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# About Sistema

Sistema is the largest diversified consumer services corporation in Russia and the CIS. Since its founding in 1993, Sistema has been growing a portfolio of market-leading businesses in the consumer and high technology areas. Companies controlled by Sistema serve more than 80 million consumers in Russia, the CIS, and across Europe.

The Corporation focuses on the development of advanced technologies both to maximize long-term returns for its shareholders and to make a significant contribution to the economic development of Russia and the other markets where it operates.

Following Sistema's IPO in February 2005, 19% of its shares are now traded on the London Stock Exchange in the form of global depository receipts (GDRs) under the ticker 'SSA'. Sistema is also listed on the Moscow Stock Exchange under the ticker 'SIST', on the Moscow Interbank Currency Exchange (MICEX) under the ticker 'AFKC', and on the Russian Trading System under the ticker 'AFKS'.

Sistema's businesses are divided into two key areas: its core businesses, in which the companies are established market leaders, and high-potential businesses, in which the subsidiaries are seeking to establish the long-term market leadership in emerging consumer market segments. Sistema's core businesses are Telecommunications, High Technology, and Real Estate Development. Its high-potential businesses are Retail, Finance, Media, Travel and Healthcare.

Sistema also maintains a portfolio of other businesses, including Radar and Space and Pharmaceuticals, as well as financial investments in the Petrochemicals area.

## KEY BUSINESSES

---

### TELECOMMUNICATIONS

MTS, COMSTAR UTS, MTT, SKYLINK

### TECHNOLOGY

SITRONICS

### REAL ESTATE DEVELOPMENT

SISTEMA-HALS

### RETAIL

DETSKY MIR

### FINANCIAL SERVICES

MBRD

### MEDIA

SISTEMA MASS MEDIA

### TRAVEL

INTOURIST

### RADAR and SPACE

RTI SYSTEMS

### HEALTHCARE

MEDSI

## OTHER BUSINESSES

---

### PHARMACEUTICALS

BINNOFARM

### CONVERGENT SERVICES

TS-RETAIL

### PETROCHEMICALS

BASHNEFT, NOVOIL, UFANEFTEKHIM,  
UFIMSKIY NPZ, BASHKIRNEFTEPRODUKT,  
UFAORGSINTEZ

### ENTERTAINMENT

RWS

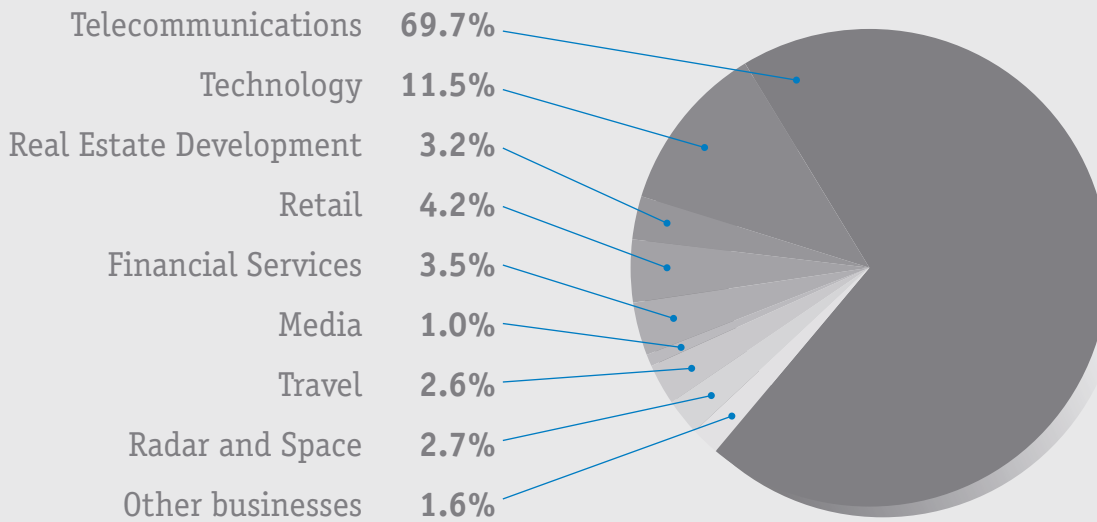
# Financial Highlights

	Revenue (\$, mln)	OIBDA <sup>1</sup> (\$, mln)	OIBDA margin	Net income (\$, mln)
2007	<b>13,701.0</b>	<b>5,050.4</b>	<b>36.9%</b>	<b>1,571.9</b>
2006	10,266.6	3,977.1	38.7%	813.0
2005	7,593.5	2,982.0	38.9%	534.4

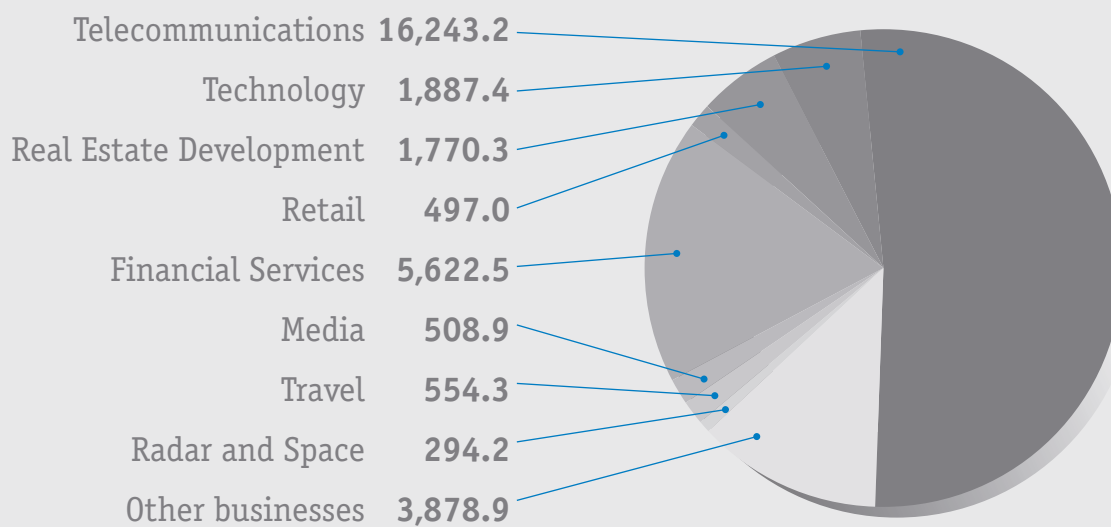
	Assets (\$, mln)	Shareholders' equity (\$, mln)	Earnings per share (\$)
2007	<b>28,396.7</b>	<b>6,658.8</b>	<b>16.88</b>
2006	20,191.2	4,505.1	8.50
2005	13,090.9	3,233.0	5.64

<sup>1</sup> OIBDA is defined as operating income before depreciation and amortization.

## Revenue by Business



## Assets by Business (\$, mln)<sup>2</sup>



<sup>2</sup> Before intersegment eliminations



Vladimir Evtushenkov

The Chairman of the Board of Directors, Sistema

# Letter from the Chairman of the Board of Directors

riding the consumer wave

One year ago, when delivering the results and the operational goals of our Corporation's development, we outlined our strategy of "new shoots of growth" as the primary factor for the future growth in capitalization. Today we proudly note that this strategy was justified and is already showing results.

We emphasized entrance into promising new territories and markets as one of our most important "shoots of growth." In 2007 Sistema was the first private Russian company to open a representative office in India. We have taken the first steps in integrating the Company into India's fast-growing and investment-friendly economy, including the purchase of a controlling stake in a national telecommunications company Shyam Telelink, receiving the necessary licenses and beginning construction of a pan-Indian network for a universal operator. In the near term, we plan on developing our Real Estate, Financial Services and Technology businesses in India, where we anticipate profitable and effective cooperation with our Indian colleagues.

Our partnership with Chinese business is no less important. This year, we have already started to implement a partnership agreement between the Russian concern Sitronics and the Chinese company ZTE, signed in the presence of both states' leaders, and this is opening new conceptual possibilities for our Corporation.

The Russian, Indian, and Chinese markets have many factors in common, including the unprecedented growth in the population's prosperity, the rapid assimilation of innovative financial tools and the high priority placed on a large-scale infrastructure transformation. These factors give our countries the extraordinary chance to implement modern, highly-effective developments that benefit all participants of this process. And we are simply obligated to take advantage of this.

These same factors allow us to implement the "new shoots of growth" strategy in another direction that we announced last year: gaining a leadership position in fast-growing consumer markets. Throughout last year, we actively invested in the development of our Retail, Pharmaceutical, Travel and Financial Services businesses. We have achieved significant success in each of these.

The consumer boom that will, according to experts, last for a minimum of five more years provides the optimal scenario to further develop our already mature telecommunications divisions. Our near-term goal is to create a single multi-profile telecommunications group on a united technological and management platform in order to provide our customers with the most modern, user-friendly, and cost-effective services. We will continue our

drive to integrate services for our consumers, that will in the future remove the line between telecommunications and multimedia services.

Our development prospects also depend on one other key "shoot of growth": partnership with the state. Our mutual interests have become virtually inseparable and this level of cooperation is necessary in order to create legitimate highly-competitive pioneering branches of the Russian economy. Sistema already participates in a whole series of promising projects together with the state. Russia was introduced to the global hi-tech market with the opening of our production facility in Zelenograd that produces 0.13-0.18-micron microchips, and is now one of a family of countries that possesses that technology. The decision made last year to build a nanotechnology company together with the government will also allow us to develop new and unique products and market niches.

It is our belief that promising, fast-growing economic sectors can only emerge from a base of innovation. And it is these sectors that can become the foundation of technological leadership in Russia.

We are grateful to everyone who worked together with us to create the "new shoots of growth" in 2007, including our employees, partners, investors, and shareholders. We are confident that the strategy that we have chosen will validate itself in the future. And we look forward to sharing the results of this work with you.



Alexander Goncharuk

President and Chief Executive Officer, Sistema

## Letter from the President

riding the consumer wave



For Sistema, last year was the beginning of a new step in our business development. On one hand, the series of successful IPOs was a singular result of our long-term effort to create value at the Corporation. On the other hand, it created the need to search for new paths that will lead to future increases in capitalization without lowering our rate of growth. We chose the "new shoots of growth" strategy to utilize the structure of our portfolio, which consists of primarily service assets, the positive economic environment, and growing consumer activity. Nonetheless, a large, ambitious task was placed before Sistema's management: we wanted to not just harness the energy of the consumer wave, but to move forward at a rate that outstripped the market.

We were able to do this in the majority of the branches where we operate. Active investment and increased management effectiveness allowed us to develop confidently and consistently.

The Corporation's consolidated revenues grew by 33.5% in 2007 from the year before and reached \$13.7 billion.

Net profit nearly doubled to \$1.6 billion.

The value of our assets grew by 40.6% to \$28.4 billion.

In spite of extremely conservative estimates, good growth rates protected our main telecommunications asset, Mobile TeleSystems. By the end of 2007, the number of MTS subscribers reached 82 million. However, even more telling was the steady growth in two key consumer indicators: ARPU (average revenue per user) reached \$10 and MOU (minutes of use) grew to 187 minutes a month. This led to a 30.8% growth in OIBDA in 2007, to \$4,223.4 million.

Our new strategy led to positive results and the rapid development of our telecommunications company Comstar UTS. In Moscow, our subscriber base grew by 81% on the year, and the number of pay-TV subscribers grew by 47%. This tendency was clearly visible in the company's financial indicators, and OIBDA grew by 80.9% to \$662.8 million.

The growth in the Russian microelectronics market, which grew at twice the rate of world markets last year, positively affected the financial results of our high-tech business Sitronics. Even though the company's earnings stayed at the same level as the year before, the new management team signed a series of new contracts that will create opportunities for a future growth spurt.

Sistema-Hals earnings grew by more than 50%, to \$452.2 million.

We took particular effort last year to concentrate on the development of our non-public assets that we expect to become our leading "shoots of growth."

Our Financial Services business witnessed a 114% increase in earnings last year. The Russian financial industry on the whole grew by one-third over the same period. By the end of 2007, the bank's retail chain had 166 branches in 34 Russian regions.

The Detsky Mir group, which is the largest children's goods retailer in Russia, grew nearly four times faster than the market. In spite of stiffening competition, this division's OIBDA nearly doubled last year, and the chain of stores went national, growing to 100 outlets in 48 cities by May of 2008.

Nearly 900,000 clients chose to use our travel business Intourist last year, compared to 600,000 clients in 2006. Furthermore, earnings increased by a third.

But, of all our businesses, our healthcare business enjoyed the highest growth rates in 2007, with its earnings growing by a factor of nearly three and its OIBDA doubling. Thanks to successful M&A activities, the total number of medical centers in Moscow and other Russian regions reached 26.

We are confident that the strategy of "new shoots of growth," which we successfully began in 2007, will continue into the future. Sistema's management will do everything possible to ensure that the Corporation's shareholders and investors will not be disappointed.

# Strategy

## Investing in Growth

In 2007 the Board of Directors approved the principles of the portfolio strategy proposed by the management. These principles call for an increase of the share of privately-held businesses in the portfolio. Following this decision of the Board, Sistema initiated several investment projects and M&A transactions in its fast-growing businesses of Financial Services, Retail, Media, Healthcare, and Travel.

Sistema was active in sourcing and taking advantage of new investment opportunities. We acquired control in Indian mobile and fixed-line operator Shyam Telelink with the goal of entering the rapidly growing Indian telecommunications market. Sistema will bring its Russian and CIS telecommunications expertise to transform Shyam Telelink into a leading pan-Indian communications provider.

The Corporation is developing its business relationships with the Russian state and is now seen as a reliable private-sector partner capable of providing competitive products and services. The new National Center for Crisis Management that Sistema's subsidiaries had built for the Russian Ministry of Emergency Situations in 2007 is one example of this partnership's potential.

## Active Management

Sistema is a strategic investor and the controlling shareholder of its core businesses. The Corporation sets targets for them, contributes to the development of their strategies, and monitors the strategy's implementation.

In 2007 the boards of Sistema's subsidiaries fixed an updated set of KPIs, the so-called Criteria Base. These KPIs steer the management towards shareholder value, creating growth, and at the same time target mid-term operational indicators, aiming to outperform the competition.

To complement the ambitious goals set before the management, we initiated a review of incentive and remuneration systems. In 2007 the boards of most companies introduced annual bonus programs linked to KPIs, as well as long-term stock option plans.

## Adding Value

Sistema's management believes that growing businesses within a diversified holding creates numerous opportunities to add value to the portfolio of the Corporation.

The holding structure in the relatively immature Russian economy helps raise financing at a corporate level on more attractive terms, launch joint projects of businesses and make the best use of cross-selling opportunities, and create and maintain a valuable corporate pool of top managers. Furthermore, as one of the leading Russian companies, Sistema can more effectively represent the interests of its businesses on national and international levels.

In 2007 Sistema raised \$500 million in debt financing to develop its Indian project and placed a 6-billion-ruble bond issue in March 2008 on very favorable terms, given the current market environment. We launched the Tochka project, a chain of all-in-one retail stores that offer goods and services from across the Corporation's areas of operations, including mobile and fixed-line communications, banking, travel services, and multimedia.

At the same time, Sistema made a series of senior level appointments in its businesses that included not only managers taken from the pool of internal candidates, but also those hired from other companies.

# Calendar of Events 2007

## January

Comstar UTS obtained licenses to provide IP voice and data traffic, including WiMAX services, in 20 Russian regions. The license gave the company an opportunity to develop a market for new-generation services, targeting both corporate clients and individuals.

Sistema-Hals announced that it signed a credit agreement with the bank Eurohypo AG to borrow \$187 million.

## February

Sistema announced that it acquired 0.48% of its own shares for \$347.3 million. The acquired shares will be used to create an options program for the Company's senior management, and may also be used for upcoming mergers and acquisitions.

Sitronics held its IPO on the London Stock Exchange, issuing global depository receipts.

Sistema sold a 46.19% stake in ROSNO to the German company Allianz. Sistema's stake in ROSNO was reduced to 3%, while Allianz's stake grew to 97%.

## March

Sistema-Hals was included in the Russian Industrial Leaders Index (RUXX), which foreign investors use as an indicator of the state of the Russian economy.

Comstar UTS announced that it obtained licenses to provide data transfer services in 8 Russian regions. In April the company obtained licenses for another 10 regions.

Sitronics and ZTE Corporation, China, signed a Memorandum of Understanding concerning the development of their partnership on the Russian, Chinese, and international telecommunications markets.

## April

Sistema acquired a 9.75% stake in Sitronics, increasing its share in the company to 60%. The deal was conducted under the framework of the current restructuring and planned consolidation of the Holding's assets, and was intended to optimize the structure of its company ownership.

## May

MBRD signed an agreement with Dresdner Bank that provided access to \$50 million over 2 years in the form of untied loans.

Sistema acquired 100% of American Hospital Group from ROSNO insurance group and 20% of Medexpress from ROSNO-MS insurance company. This strengthened the Company's position in the rapidly developing market for private healthcare services.

## June

The Medsi group of companies acquired 80% of Medexpress, one of the largest private chains of medical clinics in Russia.

MTS acquired 26% of its subsidiary Uzdurobita, increasing its stake in the company to 100%.

Sergei Pridantsev was named President of Comstar UTS. He had previously been the General Director of Center Telecom, one of Svyazinvest holding's largest subsidiaries.

## July

Sistema Telecom was incorporated into Sistema as a new business unit to manage the Company's telecommunications assets.

Sistema-Hals signed a credit agreement with VTB bank for financing worth \$500 million.

Sitronics founded Sitronics Nanotechnology to develop semiconductor nanotechnology.

Eldar Razroev was named General Director of Sistema Mass Media. Formerly, he was the General Director of Euroset, the largest mobile retailer in Russia.

## August

Sistema acquired 20% of Dalcombank, the largest bank in Russia's Far East. In October 2007 Sistema increased its stake in the bank to 48.16%.

Comstar UTS completed a deal to acquire 100% of the share capital of Sochitelecomservice, an alternative carrier in Sochi.

## September

Sistema's common shares began trading on the MICEX. On September 13, the shares were placed on the exchange's 'B' quotation list under the ticker 'AFKC'.

Sistema acquired 10% of Shyam Telelink Ltd, an Indian mobile and fixed-line operator, and signed an agreement for the option to purchase an additional 40%.

Sitronics placed its first ruble-denominated bonded loan. The placement was worth 3 billion rubles.

Sistema's shareholders approved common shares split. The share capital was divided into 9,650,000,000 common shares with a nominal value of 0.09 rubles each.

MTS acquired 80% of the share capital of International Cell Holding Ltd., the owner of K-Telecom, the largest mobile operator in Armenia.

## October

Sistema created a Healthcare business, ratifying the strategy of uniting all core assets into the Medsi group and opening a chain of 100 modern clinics by 2011.

Sergei Aslanian was named President of Sitronics. He had formerly served as Vice-President of Technology and IT at MTS.

## November

Nokia Siemens Networks and Sitronics signed an agreement for a strategic partnership in high technology.

Comstar UTS acquired a 87.5% stake in Regional Technical Center, an alternative fixed-line operator in the Khanti-Mansisk Autonomous District, Orenburg, and the Orenburg Oblast.

Sistema-Hals received \$200 million in credit from VTB bank to finance its current investment program.

## December

Comstar UTS and Intel signed an agreement for a strategic partnership to develop WiMAX technology in Russia.

Sistema launched a program of long-term bonuses for its employees. Up to 110 top and mid-level managers at the Corporation will participate.

Sitronics opened a production facility that produces 0.18 micron microchips. The total investment in the plant was \$200 million.

## Events after the Reporting Period

### January 2008

Shyam Telelink Ltd. received letters of guarantee that it would receive universal telecommunications licenses in 21 Indian states. The licenses give the operator the right to build a network and provide both fixed-line and mobile communications.

Sistema raised its stake in Shyam Telelink Ltd. to 51%.

Sistema acquired 50.5% of Dalkobank, raising its stake in the company to 98.85%.

Comstar UTS initiated construction of a network in Armenia for wireless broadband access based on WiMAX technology.

### February 2008

Detsky Mir Center and UniCredit Bank signed an agreement for \$20 million in credit with a three-year term. The funds will be used to finance the company's liquid assets.

Sistema opened an office in New Delhi. The office will represent all of the Corporation's businesses.

### March 2008

Sistema and Russian World Studios (RWS) signed a deal that created the largest film-making company in Russia on the base of RWS, with studios in Moscow, St. Petersburg and on Russia's Black Sea coast in Anapa. The new company represents a promising business unit for the Corporation.

Sistema placed a 6-billion-ruble bonded issue. The capital will be used in part to refinance the Company's existing debts and in part to realize the Company's investment program.

RTI Systems has completed the sale of 100% in CJSC Sahles to CJSC Saturn. CJSC Sahles owns a 71.63% stake in OJSC Perm Motors Plant, as well as controlling stakes in other entities which constitute the Perm Motors Group.

Comstar UTS launched a long-term incentive program for its management. 151 managers in the company and its subsidiaries are participating in the program, which covers 2008 to 2010.

# Financial Overview

The following section presents a brief overview of the company's financial results, according to US GAAP, for the year 2007. The operational and financial performance of each business is discussed in Part 2 of this annual report.

- Consolidated revenues up 33.5% year on year to \$13.7 billion
- OIBDA up 27.0% year on year to \$5.1 billion and OIBDA margin of 36.9%
- Operating income up 21.7% year on year to \$3.3 billion and operating margin of 23.9%
- Net income nearly doubled year on year to \$1.6 billion
- Total assets up 40.6% year on year to \$28.4 billion

(\$ millions)	FY 2007	FY 2006	Year-on-year change
Revenues	<b>13,701.0</b>	10,266.6	33.5%
OIBDA	<b>5,050.4</b>	3,977.1	27.0%
Operating income	<b>3,274.7</b>	2,691.2	21.7%
Net income	<b>1,571.9</b>	813.0 <sup>1</sup>	93.3%
Basic and diluted earnings per share (US cent)	<b>16.9</b>	8.5	98.7%

Sistema's consolidated revenues increased by 27.0% year on year in the fourth quarter, and by 33.5% year on year in 2007. Sistema's full year results reflected high levels of revenue growth in the Group's Financial Services, Retail, Real Estate Development, and Travel businesses, and strong performance of the Telecommunications area. Non-telecommunications businesses accounted for 32.2% of the Group consolidated revenues in the fourth quarter and 28.2% for the full year 2007, compared to 34.9% and 27.2% for the corresponding periods of 2006. The organic year-on-year and like-for-like growth was 29.9% for 2007, and amounted to \$3.1 billion, excluding businesses

acquired or divested since the end of the fourth quarter of 2006.

Group OIBDA increased by 48.5% year on year in the fourth quarter, and by 27.0% year on year for the full year 2007. The Group's OIBDA margin increased from 30.8% to 36.1% in the fourth quarter, as a result of the robust performance of MTS and the completion of certain projects in Sistema Hals. The Group's OIBDA margin slightly decreased from 38.7% to 36.9% for the full year 2007, primarily as a result of a \$155.7 million non-cash stock compensation expense to the employees of the Group in 2007. MTS demonstrated a sustained growth of 30.8% year on year in OIBDA in 2007 with an OIBDA margin of 51.2% as a result of the continued increase in usage and ARPU levels in its Russian operations. Comstar UTS's OIBDA increased by 80.9% for the full year 2007 with an OIBDA margin of 42.4% as a result of high consumer demand for MGTS's unlimited tariff plan for regulated residential voice services introduced in February 2007, as well as the revenue boost from fixed-to-mobile calls. Group OIBDA in 2007 was, however, adversely impacted by the operating losses in the Telecommunications Solutions and Consumer Services and Products division of Sitronics.

Group operating income was up 42.5% year on year in the fourth quarter, and by 21.7% year on year in 2007. The Group's operating margin was 22.1% in the fourth quarter, compared to 19.7% a year ago. The Group's operating margin amounted to 23.9% in 2007, compared to 26.2% in 2006.

Depreciation and amortization expense was up 59.0% year on year to \$570.3 million in the fourth quarter, and increased by 38.1% year on year to \$1,775.7 million for the full year 2007, following the 40.0% growth in the depreciable and amortizable assets of the Group.

Selling, general, and administrative expenses increased by 34.9% year on year to \$775.0 million in the fourth quarter and rose by 34.5% year on year to \$2,426.3 million for the full year 2007.

The effective tax rate was 29.4% for the full year 2007, compared to 29.0% for the year of 2006.

The net income nearly doubled year on year in 2007 as a result of the Group's strong operating performance and a \$521.9 million gain on the sale of ROSNO. The Group reported a 98.7% year on year increase in basic and diluted earnings per share from US cent 8.5 to US cent 16.9 for the full year 2007.

Net cash provided by operating activities decreased by 28.2% year on year million in the fourth quarter to

<sup>1</sup> Includes US\$ 170 million Bitel write-off by MTS in the fourth quarter of 2006, net of minority interests of US\$ 150 million.

\$538.3 mainly due to an increase in working capital. For the full year 2007 net cash provided by operating activities increased by 35.1% year on year to \$2,857.7 million as a result of the growth in the Group's operating profits.

