union. It also received recognition in 2005 of its efforts to increase its product offerings and strengthen its brand. The independent international firm Superbrands Ltd awarded Intourist the status "Superbrand of the Russian Consumer Market." The Moscow City Committee for Tourism named Intourist a "Travel Star" for its "Invaluable Contribution to the Development of Tourism in Moscow and Russia and High Quality of Service."

The group has put in place a three-year development plan aimed at both modernizing and expanding its network of sales offices to 500 offices by 2008. New IT systems are also being deployed to integrate into a single information space the sales network and regional offices with the Head Office. As the mid-range hotel category is expected to see the strongest growth in the next five years, Intourist aims to acquire and manage a number of hotels in key markets including Moscow, St Petersburg, the Black Sea coast, the Crimea and other key destinations, with the aim of achieving a 15% market share in the three-star plus category of hotels.

### Key Figures

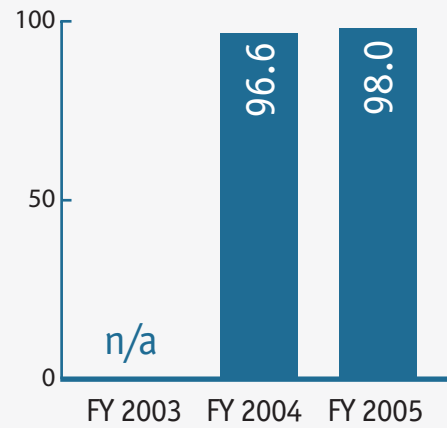
**Revenues**  
\$98.0 million

**Operating Income**  
\$1.3 million

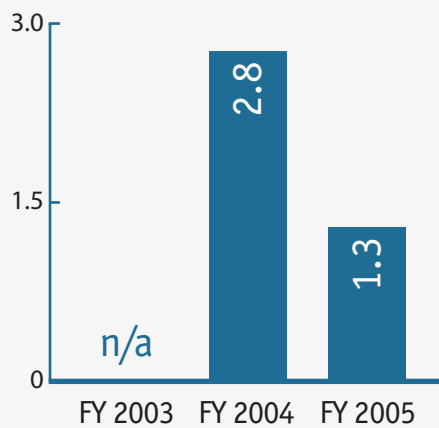
**Assets**  
\$90.7 million

**Employees<sup>1</sup>**  
3,300

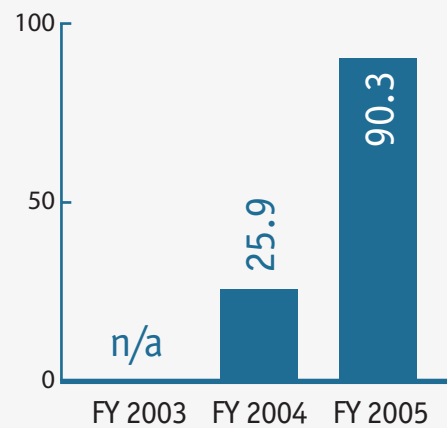
### Revenues



### Operating Income



### Assets



<sup>1</sup> As of August 1, 2006

Businesses



**Sergey Boev**

CEO, RTI Systems

## DYNAMIC

Revenues grew by more than 330% year-on-year to \$124.2 million in 2005.

## FOCUS OF THE YEAR

The company expanded its product range, with the ability to provide complex, high-value turn-key systems that maintain national security, such as radar systems.

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New acquisitions strengthened the position of RTI Systems in key segments of the market.

## RADIO AND SPACE TECHNOLOGY

### Marketplace

Sistema's radio and space technology division includes RTI Systems and its subsidiaries. The company carries out the design and production of radars and radar systems, aerospace control systems and power equipment building.