Net cash used in investing activities totalled \$2,698.6 million in the fourth quarter and \$5,753.9 million for the full year 2007, and included \$1,578.0 million and \$3,110.9 million of capital expenditure, respectively, compared to \$673.6 million and \$2,386.4 million for the corresponding periods of 2006. The Group spent \$1,459.1 million on the acquisition of businesses during 2007, compared to \$631.4 million in 2006.

Cash flows from financing activities amounted to \$2,039.1 million in the fourth quarter and \$3,243.7 million in 2007, compared to \$1,085.4 million and \$3,289.4 million, respectively, for the corresponding periods of 2006. Major sources of financing in the fourth quarter included \$125.0 million loan signed by Sitronics with Dresdner Bank, \$345.0 million additional syndicated loan facilities obtained by MTS, \$158.4 million drawn down by Comstar UTS from the existing credit facility with Sberbank, \$155.5 million of commercial paper issued by Sistema-Hals, and \$200.0 million 5-year credit line obtained by Sistema-Hals from VTB.

The Group's cash balances increased to \$1,061.7 million as at December 31, 2007, compared to a balance of \$501.7 million as at December 31, 2006. The Group's net debt (short-term and long-term debt minus cash and cash equivalents) increased to \$7,423.0 million as at December 31, 2007, compared to \$6,370.6 million as at December 31, 2006.

In December 2007 Sistema launched a put option program on Sistema-Hals global depository receipts. According to the program, the options may be exercised in six months from the options purchase date. The total amount of the program is up to \$50 million.

In December 2007 Sistema announced the launch of the long-term incentive program for its employees. The program will encompass up to 110 top and mid-level managers of Sistema. Participants will be entitled to exercise the rights granted under all plans during the year following the expiration of a three-year period from the execution date of the agreement.

In October 2007 Moody's Investor Services upgraded the corporate ratings of Sistema from 'B1' to 'Ba3' with a positive outlook.

## Credit Ratings

Independent rating agencies consider a number of key factors in determining the financial stability of the Corporation and its subsidiaries, including total debt, current obligations, existing and future liquidity needs, and cash flow. Ratings can also be seen as an outside evaluation of the Corporation's overall strategy and its position versus its rivals in core businesses. Ratings take into account the corporate governance structures in place and protection for minority shareholders. In addition, ratings reflect overall market conditions, in particular the ratings assigned to Russia's sovereign borrowing, may be seen as a benchmark of overall country risk.

	Date assigned	Rating	Outlook
<b>Sistema</b>			
S&P	01/02/2007	BB-	Positive
Fitch	19/07/2007	BB-	Stable
Moody's	24/10/2007	Ba3	Positive
<b>MTS</b>			
S&P	01/02/2007	BB-	Positive
Moody's	09/10/2007	Ba2	Positive
Fitch	07/04/2008	BB+	Stable
<b>Comstar UTS</b>			
S&P	01/02/2007	BB-	Positive
Moody's	10/05/2007	Ba3	Stable
<b>MGTS</b>			
Moody's	19/01/2006	Ba3	Stable
S&P	01/02/2007	BB-	Positive
<b>Sitronics</b>			
Fitch	14/02/2006	B-	Stable
Moody's	16/02/2006	B3	Stable
<b>MBRD</b>			
Fitch	20/07/2007	B+	Stable
Moody's	24/01/2008	B1	Stable
<b>Sistema-Hals</b>			
Fitch	23/07/2007	B+	Stable
Moody's	23/07/2007	B1	Stable

# Shareholder Capital

## General Information on Shareholder Capital

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

A share issue was announced on November 6, 2007 that split the nominal value of the Company's ordinary shares by 1,000 times. After the share split on November 13, the number of outstanding shares increased to 9,650,000,000 ordinary shares, with a par value of RUR 0.09 per share. Sistema's share capital remained 868,500,000 rubles.

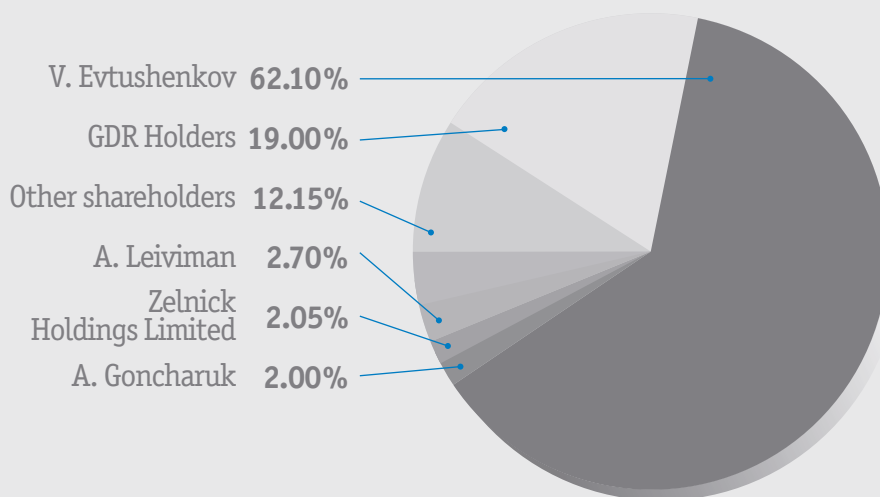
Sistema's shares are listed on the London Stock Exchange in the form of global depositary receipts (GDRs) under the symbol 'SSA'. One GDR represents 20 ordinary shares. Sistema's ordinary shares are traded on the Russian Trading System under the symbol 'AFKS', on the Moscow Interbank Currency Exchange (MICEX) under the ticker 'AFKC', and the Moscow Stock Exchange under the ticker 'SIST'.

## Shareholding Structure

As of December 31, 2007, Sistema had 22 entities and 12 individual shareholders, including 8 nominees. While the identities of its GDR holders are not generally reported to the Corporation, Sistema undertakes regular research to discover the identity of its GDR holders. Such research allows Sistema to provide as much information as possible to the largest number of shareholders and is aimed at increasing the Corporation's transparency and providing greater liquidity for its shares on Russian and international exchanges.

Between March 2006 and February 2007 Sistema purchased 284,243 of its own shares, equivalent to 2.95% of its outstanding shares, for approximately \$347.3 million dollars. This share buyback was conducted as part of a previously announced plan to establish a share option program for the Corporation's top management. These shares may also be used in future merger and acquisition activities.

Sistema Shareholders as of December 31, 2007



## Share Price Performance

Since February 2005, when Sistema completed an initial public offering on the London Stock Exchange (LSE), 19% of the Corporation's outstanding shares have been in free-float in the form of global depository receipts (GDRs). Sistema's GDRs are listed on the LSE under the ticker 'SSA'. After the November 2007 share split was completed, one GDR represents 20 ordinary shares.

Sistema's ordinary shares are traded on the Russian Trading System (RTS) under the ticker 'AFKS', the Moscow Stock Exchange (MSE) under the ticker 'SIST', and the Moscow Interbank Currency Exchange (MICEX) under the ticker 'AFKC'. Sistema's ordinary shares are a component of the MSE's technical index. On September 15, 2007, Sistema's ordinary shares were included in the list of stocks used to calculate the RTS Index.

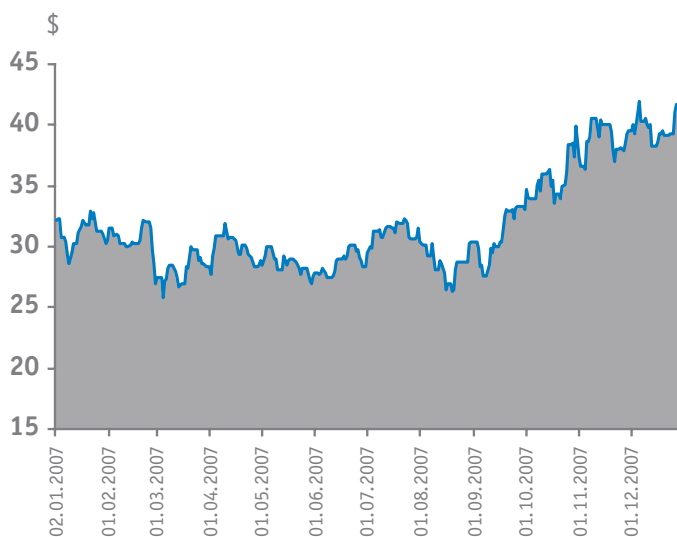
For the year 2007 as a whole, Sistema's GDR price on the LSE rose 29.7%, from \$32.20 on January 2, 2007 to \$41.75 on December 29, 2007 the last trading day of the year. The 12-month share price high (\$42.10) was hit on November 12. The yearly low (\$25.37) came on March 5. Price momentum was driven by positive news about the Company's activities, particularly the interim financial results. The growth in share price was also influenced by broader trends in the Russian economy such as GDP growth, the strengthening ruble and investor strategies linked to the desire to diversify into emerging markets.

Sistema encourages current and potential investors to seek independent expert financial advice when making decisions regarding the purchase and sale of shares. Sistema's equity shares, as well as its outstanding bond issues, are covered by analysts from a number of Russian and international brokerage houses. A list of these analysts, including contact details, is published on [www.sistema.com](http://www.sistema.com) and is regularly updated.

## Dividend Policy

Sistema's Board of Directors uses the Corporation's current dividend policy as established in April 2008 to make its dividend recommendation to the Annual General Meeting. Dividends are determined according to the previous year's financial performance, and the payout level can be up to 40% of the Corporation's consolidated net income under US GAAP. This policy aims to both provide for a predictable sizeable dividend flow and maintain a dividend history while simultaneously giving the opportunity to reinvest profits to meet Sistema's capital requirements in order to maintain sustainable growth.

At the Annual General Meeting on June 30, 2007, the shareholders approved a cash dividend of RUR 463,200,000, or RUR 48.0 per share. The total size of the dividend paid out as of December 31, 2007 was RUR 461,761,296, including RUR 14,437,012.80 that was taken as a tax on dividend income for foreign legal entities. The remaining RUR 1,438,704 had not been paid due to issues such as a lack of information about the banking information of the shareholders or the residential status of individuals.





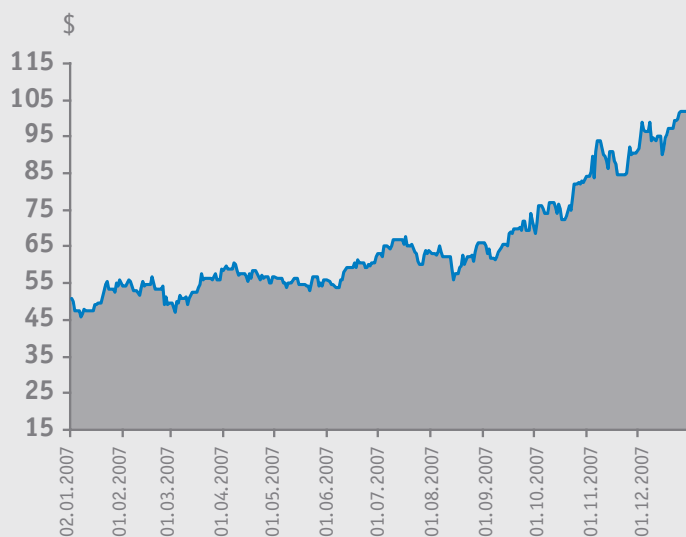
## Share Structure and Performance of Subsidiaries

### MTS

Mobile TeleSystems placed a Level III ADR issue through an IPO on the New York Stock Exchange (NYSE) on June 30, 2000. The current ADR to ordinary share ratio is 1:5, following a 1:4 ADR split in January 2005. MTS's major trading volumes are on the NYSE and trade under the symbol 'MBT'. MTS's shares are also traded on the RTS under the ticker 'MTSS' and as of March 17, 2008 had a relative weight of 0.67% on the RTS Index. Ordinary shares of MTS are included on the MICEX under the ticker 'MTSI'.

Currently the company has 1,993,326,138 ordinary shares with a nominal value of RUR 0.1 per share. As of December 31, 2007, Sistema owned 53% of MTS's shares and 46% of shares were in free-float.

MTS's ADR price closed at \$50.96 at the end of the first day of trading of 2007. The share price reached a high of \$102.12 on December 28, 2007, before closing at \$101.79 on the last day of trading of the year. As of December 31, 2007, the company's market capitalization was \$40.6 billion.

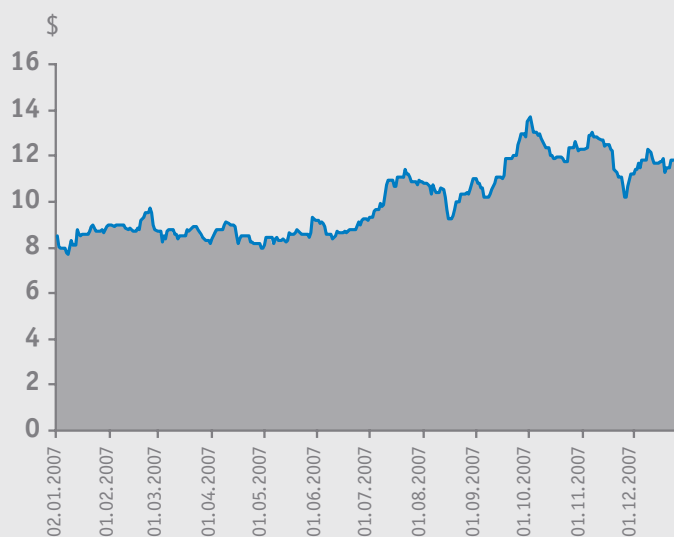


### Comstar UTS

In February 2006, Comstar UTS completed an IPO of 146,500,000 common shares. These shares included 139,000,000 newly issued shares and 7,500,000 shares sold by shareholders. The shares were admitted to trade on the London Stock Exchange in the form of GDRs at the value of 1 GDR per ordinary share. Approximately 34% of Comstar's shares are in free-float, traded as GDRs on the LSE under the ticker 'CMST'. Ordinary shares are traded on the RTS and the MSE under the ticker 'CMST'.

Currently, Comstar UTS has 417,940,860 outstanding shares with a nominal value of RUR 1 per share. As of December 31, 2007, Sistema directly or indirectly owned 51% of Comstar's common shares.

Comstar's GDRs closed at \$8.55 after their first day of trading of 2007. The year's peak share price of \$13.71 was reached on October 3, 2007 and it closed at \$12.59 on the last day of trading of 2007. The company's market capitalization as of December 31, 2007 was \$5.3 billion.



### Sistema-Hals

Sistema-Hals's shares were admitted to trading in the form of GDRs on the London Stock Exchange on November 8, 2006. The company offered 1,738,650 newly issued shares and 112,171 shares from selling shareholders. In addition, the underwriters exercised an option to purchase 168,256 ordinary shares in the form of GDRs to cover over-allotments in the offering. The shares were offered at \$10.7 per GDR and \$214.00 per ordinary share, representing a ratio of 20 GDRs per ordinary share. Sistema-Hals' shares in the form of GDRs are traded on the LSE under the symbol 'Hals', while its ordinary shares have been included on the MICEX and MSE since 2006.

Currently, Sistema-Hals has 11,217,094 ordinary shares. As of December 31, 2007, Sistema owned 71% of the ordinary shares of Sistema-Hals and 20% were in free-float.

After the first day of trading in 2007, the company's shares closed at \$13.73 per GDR, and they reached a high of \$15.05 on April 30, 2007. As of December 31, 2007, the company's market capitalization was \$1.9 billion, and the shares were priced at \$9.75 per GDR.

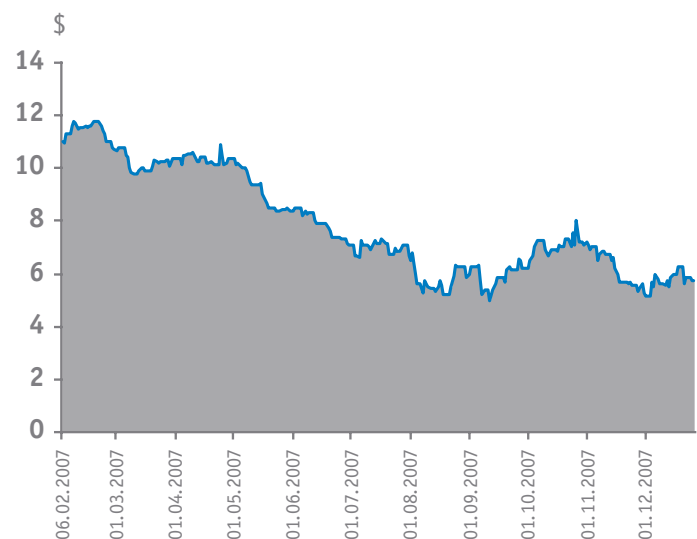
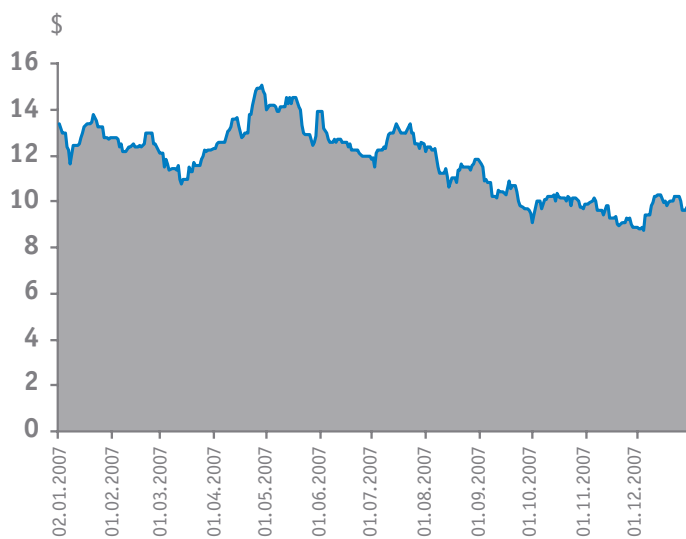
### Sitronics

On February 6, 2007, Sitronics completed an IPO in the form of GDRs on the London Stock Exchange, offering 1.675 billion ordinary shares under the ticker 'SITR'. This IPO confirmed its position as the leading high-tech firm in Russia, the CIS, and Central and Eastern Europe. The current GDR to ordinary share ratio is 1:50. Sitronics's shares are also traded on the RTS and MSE under the ticker 'SITR'.

Currently Sitronics has 9,547,087,190 ordinary shares with a nominal value of RUR 1 per share. As of December 31, 2007, Sistema owned 71% of Sitronics' shares and 17.5% of its shares were in free-float.

After the first day of trading, Sitronics' GDRs were valued at \$12.00 and the company's market capitalization was \$1.9 billion.

riding the consumer wave



# Corporate Governance

## Principles of Corporate Governance

Sistema was among the first Russian companies to recognize the value of strong corporate governance and remains a leader in informational openness and transparency. Its system of corporate governance is based on several core principles: transparency in all business processes for our investors and partners, maintaining an engaged and professional board of directors and maintaining a consistent approach to all issues concerning the Corporation's management. Sistema applies these principles to all company processes and procedures, including strategic management, financial accounting and reporting, audit, risk management, HR policy, corporate governance, and corporate social policy.

Sistema's processes and procedures are codified in the Company's Charter, which determines the structure and competencies of its governing bodies. The Company's Corporate Code and Code of Ethics contain additional commitments that Sistema has made in terms of promoting openness, collective decision-making, social responsibility, and ethical principles in its relationship with partners, governments, employees, and shareholders.

Sistema's main governing bodies are the General Meeting of Shareholders, Board of Directors, President, and Management Board. Board committees are operational at the Board level, special committees are operational at the the President level to make policy recommendations. The Company's organizational structure is built on the basis of operational management, identifying key issues and establishing bodies with the necessary competencies to resolve them.

Throughout 2007 the Company made several strides to further the development of its corporate governance structures. A new set of procedures was adopted by the Board of Directors in October 2007 to increase the effectiveness of the Board's meetings. The changes call for a slight reduction in the number of planned meetings per year and improving preparation and organization processes. This will entail preparing more thorough materials in the run-up to the Board's meetings and limiting the number of invitees to the Board's meetings. Board materials will be first reviewed by the Management Board and Board committees before being distributed. The new rules also institutionalise a constant flow of information

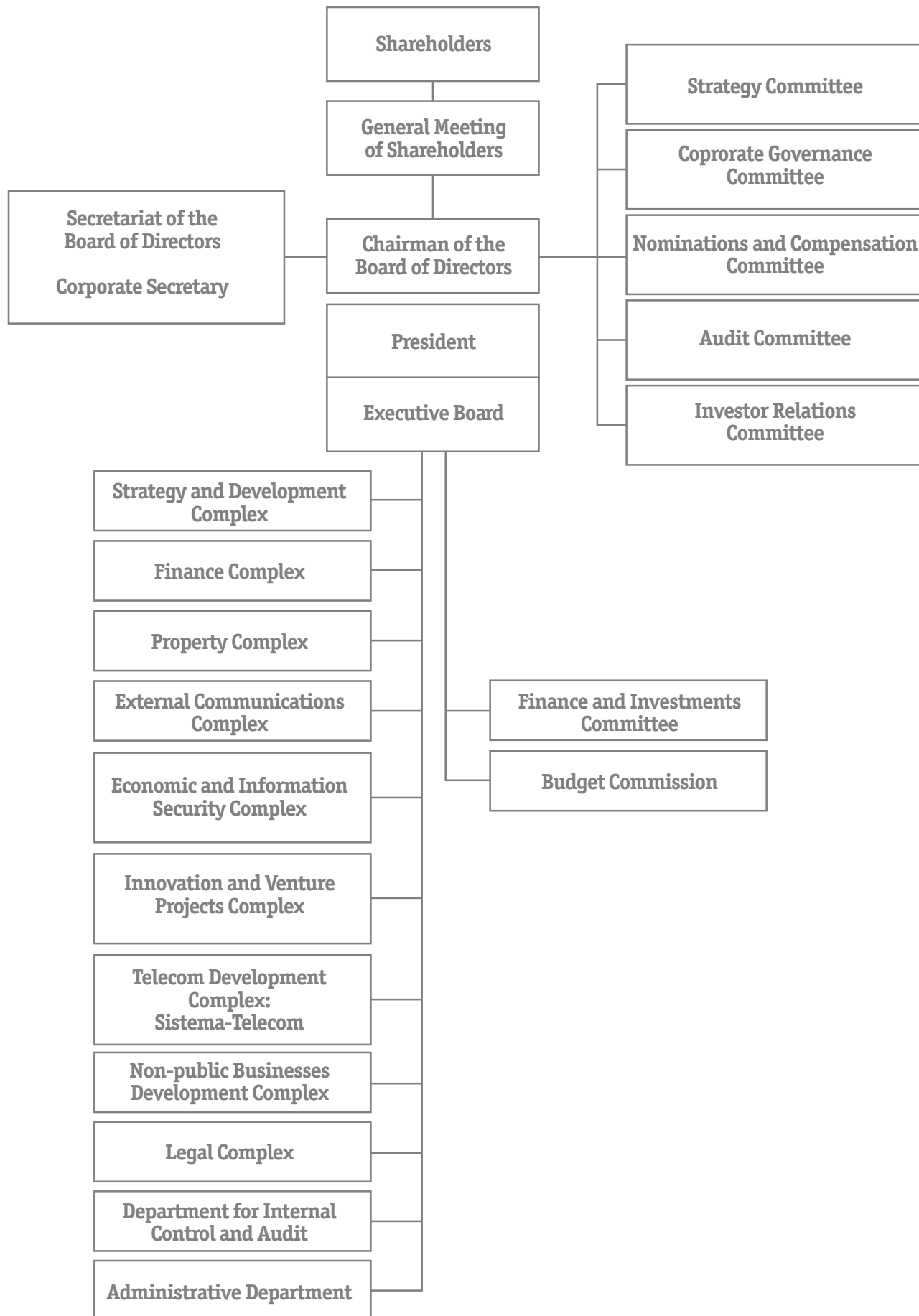
between management and the members of the Board of Directors between the Board's meetings.

Sistema launched an internal corporate governance rating system in June 2007 to measure the effectiveness of corporate governance at its subsidiaries. The methodology relies on concepts used by ratings agencies such as Standard & Poors, Moody's, and Expert RA. The results have been used to create action plans to further the development of its subsidiaries' corporate governance systems.

The Company published its first Social Report in 2007 to detail its social and charitable activities. The report's goal was to promote dialogue about Sistema's social undertakings and the principles that guide them. Sistema is currently in the process of formulating a comprehensive strategy for the Company's social responsibility with the goal of improving the management of its social activities.

Sistema is one of the leading Russian companies to invest in long-term projects which demand large sums raised on Russian and international financial markets. The ability to succeed at this requires a high level of transparency and faith in the Company's efficiency and corporate governance bodies. Sistema's continued success is a testament to the strength of the Company's corporate governance.

## Organizational Structure



## General Meeting of Shareholders

Sistema's primary governance body is the General Meeting of Shareholders. The General Meeting of Shareholders functions on the basis of Russian federal law on joint-stock companies, the Company's Charter and the Company's internal documents.

There were two general meetings of shareholders in 2007. The annual General Meeting of Shareholders took place on June 30, 2007 and an extraordinary General Meeting of Shareholders was held on September 17, 2007 in the form of a letter ballot on the question of splitting the Company's shares.

Sistema's 2007 General Meeting of Shareholders discussed the following issues: approving the annual report and annual accounts, distributing profits and determining dividends, electing members of the Board of Directors, approving the Company's auditors, approving the new Company's Charter.

The procedure for holding General Meetings of Shareholders fully corresponds to the requirements to provide fundamental safeguards of shareholders' rights. Information and material about the meeting is provided to shareholders in Russian and English 30 days before the meeting is scheduled, and published on Sistema's website ([www.sistema.com](http://www.sistema.com)). Together with the announcement of the upcoming shareholders' meeting, the shareholders also receive ballot papers; absentee voting is permitted on all meetings of shareholders. Sistema always strives to hold general meetings of shareholders in an easily accessible area near the Company's central office, as well as to provide a space that can accommodate all its shareholders or their representatives.

Vladimir Evtushenkov  
Chairman of the Board  
of Directors



Alexander Goncharuk  
President and Chief  
Executive Officer



Corporate  
g o v e r n

Dmitry Zubov

Deputy Chairman of the Board  
of Directors



Vyacheslav Kopiev

Deputy Chairman of the Board  
of Directors



Evgeny Novitsky

Director



Alexander Gorbatovsky

Independent Director



a n c e

board of d i

Sergey Drozdov

Director,  
Senior Vice-President,  
Head of the Property Group



Alexander Leiviman

Director



Ron Sommer

Independent Director



Stephan Newhouse

Independent Director



r e c t o r s





## Board of Directors

### Vladimir Evtushenkov Chairman of the Board

Vladimir Evtushenkov, together with several partners, founded Sistema in 1993. He served as President from the Company's formation until 1995, and as Chairman of the Board from January 1994 to January 2005. He once again was appointed President in the run-up to Sistema's IPO on the LSE, and has served as Chairman of the Board since February 2006. He is the majority shareholder of Sistema.

Mr. Evtushenkov has been a member of the Board of Directors of the Russian Union of Industrialists and Entrepreneurs since 2000 and has also sat on the Board of Directors of the Russian Chamber of Commerce and Industry since 2002. He is active in several public-private partnerships, and is a member of the Government Commission on Science and Innovation Policy, the Russian President's Council on Science and High Technology, and the National Council on Corporate Governance. Since 2004 he has served as Chairman of the Council of Trustees of the Development Fund for the State Russian Museum.

Before starting Sistema, Mr. Evtushenkov chaired the Moscow City Committee on Science and Engineering. From 1987 to 1990 he served the Moscow City Executive Committee in various capacities. From 1982 until 1987 he was Chief Engineer and subsequently First Deputy General Director of the Polymerbyt Scientific and Production Association. Mr. Evtushenkov worked as Deputy Director and Chief Engineer at the Karacharovo Plastics Works from 1975 to 1982.

Mr. Evtushenkov was born in 1948 in the Smolensk region. He graduated from the D. Mendeleev Moscow Chemical Engineering Institute in 1973 and from the School of Economics of the Moscow State University in 1980, where he earned a Doctorate in Economics.

### Alexander Goncharuk President and Chief Executive Officer

Alexander Goncharuk has been on the Board of Directors since 1996. He first joined the Company as a Vice-President of Sistema in 1995 and served in this position until 1998. His many positions in the group include Chairman of the Board of MTS, President of Sistema Telecom from 1998 to 2003, and General Director of

Concern Sitronics. Currently, Mr. Goncharuk serves on the boards of Sistema-Hals, Sitronics, and Ecu Gest Holding S.A.. He also holds the position of Chairman of the Board of Sistema Mass Media. Mr. Goncharuk became President of Sistema in February 2006.

Mr. Goncharuk was General Director of the company ACO Leader before arriving at Sistema. From 1987 to 1991, he was a senior officer at the Main Headquarters of the Russian Navy.

Mr. Goncharuk was born in 1956 in Sebastopol. He graduated with honors from the Sebastopol Naval Engineering Academy in 1978 and again with honors from the A. Grechko Naval Academy in 1987.

### Dmitry Zubov Deputy Chairman of the Board

Dmitry Zubov joined Sistema in 1999 and became Deputy Chairman of the Board of Directors in 2000. He holds a number of senior positions in the Group, including Chairman of the Board of Sistema-Hals and head of the Project Construction Union Sistema-Hals.

In 1996 Mr. Zubov was appointed Deputy Chairman of the Board of Moseximbank. Before that, he was the General Director of AOZT Alon from 1992 to 1996. Mr. Zubov has also held various positions in the Komsomol organization, including Secretary of the Komsomol Committee, the head of the All-Union School for training team leaders of Komsomol Youth brigades and in the Central Committee of the Leninist Youth Communist League of the Soviet Union. In 1978 and 1979 Mr. Zubov worked as a foreman at the Lukhovitsky Engineering Plant.

Mr. Zubov was born in 1954 in the Gorky region. He graduated from the S. Ordzhonikidze Moscow Aircraft Institute in 1977 and holds a doctorate in economics.

### Vyacheslav Kopiev Deputy Chairman of the Board

Vyacheslav Kopiev joined Sistema as a Vice-President in 1997. He served as Senior Vice-President and Chief of the External Business Relations Group from 2000 to 2003, and has been a Director since 2001. He was elected Deputy Chairman of the Board in 2003. He serves as Chairman of the Board of Intourist.

From 1989 till arriving at Sistema, Mr. Kopiev occupied leading positions at the Administrative Board of the Union of Engineering Societies, including Director for International Relations and Innovation from 1992 to

1997. He also served as Chairman of the Board of Directors of JSC Sputnik from 1990 to 1997. In 1989 he was elected First Secretary of the Moscow City Committee of Komsomol and later became Second Secretary of the Komsomol Central Committee. From 1980 to 1989 he was Deputy Chairman of the Moscow City Council of Young Scientists and Specialists as well as the Moscow City Council for the Development of the Scientific and Technical Abilities of Youth.

Mr. Kopiev was born in 1954 in Moscow. He graduated from the Cybernetics Department of the Moscow Institute of Engineering and Physics in 1977 and from the Law Department of the Russian Academy of Management in 1993. Mr. Kopiev also graduated with honors from the Economy Department of the International Marketing and Management Academy in 1994. He holds degrees in Engineering and Law and is the author of over 70 scientific works.

### Evgeny Novitsky Director

Evgeny Novitsky joined Sistema in 1995 as Director and President and continued in these roles until January 2005. He then became Chairman of the Board, where he remained until February 2006. From there, he remained on the Board as a non-executive director.

Mr. Novitsky headed the development and production of computers as well as assembly of IBM computers at the Kvant plant in Zelenograd from 1991 to 1995. He also served as Chairman of the Board of IVK, a Russian information technology company.

Mr. Novitsky was born in 1957 in the Tomsk region. He received a degree in Engineering from the C. Bauman Moscow School of Engineering in 1985 and continued his studies there as an engineer-mathematician until 1990. He is now a member of that school's Board of Trustees. From 1989 to 1990 he also studied management at the Moscow State Institute of International Relations and at Manchester Business School, University of Manchester (UK). He is the author of a number of publications and a monograph.

### Alexander Gorbatovsky Independent Director

Alexander Gorbatovsky has been a Director since August 2004, and is currently also Chairman of the Board of MMZ No.3. Before joining the Board, he was the President of Sistema-Neft from 1997 to 2002 and, prior to that, General Director of Kedr-M.

### Sergey Drozdov Senior Vice-President, Head of Property Group

Sergei Drozdov has been working at Sistema since 1995. He began managing the Department of Development and Investments from 1995 to 1998 and served as Vice-President, Acting President, and First Vice-President of Sistema-Invest from 1998 and 2002. In May 2002 Mr. Drozdov became Acting First Vice-President and head of the Department for Corporate Property, and later that year was appointed Director and First Vice-President of Sistema and Chief of the Property Complex.

Currently, Mr. Drozdov serves on the boards of MTS, Sky Link, Detsky Mir Center, Sistema-Hals, Intourist, Ecu Gest Holding S.A., and Medexpress Company. He also holds positions of the Chairman of the boards of Reestr, Medsi Group, and Sistema-International.

Before coming to Sistema Mr. Drozdov headed the Administration for Financial Innovation and Marketing at the Moscow Property Fund from 1994 to 1995.

Mr. Drozdov was born in 1970 in Archangelsk. He graduated in 1993 from the S. Ordzhonikidze State Academy of Management in Economics.

### Alexander Leiviman Director

Alexander Leiviman has been working at Sistema since 1993. His corporate roles include President of Sistema-Invest (1996–1997), President of Intourist (1997–1999) and First Vice-President and Chief of the Finance and Investment Group (1999–2002). Mr. Leiviman has been General Director of Sistema Mass Media from 2003 to 2006.

Mr. Leiviman was Deputy General Director of the Innovation Fund of the Moscow Mayor's Office from 1992 to 1993. Before that, he occupied a number of leading positions at the chemicals plant in Chernovtsy from 1978 to 1992. In the 1970s, Mr. Leiviman worked as deputy shop foreman at MosBytKhim and senior staff scientist at the Institute NIPIOTSTROM in Novorossiisk.

Mr. Leiviman was born in 1949 in Chernovtsy.

## Ron Sommer Independent Director

Ron Sommer has been serving as Chairman of the International Advisory Council of Sistema since May 2003. Mr. Sommer was elected as a non-executive independent member of the Board of Directors of Sistema in June 2005.

Mr. Sommer began his professional career with the Nixdorf Group in New York, Paderborn, and Paris. In 1980 he was appointed Managing Director of the German subsidiary of the Sony Group. In 1986 he became Chairman of the Management Board of Sony Deutschland, and was subsequently appointed President and Chief Operating Officer of Sony Corporation of America in 1990. In 1993 Mr. Sommer served at Sony Europe in the same function. From May 1995 to July 2002 he served as Chairman of the Management Board of Deutsche Telekom AG.

Mr. Sommer was born in 1949 in Israel. He studied mathematics at the University of Vienna, where he earned his doctorate in 1971.

## Stephan Newhouse Independent Director

Stephan Newhouse joined Morgan Stanley in 1979 and served as a Managing Director, Vice-Chairman, and Chairman of Morgan Stanley International, and as President of Morgan Stanley from 2003 until 2005. He was also appointed to the Management Committee of Morgan Stanley, the parent company, in 1998. Prior to joining Morgan Stanley, Mr. Newhouse worked in the investment banking division of the First Boston Corporation. Mr. Newhouse was elected as a non-executive independent member of the Board of Directors of Sistema in June 2006.

Mr. Newhouse was born in 1947. He received a Bachelor of Arts degree cum laude at Yale University in 1969. After graduation, he served as an officer in the United States Navy and then attended the Harvard Business School, where he earned his MBA with Distinction in 1975.

## Functions of the Board of Directors

The Board of Directors is responsible for the strategic management of Sistema. The Board defines the Company's development strategy, establishes strategic and financial development plans, determines the Company's approach to investments, evaluates the effectiveness of the Company's management, assesses risks that Sistema faces, determines corporate governance structures and approves deals and oversees the Company's internal controls.

## Review of the Board's Sessions

The Board of Directors met 11 times in 2007 and held one meeting by letter ballot to resolve an issue that required immediate action. In total, Sistema's Board held 12 meetings, averaging one meeting a month.

On average, each meeting's agenda consisted of three to five matters relating to the Board's key competencies, including Sistema's development strategy, issues concerning development of businesses, financial results, corporate governance issues, and HR policy. Other issues about the Corporation's business processes, including issues concerning an additional float of Sistema shares, participating in equity swaps with daughter companies, and approving interested party transactions and deals to acquire capital shares of other companies, were also considered by the Board.

In 2007 the Board of Directors' main focus was on questions of strategic development, corporate governance, and HR policy (with the exception of issues relating to approving related party transactions and transactions to acquire shares in other companies, the approval of which is prescribed by Russian corporate law).

The most frequently discussed matter in 2007 Board meetings related to Sistema's strategy, investments, and new areas of operations. These matter occupied 24 percent of the Board's agenda. Other key issues involved approving related party transactions (16 percent), participating in subsidiary companies (15 percent), corporate governance (14 percent), appointments and HR policy (13 percent), financial accounting, planning, and audits (12 percent), stock issues and charter capital (4 percent), and approving of internal documents and policies (2 percent).

## Committees of the Board of Directors

Sistema has five committees of the Board of Directors: the Audit Committee, the Nominations and Compensations Committee, the Corporate Governance Committee, the Investor Relations Committee, and the Strategy Committee. These committees play an important role in advising the Board of Directors about the issues within their competency. The committees report to the Board of Directors.

### Audit Committee

The Audit Committee consisted of three members as of December 31, 2007. It was chaired by A.I. Gorbatovsky and included A.L. Leiviman and S. Newhouse. L.V. Gorbatova was committee secretary.

The Audit Committee's primary function is to supervise the preparation of financial reporting, oversee internal audits of Sistema and its subsidiaries and coordinate the work of the Company's internal control and audit departments. It also supervises the work of all external auditors and advises on their appointment and compensation, including mediating any disputes between Sistema's management and external auditors. Furthermore, the Audit Committee conducts an initial review of all issues that will be presented to the Board of Directors. It met seven times in 2007.

### Nominations and Compensations Committee

The Nominations and Compensations Committee consisted of four members as of December 31, 2007. It was chaired by V.P. Evtushenkov and included A.Y. Goncharuk, D.L. Zubov and V.V. Kopev. A.N. Buyanov was committee secretary.

This committee sets the Company's HR policy, providing the Board of Directors with recommendations for appointments to the Corporation's top management and recommending candidates for the boards of directors of subsidiaries and affiliate companies. It also formulates incentive programs and salary recommendations for the Company's top management. The Appointments and Awards Committee met two times in 2007.

### Corporate Governance Committee

The Corporate Governance Committee consisted of seven members as of December 31, 2007. It was chaired by V.V. Kopev and included I.V. Belikov, S.A. Drozdov, G.V. Ermakov, I.O. Petrov, A.S. Semenov and S.E. Cheremin. E.G. Tulupov was committee secretary.

The main tasks of this committee include development of corporate governance practices at Sistema and instituting improved corporate governance policies at Sistema's subsidiaries and affiliate companies. It also monitors the Company and its affiliates' observance of existing legislation, the Company Charter and internal normative documents on corporate governance. The Corporate Governance Committee is responsible for preventing and resolving corporate and ethical conflicts. The committee held 10 meetings in 2007.

### Investor Relations Committee

The Investor Relations Committee consisted of 5 members as of December 31, 2007. It was chaired by R. Sommer and included A.V. Abugov, A.N. Buyanov, S. Newhouse and S.E. Cheremin. P.V. Kim served as committee secretary.

The primary function of this committee is to formulate corporate policy towards investor relations in Russia and abroad and to present its recommendations to the Board of Directors. The Investor Relations Committee met 10 times in 2007.

### Strategy Committee

The Strategy Committee consisted of 16 members as of December 31, 2007. It was chaired by V.P. Evtushenkov and included A.V. Abugov, R.F. Almakaev, S.G. Aslanian, S.F. Boev, A.N. Buyanov, A.Y. Goncharuk, S.A. Drozdov, F.V. Evtushenkov, D.L. Zubov, V.V. Kopev, D.G. Muratov, E.V. Utkin, S.E. Cheremin, V.G. Savelev, and D. Khidasheli. E.L. Madorsky was committee secretary.

This committee's main function is to consider and analyze questions of strategic development that concern Sistema and its businesses. It met nine times in 2007.

Alexander Goncharuk

President and Chief  
Executive Officer



Anton Abugov

First Vice-President,  
head of Strategy and  
Development



Vitaliy Savelyev

First Vice-President,  
head of Telecommunications  
Asset Management Division



Alexey Buyanov

Senior Vice-President,  
head of Financial Group



Sergey Drozdov

Senior Vice-President,  
head of Property Group



# Corporate governance

**Sergey Cheremin**

Vice-President,  
head of External Relations



**Anna Goldin**

Vice-President,  
General Council



**Ruslan Almakaev**

Vice-President,  
head of Economic and  
Information Security Group



**Denis Muratov**

Vice-President,  
head of Innovations  
and Science



**Sergey Boev**

Vice- President for  
Development of State  
Programmes and  
Non-Public Assets



# Key management

## Key Management

### Alexander Goncharuk President and Chief Executive Officer

Alexander Goncharuk has been on the Board of Directors since 1996. He first joined the company as a Vice-President of Sistema in 1995 and served in this position until 1998. His many positions in the Group include Chairman of the Board of MTS, President of Sistema Telecom from 1998 to 2003 and General Director of Concern Sitronics. Currently, Mr. Goncharuk serves on the boards of Sistema-Hals, Sitronics, and Ecu Gest Holding S.A. He also holds the position of Chairman of the Board of Sistema Mass Media. Mr. Goncharuk became President of Sistema in February 2006.

Mr. Goncharuk was General Director of the company ACO Leader before arriving at Sistema. From 1987 to 1991 he was a senior officer at the Main Headquarters of the Russian Navy.

Mr. Goncharuk was born in 1956 in Sebastopol. He graduated with honors from the Sebastopol Naval Engineering Academy in 1978 and again with honors from the A. Grechko Naval Academy in 1987.

### Anton Abugov First Vice-President, Head of Strategy and Development

Anton Abugov has served in his current position since 2006. Prior to joining Sistema, Mr. Abugov was a Managing Director of AKB Rosbank responsible for its Corporate Finance Department. Before that, he was a partner in Eurasia Capital Partners, overseeing investment projects in Eastern-European telecoms and Russian petrochemical businesses. From 1997 to 2006 he also served as a strategic adviser to the TAIF Group of Companies, one of the biggest finance and industrial groups in Russia. Between 1995 and 2002 Mr. Abugov was head of Corporate Finance at UFG. He has also served as an advisor to RAO UES and was involved in developing the infrastructure and regulatory framework for the securities market in Russia.

Currently, Mr. Abugov serves on the boards of Sitronics, Svyazinvest, and Sistema-Invest. He also holds positions of the Chairman of the boards of Sky Link and Detsky Mir Center.

Mr. Abugov was born in 1976. He graduated from the National Economics Academy of the Russian Federation.

### Vitaliy Savelyev First Vice-President, Head of Telecommunications Asset Management Division

Vitaliy Savelyev arrived at Sistema in 2007. Previously, from 2004 to 2007, he served as a Deputy Minister of Economic Development and Trade in the RF. Before that, he held senior positions at several companies, including Vice-President of Gros, an advisor to the General Director of Syazinvest, Deputy Chairman at Gazprom, and Chairman at Menatep SPB. In 1988 he founded Dialog, the first joint Soviet-American company that dealt with computer equipment and software promotion.

Mr. Savelyev currently holds the position of the Chairman of the Board of Comstar UTS.

Mr. Savelyev was born in 1954. He graduated from the mechanics-engineering faculty of Polytechnic Institute in St. Petersburg and received a second degree from the Engineering-Economic Institute.

### Alexey Buyanov Senior Vice-President, Head of Financial Group

Mr. Buyanov joined Sistema in 1994 and occupied various posts at the Property Group until 1995 when he was appointed head of Administration at Sistema-Invest, later becoming Vice-President in 1996 and First Vice-President in 1997. He also served as Vice-President of MTS from 1998 to 2002. Also in 2002, he was appointed Vice-President of Sistema and Head of the Financial Restructuring Department. Later that year, Mr. Buyanov became First Vice-President and Head of the Finance and Investment Group.

Currently, Mr. Buyanov holds a number of senior positions in the Group, including Chairman of the boards of MTS, Director of Sistema Finance S.A., Sistema Holding Ltd., Financial Fleurus Holding S.A., and Sistema Pension Fund. He also serves on the boards of MBRD, Sistema-Hals, Sistemny Project, East-West United Bank S.A. (Luxembourg), and Ecu Gest Holding S.A.

He graduated in 1992 from the Moscow Physics and Engineering Institute (MPEI) specializing in applied mathematics and physics, and was an intern researcher at the Institute of Mechanics Problems (IMP) of the Russian Academy of Sciences from 1992 to 1994.

Alexey Buyanov was born in 1969 in Moscow.



## Sergey Drozdov

Senior Vice-President, Head of Property Group

Sergei Drozdov has been working at Sistema since 1995. He managed the Department of Development and Investments from 1995 to 1998, and served as Vice-President, Acting President, and First Vice-President of Sistema-Invest from 1998 and 2002. In May 2002 Mr. Drozdov became Acting First Vice-President and Head of the Department for Corporate Property, and later that year was appointed Director and First Vice-President of Sistema and Chief of the Property Complex.

Currently, Mr. Drozdov serves on the boards of MTS, Sky Link, Detsky Mir Center, Sistema-Hals, Intourist, Sistema-Invest, Sistemny Project, Sistema-Inventure, Ecu Gest Holding S.A., and Medexpress Company. He also holds positions of the Chairman of the boards of Sistema-Telecom, Reestr, Medsi Group, and Sistema-International.

Before coming to Sistema, Mr. Drozdov headed the Administration for Financial Innovation and Marketing at the Moscow Property Fund from 1994 to 1995.

Mr. Drozdov was born in 1970 in Archangelsk. He graduated in 1993 from the S. Ordzhonikidze State Academy of Management in Economics.

## Sergey Cheremin

Vice-President, Head of External Relations

Sergey Cheremin first joined the Sistema group of companies in 2004 as CEO of MBRD Bank, and became the bank's Chairman of the Board in April 2005. He also became Sistema's Head of External Relations at that time.

Mr. Cheremin has an extensive background in banking, and has held several senior positions at major Russian banks, including Deputy CEO of Print Bank from 1991 to 1992, CEO of Moscow Export-Import Bank from 1992 to 1998, and Vice-President of Ural Trust Bank from 1998 to 2000. From 2000 until joining MBRD, Mr. Cheremin was an advisor to the President of Severo-Vostochny Alliance Bank.

Currently, Mr. Cheremin holds a number of senior positions in the Group, including Chairman of the Board of MBRD and Dalcombank. He also serves on the boards of Intourist, NIS, and Sistema Pension Fund.

Mr. Cheremin graduated with honors in 1989 from the Moscow State Institute of International Relations with a specialization in international journalism. He completed a postgraduate course in global economic issues at Moscow State University. In 1992 he interned at the New York Institute under the Investments and International Accounts Program and enrolled in a course for banking specialists at Fairfield University (USA) in 1993.

## Anna Goldin

Vice-President, General Council

Anna Goldin joined Sistema's legal team in 2007. Prior to joining Sistema, she worked at Latham&Watkins, where she started as an associate in Los Angeles in 1990 and eventually worked her way up to become an Office Managing Partner in their Moscow office. At Latham&Watkins, Ms. Goldin specialized in corporate finance, capital markets and M&A, and provided legal services to leading Russian and international companies in telecommunications, high-technology, oil and gas, finance, and other fields.

Ms. Goldin serves on the Board of Thema Production S.A.

Ms. Goldin was born in St. Petersburg. She received her BA and law degree from the University of California, Berkley.

## Ruslan Almakaev

Vice-President, Head of Economic and Information Security Group

Ruslan Almakaev came to Sistema as Head of Non-Corporate Restructurings in 2002. Prior to joining Sistema, he worked as a Deputy General Director at AOZT Commercial and Industrial Company Eurasia from 1993 to 2002. At the same time, he served as an assistant to a State Duma deputy and a Deputy General Director of the Russian Aviation Fund, a public fund to support members of the Russian Air Force.

Mr. Almakaev holds the position of Chairman of the Board of NTR Region. He also serves on the boards of Sistema Mass Media, Sistema Invest, and Sistemny Project.

Mr. Almakaev was born in 1963 in Kharkov and graduated from Kharkov State University in 1994. In 2003 he finished graduate work at Krasnodar State University specializing in methods and systems of macroeconomic processes.

## Denis Muratov

Vice-President, Head of Innovations and Science

Denis Muratov joined Sistema in his current position in 2006. Prior to that, he served as the General Director of the Idea Innovation and Industrial Technopark in Kazan and served as an economic advisor to Tatarstan's First Vice Prime Minister. Between 1992 and 2004 Mr. Muratov lived and worked in Sweden, where he managed several companies, including Anton Invest AB, Nordic Industrial Development AB, Scantat AB, and Media Resources International Scandinavia AB.

Currently, Mr. Muratov serves on the boards of Sistema Mass Media, RTI Systems, Dubna-Sistema, NIS, and the Coral/Sistema Strategic Fund. He also holds some other positions in the Group, including the Chairman of the boards of Sitronics, Intellect Telecom, Binnofarm, and Sistema-Venture.

Mr. Muratov was born in Ekaterinburg (Sverdlovsk). He holds degrees from the Sverdlovsk Institute of Architecture and the Chalmers University of Technology in Göteborg, Sweden.

## Sergey Boev

Vice- President for Development of State Programmes and Non-Public Assets

From 1971 until 1999, Sergey Boev worked at the A.L. Mints Radio-Technology Institute. In this time, he started as an assistant mechanic and worked his way up to become the institute's General Director. In 2000, he became General Director and a member of the Board of Directors at Radio-Technology and Information Systems Concern. Starting in February 2008, he became Sistema's Vice-President for Development of Focused Programs and Non-public Assets.