In the area of radio equipment, the primary customer for the company is the Ministry of Defense of the Russian Federation. The volume of government defense contracts was approximately 215 billion rubles (\$7.7 billion) in 2005. 50% of the budget (around \$3.9 billion) went to the creation of new equipment (R&D). Around 4.2% of the general R&D budget (\$160 million) consists of the market for long-range radar systems. The RTI Systems occupies 90% of this sub-segment and is the undisputed leader in Russia. The market for long-range radar between 2005 and 2008 will grow by 38% as government policy in the area of defense is directed at creating new radar complexes. Therefore, the leading position in this segment will allow the company to maintain a strong organic growth rate.

The market for short-range systems, where the company is also successfully advancing its products, makes up around 6.5% of the total R&D budget or \$250 million and is dynamically developing. This market will grow by approximately 20% between 2005 and 2008. The company's main goal in the near-term is to significantly expand its presence in the short-range radar segment.

In the second half of 2005, a new division was formed, Aerospace and Terrestrial Control Systems, within the company. The domestic market for these products is around \$3.0 billion and the sub-segments in which the company operates occupy around 14.3% of this market (approximately \$430 to \$450 million). The main factor for growth in these sub-segments is high domestic demand and strong export potential. In the period of 2005 to 2008, growth is estimated at approximately 46%. The main goal of the company in the next few years is to expand its presence in the domestic and overseas markets. This appears fully realizable, and in the beginning of 2005 yet another major player, DMZ-Kamov, joined the division.

The formation of the Power Equipment Building division began in the first quarter of 2006 after the acquisition of UralElektro. The company entered the relatively small market for equipment, which has volumes of approximately \$430 million. The main goal in the next few years is to complete the formation of this division and then enter the market for large systems projects in this sector of the economy, which is expected to see growth to more than \$8 billion.

The volume of defense exports, according to FinAm, amounted to \$6.126 billion in 2005, the large majority of which (85%, or \$5.2 billion) was attributable to the state-run Rosobonexport. RTI's exports were \$15.1 million. Today, the export portfolio of the company has contracts worth \$26.0 million.

### Business

RTI Systems and its subsidiary companies bring together leading Russian enterprises with strong track records in management of large-scale projects in the high-technology sphere and considerable research and production potential.

As part of Sistema's strategy of consolidating and restructuring assets, Sistema has combined a number of subsidiary businesses into RTI Systems to create a market leader in the fast-growing radio and aerospace technology market segments. The three main business areas were formed in 2005 and in 2006 RTI's main business areas will be restructured along a clear divisional structure.

## Businesses

During 2005, a number of subsidiaries were added to RTI as the corporation's main holding in this business area. These included Yaroslavksy Radio Factory, MTU Saturn and Defense Construction Bureau Planeta. These enterprises substantially strengthen the position of RTI in the market for space and terrestrial control systems.

Acquisitions and consolidation have allowed RTI to significantly expand its product line. It is now able to offer satellite and aviation communications systems and rescue and recovery devices. RTI is able to offer "turn-key" systems for creating specialized satellite communications networks and is developing similar radar stations that are already functional upon leaving the factory. Preliminary testing of these systems began in December 2005.

### Results

Revenues in the Radio and Space Technology segment grew more than three-fold in 2005 to \$124.2 million, from \$37.1 million in 2004. OIBDA in the business grew nearly four-fold to \$10.7 million year-on-year.

RTI Systems and its subsidiaries were successful in a number of high-profile tenders in 2005. In June 2005, RTI Systems won the open competition for the supply and installation of satellite communications equipment held by the Ministry of Finance of the Republic of Sakha (Yakutiya) and in December 2005 the project was put into operation.

In October 2005, as part of the IX International Exhibition Interpolytech 2005, RTI's subsidiary Yaroslavksy Radio Factory was named a laureate in the "National Security" category for its portable KVARTs-N radio location equipment. The KVARTs-N is a civilian version of the popular P-168-1K and is designed to function in urban areas. The device received a high evaluation from President Vladimir Putin for its results in test conditions.

In March 2006, after the reporting period, Concern RTI purchased a 50% plus one share in UralEleketro and 100% share in UralElektro-K for \$5.4 million. Both companies are producers of electronic equipment and the acquisitions further bolster RTI's competitive edge in the market.