He is the Chairman of the Board of Directors of RTI Systems.

Mr. Boev was born on September 17, 1953 in Moscow. He received a diploma from the All- Union Correspondence Legal Institute in 1978, graduated from the Moscow Ordzhonikidze Institute of Management in 1984, and completed coursework in the State Plan of the USSR in 1988.

## Asset Structure

The table below outlines Sistema's beneficial ownership and voting interests in subsidiary and associate companies where the Corporation's ownership exceeds 20% of total ordinary shares. This list reflects shareholdings as of January 31, 2008.

Since the end of the reporting period, in February 2007, Sistema sold 17.5% of its shares in Sitronics through an initial public offering on the London Stock Exchange and listings on the Moscow Stock Exchange and Russian Trading System.

On February 21, 2007 Sistema announced that it would sell 46.19% of ROSNO shares to Allianz as part of a share purchase agreement. Following the agreement, Sistema's shareholding in ROSNO was reduced to 3%.

In April 2007 Sistema acquired 9.75% of the issued share capital of Sitronics from Ecu Gest Holding S.A., a Sistema subsidiary, as part of the Corporation's strategy of restructuring and optimizing the structure of its shareholding companies.

On August 15, 2007 Sistema announced the acquisition of a 20% stake in Dalcombank, a commercial bank based in the Far East of Russia. In October Sistema increased its ownership in Dalcombank to 48.16%. In January 2008 Sistema acquired 50.5% of Dalkombank, raising its stake in the company to 98.85%.

In September 2007 Sistema acquired a 10% stake in Shyam Telelink Ltd., an Indian telecommunications operator. In October Sistema signed a share purchase agreement for the acquisition of an additional 41% stake in Shyam Telelink Ltd., and a call option agreement which gives Sistema the right to increase its stake up to a maximum of 74%. In January 2008 Sistema increased its ownership in Shyam Telelink Ltd to 51%.

Company	% of total ordinary shares owned by Sistema
<b>Telecommunications Business</b>	
Mobile TeleSystems	53%
Comstar UTS	53%
MGTS	33%
Sky Link	50%
MTT	43%
Svyazinvest	25%
Shyam Telelink	51%
<b>Technology Business</b>	
Sitronics	85%
<b>Real Estate Development Business</b>	
Sistema-Hals	80%
<b>Retail Business</b>	
Detsky Mir Center	100%
Detsky Mir	75%
<b>Financial Services Business</b>	
MBRD	95%
East-West United Bank S.A.	100%
Dalcombank	98,85%
<b>Media Business</b>	
Sistema Mass Media	100%
<b>Travel Business</b>	
Intourist	66%
<b>Radar and Space Technology Business</b>	
Concern RTI Systems	100%
<b>Healthcare Business</b>	
Medsi	67%
Medsi-2	74%
<b>Pharmaceuticals Business</b>	
Binnofarm	100%
<b>Convergent Services</b>	
TS-Retail	100%
<b>Entertainment Business</b>	
Russian World Studios	51 %
<b>Petrochemicals Business</b>	
ANK Bashneft	21%
Ufimsky NPZ	24%
Novoil	27%
Uralneftehim	23%
Ufaorgsintez	23%
Bashnefteproduct	25%

## Risk Management

The favorable economic environment of the last several years, the positive dynamic of macroeconomic indicators, and steady growth of real wages all promote further growth in consumer demand in our markets. The consumer sectors of Russia and the CIS are the basis of Sistema's businesses and continue to play a decisive role supporting overall economic growth. Nonetheless, there are significant risks that could negatively affect the pace of development of the Company's subsidiaries.

There are numerous risks that Sistema's businesses could face. They represent processes and factors that the company has little or no influence over. Therefore, effective evaluation and management of these risks is an important component of Sistema's strategy.

Risk management is conducted in a centralized manner within the framework of the laws and statutes confirmed on a Sistema-wide level, as well as on a business level. This process touches on all corporate activities and is intended to expose and reduce the likeliness and scale of the impact of any events that could negatively influence the Company's operations. The corresponding measures are a reasonable guarantee that the strategic goals of the Company's activities will be realized.

### Political Climate

The political situation in Russia over the last year was characterized by a reasonably high degree of stability. At the same time, there has been increasing political instability in several neighboring CIS member states. This allows various political forces to influence these countries' economies and especially the private companies.

### Economic Situation

The economic growth rate remained high in 2007. GDP growth in 2007 reached 8.1% after having grown 7.4% in 2006. The economic situation in Russia enabled further growth of the investment market and consumer demand. However, amidst this backdrop the rate of inflation grew and the consumer inflation indicator hit 11.9%, well above the 8.5% rate that had been forecast in the budget. This was the highest level in the last three years.

Rising inflation in 2007 was caused by the significant growth in the price of oil and food staples on world markets. The Ministry of Finance and the Central Bank have taken a measured approach to fiscal and monetary policy, as demonstrated by the considerable increase in Russia's gold and currency reserves and the Stability Fund. However, the positive effect on the economy has been limited by growing budget expenditures and the growth of regulated tariffs.

Another significant factor is the credit crisis that hit world financial markets in August 2007 on the back of the subprime mortgage crisis in the USA. In connection with this, the goal of supporting the stability of the banking system and ensuring that it maintains adequate liquidity may become a barrier in achieving price stability. As such, inflation on the whole and rising prices in the consumer sector are the main macroeconomic risks. Another significant risk is the exceptional dependence of the Russian economy and the economies of the CIS on the price of fossil fuels. Some CIS countries are also at risk that positive economic tendencies could be weakened by political instability or attempts to strengthen the state's role in the economy.

### Exchange Rate

Sistema faces exchange rate risks linked to changes in the value of the ruble, the euro, and the hryvna to the US dollar. Given a backdrop of the steady decline of the dollar's value, several of the Corporation's companies have moved to switch the pricing of their services into rubles. This step meant an increase in earnings in dollar terms and created an advantage with the cheapening of dollar-denominated financing, as a significant part of the company's borrowed capital was denominated in US dollars. However, there is a risk that the Russian Central Bank will refuse a strong-ruble policy as a way to fight inflation and instead favor its weakening in order to protect domestic companies from losing competitiveness and to slow the growth of imports.

### Capital Markets

There is the risk that Russian equities will underperform their counterparts on other developing markets. The two principle reasons for this possible weakness are the methods used to establish their fair value and the current level of liquidity in the Russian market. There is also a risk that capital inflows will shrink on the back of tighter global liquidity, political risks and high market valuations.

### Interest Rates and Other Credit Risks

Changes in interest rates on the Russian and international markets caused by the global credit crisis and tighter liquidity in the banking system could significantly affect the cost of borrowing and of raising additional capital. Sistema operates a number of capital-intensive businesses and therefore any changes in borrowing costs could have a negative impact on the Company. Furthermore, 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.

# Social Responsibility

At the core of Sistema's corporate outlook is the belief that the Company's businesses make vital contributions to improving the quality of life in the markets they serve. Sistema focuses on growing service-oriented high-technology businesses that foster the creation of an innovation economy in Russia and help diversify the economy to compete on the global marketplace. Sistema's business strategy dovetails with the Russian government's belief that promoting high technology is a national priority and crucial for the country's development.

Sistema's products and services provide customers with access to world-class communications, credit, and modern homes, offices, and infrastructure. As a responsible employer and corporate citizen, Sistema has always been on the forefront of adapting international best practice to the Russian landscape. Sistema has also played an important role in the growth of Russian capital markets and creating a positive investment environment in the country.

At the same time, Sistema recognizes that it has a moral obligation as a leading Russian company to contribute to the development of a better society in ways not limited to its businesses. Sistema is an important patron of the arts, promotes sports, helps preserve cultural treasures, contributes to the development of science and education, and reaches out to vulnerable layers of society. In 2007 it published its first ever Social Report, which highlighted the range of programs and charities it sponsors in the communities where it operates.

Sistema is an important patron of the arts in Russia and sponsors several national museums, including the Pushkin Museum, the State Tretyakov Gallery, the Kremlin museums, and many others. The Company is a key partner of the Russian Museum and is in the midst of a 10-year, \$10 million partnership agreement signed in 2003 to provide the museum with support for its publications, restoration work, security and community outreach, as well as items to expand its collection. Sistema has also created a series of educational centers across Russia called the Virtual World of the Russian Museum, which allows visitors in the regions to take a virtual tour of the St. Petersburg museum. It plans on opening similar exhibits in London and Istanbul to help popularize the Russian culture abroad.

Sistema also supports Russian music and dance, and is a sponsor of the world-renowned White Nights Festival, the Mariinsky Theater, the Musical Kremlin international festival, the Earlymusic festival, and the Benois de la Danse award, which has developed into the premier ballet award in the world since its inception 15 years ago. Modern art and culture are not ignored, and Sistema sponsors concerts, art exhibitions, and the annual Smolensk film festival. Under Sistema's patronage, the Petr Fomenko Studio opened a new theater building on Taras Shevchenko Embankment in Moscow. The theater, which won an award for innovative architecture in 2006, gave the renowned troupe its first permanent home.

By financing important restoration projects, Sistema is helping preserve Russian culture for future generations. In 2007 it funded numerous projects across Russia, including the 19th century Ivangorod Holy Trinity church, Moscow's 16th century Donskoi Monastery, and the Marfo-Mariinsky cloister.

In education, Sistema provides financial support to students who excel in math and science, engineering and computer science. At the same time, Sistema has partnered with Moscow State University to develop its own corporate university, the Higher School of Management and Innovation. Sistema supports summer programs, competitions and a lecture series intended to engage talented youth.

Sistema funds sports to both promote physical fitness and support members of Russian national teams. The Company is an active partner of the Russian Olympic and Paralympics teams. It also sponsors the Russian Rugby Union and participates in international youth tournaments, the Tretyak International Athletic Academy fund, and a sports league for Russian law enforcement officers.

Charity is an important dimension in Sistema's social policy, and children's wellbeing is particularly important to the company. It assists several orphanages around Russia to help integrate their charges into society. It also provides material support for schools that cater towards children with disabilities and supports charities such as the Independence fund, which assists disabled children and World War II veterans, and the St. Petersburg-based Salvation fund, which provides medical care to young burn victims. At the same time, Sistema provides medical equipment to the Red Cross in Moscow and has frequently partnered with the Russian Ministry of Emergency Situations to provide humanitarian aid in the aftermath of disasters.

In its philanthropic and charitable activities, Sistema applies the same strict criteria as it does for any other

aspect of its business: its social programs should provide tangible and verifiable results that improve society. Company social policy is guided by internationally recognized principles of sustainable development and corporate social responsibility. Sistema became one of the first companies in Russia to sign the Global Compact of the United Nations (UNGC) in 2002 and it joined the World Business Council for Sustainable Development (WBCSD) the following year. Sistema is one of Russia's most generous companies and continues to support projects in its markets that create new, exciting opportunities and make it a richer and more textured world.

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# Riding the Consumer Wave

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# Riding the Consumer Wave

## Economic Indicators

Russia is enjoying a consumer boom. Several factors, including growth in the population's real income, the rapid development of consumer credit, and the traditional skepticism with which Russians treat savings, have created a stable foundation for future dynamic growth in the consumer sector. According to analysts, the current Russian boom will continue for a minimum of five years.

The current dynamic growth in consumer demand is the result of nearly eight years of economic growth (with an average annual rate of 6.6%) and is partially related to the record oil and gas prices that followed the 1998 default and financial crisis. The population's real wages and consumer spending are now growing at nearly twice the rate of the GDP.

Today, the Russian economy ranks seventh in the world in terms of GDP calculated according to purchasing power parity, making its economy larger than those of developed countries like France and Italy. It is also bigger than Brazil's economy, which has rapidly developed in recent years. Growth in 2007 was higher than at any point over the last ten years. According to the Federal Service of State Statistics (Rosstat), GDP growth in Russia hit 8.1%. The most important factors in achieving this result were the condition of the world energy market, the influx of foreign capital into Russia and growing domestic industrial production and demand.

## Creating a Consumer Society

The high inflation rates of the last three years (inflation hit 11.9% in 2007) are a typical indicator of a consumer boom. Inflation rises in a large part due to increasing consumer prices, which would be impossible to sustain without the continuing growth of the population's income. According to Rosstat, the average monthly salary last year was 13,518 rubles, representing a 26.7% growth from 2006.<sup>1</sup> Real wages grew over this same period by 10.4%.

According to the Ministry of Economic Development and Trade, the total volume of Russians' income in 2007 was over 21.1 trillion rubles, a 22.4% increase over 2006. Over the same period, spending on goods and services grew by 23.5%.

It should be noted that the population's spending habits are changing relatively slowly. Consumer spending equaled approximately 70% of income and spending on purchases was around 54%. In Russia's earnings profile, approximately 65% was attributed to salaries, with the remainder coming from pensions, scholarships, income from properties, and income from business activities.

The Independent Institute for Social Policy, in analyzing indicators such as salary levels, savings, and real estate holdings, determined that consumers of deluxe-class products and services represent about 1% of the population. Less than 10% of the population lives below the poverty line. About 70% make up the lower middle class, or people who have not quite reached the middle class, but have already crossed the threshold of a 'consumer society' and buy more than just life necessities. Therefore, more than 90% of the population, representing tens of millions of people, consists of potential consumers in the market for goods and services.

Both upper and lower middle classes have radically changed their attitudes over the last ten years. On the whole, the population's welfare has increased and many representatives of the middle class work in dynamically growing sectors (such as raw materials, banking and retail services), where income has outstripped growth rates.

Another factor that stimulates consumerism in Russia is the relatively low prices for utilities and housing costs. Even though these fees are growing, they remain below the cost of production. This allows Russians to spend a significant part of their salaries on consumer desires.

Furthermore, Russia does not have a tradition of saving, and the population is much more willing to spend money than put it aside. One of the reasons for this preference is fallout from the limited consumer options available during the Soviet period. Many Russians still remember the era of deficit and when salaries were not paid in full, and therefore are trying to compensate for those lost opportunities.

All of these factors explain why the population's savings are only growing at a modest rate. In the first half of 2007, savings grew by 1.1 trillion rubles, just a 1.7% increase over the same period in 2006.

<sup>1</sup> According to the Ministry of Economic Development and Trade (MEDT)



Another powerful source of growth in the consumer sector is the explosion in the availability of retail credit. In 2007 the size of this market grew to \$100 billion. Credit available for specific purchases at retail outlets is largely responsible for the market's rapid growth. At the same time, the market for credit cards and express credit is also growing.

### Changes in Consumer Habits

The population's growing income — in June 2007 the average salary crossed the psychological barrier of \$500 — is responsible for the convergence of consumer habits with those of more developed countries. In more developed countries, the share of spending on foodstuffs is significantly less than in Russia, and cafés and restaurants are much more popular.

In recent years, there has been a tendency for the volume of non-food goods and catering to outstrip growth rates. Car sales are growing particularly quickly. According to the Association of European Business, in 2007 the number of foreign cars sold in Russia grew by 61%, reaching 1.6 million. This was the first year that more foreign cars were sold than domestic cars. By 2010, according to some forecasts, the Russian automotive market could become the biggest in the world.

### Advantages of Russian Business

Even though Russia is primarily perceived as an energy exporter overseas, transnational corporations ranging from automobile giants to perfume companies already consider it, together with China and India, as one of the most dynamic markets for consumer goods.

Russian businesses have also recognized that the consumer market offers excellent opportunities for growth with minimal political risk and state interference. The same cannot be said about the energy sector. Sectors like retail, mobile communications, automotive and food products are particularly interesting.

By 2010 the total turnover of retail sales is projected to double from \$245 billion to \$526 billion. At the same time, Russia's retail market is expected to rise from 12th to 9th place by volume. Currently, chain retailers and large stores only represent 15–20% of the market, with basic markets, street kiosks and Soviet-style stores accounting for the rest, meaning that vast development opportunities are available.

The Russian consumer market's potential is clearly attracting serious interest from international companies. However, while latecomers are weighing the pros and cons of entering Russia, local players are actively pursuing growth. Russian business has an indisputable advantage in that it understands local realities and consumers, which in turn supports its access to market capital. They have compensated for their insufficient international experience by attracting Western managers to their companies. This has helped level the field when competing with international players.

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# Telecmmunications

riding the consumer wave

## Telecommunications



Leonid Melamed

President and CEO, MTS

The Russian mobile communications market is entering a new phase of growth. Its key driver has become the growing popularity of additional services (content, mobile internet, etc.) and experts predict that this will allow mobile communications operators to double ARPU in the next 10 years.



Sergey Pridantsev

President, Comstar UTS

Broadband internet access in Moscow and, to an even greater degree, Russia's regions has huge growth potential. In 2007, market penetration was only 49% in the capital and just 4% in the regions. By 2011, broadband access is expected to reach 84% of Moscow households while its market penetration outside of the capital will triple.



Igor Zabolotniy

Acting CEO, MTT

The deregulation of long distance and international communications has opened exciting possibilities for the market's alternative operators. In just 2 years, alternative operators have already taken over approximately 20% of the long distance market, due to more flexible pricing, high quality service and effective marketing. The market's volume in 2007 was \$3 billion.



Gulnara Hasyanova

CEO, Sky Link

Mobile data transfer is a relatively new segment of the mobile communications market, and one of its fastest growing. Its growth rate has outstripped growth in the voice services market by nearly 2.5 times. In the next 3 to 4 years, the high speed data transfer segment could represent 10% of Russia's mobile communications market.

## Overview

Telecommunications represents a core, long-term business for Sistema. Sistema Telecom manages the companies in the Telecommunications business, including MTS, Comstar, MTT, and SkyLink. Sistema Telecom is developing businesses along two main lines: wireless and fixed-line communications. At the same time, it is building convergent services across wireless and fixed-line and delivering value-added services such as Internet banking that employ synergies with Sistema's other businesses.

### Wireless Communications

Operating in the wireless communications market, Mobile TeleSystems (MTS) is Sistema's largest asset and the leading cellular operator in Eastern Europe. MTS is one of the top-10 mobile companies in the world in terms of subscriber numbers<sup>1</sup>. The company is the leader in Russia's highly competitive mobile telephony market, with a market share of 33.2% in 2007<sup>2</sup>. MTS is also a leading player in the emerging mobile markets of Belarus, Turkmenistan, Ukraine, Uzbekistan, and Armenia. As of December 31, 2007, MTS had 81.97 million consolidated subscribers in Russia and the CIS, or 85.77 million total including unconsolidated subscribers in Belarus.

SkyLink provides high-speed mobile Internet, data, and voice services using third-generation CDMA 2000 1X EV-DO technology in Russia and it is present in 31 regions. The target market segment for CDMA 2000 services includes selected corporate and heavy-use private subscribers requiring wireless transfer of multimedia data, high-speed Internet access and significant volumes of high-quality voice traffic.

### Fixed-line Communications

Comstar-United Telesystems (Comstar) is a multi-service, fixed-line telecommunications operator based in Moscow. Through incumbent operator MGTS, Comstar owns the 'last-mile' access to around 3.6 million households in Moscow, representing 97.3% of total households in Russia's capital. In the alternative fixed-line segment, Comstar is the number-one provider of broadband Internet access to residential users in Moscow with 34.3% market share, and is a leading provider of complete service packages for corporate clients, which incorporate local and long-distance voice calling, virtual private networking, and other solu-

tions. In addition, Comstar holds a 25% plus one blocking stake in Svyazinvest, the holding company for Russia's incumbent regional operating companies.

Multiregional TransitTelecom (MTT) is a Russian domestic long-distance and international telecommunications operator. In an inter-carrier segment, MTT provides services for domestic long-distance, international, and inter-zone (in Moscow) traffic transmission to Russian and foreign telecom operators. In a subscriber segment, MTT provides domestic long-distance and international services to Russian fixed-line network subscribers.

## Marketplace

The market for telecommunications services continues to be one of the most dynamic and competitive sectors in Russia and the CIS today. The sector's significant growth potential is apparent in all key segments of the telecommunications business. According to data from the Russian Ministry of Information Technologies and Telecommunications, the total volume of the Russian telecommunications market grew by 15% to over \$32 billion in 2007.

### Wireless Communications

The total size of the Russian mobile telecommunications market reached \$18 billion<sup>3</sup> in 2007, up 28.6% year on year. Total mobile penetration passed 100% during the course of 2006 and reached 119% at the end of 2007. MTS remained the clear market leader in terms of market share, with the top three mobile operators accounting for 84% of subscribers<sup>4</sup>.

The Russian mobile market reached an important turning point in 2007. Previously, revenue growth was primarily driven by gaining new subscribers. As the market has developed, large numbers of new subscribers diluted average revenue per user (ARPU) numbers. In 2007, however, there was a clear shift towards increased usage and take up of value-added services, driven both by new services offered by mobile operators and increased consumer spending power. With nationwide penetration, mobile operators are able to stabilize or reduce capital expenditure and focus on deriving revenue growth from existing subscribers, even as average price per minute has declined in recent years. Adding new subscribers remains important, but is no longer the driving force in the marketplace.

1 According to Informa Telecoms & Media's World Cellular Information Service, by proportionate subscriptions in Q4 2007 (proportionate subscriptions relate to equity stakes in company's operations).

2 Source: AC&M Consulting, 31 Dec 2007

3 Source: Uralsib

4 Source: AC&M Consulting

Other important trends in the mobile market include the introduction and development of 3G (third-generation) services in Russia. The Federal Communications Agency completed a tender for licenses for IMT-2000/UMTS standard technology in April 2007, with MTS and two other leading mobile operators being awarded licenses. 3G coverage will allow operators to deploy new services, including wireless broadband, aimed at increasing ARPU and encouraging customer loyalty.

Russia's regional markets remain a key priority for mobile operators, as penetration is lower than in Moscow and the largest regional cities, and less-developed fixed-line infrastructure drives further demand. At the same time, Russian mobile operators are also fighting to build market share in CIS countries, where lower rates of penetration, generally poor fixed-line service, and rapid rates of economic growth allow companies to derive both organic revenue increases and gain market share through acquisitions and tie-ups with local operators. Going forward, the markets of developing countries outside of the former Soviet Union represent a further long-term growth opportunity.

In 2008 the total value of the mobile telecommunications market is forecast to grow by 27.8% to \$23 billion. Growth is expected to moderate to a sustainable level of \$2 billion to \$3 billion per annum after 2009, with a forecast value of \$35 billion by 2012.<sup>5</sup> Lehman Brothers has forecast a value of \$41 billion by 2017. Analysts predict growth in penetration will level off by 2011, with penetration of around 136%. Nonetheless, given the expected fall in the Russian population over the period and stability in the subscriber base, penetration rates could rise beyond this level, in particular if subscribers use additional cards for additional services such as Internet and mobile broadband. ARPU predictions vary significantly, with long-term (8–10 years) forecasts of between \$15 to \$30 per month or higher, depending on broader macroeconomic conditions.

### Fixed-line Communications

Fixed-line services for both residential and corporate subscribers, including voice, data-exchange, Internet broadband and related 'double-play' and 'triple-play' services, including IPTV, are developing dynamically, although there is still considerable unmet demand for services. The market remains at a far earlier stage of development than the mobile market, presenting major opportunities for development, particularly for operators able to combine the full

range of fixed-line services, including voice, broadband, data and local and long-distance voice services.

The combined value of the fixed-line telecommunications market in Moscow, including traditional and alternative services, was estimated by independent research group Direct Info at \$5.4<sup>6</sup> billion in 2007. The Moscow market is developing rapidly. Internet penetration reached an estimated 53% at the end of the year, with broadband Internet penetration of 49% and pay-television penetration of 17%.<sup>7</sup> The near-total penetration of voice services and the rapid decline in the use of dial-up services has meant that broadband has emerged as the primary market driver in Moscow. By 2011 total Internet penetration in the city is forecast to reach 84%, broadband Internet penetration 83%, and pay-television 38%.<sup>8</sup>

Moscow Oblast (which surrounds but does not include the city of Moscow) was the fastest-growing telecommunications market in the country during 2007 and there is a clear overlap in existing and potential client base. Moscow Oblast is the third largest region in Russia after Moscow City and St. Petersburg, with a population of 6.7 million and 2.2 million private households. The level of penetration of telephony remains low at 26%, and broadband stands at 6%, although it is growing quickly.

Internet and broadband penetration outside of Moscow are low but increasing rapidly, underlining the long-term attractiveness of the regional marketplace. Internet penetration at the end of 2007 was estimated at 15%, up from 9% in 2006. It is forecast to grow by a compound annual growth rate of 25% through 2011, reaching a level of 28%. Broadband penetration was estimated to have roughly doubled between 2006 and 2007, reaching 4% and is expected to reach 12% of households by 2011.<sup>9</sup> Independent consultancy iKS estimates that 75% of Internet access in Russia as a whole will be through wire-line broadband in 2010, with a further 10% through wireless broadband. The share of dial-up will fall from 28% at the end of 2007 to 15% by 2010.<sup>10</sup>

## Results

Consolidated revenues in the Telecommunications segment grew 31.7% to \$9.84 billion in 2007, compared to \$7.48 billion in 2006. Revenue growth outpaced the overall rate of the telecommunications market for the sev-

5 Source: Uralsib

6 Preliminary 2007 estimate by Direct Info research group includes fixed-line, data exchange and Internet.

7 Penetration is calculated as % of households; 2007 data is forecast/estimate. Source: Company data, Pyramid Research, J'son & Partners

8 Source: Company data, Pyramid Research, J'son & Partners

9 Penetration is calculated as % of households; 2007 data is forecast/estimate. Source: Company data, Pyramid Research, J'son & Partners

10 Company data, Pyramid Research, J'son & Partners

enth year in a row. OIBDA increased 37.5% during the year, reaching \$4.98 billion.

### Wireless Communications

In 2007 MTS retained and strengthened its market leadership in the Russian mobile market, with a market share of 33.2%. Also during the year, MTS increased its subscriber base by 12.5% to 81.97 million consolidated subscribers (total base including subscribers Belarus grew up by 13% to 85.77 million subscribers), and its subscriber base in Russia increased by 12.1% to 57.43 million users.

In April 2007 MTS received a license to provide wireless communications services using the IMT-2000/UMTS technical standard (3G) for all of Russia. During 2007 and entering 2008, the Company has been equipping and testing networks in a number of Russian regions. Before the end of 2008, MTS plans to launch 3G networks in a number of large cities, pending final agreements with regulators regarding frequency allocation. These 3G networks will allow MTS to substantially expand its ability to deliver additional services, including broadband Internet access through mobile devices.

One of the most significant events for MTS during 2007 was its entry into the fast-growing Armenian market with the September acquisition of an 80% stake in K-Telecom, operating under the VivaCell brand. In June MTS acquired the remaining 26% stake in its subsidiary in Uzbekistan, bringing its share in the company to 100%. Also during 2007, MTS began rebranding of its Ukrainian subsidiary UMC under the MTS brand, a move underlining the strength and quality perceptions of the MTS brand in the wider CIS region.

In addition, during the year, MTS received a license to provide 3G services in Uzbekistan as well as frequencies for providing WiMAX wireless broadband services in the country. The Company also received frequencies for providing 3G services in Armenia.

During 2007 MTS launched a range of new tariff plans and services for its subscribers, in line with MTS's strategy of continually developing the quality and range of its mobile services and extending its coverage area to retain existing customers, attract new subscribers and increase ARPU and MOU.

Beginning in May 2007, the Company launched a new credit-based billing system. New nationwide tariff plans 'Red\_text' and 'SMS-extra' were introduced to provide better value-for-money for frequent users of SMS and MMS messaging. The 'Svobodniy' tariff plan was launched to allow subscribers to talk for longer with minimal additional expenditure. Also during 2007, MTS launched the 'Regionalniy' tariff plan, developed for residents of Moscow Oblast with special tariff conditions during the 'dacha season' in the summer, when many city residents go to their country houses for weeks at a time.

Other tariff plans launched or expanded in 2007 include 'Rodnye Goroda' and 'Super Perviy', which provide unique pricing propositions for calls to local numbers, and a corporate tariff aimed at small businesses, which also offers attractive rates for calling within the subscriber's home region. 'Red Zone' was also launched, and provides subscribers under the 'Red' and 'Red\_text' plans located in certain areas to call other MTS subscribers with a 50% discount.

In a unique product for the Russian market, MTS launched the 'Classniy' tariff plan developed specifically for children, which allows children and parents to always stay in touch and includes access to a special WAP portal developed for schoolchildren. Another first during 2007 was the launch of Livejournal, an online diary service on the MTS WAP-portal, and social networking services, including blogs and other user-generated content.

In Ukraine, the Company launched BlackBerry services jointly with R.I.M, allowing encrypted mobile access to corporate email and attachments. For subscribers traveling in Europe, a new 'Europeyskiy' tariff plan now allows subscribers to take incoming calls without charge while roaming. Also during the year, MTS began testing MMS-based advertising with volunteer subscribers, and this format represents a potentially important future revenue generator.

The Business WAP portal allows users to get the latest information on stock markets and financial news and a new MTS-News section on the WAP portal brings subscribers breaking news from RIA-Novosti agency. A joint project with a range of leading Russian email-hosting companies alerts subscribers to incoming emails and is developing a WAP version of these email services to allow users to check their mail on their phones.

11 Source: Direct Info

12 Source: Direct Info

In 2007 SkyLink continued to launch innovative new services, many among the first of their kind in the Russian marketplace, to attract new subscribers and retain existing ones. In this area, SkyLink continued to be a trailblazer in the Russian communications market.

Sky Link delivers both mobile data (which is a priority segment for Sky Link) and voice services to subscribers. The company's profit in high-speed data services grew up to 30 percent. According to the company's forecast, it will increase up to 50 percent in 2008. Sky Link's network is based on the CDMA2000 1X EV-DO. Technological advantages of this digital standard give Sky Link's subscribers the high-speed mobile Internet and data transfer (up to 2.4 Mbs), high-quality voice communications, and the ability to access solid volumes of information and multimedia services.

In all segments (Voice and Data, Voice Only, and Data Only), new product launches included 'Platinum Number' and 'Choice of Diamond Number' in Moscow and 'Beautiful Number' in St. Petersburg, which allow subscribers to choose numbers with paired digits or two repeating pairs. New services in Moscow and St. Petersburg allow for changing tariff plans through the Sky Point application. Payment on credit was launched in Ulyanovsk and 'Single Balance' was launched in Omsk, allowing customers to monitor accounts linked to several different numbers.

Entering 2008, Sky Link had developed a new loyalty program for its subscribers, including participation in the Malina loyalty scheme, due to begin in June 2008, which includes a number of leading Russian retailers and consumer providers, and working to develop co-branded cards with banks, among other projects.

In the Voice and Data segment, the company launched Mobile-Television and Videotech services in Moscow and St. Petersburg in 2007, and commercialized its remote Video Observation service. Other services launched include Mobile MSN and Mobile Livejournal (as part of the SkyMobile Web portal). In early 2008 'Mobile Media Broadcasting' based on RSS channels was put into commercial use in Moscow, and 'Mobile TV', developed with Sistema Mass Media was launched with five original Stream channels. 'Mobile Rutube' was launched in Moscow and St. Petersburg, allowing users to post and share video content.

In the Voice Only segment, a new service allowing for free incoming calls for subscribers with negative or zero balances was launched. A new tariff option allowing for discounted domestic and international long-distance calls was introduced with the goal of raising to 10% the share of long-distance traffic in outgoing voice calls on the network. The service was launched in Moscow, Voronezh,

Omsk, and Novosibirsk in 2007, and covered six regions by early 2008.

Also during the year, a new mobile banking service was introduced in Moscow in cooperation with SmartCardLink CJSC, while in early 2008, the SMS Banking service, allowing subscribers to check bank balances by text, was expanded to 24 Russian regions. During the Presidential Elections in March 2008 Sky Link provided a nationwide text update service on the results of the polls.

Plans in the Voice Only segment for 2008 include further development of domestic and international long-distance voice services through the expansion of new tariff options to a further four regions during the first half of the year. In Moscow, Sky Link plans to launch the 'Overseas Telephone Number' service, providing subscribers with the option of an additional overseas telephone number that can be paid through a single Sky Link bill and offered in conjunction with partner company Traveltele.com.

In 2007, in the Data Only segment, Sky Link tested a speed quota system for data exchange using unlimited Internet access tariff plans necessary for the future launch of unlimited Internet content-oriented tariff plans. It also launched a new luxury product, SkyVIP, and the series Black Tie and Black-Tie Business in Moscow, while carrying out a major promotion jointly with Videoport Ltd by offering a month of unlimited video communications. An Internet-based VideoCalls service was launched in cooperation with Videoport in early 2008. In 2007 the Company also set up a test zone for Session Initiation Protocol (SIP-based) telephony in Moscow.

In St. Petersburg, subscribers were offered access to the gaming portal Nienshants-Home and multiplayer gaming servers. Preparations were made for the launch of a test zone for a new 'Dacha Guard' product allowing for remote video monitoring of holiday homes, using Goal systems developed by All Systems Limited and Tral by SMP Ltd. The 'File Express' service offered in Ulyanovsk and Rostov allows users to increase file-download speeds by 50%. Other local services launched in 2007 included 'Local Data Exchange,' providing free data transfers within the Sky Link network for users in Ulyanovsk, and e-mail services on the Sky Link servers for users in Tver.

In 2008 Sky Link plans to launch a 'Data Only' version of its box product with blocked voice services and a simplified sales and connection procedures. Other expected product launches include push e-mail services in Moscow and St. Petersburg from May 2008.

In early 2008, after the reporting period, Sky Link signed a deal with Qualcomm Inc. expanding the territory for



BREW hosting to all of Russia, the CIS, the Baltic States, and Eastern Europe without additional expenditure for technical support from Qualcomm.

### Fixed-line Communications

Comstar accounted for an 8% revenue share of the total fixed-line market in Moscow. Including MGTS, Comstar's total share of the Moscow fixed-line market stood at 29%, making it the clear market leader. At the end of 2007 MGTS had 4.8 million installed lines in the city. MGTS accounted for 20.5% of the Moscow fixed-line market in terms of revenue in 2007. In 2007 Comstar had a 2.5% revenue share of the combined traditional and alternative fixedline market in Moscow Oblast, which was valued by the Group at \$378 million. Comstar has targeted a market share of 16.4% by 2011. Comstar's broadband strategy extends to the regional markets. At the end of 2007, it had some 48,000 broadband users outside Moscow. Its pay-TV subscriber base in the Russian regions reached 102,200 subscribers. In the CIS, Comstar's Ukrainian subsidiary has a base of 3,000 subscribers and a number capacity of 22,800. In Armenia, Comstar's subsidiary has been limited to Internet access provision until deregulation at the end of 2007, and it accounted for around 20% of the Armenian Internet and data exchange market in late 2007.

During 2007 a new management team was put into place at Comstar to guide the Company during the next phase of its development. In June Sergey Pridantsev joined Comstar as President. A five-year Strategic Plan for the integration of Comstar's assets, the introduction of process management, and aggressive plans for existing and new markets was adopted during the second half of 2007. A new Management Board was created to lead the operator, and substantial efforts were focused on reducing intermediate management levels, cutting costs and simplifying the legal structure, with the long-term plan to create a fully-integrated operator at Comstar, with MGTS remaining a separate legal entity as Moscow's regulated incumbent operator.

In 2007 Comstar's number-one commercial priority was increasing broadband penetration both in Moscow and in Russia's regional markets, as broadband represents the key growth area in the fixed-line market and the key technology for delivering additional services.

As part of its broadband strategy, Comstar started to use the MGTS brand for mass-market tariffs for speeds up to 2 megabits per second, which are available on credit-based payment plans. The Stream brand continues to be used for

premium tariff plans (from 1 to 6 megabits per second). During 2007 Comstar increased the number of Moscow broadband subscribers by 81% to 695,000, including 651,000 residential subscribers.

Also during 2007, Comstar began preparation for the deployment of a Mobile WiMAX network to provide wire-line broadband subscribers with a new seamless service outside the home. Comstar signed a strategic cooperation agreement with leading global technology group Intel for the wide-scale development of Mobile WiMAX technology in Russia. With Intel's technical support, Comstar plans to deploy an IEEE 802.16e Mobile WiMAX network covering the entire area of Moscow and the surrounding Moscow Oblast by the end of 2008. Going forward, Comstar and Intel will work together on future launches of Mobile WiMAX networks in other Russian cities and regions.

In the third quarter of 2007 Comstar launched an integrated program to modernize its network in Moscow in order to reduce investment and operational costs associated with servicing the infrastructure, as well as to increase its capacity. During 2007 the Group completed the upgrade of MGTS's backbone network to 40 Gbps, enabling Comstar to offer its customers a high-quality service and to reduce the connection time for new subscribers. Comstar has also upgraded Comstar Direct's backbone network, resulting in the increase of its capacity from 20 Gbps to 40 Gbps.

Alongside the development of existing regions, Comstar is also focused on expansion into selected target markets through acquisitions of competitive local exchange carriers (CLECs) that are ranked number one or two after the incumbent operator in their local markets. In late 2007 Comstar bought Digital Telephone Networks South (DTN) for approximately \$167.4 million. DTN is the largest alternative operator in southern Russia. In a second major deal, Comstar acquired 87.5% of Regional Technical Center (RTC) for \$21 million. RTC is an alternative fixed-line operator in the Khanty-Mansiisk Autonomous District and in Orenburg Oblast. In addition, the operator also has branches in Saratov, Ryazan, and Moscow.

Over the past five years MGTS has increased the level of digitalization of its network from 13% to 54%, having built a digital transport network and putting into use a data-exchange network for general use. At the same time MGTS is conducting a selective modernization of its 'last-mile' infrastructure to allow itself and Comstar to further exploit technical and marketing synergies and deliver broadband Internet access at a higher speed, while also providing

additional value-added services such as High-Definition Television, gaming, home monitoring, and much more.

The main driver of revenue growth for MGTS as the regulated monopoly operator is growth in tariffs, which are regulated by the Federal Tariff Service. In February 2007, following regulatory changes affecting residential telephone tariffs, MGTS offered its residential subscribers the choice of three calling plans aimed at best meeting their budgets and calling habits. MGTS was able to accomplish this transition smoothly, technically allowing all subscribers to make their choice, unlike other regulated Russian companies. At the end of 2007 more than 50% were still on unlimited, 28% on 'per minute' and 21% on combined plans. From February 2008 the cost of unlimited monthly tariff plans was reduced by 10% under tariff rates agreed with the Federal Tariffs Service in November 2007.

After the reporting period, in February 2008 Comstar completed the construction of its own domestic and international long-distance network. The company installed seven inter-city transit nodes, accounting for each of the seven federal districts in Russia, and four international nodes. In addition, Comstar concluded agreements with all Russian operators of zone telecommunications, as well as with international operators. The investment of around \$14 million will allow Comstar to further strengthen its client service offering with its own long-distance services.

Comstar's 25% plus one blocking stake in Svyazinvest puts it in a strong position in the event of a future privatization of the holding, and continues to represent a sound financial investment.

MTT reported strong operational results in 2007, including a sharp increase in revenues year on year. In an inter-carrier segment the MTT market share has increased substantially, from 27%–28% to 37%–38%. MTT has also gained in market share equal to 11% in a segment of traffic transmission to foreign operators. In a subscriber segment, MTT succeeded in increasing its market share from 4% to 7%.

The MTT's chief source of revenue in an inter-carrier segment in both 2006 and 2007 stayed on domestic long-distance and international traffic transmission of mobile network operators, amounting to \$419 million for the year 2007. The traffic transmission services market is reaching saturation with average annual growth rate between 2005 and 2007 of some 110%. After the liberal-

ization of the a long-distance market in 2006, provision of traffic transmission services to foreign telecom operators became a new area of an inter-carrier market for MTT. This part of the market accounted for \$46 million of MTT's revenues in 2007.

In 2007 the market for services of termination and transit of incoming traffic to Russia from foreign operators grew by 102%. This became possible due to the continuous development of international telecommunications and the expanded presence of foreign companies and enterprises in the RF.

Following the 2006 liberalization of the long-distance market, MTT has entered the subscriber segment for mobile telecommunications company subscribers. Revenues from provision of services to mobile customers amounted to \$206 million, which corresponds to 6.8% MTT market share. During 2007 MTT focused considerable efforts on the regions, in order to develop sales of telecommunications services and other services to end-users through the active development of a representative network.

This paid off through faster-than-expected growth in revenues in the regions, with sales 15% above expectations. More than 55% of revenues from long-distance telecommunications services were gained from private users. The average growth rate in this segment was 110%, with the average growth rate in the market for business users growing by 105%

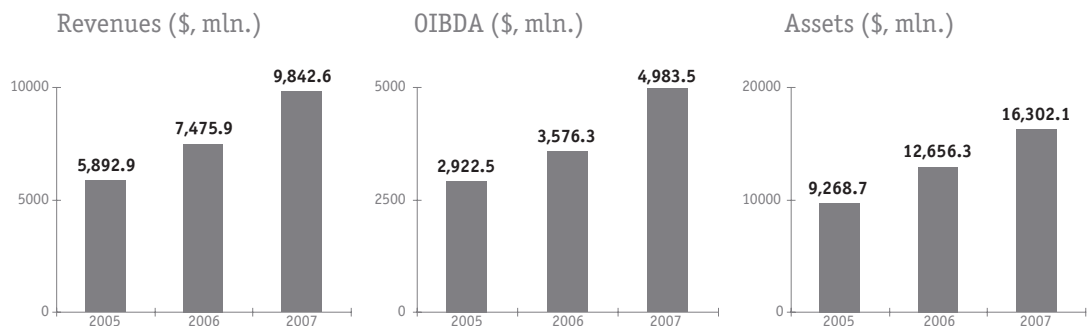
Also in 2007, MTT launched a new 'Subscriber Portal' to manage subscriber accounts online and provide better feedback communication. The portal allows to manage the service and monitor its usage, providing more accurate statistics, improving feedback, answering frequently asked customers' questions. To improve customer loyalty, MTT has signed contracts with leading Russian payment systems to provide another convenient way of payment of domestic and international telecom services.

New services launched by MTT include 'Universal Access Number,' a fixed-to-mobile convergence service providing a subscriber with the service of a single virtual 804 code telephone number. 'International Free Transit Calls' service allows an outside provider to organize International Free Calls (IFS/UIFN) from a country such as Russia, where that provider does not have an IFS/UIFN service agreement. In addition, MTT has launched Home-Country Direct (HCD), enabling to call a special number in a home

country toll-free and complete the call with an operator in a home country. Moreover, within the previous year MTT has launched a 'Virtual Calling Card' aimed at individual users.

One of the key areas of strategic development for MTT during 2007 was a further development of intelligent data network services, including services aimed at corporate users and development of projects such as 'televoting' and traffic transmission for content providers. In addition, MTT focused on an intensive development of services for traffic transmission to outside intelligent data network operators and content providers.

Revenues, \$ **9,842.6 mln**  
 OIBDA, \$ **4,983.5 mln**  
 Assets, \$ **16,302.1 mln**



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# Techn*i*logy



Sergey Aslanian

President, Sitronics

## Technology

The Russian market for microelectronics is growing at twice the world average. The main factor behind its momentum is the active growth in domestic demand for microelectronics solutions in transport, finance and other economic sectors. In the Moscow Metro alone, 8 million passengers a day use smart cards.

### Overview

Sistema's Technology business is represented by Sitronics, a leading provider of innovative and complete telecommunications and technology solutions, including software, equipment, systems integration, microelectronics solutions, IT solutions, as well as production of consumer electronics in Russia and the Commonwealth of Independent States, along with a strong presence in Central and Eastern Europe and a growing business in the Middle East, Africa, and Asia. Sitronics has offices in 32 countries and exports products and services to more than 60 countries, serving over 3,500 clients.

Sitronics is a truly multinational group, with its Telecoms Solutions operations based in Zelenograd, Russia, Prague, Czech Republic and Athens, Greece. The Company's IT Solutions division is based in Kiev, Ukraine, and the Microelectronics Solutions is based in Zelenograd, Russia. Sitronics has over 10,000 employees. In 2007 it established a Sitronics-Nanotechnologies in cooperation with the Russian government to drive development of this fast-emerging technology sector.

## Marketplace

### Telecommunications Solutions

Today, the global telecommunications marketplace is being driven by growth in demand for next-generation data and convergent services as opposed to traditional voice services, and this trend is observed in both developed and emerging markets, where enormous potential in this area is becoming unlocked. In particular, there is growth in Internet usage and access to a variety of services and offerings, such as online gaming and streaming video, as well as the rapid development of VoIP (Internet telephony), IPTV and 'triple-play' services (voice + data + video). A new generation of technology and tough competition are pushing both fixed and mobile operators to invest in new equipment and acquire end-to-end network solutions to preserve and enhance market share and increase average revenue per user (ARPU).

According to data from ACM Consulting, in 2007 the level of broadband Internet penetration in Russia was just under 10%, representing a near doubling of the market compared to just one year earlier. Analysts at Renaissance Capital investment bank have estimated that Russian broadband penetration may reach 50% by 2013.

These growth dynamics are driving the market for data-exchange equipment, broadband access, routers, and other related products in the target areas. According to IDC, the market for broadband telecommunications equipment in Eastern Europe, the Middle-East and Africa (EEMEA) grew by 6.5% year on year in 2007. The market for WiMAX equipment grew by 31%.

In order to deliver convergent services, telecommunications operators across the world are moving away from Time Division Multiplexing (TDM) technology and towards the convergence of mobile and fixed-line communications and consequent shift to the next generation of networks based on IP protocols and IP Multimedia Subsystem (IMS) networks.

Telecommunications markets across the globe are in the process of shifting to combined NGNs with the use of 'Softswitch' (software switching equipment) that simultaneously support wire-line and wireless access to a full range of services for voice, data, and video. Regional telecommunications operators in particular are expected to increase capital expenditure in 2008, increasing digitalization and delivering DSL services. As a result of convergence, the market for TDM equipment in Europe, the Middle East and Africa (EMEA) declined by 18.6% in 2007 compared to 2006, while the market for NGN solutions

grew by 29.5%, and Media Gateway technology grew by 37.6% over the same period (according to IDC).

Deregulation and a tough competitive environment for mobile operators will drive future investment in network technology in large markets such as India. There, moves towards de-regulation mean that operators will need to invest more in new technology in coming years to deliver value-added services and maintain customer loyalty, while boosting average revenue per user. In the Middle East, the growing young populations, expatriates, and cross-border expansion by telecommunications operators also contribute to the need to invest in new technology platforms in these markets.

### Microelectronics Solutions

According to data from company iSuppli, the global market for semiconductors in 2007 showed modest growth of 3.3% compared to 2006, reaching a value of \$268.9 billion. The Russian market grew by 9.3% in 2006, and relatively slow growth globally of microelectronics production over the past two years is linked to strong competition and better management of inventories (and hence clearance of stocks), along with increased production capacities and greater flexibility in the production of chip memory.

In addition, the demand for microchips for computers and a range of consumer electronics was significantly lower than expected in 2007, and this had an impact on contract chip makers (foundries). The low ebb in this cycle is estimated to have been crossed in the beginning of 2008, and the situation is expected to improve. Against this background, chip producers have been engaged in improving production technology and preparing for the next-wave growth to hit the marketplace. This growth will include the development and production of the newest types of chips for the new generation of electronic devices, such as mobile telephones and gaming devices.

According to iSuppli data, the fastest growth segments globally of the microelectronics market will be the data processing, fixed-line, optical semiconductors, sensors and actuators, automotive and consumer electronics. Looking forward, iSuppli forecast rates of market growth of 7.5% in 2008 and 4.1% in 2009 before the market is forecast to pick up momentum with up to 10% growth in 2010.

The relatively high growth was posted by Asia-Pacific region, expanded by 6.6 percent in 2007. Given the serious potential for growth, we view Asian markets, mainly China and Taiwan, as our major export bases. Lower production costs and proximity to the buyers led to the strategic decision to place export assembly capacity there.

## IT Solutions

IT market research company IDC estimated the total value of the Russian IT market (IT services, hardware, and software) at \$16.7 billion in 2007, and forecasts it will reach a value of \$27.5 billion in 2010. The share and growth of the hardware segment of the market is declining as the market matures, with the share of IT services and software increasing to around 33% of the total market in 2007.

The structure of IT demand has a mid-term tendency to shift from horizontal IT solutions, such as ERP systems and infrastructure solutions, towards integrated vertical solutions for key business processes. Expenditure from the federal and increasingly regional government budgets and by state agencies are also key contributors. Sales of legal software in the Russian market reached \$600 million during 2007, according to the Russian Ministry of Communications. Continued efforts to combat software piracy and Russia's strengthened intellectual property (IP) commitments as a part of its WTO membership bid are helping to drive software sales.

In other CIS markets, the share of IT services and software in total IT sales remains substantially lower, averaging less than 15%, with hardware sales remaining key growth driver. These markets are still in the early stages of developing strong domestic markets for IT services and retain strong long-term growth potential. Spending on IT infrastructure by governments and state agencies is contributing to rapid development in these markets. IDC is currently forecasting that the Central and Eastern-European markets for IT services will grow by a CAGR of 17% between 2007 and 2010, from a value of \$9.9 billion in 2007.

## Results

The Technology continues to represent a major, long-term growth opportunity for Sistema. The performance in 2007 was affected by the postponement of two large projects in the Telecom Solutions business segment, the 3G network deployment for MobileTelesystems (MTS) and the NGN project for Comstar, until 2008.

Revenues amounted to \$1,619.6 million in 2007, compared to \$1,610.7 million in 2006.

Sitronics conducted an IPO on the London Stock Exchange in mid-February, 2007 selling 17.5% of its shares in the first-ever international listing by a Russian technology company and the second largest technology IPO on the LSE. The transaction raised a net \$356.4 million for the future development of the company.

During 2007 Sitronics launched a restructuring strategy to more tightly integrate its group of leading technology assets (in Russia, Greece, Ukraine, and in the Czech Republic) to make the company more efficient and exploit as yet unrealized synergies between business divisions. The management of major projects will be overseen by headquarters to better coordinate cooperation across business units and best manage large-scale and highly complex projects.