**Financial Highlights****Revenues**

\$124.2 million

**Operating Income**

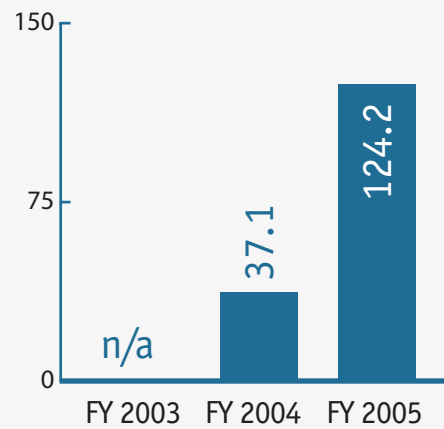
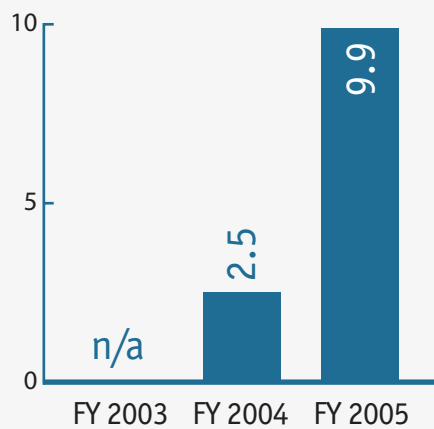
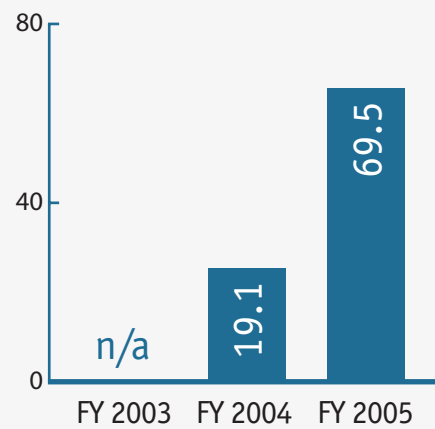
\$9.8 million

**Assets**

\$69,5 million

**Employees<sup>1</sup>**

7,458

**Revenues****Operating Income****Assets**<sup>1</sup> As of August 1, 2006

## OTHER BUSINESS AREAS

In addition to its core business areas, Sistema maintains a small number of other companies in fast-growing areas of the economy. These companies represent investments in areas with long-term promise or that can serve short- to medium-term financial investments that permit the corporation to increase shareholder capital. These businesses do not occupy a large portion of management time or financial resources.

### Medsi

Sistema manages its medical services business through Medsi and Medsi-P. Medsi provides ambulatory and primary care services to patients over 15-years-old while Medsi-P specializes in pediatrics. Medsi is a full-service medical center for providing diagnostics and ambulatory care. In addition, the center provides specialist care in its dedicated Diabetes Center, 40-plus Health Center and the Center for Extracorporeal Healing.

MEDSI Ltd's key areas of business in 2005 included participation in the voluntary medical insurance sector in Moscow, provision of medical services at Moscow hotels through a network of mini-clinics, medical screening and vaccinations at Moscow enterprises, medical services through direct contract with businesses and individuals and the sale of medicines through the center's pharmacy. During the year, MEDSI cared for 21,338 patients and provided 761,600 services.

MEDSI-P began opened in May 2005 and is located in a separate building in the center of Moscow. It meets the very latest world standards for a medical care institution. The center has more than 120 doctors in eight departments. A Scientific Committee, composed of leading researchers and academics from the Russian Academy of Medical Sciences, oversees research work on current pediatric issues and has introduced of the latest methods in preventive treatments and pediatric care. In 2005, MEDSI-P cared for 3,250 patients and provided 32,842 services.

### Binnofarm

Binnofarm was created in March 2006 when Sistema decided to create a single holding for its pharmaceutical and biotechnology assets. During 2005, the business was run through two main subsidiaries, Medical-Technological Holdings (MTH) and NPO Orgsintez-1. The business segment was also involved in equipping hospitals under construction in Moscow with medical equipment. Alexander Bakhutashvili was named head of the new Binnofarm pharmaceutical holding and brings a wide range of experience across the industry, from R&D and marketing of new medicines to branded generics to wholesale trade in medicines.