As part of the ongoing restructuring program in 2007, the Consumer Electronics and Electronics Manufacturing Services segments were merged into the Consumer Services and Products segment. The new segment manufactures and contracts production of consumer electronics for third-party clients, as well as markets consumer electronics under the Sitronics brand, sold by retailers throughout Russia.

A number of senior management changes were made during the year as Sitronics embarked on this new stage of development following its IPO. Sergey Aslanian was named President of Sitronics in October, 2007. A new Management Board was also approved, with a number of new key managers appointed during late 2007 and early 2008 to develop and implement the company's long-term strategy.

New product strategies were adopted in 2007 in each of the business units within Sitronics (Telecom Solutions, IT Solutions, Microelectronics Solutions, and Consumer Services and Products) to optimize existing product range and target fast-growing product segments where Sitronics can achieve long-term profitable growth and benefit from emerging technologies and burgeoning consumer spending in both Russia and emerging markets worldwide.

During 2007 Sitronics launched a major restructuring and cost optimization program in the Telecoms Solutions business unit. New management appointments were made, and unified business processes applied throughout the business divisions. A new strategy was put in place for making the most effective use of alliances and partnerships with other global technology companies. Under this strategy, priority is assigned to the most productive partnerships and a new system of incentives has been developed for partners.

A full audit of the product portfolio of the business was also conducted in order to identify the products and services with the highest growth potential. This led to the launch of a new product strategy at the Mobile World Congress in Barcelona in February 2008, aimed at supporting the development of product areas with the maximum potential to deliver high-margin growth, such as

NGN technology, while preparing to exit segments that are loss-making or offer limited longer-term returns, such as TDM technology.

In 2007 a number of major international technology companies became partners of Sitronics, while existing alliances were expanded, underlying the continued potential of strategic agreements to strengthen product offerings in existing markets and enter new product and geographic markets.

In March 2007 at a ceremony attended by Russian President Vladimir Putin and Chinese President Hu Jintao, a Memorandum of Understanding was signed between Sitronics and China's ZTE Corporation envisioning cooperation in the Russian, Chinese, and international telecommunications markets. The companies agreed to concentrate their efforts in a joint enterprise for the production of telecommunications equipment. Chinese production represents a major opportunity for Sitronics not just to develop a new low-cost production base, but to position itself in proximity to fast-growing markets in South and Southeast Asia.

Also during the year, Sitronics signed a framework purchase agreement with Nokia Siemens Networks for the development of high technology products and solutions. In addition, jointly with Ericsson, Sitronics is supplying operator MTS with equipment and services for the development of its 3G telecommunications and service networks in Russia and the countries of the CIS. As part of the project, Ericsson and Sitronics will provide UMTS technology for the MTS network.

A newly-formed alliance between Sitronics and Microsoft in March provided operators an end-to-end billing solution. The first customer to benefit from this collaboration was Vodafone Czech Republic, which is today using the integrated solution to enhance its billing, customer care, and ordering processes in order to more rapidly deliver new, more sophisticated packaged services to the market.

The Telecom Solutions segment generated 35% (2006: 44%) of total company revenues in 2007.

The Telecom Solutions business unit made major progress in expanding its client base in the global marketplace. It was able to win new clients in 2007 in areas such as the supply of broadband access services, the construction of WiMAX networks, and the supply of Content-Delivery Networks, such as IPTV and triple play services.

Large-scale contracts were signed with a leading Greek Internet provider Hellas Online to supply an NGN network on a turn-key basis, as well as a contract with Zain

Bahrain for the deployment of a WiMAX network. In addition, Sitronics signed a partnership agreement with Jordan Telecom Group to supply IPTV equipment and services for the JTG Orange ADSL network. Contracts were signed with Wateen Telecom in Pakistan and Telecom Srbija in Serbia for the supply of billing systems. A contract was signed to supply a WiMAX network for newly-created Montenegrin mobile operator MTEL. In addition, new contracts were signed for the development and installation of telecommunications infrastructure for BTC Mobile in Bulgaria. At the same time primary attention was paid to the Telecom Solutions business division's traditional client base in Russia, the CIS, Greece, Czech Republic, Germany, and the Middle East.

Kvazar-Micro, representing the IT business division of Sitronics, continued to demonstrate its status as the leading systems integrator in the CIS. In 2007 it successfully installed information systems in the largest banks in Ukraine, Russia, and Kazakhstan, and carried out IT projects for ministries, departments and regional administrations. Today it is entering new industry and geographic markets, providing its clients with an even wider array of services and integration opportunities.

The Information Technology Solutions segment's revenues were up 36.6% year on year for the full year 2007, as the business continued to demonstrate a strong performance in the fourth quarter, both in the system integration and distribution businesses.

Major complex projects include the construction of a CDMA-2000 network for MTS-Ukraine in cooperation with Alcatel Lucent. A budgeting system was implemented for telecommunications group BITE in Latvia. Other projects were delivered for Delta Bank in Ukraine, Nurbank, and Bank Turan Alem in Kazakhstan, and supermarket group O'Kay in Ukraine, among others. In addition, a Microsoft licensing program was carried out for a range of clients within the wider Sistema Corporation, including Comstar, the Moscow Bank for Reconstruction and Development, MTS, Intourist, and Medsi.

The Microelectronic Solutions segment was Sitronics's best-performing business during 2007, with year on year revenue growth of 77.1%. The strong sales growth was fueled by robust demand in the Russian microelectronics market, which grew at approximately double the pace of the global market. A doubling in Russian government orders for research and development projects was made possible by Sitronics's continued technological leadership in the industry in 2007, including the launch of 0.18-micron EEPROM technology at Mikron's facility in Zelenograd.



In early 2007 Sitronics began supplying smart cards for the Moscow Metropolitan underground rail system, one of the largest metro systems in the world used by over 8 million passengers each day. The contactless tickets are more efficient than older magnetic-strip ones, making the system both more efficient and flexible for passengers. The expansion of RFID card production during the year saw the establishment of a value-added chain from the chip to the finished card. Sitronics received a new contract from the Moscow Metro for 2008, and the company is targeting opportunities for smart-card solutions for federal, regional, and municipal clients in Russia and the CIS.

The active and successful partnership of Sitronics and the Russian government continues to drive a renaissance in the Russian microelectronics industry, which only a few years ago was seen as all but moribund. Sitronics built a new microelectronic production line based on 0.18-micron EEPROM technology at its Mikron facility in Zelenograd in December 2007, having obtained state-of-the-art production technology and personnel training from a long-term strategic partnership with France's STMicroelectronics. More than 100 engineers from Micron underwent re-training at factories in France, Germany, and Japan.

The Russian state became a 10% shareholder in NIIME and Mikron OJSC. In late 2007 and early 2008 the Russian Ministry for Economic Development and Trade, the Ministry of Regional Development of the Russian Federation, and a Government commission approved the investment project 'Organization of microchip production based on 12" wafers for 65–45 nm design rules'. It is envisioned that Sistema and Sitronics would jointly own 53.92% of a new nanotechnology venture. Sitronics plans to begin implementing a project to build a factory for making microchips based on 65–45 nanometer technology. Construction of the new facility is planned to take place in 2009 and 2010.

Together with the government of the city of Moscow, Sitronics is playing a leading role in creating the Moscow Economic Cluster in Zelenograd, the center of which will become the new 65–45 nanometer microchip production facility. A unique 'innovation ecosystem' is being developed around this plant which will attract smaller research companies. With this project, Russia is reviving its scientific and technical school and it will define the future direction for the development of microelectronics in the coming decades.

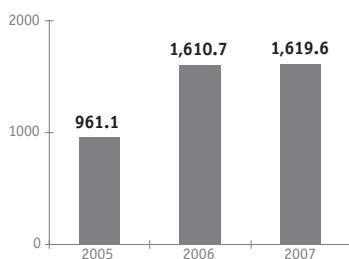
In September 2007 Sitronics conducted its first ruble bond issue. The 3-year RUR 3 billion issue was priced at 100% with an annual coupon of 10% and a put option after 1.5 years, at which time the coupon rate could be reset. The issue allows Sitronics to re-finance existing US-dollar-denominated debt into local currency and makes the company's cash flows more transparent.

International agencies Moody's Investors Service and Fitch confirmed their ratings for Sitronics during mid-2007. Moody's confirms the long-term foreign-currency credit rating of the Company at the level of 'B3,' with stable forecast moving forward. Fitch Ratings confirms a Long-term Issuer Default rating (IDR) of 'B-' with a stable outlook. The ratings underlined the continued strength of the operating activities and financial position of Sitronics and its ability to raise finance on attractive terms in the international debt markets.

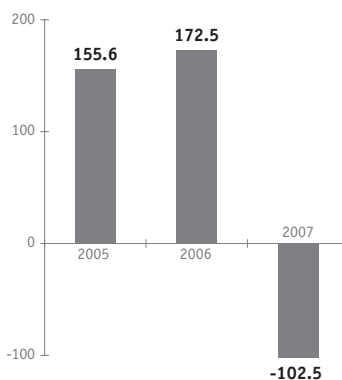
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Revenues (\$, mln.)

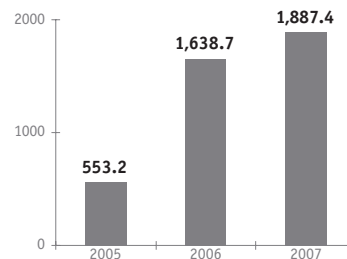
Revenues, \$ **1,619.6 mln**  
 OIBDA, \$ **-102.5 mln**  
 Assets, \$ **1,887.4 mln**



OIBDA (\$, mln.)



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# Ral Estate Development

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Felix Evtushenkov

President, Sistema-Hals

## Real Estate Development

Against a background of general economic growth, the real estate market is experiencing exceptional growth rates. In 2007, about 1.5 million square meters of class A and B office space were brought on line, representing twice the level of the year before. According to experts, this indicator will reach 2.65 million square meters in 2009.

### Overview

Sistema-Hals is Sistema's main operating subsidiary in the Real Estate Development business and is a leading Russian real estate developer with unique exposure to premium segments of the marketplace. The company provides integrated services in four strategic areas that cover the entire lifecycle of a property: real estate development, project and construction management, real estate asset management, and facility management.

Sistema-Hals has unique exposure to all segments of the construction industry, including residential, commercial, retail, and infrastructure projects. It also has proven expertise and resources to deliver on complex ventures, with a track record of successfully completing more than 30 major projects with a total area of approximately 300,000 square meters. Sistema-Hals has been the developer of choice in Russia for blue-chip companies, including DaimlerChrysler, Dresdner Bank, Raiffeisenbank, and Siemens.

## Marketplace

The Russian real estate market is in the midst of an unprecedented boom, fuelled by the country's macro-economic growth and continued demand for modern, high quality office, retail, and residential space, as well as major, long-term infrastructure improvement projects being carried out by the Russian government and local authorities to meet the needs of the 21st century economy and society.

Russian and international companies have expanded their presence in the country and require world-class office space. An emerging middle class is investing money in modern housing with modern infrastructure, and the rapid recent expansion of the mortgage market is fuelling further demand for new housing and accompanying infrastructure.

Total construction increased by 18.2% in 2007, according to real estate consultancy Blackwood. In the commercial market, the total volume of office space put into the Moscow market stood at around 1.5 million square meters, two times the level in 2006, and exceeding volumes seen in the largest cities in Western Europe and North America, according to consultancy CB Richard Ellis. At the same time, high costs and limited space in the capital have pushed many companies to seek high-quality office space outside of the city limits, in the neighboring Moscow Oblast beyond the MKAD circular highway.

In St. Petersburg, the total volume of class A and class B office space at the end of 2007 stood at around 590,000 square meters, according to Colliers International. Around 170,000 square meters of office space was put into market in 2007, with a further 330,000 square meters planned.

Looking forward, Colliers International forecasts that new construction and reconstruction will see 2 million square meters of quality office space added in the Moscow market in 2008, 30% of this in the class A category. In 2009 the total figure is forecast at 2.65 million square meters, with class A accounting for 40% of the market for quality office space. In Russia's regions, the market is being driven by continued demand for quality office space and consequent recent sharp rises in leasing costs.

Similar dynamics were seen in the retail property market in 2007. In Moscow, the amount of new retail space offered grew by 18% to 545,000 square meters, including 280,000 square meters of trading space. By the beginning of 2008 the total floor space of Moscow retail centers stood at more than 3.43 million square meters, with 1,800,000 square meters of trading space, according to Colliers International. Colliers forecasts that 24 retail

centers will open over the course of 2008, representing an additional 1,700,000 square meters, including trading space of 800,000 square meters. Similarly dynamic development was seen in Russia's regional markets.

The pace of residential construction in Russia continued to accelerate in 2007, with more than 60 million square meters of new residential housing built during the year, around 20% greater than the residential space added in 2006, according to Blackwood. The fastest rate of development was seen in Moscow Oblast, in the suburbs of the capital. The city of Moscow saw around 4.8 million square meters of residential space built during the year. In the premium residential segment, Moscow saw sales on the primary market at 57 residential complexes at various stages of construction, a 46% increase on 2006 levels, according to Knight Frank. Average prices for elite, new-build housing jumped 22.9% during the year. Prices in St. Petersburg increased by an average of 40%, reflecting a continued shortfall in capacity to meet demand and similar trends are visible in other large regional cities.

## Results

The Real Estate Development business consolidated revenues for 2007 increased by 59.8% year on year to \$452.2 million, compared to \$282.9 million for the full year 2006, driven by the strong performance of Sistema's operating subsidiaries in the area. In 2007 consolidated OIBDA amounted to \$56.7 million; OIBDA, excluding the non-recurring expense of the stock compensation bonus plan, increased by 85.0% to \$156.6 million compared to 2006. In 2007 the OIBDA margin, excluding the non-recurring expense of the stock compensation bonus plan, was 34.6%.

According to an independent analysis conducted by Cushman & Wakefield Stiles & Riabokobylko (C&WS&R), the value of Sistema-Hals's holding in properties and development projects rose by 30% during the period from July 1, 2007 to January 1, 2008.

C&WS&R determined that as of January 1, 2008, the total market value of 100% ownership of 103 projects and properties amounted to \$4,645.3 million. Of this amount, \$3,745.9 million was attributable to Sistema-Hals after deducting minority interests.

The growth in the value of the company's share in properties and development projects is largely the result of acquisitions of new projects, progress in the execution of ongoing projects and an increase in the gross building area (GBA) of development projects and properties in the premium segments.

According C&WS&R, Sistema-Hals had 103 properties, including 24 held as investments, 33 in course of development, and 46 held for future development. These properties accounted GBA of 8.928 million square meters and an open-market value of \$14.954 billion.

New projects under development include Khamovniki, 23/7 and 23/6 Lev Tolstoy Street in Moscow at the former site of the Khamovniki Experimental Drinks Factory. Sistema-Hals plans to build an elite residential complex with a total area of approximately 70,000 square meters, including luxury apartments, three detached mansions, office space, ground-level and underground parking, and associated infrastructure.

The Gorky 8 project envisions the building of more than 70 townhouses and a retail mall of approximately 35,000 square meters on a land plot of nine hectares on the Rublevo-Uspensky Highway in Moscow Oblast. The Gorky 8 Second Phase includes plans to construct a mega villa community situated between two Sistema-Hals developments, Landschaft and Gorky 8, and totals 61 hectares.

Also during 2007, Sistema-Hals established Sistema-Hals Ukraine to manage the development of the company's projects in Ukraine and search for new sites. In Ukraine, the Company is developing a multi-functional residential complex in Yalta with a total space of 140,000 square meters. The complex includes three 22-storey two-sectioned apartment buildings. Office spaces are planned for the non-residential part of the development, along with two restaurants, a store, a fitness center, spa, and a helicopter pad on the roof.

As part of the company strategy to enter the Kiev property market, Sistema-Hals acquired a controlling share in a construction project of a residential complex on a plot located in the Shevchenko district of the Ukrainian capital. The project plans envision more than 100,000 square meters of space, with business-class residential housing as well as office space, a retail center, and underground parking. In addition, Sistema-Hals is building a super-regional 2-storey retail and entertainment center Leto located on a 17.7 hectare site on Pulkovskoye Highway south of St. Petersburg, a mixed-use complex in Krasnoyarsk and the Kamelia resort in Sochi, site of the 2014 Winter Olympics.

In September 2007 Sistema-Hals and the administration of Astrakhan announced an intention to develop the 'New City Center' project for the construction of 2.8 million square meters of mixed-use property in the center of the city in line with the historic architectural style of

Astrakhan. The project will include 1.5 to 1.8 million square meters used for residential construction.

Another major new project in Nizhny Novgorod is in the planning stage and envisions the building of 2.3 million square meters, including 1.85 million square meters of residential housing and 330,000 square meters of other housing, and represents the construction of a wholly new residential district for the city with accompanying infrastructure, including transport, entertainment, administrative, social, and other services. This ambitious project will be realized from 2009 to 2018.

In order to further develop the Company's competitive advantage and strategy, Sistema-Hals has also entered into a number of key strategic agreements with recognised international companies in key areas of project development and commercial real estate management.

First, a joint enterprise was created with global retailer Apsys, which will engage in development and management of projects in the retail property segment. The first investment project for the new joint venture was the acquisition from Sistema-Hals of the Leto shopping and entertainment complex on Pulkovskoye Highway in St. Petersburg. In another deal, Sistema-Hals attracted a strategic investor, the Saudi Arabian company Saraya, for the construction of the world-class Kamelia resort complex in Sochi. These deals underline the synergies inherent in combining the unmatched local project expertise of Sistema-Hals and industry knowledge of companies such as Apsys in retail and Saraya in tourism.

Sistema-Hals continues to seek additional opportunities to make project implementation more efficient and reduce delays. In early December Sistema-Hals signed a cooperation agreement with Hebei Construction Group, one of the largest state-owned construction companies in China. This company combines both highly professional specialists and world-class technology, and can perform the widest range of finishing work using high-quality materials. Under the terms of the agreement, Hebei will act as general contractor on a number of our key projects at prices which are fixed for the entire duration of work.

In the long term Sistema-Hals is focused on premium segments of the market, including commercial property such as offices and class-A retail property, as well as premium-class residential developments, and plans to gradually rebalance its portfolio in this direction. In particular, the market for office properties remains very attractive and Sistema-Hals plans to increase its presence in the class-A office segment.

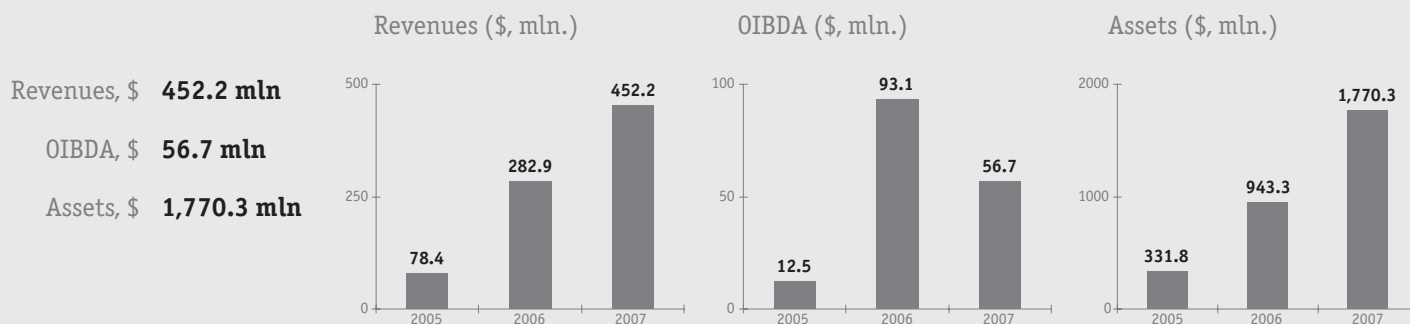
In the retail segment of the market, the company plans to concentrate on high-quality projects with strong retail partners. At the same time, the market for residential property is growing and revenues from the sale of these properties represent an additional source of profit, requiring relatively small amounts of investment, and Sistema-Hals plans to significantly increase the share of premium residential properties while reducing the share of mass-market sales.

In July 2007 rating agencies Moody's Investor Service and Fitch Ratings assigned their first ratings for Sistema-Hals. Moody's assigned the company a long-term foreign-currency rating of 'B1,' while Fitch assigned it a rating of 'B+' and a short-term rating of 'B.' All ratings had a stable outlook. At the same time, Moody's Interfax Ratings Agency assigned Sistema-Hals a top long-term credit rating of 'A1.ru' on the national scale and Fitch Ratings assigned it a national credit rating of 'A-(rus)'.

In January 2007 the Russian agency RBC ranked Sistema-Hals 51st in its rating of the 100 most valuable public companies in Russia. In March the magazine Commercial Real Estate ranked CEO Felix Evtushenkov sixth in its rating of the 100 Best Top Managers in the Market.

Commercial Building magazine ranked a Sistema-Hal-led project, the DaimlerChrysler headquarters building in Moscow as one of the Top-10 most beautiful business centers in Moscow.

At the CRE Moscow Awards 2007, Sistema-Hals won an award in the nomination 'Multi-functional property' for the office and hotel complex Pokrovskie Gates in Moscow, and its November 2006 IPO on the London Stock Exchange was awarded 'Deal of the Year'. Sistema-Hals was also recognized at Building Awards 2007 in the category 'Investment Attractiveness'.



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Maxim Entyakov

CEO, Detsky Mir Center

## Retail

The birthrate in Russia grew in 2007 by 8.7%, the highest rate in 15 years. This led to, among other factors, rapid development in the children's product retail sector. This sector's annual average growth rate for the 2006-2010 period is forecast at approximately 20%, with the share of modern retail formats doubling.

### Overview

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

Sistema has been a shareholder in Detsky Mir since 1996. Since acquiring control of the group, Sistema has spearheaded an aggressive expansion of the chain while securing stable revenue and earnings growth. In an environment of increasing competition in the retail sector for children's goods, Detsky Mir's key competitive advantages include the largest chain of outlets in Russia, encompassing 46 cities and 38 regions, a strong and long-established brand, a wide range of quality products including top Russian and international brands, attractive store locations and shopping environments.

### Marketplace

The retail market for children's goods in Russia represents a key long-term growth opportunity for Sistema. Russia's

continued economic growth and stability have driven increases in real disposable incomes. Increased prosperity and government incentives are encouraging Russians to have more children after more than a decade of falling birthrates, with the number of births in 2007 the highest in 15 years, up 8.7% year on year, and this trend was seen across Russia.

In 2007 the Russian market for children's goods grew by 20%<sup>1</sup> year on year to \$8.4 billion, and is forecast to grow to \$14.5 billion by 2010, representing a compound annual growth rate of 20% for the period of 2006 to 2010. Russia's ongoing retail revolution is changing the way Russians shop. Modern chain shopping formats, primarily food retailers, accounted for around 15% of all retail sales in 2007 for Russia as a whole, with a far higher share in Moscow (around 40%) and large cities (around 20%) and the penetration of chain stores is growing rapidly.<sup>2</sup>

Modern retail formats accounted for approximately \$2 billion or 24% of all sales of children's goods in 2007 and this ratio is expected to rise to 39% by 2010, according to company estimates. The retail market for children's products remains relatively unstructured, however, with the presence of competitors from different market segments, many with narrow product ranges. Grocery chains increasingly offer non-food products for children, but most consumers still do not see grocery stores and hypermarkets as places to buy products for children. Clothing and shoe retailers are playing a growing role as are small-format stores offering products for newborns and very young children in the middle and premium segments.

Demand for non-food products remains concentrated in cities with populations of 100,000 and above, which account for two-thirds of retail turnover and 54% of Russia's population. The spending power and, consequently, consumption patterns continue to vary widely, with large regional cities presently seeing the highest growth rates in non-food retail, which accounted for 56% of the total \$392 billion retail market in 2007, according to Rosstat. In the more mature Moscow market, the average annual expenditure on products for one child stood at around \$1,300 in 2007 and in St. Petersburg the amount was around \$900, with average levels nationwide at between \$350 and \$400.

The opportunities in the Russian retail market remain immense, with consumer disposable income forecast to grow by 8% per year through 2010, compared to overall GDP growth of 5% per annum. As Russia's consumer boom continues, spending on consumer goods is forecast at between 10% and 13.5% for the period of 2005 to 2010, while the share of foodstuffs in household spending has fallen from 49.5% in 2001 to 33.2% in 2005, reflecting increasing affluence. At the same time, the retail market outside of Moscow, measured in terms of expenditure per capita, continues to trail levels in peer countries in Central and Eastern Europe, with spending in the regions of around \$1,800 per capita compared to \$3,900 in Poland and \$4,300 in Czech Republic in 2006.<sup>3</sup> Russia ranked second, after India and ahead of China, in AT Kearney's 2007 Global Retail Development Index (GRDI), a measure of the potential of emerging retail markets worldwide.

Today children under the age of 14 account for around 15% of the Russian population, representing a market of 20.9 million people. Patterns of purchasing children's products are dictated by income levels, with an emerging middle class leading consumption and children themselves playing an ever-increasing role in influencing purchasing decisions and possessing greater amounts of pocket money. For wealthier parents, representing 20% to 25% of the population, time is at a particular 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. 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.

## Results

The Retail business delivered another strong performance in 2007, through a mix of organic growth in sales in existing stores and expansion as well as tight cost controls. Detsky Mir increased its revenues by 78% year on year in 2007 to \$597.2 million, compared to \$335.3 million in 2006. OIBDA increased 73% to \$36.1 million. Total retail space reached 174 thousand square meters. Same-store sales<sup>4</sup> at Detsky Mir increased by 36%.

Detsky Mir opened a net 30<sup>5</sup> stores during 2007, adding another 65 thousand square meters of retail space and

1 Source: ROMIR, company data

2 Source: retail.ru, Renaissance Capital

3 Sources: Rosstat, Factiva, Deutsche-UFG, EIU, Renaissance Capital, AT Kearney

4 Defined as stores opened before December 31, 2005

5 32 stores were opened during the year; two in St. Petersburg were closed due to the opening of new outlets in more attractive trade centres in same locations

entering 13 new cities in 11 new regions for the Company. This represented 90% of the planned openings, with the shortfall due to delays in the opening of new shopping centers being built by third-party developers. As of December 31, 2007, it operated 95 stores in Russia and remained the clear leader among modern-format retailers of children's products, with a 30% market share, twice the level of its nearest competitor.<sup>6</sup> As of January 1, 2008, Detsky Mir was present in 46 cities in 38 Russian regions, covering more than 70% of the country's population and representing 85% of total retail turnover.

At the same time, the Russian market is becoming ever more competitive, with mass grocery retailers offering an ever-growing number of non-food products for children, growing numbers of chain shoe and clothing retailers targeting the children's market, and small-format specialist retailers. In view of these fundamental shifts in the marketplace, Detsky Mir moved to reduce prices while expanding its product offering to customers and further improving its market-leading customer service experience. In 2007 the company continued to execute its strategy to enhance its leadership in the children's goods segment of the Russian retail market, while strengthening cost controls to compete in an ever-tougher pricing environment and reduce the impact of the rapid growth in a number of external cost factors, such as labor, transportation, and advertising.

Detsky Mir plans to continue expanding its total store numbers and geographic presence to benefit from rapid income growth in Russia's regional markets as well as promising markets in Ukraine and Kazakhstan, the two most attractive markets for children's products in the CIS after Russia. Detsky Mir's strategy includes enhancing its existing leadership in Moscow and Russia's other largest cities, and targets cities with populations of 100,000 and above, in particular many regional cities with populations between 100,000 and 300,000 with markets capable of supporting large-format stores for children's products and where competition is limited.

In 2008 the company plans to open 80 thousand square meters of retail space and enter 12 new Russian regions, amounting to an investment of around \$110 million. By the end of 2008, Detsky Mir plans to be present in all of Russia's largest cities. In addition, the company has prepared to enter the Ukrainian market with the opening of its first store in the city of Dnepropetrovsk in 2008.

Detsky Mir continued to develop new formats aimed at increasing margins, enhancing customer experience and facilitating entry into new geographic markets and new locations within existing markets. A pilot project for premium-segment stores is being prepared for a launch in July 2008.

During 2007 Detsky Mir took a number of steps to further strengthen its market-leading brand. A project was carried out with the international branding agency Fitch to develop a new retail concept for Detsky Mir stores and is due to be launched in June 2008 at the Detsky Mir outlet in Nagatino in Moscow. A new brand communication platform was created, and sales of private-label products were launched in 2007 in order to strengthen margins and leverage the strength and qualities of trust contained in the Detsky Mir brand.

During 2007 the company optimized the scheduling of work in its stores, allowing a 7% reduction in total headcount while simultaneously increasing the number of assistants available to customers during peak shopping hours. A single internal logistics complex is being developed and is due to be launched by the end of 2008.

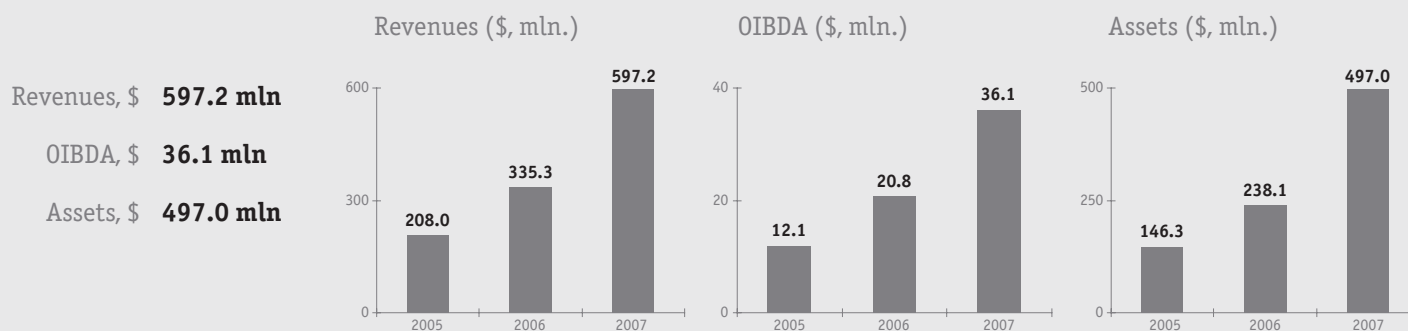
During the year, a major organizational restructuring was completed, with establishment of a three-level management system consisting of a corporate center, regional trading representative offices, and primary business units. A project for organizational development was launched to introduce a single set of business procedures at every level of Detsky Mir, further optimizing the organizational structure, including the concentration of head office functions at a single location.

<sup>6</sup> Sources: company estimates, Renaissance Capital, Deutsche-UFG, RBC

In 2008 the company plans to complete the first stage of the implementation of ERP (Enterprise Resource Planning) systems for the more efficient management of functions such as sales auditing, pricing, supply management and financial management. CRM (Customer Relations Management) systems and a modernized customer loyalty program are also in the process of being developed. In addition, Detsky Mir is completing the second stage of its asset restructuring, with the conversion of existing shares into a single share in early 2008.

The Company's debt portfolio was restructured, reducing the average interest rate by 2.5%, increasing the average maturity by two years and eliminating a number of contract limitations contained in debt agreements. A single accounting policy was developed and introduced for all levels of the company. A single structured set of procedures for taking investment decisions was established. The company also restructured a major part of its working capital by launching letter of credit and factoring facilities with its key suppliers. At the end of 2007 a \$55 million trade finance line was opened with HSBC.

Going forward, the key target for Detsky Mir over the next three years is to fuel growth with the further expansion of its network in Russia and the CIS to sustain and enhance its leading position as the number-one retailer in the market for children's products.



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# Financial Services

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## Financial Services



Sergey Zaytsev

Chairman of the Management Board, MBRD

The financial sector is becoming one of the key drivers of the Russian economy. In 2007, the volume of loans issued to individuals and businesses grew by more than 50% and, as a percent of the country's GDP, it grew from 52.2% to 61.4%.

### Overview

Sistema's banking business, the Moscow Bank for Reconstruction and Development (MBRD), has evolved rapidly into one of Russia's leading retail banking networks, having entered the sector in 2004. In the past, MBRD primarily carried out treasury functions for companies in the Sistema group. Today MBRD is a fully-fledged universal bank, offering a full range of services to corporate and retail clients. MBRD has focused on retail banking as its main avenue of development since 2004.

### Marketplace

Russia's banking sector benefited from a strongly positive macroeconomic situation in 2007, with GDP growth of 8.1%, and growth in demand for banking services from both companies and individuals. The continued implementation of new banking legislation and regulations, including the introduction of a voluntary deposit-insurance scheme, has increased the stability of the banking sector and encouraged the development of consumer credit and mortgage lending, which in turn has helped

fuel Russia's continued consumer boom and the rapid development of areas such as real estate and car sales.

During the year, bank assets grew by 44% and their share of Russia's GDP jumped from 52.2% to 61.4%. The volume of credit issued to the real sector of the economy and to individuals grew sharply, with credits to enterprises and organizations increasing by 51% and credits to individuals by 57% during the year. In an important shift reflecting the development of the small and medium-sized enterprise (SME) sector, which had previously been deterred from obtaining credits by unfavorable terms, the amount of credit issued to SMEs by banks increased, while the average interest rates on ruble-denominated loans fell to a level of 14% to 16%.

Funds from companies and organizations continued to represent the main source of growth in the resource base of Russian banks and accounted for 31% of the growth in liabilities of Russian banks. The Russian banking system remains to a significant degree dependant on inflows of foreign funds, leaving the Russian market exposed to problems in the international banking system. The crisis in the international financial markets, precipitated by problems in the US mortgage market, led to a fall in volumes of foreign financing for Russian banks and growth in interest rates on loans, as well as all but eliminated the opportunity to securitize consumer credit through the first half of 2008.

However, the timely intervention of the Bank of Russia, which lowered interest rates despite the inflation risk, provided the opportunity for banks to get credit from it under the guarantee of the largest and most reliable credit organizations. Interest rates on credit rose and the issuance of credit to individual and corporate customers slowed as stock prices fell. Nonetheless, the financial results for the fourth quarter of 2007 were positive for the majority of Russian banks. For 2007 as a whole, Russian banks generated revenues of RUR 508 billion, 48% higher than the 2006 figure.

The same broad tendencies seen in the development of the Russian banking system in recent years are expected to continue through 2008, including the expansion of lending and services to SMEs, the active expansion of large banks into regional markets, and the ongoing consolidation of the banking sector. The price of banking assets is expected to fall in the current environment and fuel merger and acquisition activity.

## Results

Despite challenging conditions in the banking sector in 2007, MBRD delivered strong revenue growth of 114.2% year on year in 2007 to \$488.8 million, compared to \$228.2 million in 2006. OIBDA increased 70.4% to \$63.4 million in 2007. This strong performance was driven by the rapid development of MBRD's retail business, in particular the consumer credit and mortgage lending, where the bank is among the Russian market leaders, and a strong increase in corporate lending.

In 2007 MBRD continued to focus on the development of its retail business as a core element of its long-term strategy and building upon Russia's current consumer boom. The balance on accounts held by individuals grew by 61.4% in 2007, and share of individual balances in the total assets of the bank stood at 14.3% as of January 1, 2008. The credit portfolio of individual customers increased by 109.1% and the MBRD improved its positions in ratings in all segments of the retail credit market. The share of loans to individual clients accounted for 16.6% of the Bank's assets at the beginning of 2008.

During 2007 the bank pursued the active expansion of its retail and corporate business in Russia's regional markets. At the end of the year MBRD had 92 branches and offices in 55 Russian cities, with 40 offices added during the year. Entering 2008, MBRD was present in six of Russia's seven federal districts, having entered 11 new regions and 17 new cities during 2007 alone. Going forward, regional markets remain a central strategic focus, with MBRD targeting large regional cities and increasing branch numbers in existing markets to expand the number of retail clients.

In 2007 MBRD focused on attracting individual depositors, and balances on individual accounts grew to \$575.9 million compared to \$347 million in 2006. Balances on demand and current accounts grew to \$22.2 million compared to \$8.4 million a year earlier. The number of term accounts more than doubled from 3,112 to 8,602. The bank has been successful in increasing the number of individual depositors by offering a wide variety of account types and conditions, including classic accounts, accounts with overdraft facilities, accounts for employees of corporate customers and others to meet both the needs and means of the customer.

During the year, MBRD's consumer loans portfolio increased by 72.7%. The total volume of express loans issued to customers exceeded \$37 million. The primary competitive advantage of MBRD in the consumer credit market is its ability to offer low-interest rates, minimal documentation requirements, and a fast approval process.



For the convenience of borrowers, when a credit is approved, the customer is issued a special card allowing them to make payments on the loan via the bank's network of automated teller machines. The volume of MBRD's targeted consumer credit business made it a member of the Top-10 Russian banks rating published by Finans magazine in 2007.

MBRD also continued to develop its mortgage-lending business during 2007 as a key component of its retail business. At the end of 2007, MBRD had put into place 13 mortgage credit programs designed to meet the needs of every type of client. Along with providing credits for purchasing apartments in the secondary property market, the bank offers mortgages for buying homes in development, being built by accredited builders. One of the most popular options in all of the regions where the bank is operating is the Federal Mortgage Program. This program is being implemented within the framework of agreements signed with the Russian Federal Agency for Housing Credit as well as regional operators.

One of the most significant new mortgage products introduced in 2007 was the new 'For Any Purpose' program, allowing borrowers to obtain credit on their existing home. This allows customers to raise money to meet their family's requirements for building, renovation, interior decoration, tuition for education, and other purposes.

In recognition of MBRD's innovation as a mortgage lender, it received a prize in the category 'Best Mortgage Bank of the Year' at the Financial Elite of Russia 2007 awards. In March 2008 RBC Ratings placed MBRD in the Top-10 list of the largest mortgage banks in Russia, based on the number of mortgages issued in 2007, a jump of 12 places compared to the 2006 ratings.

Car loans remained another priority area for the development of the Bank's retail business in 2007. A significant increase in sales was achieved through intensive development of the Bank's partnership network of auto dealers and through entry into new regional markets. Over the course of 2007 13,636 automobile loans were issued for a total sum of \$254.2 million, a 48% increase year on year.

Credit and other bank cards were another important area of growth for the retail business in 2007, with the total number of Visa and MasterCard issued reaching 322.6 thousand at the end of the year, and the credit portfolio reaching \$60.3 million. A new program to sell credit cards to non-payroll clients led to a six-fold increase in the number of individual clients at the bank's branches during the year. For wealthier clients, MBRD launched the MasterCard Platinum card with a unique set of services. Cross promotions with such partners as Detsky Mir, MTS,

and car dealer Armand both increased the volume of cards issued and raised the profile of the MBRD brand. At the same time, the bank demonstrated both its technological capabilities and reliability as a financial partner: its EMV Processing Center completed the process of obtaining certification in MasterCard WorldWide, and a contract was also signed with insurance company ROSNO to insure against credit card risks.

Internet and mobile banking represent other examples of combining technological innovation and reliability to deliver services that are the most convenient for a client. In 2006 MBRD launched its Internet-banking service, allowing customers to manage their accounts online. The bank has continued to enhance this service, and today customers can carry out more than 30 different banking operations online, including money transfers, paying bills, and seeking online consultations from MBRD specialists. The bank also continued to develop its mobile banking services, which allow customers to check bank balances and purchase services directly from their mobile phones.

In its corporate business, MBRD continued to focus on expanding the corporate credit portfolio, paying particular attention to the regional markets and SMEs, and the ongoing diversification of the bank's client base into different sectors of the economy. In 2007 the volume of the consolidated credit portfolio of corporate borrowers stood at \$1,457.9 million, a 44.1% increase on 2007.

In its investment business, MBRD increased its presence in the Russian and international money and capital markets. This was closely linked to the implementation of the bank's strategy to expand its volume of retail services and the development of its regional network, as well as growth in client requirements to attract resources in the financial markets and an increase in the volume of transactions carried out by the bank on behalf of its corporate clients.

During 2007 MBRD placed three issues of promissory notes for a total sum of RUR 4 billion with maturities of one year and 18 months, and the average annual interest rate obtained was less than 8.5%. In May 2007 MBRD raised \$50 million in mid-term funds through a two-year loan from Dresdner Bank. In July and December 2007, despite extremely difficult market conditions, MBRD syndicated two three-year facilities for the total amount of \$85 million from a consortium of banks led by VTB Bank Europe.

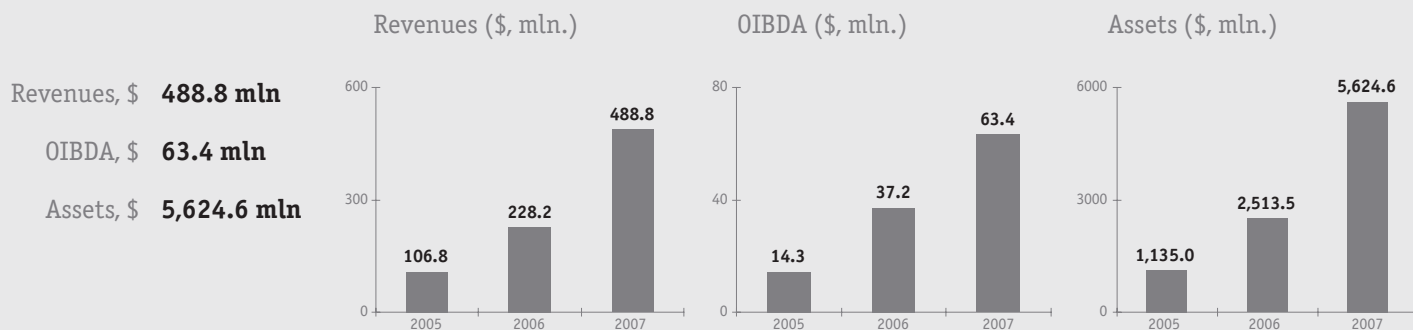
The bank's brokerage business continued to grow rapidly in 2007, with the number of client transactions brokered by MBRD increased by more than 50% year on year. In

investment banking, MBRD was actively engaged in underwriting corporate bonds for the domestic Russian market during the first half of 2007, although it left this segment of the market in the second half of the year due to the broader market conditions. Nonetheless, MBRD was ranked among the Top-50 Russian investment banks in 2007, having participated in 25 placements as arranger and underwriter, as well as co-arranger and co-underwriter, for a total sum of RUR 70 billion.

Also during 2007, MBRD strengthened its positions in the market for export and trade finance by offering highly competitive terms and conditions for its services. The portfolio of such deals grew three-fold in 2007, reaching a value of \$180 million. The bank continued to attract tied credit from foreign banks under guarantees provided by such export credit agencies as Euler Hermes (Germany), SACE (Italy), EKN (Sweden), SERV (Switzerland), Atradius (the Netherlands), and EDC (Canada). As a result, MBRD's clients were able to take advantage of the opportunity to gain financing on highly attractive terms, with maturities of five to 10 years at low interest rates for investment goods and services. Short-term financing support for importers was provided primarily through blank trade finance limits, the total sum of which grew in 2007 from \$130 million to \$270 million. The total number of bank-counterparties grew from 22 to 30. The cost of attracting trade financing from foreign banks was reduced on average by 0.8% at an annualized rate, with tenors extended to between two and three years, underlining MBRD's growing reputation as a reliable international partner.

In December 2007, MBRD acquired the remaining 49% stake in East-West United Bank, Luxemburg (EWUB) for a total cash consideration of Euro 31.0 million (approximately US\$ 44.6 million). East-West United Bank, in addition to its current portfolio of services, is looking to develop Private banking together with MBRD.

From August 2007 to February 2008 Sistema acquired 98.85% of Dalcombank, the largest bank in Russia's Far East. Dalcombank will be integrated into Sistema's Financial Services business, which will facilitate the expansion of its geographic coverage as well as financial indicators.



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## Media



Eldar Razroev

CEO, Sistema Mass Media

The pay TV market in Russia is still in its early stages of development and therefore has high growth potential. By 2010, experts predict that pay TV services market penetration will reach 25.8%, while the market volume will double to \$1.2 billion.

### Overview

Sistema Mass Media (SMM) is the Corporation's vertically-integrated company operating in the media business. SMM is focused on the development of the pay-TV business, including network operation, media content production, and advertising. These segments represent key technology-driven businesses in the Russian media market as the Corporation not only adapts to, but also drives the development of new media platforms and technologies. SMM operates Stream TV, one of the leading companies in the Moscow and Russian pay-TV market, in tandem with Comstar.

Previously, SMM was active in advertising and print distribution, publishing, terrestrial TV broadcasting and news services. However, following a major restructuring conducted in 2004–2006, the company exited a number of these businesses to focus on high-revenue, high-technology segments of the media market. Today, its core business segments are being combined and deployed over new technology platforms, including DVB-H and IPTV, and its strategy is focused on deriving synergies within its media assets and exploiting emerging technologies such as mobile and Internet content.

## Marketplace

The Russian pay-TV market has developed rapidly in recent years, lately posting annual growth rates exceeding 30%. At the same time, the market is still at an early stage of development, in particular when compared with the mobile communications market. In 2007, according to data from market research group J'son & Partners, pay-TV penetration reached 17.8% of Russian households, with average revenue per user (ARPU) of \$6.7 to \$7.4. Penetration is forecast to reach 25.8% of households by 2010, representing a compound annual growth rate of 13.17%. The volume of the pay-TV market exceeded \$686 million in 2007 and is expected to grow to \$1.2 billion in 2010.

Outside of Moscow, Internet broadband penetration remains low in absolute terms, at 6.2% in 2007, according to J'son & Partners, but this market is developing rapidly, with penetration forecast to reach 28.2% by 2010, representing a striking 66% CAGR for the period of 2007 to 2010. In Moscow, wire-line and wireless broadband access have all but eliminated dial-up in just the last few years, and this trend is expected to arrive to large regional cities and the country at large in the coming years, as fixed-line operators such as Comstar create the necessary technical infrastructure and offer affordable services to household users.

The Russian pay-TV market is undergoing a period of consolidation. Smaller local operators are being acquired by larger regional operators, then in turn by federal-level players, which are also developing content as well as deploying technical capacity. Hybrid operators, such as SMM, which provide cable TV, IPTV, broadband and content, are leading the consolidation process, given their ability to provide a superior product offering at a low price and deploy a single brand on an increasingly federal scale.

## Results

In 2007 the Media business reported a 28.4% year on year increase in revenues to \$137.0 million compared to \$106.7 million in 2006. OIBDA amounted to \$23.2 million. The results reflect strong growth in the Stream TV business, where revenues grew 49% year on year, as well as continued cost savings and synergies gained from the restructuring carried out in 2005 and 2006.

SMM made substantial progress on its strategic goal of creating a vertically-integrated media group including pay-TV, multimedia services, content, and other businesses. Stream TV added 300 thousand pay-TV subscribers during 2007, reaching 1.8 million subscribers at the end

of the year. Stream TV added 60 thousand broadband Internet subscribers during the year, reaching a total of 130 thousand. In 2007 the market share of Stream TV reached 17% of the total Russian pay-TV market in terms of subscribers, placing it first, and 14% of the total Russian pay-TV market in revenue terms, placing it second overall, and just 1% behind the market leader in a still fragmented marketplace. At the beginning of 2008, Stream was present in 40 Russian cities in 22 regions. The network covered 3.5 million households, representing 15 million people.

SMM is establishing nation-wide coverage for its pay-TV network in Russia under the Stream TV brand. Beginning in December 2007, all cable TV, broadband, and IPTV services operated by SMM are now being offered under the single 'Stream TV' umbrella brand, which had previously been used only in the Moscow market. Along with the single brand, SMM is developing unified basic services packages to provide all of its regional subscribers with the same levels of choice and flexibility as in the Moscow market, while taking into account lower consumer spending power in the regions.

In 2005 and 2006 the company acquired regional cable television operators Regional Cable Networks (RCN) and United Cable Networks (UCN) and became the leading cable television operator in Russia's regions. During 2007 SMM began the process of turning them into affiliates and buying out minority shareholders, a reorganization being extended to all of SMM's regional operators. In addition, in December 2007, pay-TV operators were acquired in Kursk, Oryol, and Tambov, adding an additional 116,000 television subscribers and 11,000 broadband Internet subscribers.

SMM also continued the modernization of its regional cable operators with new technology (such as FTTB/HFC/Metro Ethernet) to provide double- and triple-play services for subscribers and expand the number of channels available. At the end of 2007 SMM operators in 38 cities were providing Internet and pay-TV services, and were in the process of rebranding under the Stream TV and Stream Internet brands. Going forward, new services will be launched in the regions that are already available in Moscow, including IPTV and mobile TV in the DVB-H format. IPTV allows subscribers to flexibly choose which channels and content they want and deploy such services as video-on-demand and HDTV, leading to sustained increases in ARPU.

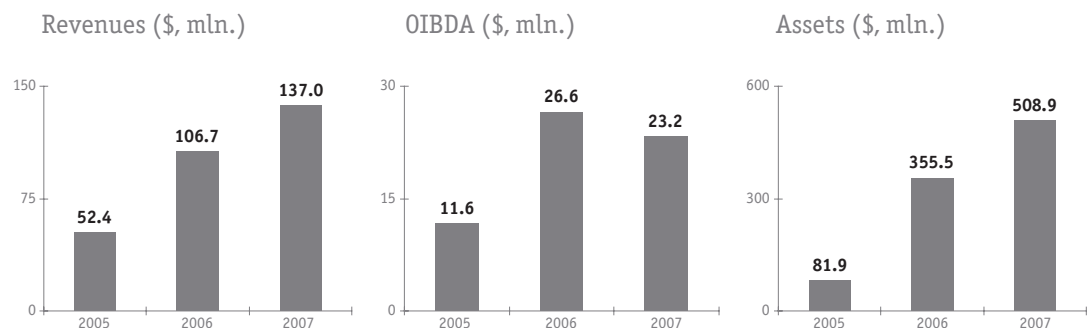
SMM's Stream Content subsidiary manages and aggregates advertising and rights for content and five of its own cable channels: Drive, 'Zdorovoye TV' (Health TV), 'Okhota i rybalka' (Hunting and Fishing), Retro-TV, and

'Usadba' (Country Residence). These channels added 1.6 million viewers to their combined audience in 2007, reaching 3.8 million households and approximately 12 million viewers.