In 2005, MTH began the first industrial production of a vaccine for hepatitis B. The company completed clinical testing and registered a children's form of the vaccine. Presently, MTH is one of the only enterprises in Russia conducting full-cycle vaccine production from substance to final form product. Some 250,000 doses were produced during the year and MTH became a full-fledged biotechnology company. In addition, MTH produced three million doses of medicines in ampoule form, including nitroglycerin, polioxides, cyclopheron and thymodepressin. The company began to implement plans to expand the nomenclature of immunobiological medicines produced, which it sees as the basis for its development in the future.

In 2005, Orgsintez-1 completed a production plan developed on the basis of a state tender agreement to make central nervous system analgesics, including promedol and fentanyl. The company also conducted work to expand the portfolio of these medicines.

Binnofarm's plans include the launch of new, Good Manufacturing Practice compliant production facilities for making medicines in various forms, including aerosols, injected forms, hard forms, infusions and bio-generics. The holding is working to expand its product portfolio, creation of new trademarks and deployment of a national network of medical representatives. R&D will be focused on developing new medicines. M&A activities will focus on obtaining intellectual property, research skills and creating cost synergies.

### Financial Investments

In August 2005, Sistema acquired minority shareholdings in six raw oil processing and oil extracting companies located in the Russian Republic of Bashkortostan. Later, the corporation increased its shareholdings in these assets. The total acquisition costs were around \$600 million. The acquisition of the shareholdings does not represent any change in Sistema's strategic focus on core business areas involving Russia's consumer sector. Rather, the corporation views the acquisitions as an opportunity to invest shareholder's funds for the short- to medium-term while waiting for M&A deals to boost its key businesses. One example is future participation in the privatization of the state fixed-line operator Svyazinvest.

As of the end of 2005, Sistema had 20.77% of the charter capital of oil extracting company Bashneft (amounting to 25% of the voting shares). It has a 25.62% stake of the charter capital of Novoil (28.17% of the voting shares), 18.19% of the charter capital of Ufaneftekhim (22.43% of the voting shares) and 22.46% of the charter capital of Ufimskiy NPZ (25.5% of the voting shares), all of which are oil processing companies. In addition, Sistema had acquired 17.21% of the charter capital of Bashkirnefteprodukt (18.57% of the voting shares), a company involved in the retail sale of oil products, and 21.53% of the charter capital (24.87% of the voting shares) of oil chemicals company Ufaorgsintez.

The companies occupy a leading position in the oil-energy market in the region. They operate across the production chain, from oil extraction to oil chemicals. The combined assets represent the third-largest player in the Russian market for oil processing. The shares of all of the companies are quoted and traded on the Russian Trading System. The shares were acquired from Bashkirskiy Capital, which currently owns controlling shareholdings in all of the companies. Bashkirskiy Capital approached Sistema with the offer to purchase the shareholding in order to make use of the corporation's long-standing experience in restructuring businesses.

Sistema's experts are working with Bashkirskiy Capital to create a transparent, vertically integrated holding with the goal of maximizing the shareholder value of each company and the holding as a whole. The restructuring will include the introduction of international best practice in corporate governance and financial management and reporting.

Sistema's management believes that participation in these companies provides the corporation with the ability to make efficient use of shareholder funds, and to benefit from additional revenue from the dynamic development of the oil sector.



## CONTACTS

### **Sistema Joint-Stock Financial Corporation**

Andre Bliznyuk  
Head of Capital Markets  
Phone: +7 (495) 730 1543  
bliznyuk@sistema.ru

Irina Potekhina  
Head of PR  
Phone: +7 (495) 730 7188  
potekhina@sistema.ru

10 Leontievsky Pereulok  
125009 Moscow, Russia  
Phone: +7 (495) 629 0600  
Fax: +7 (495) 232 3391  
www.sistema.com