SMM's Digital Television subsidiary is developing the technology and content to deploy mobile TV (based on the DVB-H format) for mobile telephones and automobile receivers, including thematic, targeted television channels, such as news, sports, music, fashion, and others. During 2007 Digital Television continued to develop its business plan, test its services, and prepare the technical infrastructure for the commercial launch of its first services in Moscow and other Russian cities over the course of 2008, with testing of the DVB-H format services outside of Moscow beginning in the first quarter of the year. The business plan envisions broadcasting frequencies in the 17 biggest Russian cities, including the 14 cities with a population of one million or higher, covering a total of 34 million people.

Maxima, SMM's integrated communications group specializing in advertising, is one of Russia's largest media buying agencies and is present in Russia, Ukraine, Belarus, and Kazakhstan, giving it access to fast-growing advertising markets with long-term potential. The agency provides SMM and Sistema with a strong and established media buying platform.

Revenues, \$ **137.0 mln**  
 OIBDA, \$ **23.2 mln**  
 Assets, \$ **508.9 mln**



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Alexander Arutyunov

President, Intourist

## Travel

The most dynamic segments of Russia's travel services market are outbound travel and domestic tourism. In 2007, the volume of these segments grew by 30% and 10% respectively, and the market's overall volume reached \$12.3 billion. By 2011, it will grow to \$25.9 billion.

### Overview

Intourist represents Sistema's assets in the Travel business and is Russia's leading universal operator in the travel market, providing comprehensive services for Russian tourists traveling domestically and overseas as well as for international visitors to Russia. A primary competitive advantage for the company is its unrivalled international and domestic network. Currently, the company has 18 affiliate companies overseas with 7,000 partners in 168 countries. This allows it to provide comprehensive travel services worldwide. In addition, Intourist has a sales network of 232 of its own sales points as well as 154 franchised outlets present in 80 of Russia's regions.

Intourist was founded in 1929. In Soviet times, Intourist was the monopoly provider of travel services. In 1992 the assets of Intourist were restructured; as a result, the company was left with only international and domestic tour operators. All of the other assets, including hotels and tour buses, were put under the control of the Russian government. In 1994 Intourist was acquired by Sistema. Following a significant restructuring in 2005, the compa-

ny was positioned as the leading universal operator in the travel market.

At the end of 2007, Sistema and its affiliated companies controlled over 65.10% of Intourist. The second and third principal shareholders are Moscow City Government and GAO Moskva. Owned by the Moscow City Government, GAO Moskva is focused on developing the city's potential as a tourist destination.

## Marketplace

The total value of the Russian market grew by 11.4% in 2007, reaching a value of \$12.36 billion. The market is expected to reach a value of \$25.98 billion by 2011, representing an annual growth rate of nearly 22% for the period of 2006 to 2011. Both the inbound and outbound markets grew in 2007, driven by Russia's continued economic growth and a growing perception among both domestic and foreign visitors that Russia is an exciting and safe touristic destination offering high-quality services and accommodation.

The outbound market continues to see the highest rate of growth, driven by increased consumer spending power. The number of outbound tourists grew by 30% in 2007, reaching 7.16 million, due both to the number of first-time travelers, especially from the Russian regions, and the increased frequency of travel. The number of domestic tourists rose more than 10% to 9.08 million.

For Russians traveling abroad, the choice of destination, particularly for repeat travelers, is shifting over the longer term in favor of such sub-mass destinations as Spain, Italy, Greece, and Thailand. At the same time, due to the fall in the exchange-rate value of the US dollar, the popularity of destinations where the US dollar is widely used (such as Thailand, Egypt, and Turkey) is growing, in particular among tourists travelling abroad for the first time. The main negative tendency going forward is the potential threat of reduced flights to Egypt and Turkey due to the possible introduction of bans on certain Russian airliner makes used by a number of Russian charter operators and airlines, as well as a lack of aircraft to meet record demand.

Among Russian tourism operators, the long-fragmented market is undergoing a wave of consolidation, with the exit of many small and mid-sized operators due to competition and the application of stricter standards for

licensing and client guarantees being enforced by Russia's Federal Agency for Tourism.

Russian tourists are increasingly demanding branded products and reliable and high-quality tourism products and services. Larger operators, such as Intourist, can offer better prices and have better access to scarce services, such as flights and hotel rooms. The competitive environment is becoming tougher with diminishing margins as many operators resort to slashing prices in order to secure positions in new geographic markets. The market leaders remain focused on mass and sub-mass destinations in order to deliver high passenger volumes and take advantages of economies of scale.

In the inbound market, the number of foreign tourists visiting Russia increased by almost 4% in 2007 to 1.64 million and is forecast to reach 1.92 million by 2011. The continued political stability in Russia and an increase in international business activity are the primary drivers of stable growth in the inbound market, with the Russian government actively promoting the attractions of the country's historical patrimony. Looking ahead, the rapid development of Russia's tourism infrastructure will offer more choice and better prices, in particular as a number of hotel-building projects in Moscow are expected to eliminate the deficit of hotel rooms in the capital caused by the closure of older facilities in recent years.

Packaged group tours accounted for around a half of all inbound tourism in 2007, although the lack of three- and four-star hotel facilities has kept the price of tour packages relatively high compared to other destinations. The market entry of foreign tour operators represents a threat to domestic operators catering to foreign visitors, as well as, to a reduced degree, to Russian tourists traveling abroad. Visitors from Germany remain the largest single source of foreign tourists and their numbers grew by more than 18,000 in 2007, with similarly strong growth in visitor numbers from other Western European countries as well as from Turkey and Asia. A weak dollar and concerns about a domestic economic slowdown saw a fall in US visitors in 2007, a trend that is likely to continue in the medium term.

## Results

The Travel business delivered strong performance in 2007, as Intourist continued to implement its strategy of exploiting synergies between its key businesses in tourism, retail chain, hotels, and transport to deliver the

full range of services as a truly universal travel operator. Revenue rise was driven by organic growth in sales of travel packages, primarily in the outbound market. Revenues increased by 38.4% in 2007, reaching \$374.0 million, compared to \$270.2 million in 2006.

The strategy of Intourist is to become a truly universal operator in the tourist market, offering its clients a full range of tourist services. During 2007 the company completed the creation of a vertically-integrated structure including four subsidiary business units: Tour Operating, Retail Sales, Hotel Business, and Transport Services. Intourist has strengthened its ability to provide complete, higher-margin tour packages to such mass-market destinations as Turkey and Egypt, as well as sub-mass-market destinations like Thailand, Spain, Italy, Greece, and Tunisia. At the same time, the company increased its range of travel solutions for corporate and government clients.

In 2007 Intourist consolidated its leading position in the Russian marketplace, with strong organic growth in the outbound market, where the total number of travelers served increased by 36% to 225,000. This made Intourist one of the top-five outbound operators, with a strong and established position in the market for travelers to Egypt, as well as a rapidly developing business for travelers to Thailand, which has emerged as one of the top-10 destinations for Russian travelers for the first time in 2007. The share of Intourist in the outbound market stood at 3.1% in 2007 and at 10.8% in the inbound market. Intourist's strategy aims to establish a 15% market share in the outbound market through leadership in a consolidating marketplace.

New tour products launched in 2007 included a Trans-Siberian railroad package for inbound tourists. For outbound tourists, Intourist continued to expand the geography of flight programs, with departures available in nine Russian cities: Moscow, St. Petersburg, Yekaterinburg, Chelyabinsk, Novosibirsk, Rostov, Perm, Samara, and Krasnodar. In addition, Intourist launched a new subsidiary, Intourist-Ukraine, to develop its presence in this fast-growing market for tourism services.

As part of its strategy to create a vertically-integrated holding company, Intourist consolidated 100% of the

shares of tour operators Riviera and Skyway, controlling shares of which were acquired in 2006. The acquisition of St. Petersburg-based Riviera substantially strengthened the position of Intourist in the key St. Petersburg market, with Moscow-based Skyway providing leadership in Egypt-bound tours. These operators have now been fully integrated into Intourist under its single well-known brand. Future acquisitions will focus on adding new destinations and markets to strengthen the company's market-leading offering.

Intourist continued to implement its retail strategy in 2007, with the restructuring of its regional subsidiary networks and the opening of new sales points. At the end of 2007 it had 232 company-owned sales points, as well as franchise partners running a further 154 sales points. This retail presence provides Intourist with one of the largest networks in Russia and provides exposure to fast-growing regional tourism markets.

The hotel business has been a primary growth area for Intourist. The Intourist Hotel Group subsidiary operates both company-owned and third-party hotels. Intourist was the leading domestic hotel operator and management company, with the largest number of hotel rooms among any Russian chains during 2007. The present strategy is focused on developing three- and four-star hotels in the main cities in Russia's Central Federal District.

The goal of the hotel business is to operate hotels in order to maximize the sales and earnings potential of each facility, through the introduction of rigorous accounting and management systems and application of the corporation's wider experience in areas such as human resources and IT. In addition, the hotel business benefits from synergies within the company, such as access to the retail sales network and inclusion in tour packages. The share of Intourist in the three- and four-star hotel category stood at 3.9% at the end of 2007.

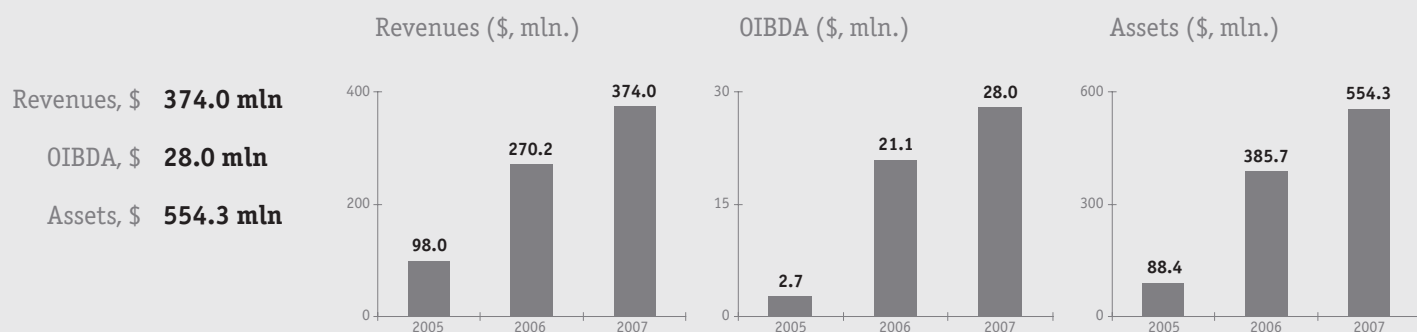
Intourist continued to expand its Hotel Group during 2007. In spring 2007 Intourist Hotel Group received into management two new three-star hotels in historic cities in Russia's Golden Ring, the Moskva Hotel in Uglich and the Moskovskiy Trakt in Rostov Veliky. These hotels were built as part of the inter-regional program in the con-

struction field of the Government of the City of Moscow. In addition, in 2007 Intourist acquired a further 50% of the five-star Savoy Westend Hotel in Karlovy Vary in the Czech Republic, bringing the ownership level to 100%. A five-star hotel was also acquired in Forte dei Marmi, Italy. After a reconstruction project, which is due to be completed in 2009, the hotel will be positioned as a 'five-star plus' boutique hotel. In December 2007 Intourist received a €2.3 million credit from HSBC Bank (Turkey) for leasing hotels in Turkey.

Also in December 2007, Intourist announced the completion of the first phase of its tourism and spa complex Altai in the Russian Republic of Altai, representing an investment of \$5.4 million. The complex is designed to cater primarily to Russian domestic tourists seeking an ecologically clean vacation destination and the second phase envisions ski-lifts and an artificial lake. The project is due to be completed in 2009.

Intourist also saw growth in its Transport Services unit. The company is Russia's largest broker for charter flights, a fast-growing business strengthened with the 2007 acquisition of a leading consolidator, Megapolis-Avia-charter. In addition, the company runs tourist bus services, a market that has seen rapid growth due to an increase in the numbers of international and domestic tourists in the country.

In April 2007 Intourist became the first Russian travel operator to issue bonds, with a debut issue of RUR 1 billion for a period of three years with half-yearly coupons at an annual interest rate of 9.00%. The offer underlined investor interest in Intourist and the broader Russian tourism sector, with the offer 2.5 times oversubscribed.



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# Radar and Space



Sergey Tischenko

CEO, RTI Systems

## Radar and Space

The Russian defense technology industry is entering a new stage of development as it commercializes itself for mass consumption. Experts estimated that until 2010 Russia would need about 20 million of such devices, with market size about 2.7 billion dollars.

### Overview

Sistema's Radar and Space business includes the Concern RTI Systems holding (RTI Systems) and its subsidiaries. RTI Systems specializes in the development and implementation of major science-intensive system projects in such fields as radar/radio technology construction as well as air, space, and ground control systems and power machinery. RTI Systems is today the recognized leader in the Russian marketplace for the construction of radar technology facilities and has a leading position in airborne communications systems and information transmission.

Its largest clients include the Russian Ministry of Defense, the Ministry of Atomic Energy, the Emergency Situations Ministry, as well as private-sector clients. RTI Systems provides leading Russian enterprises with proven cutting-edge research and production expertise and the ability to successfully implement extremely complex, high-technology projects. The priority growth areas for the business are radio technology, aerospace, and ground control systems, mechatronics and robotics.

## Marketplace

The combined value of the market for military technology in Russia amounted to \$8.97 billion in 2007. The market is developing dynamically due to major ongoing investments by the Russian government in upgrading its military capabilities to ensure the country's security in a complex and rapidly changing global security environment. The ongoing implementation of the Russian State Armaments Program for the period of 2006 to 2015 includes a number of large-scale complex projects in which RTI Systems is playing a leading role, given its proven track-record for delivering innovative and comprehensive defense solutions.

In addition, in May 2006, the Russian President approved the list of critical technologies for the development of a diversified and innovation-driven economy. Since then, the key technology sectors have seen inflows of both research and development and production funding via federal target programs (FTPs). Partnerships between the private and state sector play a leading role in implementing the FTPs. The Radar and Space business of Sistema is developing a number of these projects.

The radio-technology and information systems segment of the Russian defense sector was worth \$865 million in 2007. The market for aerospace equipment and avionics devices amounted to \$221 million, and in the market for mechatronics and robotics, asynchronous electric motors accounted for \$254 million and actuators for \$73.7 million, according to RTI Systems data. The Radar and Space business derives the largest portion of its revenues from the market for radio-technology equipment and systems, and the market is growing at an average annual rate of 15%. The market for aviation products is growing at a rate of 32% annually, and is increasing for space products at a rate of 20% per year, according to company estimates.

RTI Systems is a key contractor of the Ministry of Defense of the Russian Federation for developing radar and information equipment and systems for missile early-warning, anti-missile defense and aerospace monitoring facilities. In 2007 the Russian market for ground-based missile defense systems was valued at an estimated \$150 million with forecast annual growth of around \$30 to \$40 million over the next five years. In addition, the market for other key long-range radar systems, including anti-aircraft and air-traffic control facilities, is worth \$80 to \$120 million per year with an estimated annual growth rate of 20% to 25%. Demand for short-range radar equipment and systems is similarly dynamic, valued at around \$200 million to \$300 million per year over the next five years.

The market for on-board radar equipment and avionics in the next five to seven years is expected to undergo a major boom due to the active development of drone and

control systems. The volume of the market for avionics systems under development is expected to be worth between \$6 billion and \$7 billion through 2010.

The demand for integrated management center solutions for both the military and civil sectors is likely to grow 20% to 25% per year over the coming decade. A substantial part of this market includes navigation and telematics-related solutions, which are also predicted to see growth rates in the range of 20% to 25% per annum.

In addition, the market for information communications systems and devices, primarily destined for various corporate users in Russia and the CIS, as well as opportunities in other developing markets are also growing rapidly. The potential market for Russian companies in this segment is estimated at around \$1.5 billion over the course of the next five years. One area with enormous potential is Russia's GLONASS satellite navigation system, where RTI Systems has already implemented a range of major military and civilian projects for the Russian state. Sistema is working closely with the Russian government to develop a corresponding legislative framework for developing navigation and monitoring devices based on GLONASS technology for the corporate and consumer markets.

In 2006 RTI Systems has launched its Mechatronics and Robotics division, which develops and manufactures products including electric motors and low-voltage devices. Since 2006, the Russian market for electric motors has grown by 25% per year, representing a substantial jump from earlier observed growth rates of around 10% annually. According to RTI Systems data, the market for low-voltage apparatus is growing by 15% per year.

Continued strong growth in the Russian economy is driving demand for measurement and diagnostic equipment, with the market worth an estimated \$350 million over the next five years.

The power engine building industry is a part of the industry for electronics technical equipment. Today this market is developing dynamically, including demand from raw-material industries (such as oil, gas, and mining). The overall dynamics of growth is from \$1.5 billion to \$2 billion per year. The market is dependent on overall dynamics in the economy and is growing by around 20%–25% per year.

## Results

The Radar and Space business delivered impressive growth in revenue and OIBDA during 2007. Revenues grew by 50.6% in 2007 to \$375.0 million, compared to \$248.9 million in 2006. OIBDA grew 93.5% to \$45.9 million, compared to \$23.7 million in 2006.



The market share of the Radar and Space business in the market for ground-based information systems for arms and military technology was 28.7% in 2007. This includes a 92% market share for ground-based early-warning systems, 23% for information and communications equipment for the Russian Ministry of Defense, and 55% of the market for information systems for missile and space defense.

In 2006 RTI Systems entered the broader market for electronics equipment, including induction motors and switches, where it secured 12% in terms of sales. The medium-term goal for the business of Sistema is to increase its share in the Russian market for electric motors to 34% by 2010. Over the longer term, the goal of RTI Systems is to become the leading systems integrator with effective engineering solutions in the field of production and implementation automation. According to research by RTI Systems, the Russian market for project solutions was worth \$650 million in 2007 and is experiencing compound annual growth rates of 30%.

Major new products and solutions implemented in the Radar and Space business in 2007 include an automated system for the National Center for Crisis Management for the Russian Ministry of Emergency Situations, BRIZ-M multi-band infocommunication radio system development, and the completion of a new decimeter-band open-architecture radar system for early-warning facilities.

During the year, RTI Systems demonstrated its ability to deliver on a key element of Sistema's strategy of further developing state and private-sector partnerships to provide innovative technology solutions for both the defense and civilian sectors, and work on the long-term development of key technology areas identified by the Russian government as vital for the further diversification and growth of the Russian economy. At the same time, its substantial research and development facilities are being developed in cooperation with main state R&D institutes as well as with leading universities and other research institutions.

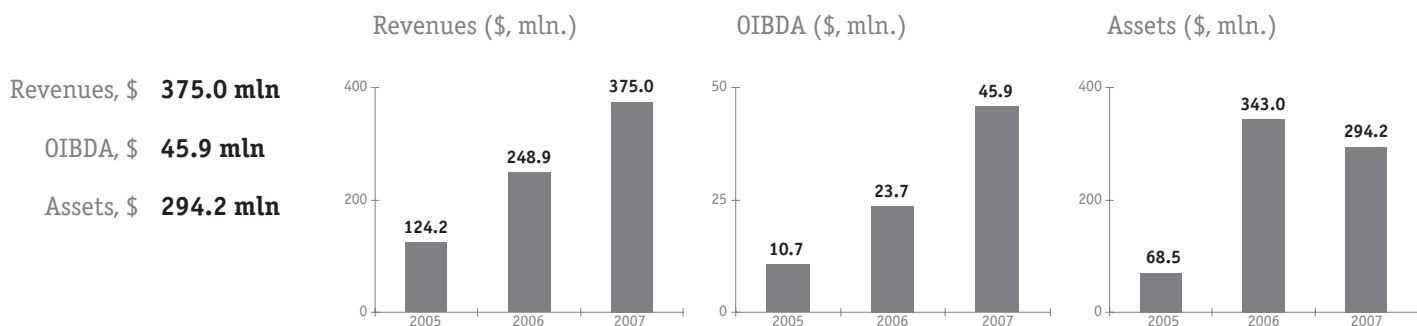
The project 'Laser Technology and Atomic Energy Systems' was a major new initiative for RTI Systems in 2007 that underlined the potential for state and private-sector coop-

eration. The project has been developed as part of the cooperation agreement between Sistema and the Russian Ministry of Industry and Energy signed in April 2007. The project is also an important component in a project developed by the Russian Ministry of Atomic Energy as part of a draft of a federal target program aimed at diversifying the work of the ministry. The FTP envisions financing of work as part of state and private-sector partnership, beginning in 2009. The planned budget for the Sistema-Laser project is RUR 10 billion. At present, the project is being prepared for presentation to the government for approval.

The Radar and Space business has diversified its development and production capacity to target higher-value product segments, exploit its proven ability to develop and implement large and complex projects and take full advantage of synergies in technology and know-how with other Sistema's businesses. Similarly, it is applying technological innovations developed for defense clients to create new products and services for civilian ministries and agencies in the corporate and consumer marketplace.

Examples of such cross-sector work include developing device programming products and different types of services based on the GLONASS satellite system, as well as novel digital transmitters, originally developed for the Russian Air Force and capable of being used for TV and radio transmission. In late 2007 Sistema and the Russian Ministry of Industry and Energy collaborated on the development of proposed legal and regulatory guidelines that will allow for the future mass-market deployment of GLONASS-enabled products and services and the long-term development of this marketplace for both Sistema and other Russian and international players in this potential marketplace. Also during the year, the Navigational and Information Systems OJSC, a joint-venture project, was established in cooperation with the Russian Institute for Space-Device Engineering (RNII-KP) to develop GLONASS-based navigational services.

For the first time, in 2007 RTI Systems was featured in Russia's top-20 defense-sector enterprises annual ranking, the Russian equivalent of the international ranking of the Global Defense News Top-100.



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# Healthcare

## Healthcare



Vladimir Gurdus

President, Medsi Group

The market for pay medical services in 2007 grew by 13%, reaching \$5.9 billion. Due to rapid growth in the voluntary medical insurance segment, the market for pay medical services will reach \$8.3 billion in the next three years.

### Overview

The Healthcare business assets are in the process of integration into the Medsi Group holding structure, and comprise the Medsi clinics (two out-patient clinics for adults), the Medsi-II clinic (out-patient clinic for children), the American Hospital Group (a family clinic operating under the 'American Medical Centres' brand for VIP clients and expatriates), and MedExpress (a chain of private healthcare facilities in Russia including 22 clinics in Moscow and the regions, and an ambulance service in Moscow). The Medsi Group is 100%-owned by Sistema and comprises 14 clinics in Moscow and 12 clinics in the regions.

The flagship facility in Moscow is Medsi, one of the country's most advanced medical centers providing clinical diagnostics, prevention and treatment for adults. A 12-storey extension is due to be completed in 2008, which will house Moscow's top private prevention and treatment center for diabetes. The Medsi II children's clinic opened in May 2005 and represents state-of-the-art in science and technology in pediatrics. The center includes clinics for non-surgical vision correction, allergies, immunological and metabolic disorders, diabetes, posture correction,

and care for children in their first year. The clinic has a Scientific Committee composed of leading scientists and academics from the Russian Academy of Medical Science. The committee's aim is to conduct pediatric research and introduce new technologies and methods for prevention and treatment of pediatric illnesses, and put these breakthroughs to work at Medsi II.

## Marketplace

In 2007, the Russian market for paid medical services grew by 13% and reached approximately \$5.9 billion, and is forecast to see a compound annual growth rate of 12% between 2007 and 2010, reaching a value of \$8.3 billion. The market for voluntary medical insurance (VMI) reached \$1.7 billion and is forecast to grow at a CAGR of 37% between 2007 and 2010.<sup>1</sup> Moscow accounted for a 35% share of the market for paid medical services, and the market for these services has grown at 20% per annum.

Russia's healthcare system has endured a long crisis due to insufficient funding and structural inefficiencies, such as excess secondary care capacity. Public financing of healthcare has averaged 3% of GDP in recent years, significantly below the 5% level recommended by the World Health Organization (WHO). According to the WHO, Russia ranks 75th worldwide in terms of per-capita healthcare expenditure, significantly trailing countries such as Mexico, Turkey, and Poland.

The corporate market is a primary driver of the market for paid medical services and VMI offered to employees as a social benefit on top of existing obligatory medical insurance policies run by the state. In addition, companies are increasingly seeking providers to run in-house medical service points, oversee industrial health programs and carry out medical screenings for new employees as well as periodic screenings for existing staff. Individuals are also purchasing medical services in order to obtain better-quality treatment and avoid delays in the state-run healthcare system.

The market for private clinics remains highly fragmented, with the share of the top-five private providers less than 3%. The market is still at an early stage of development, with a lack of large-scale chains and considerable first-mover opportunities both in Moscow and in Russia's regional markets.

## Results

The Healthcare business represents one of the fastest-growing directions for Sistema. In 2007 revenues increased nearly four-fold to \$79.1 million, compared to \$16.9 million in 2006. OIBDA increased by 247% to \$10.7 million.

At the end of 2007 Medsi Group had established the largest network of clinics in Russia by number of outlets with 14 medical centers in Moscow and 12 in Russia's regions, covering St. Petersburg, Nizhnevartovsk, Nizhny Novgorod, Volgograd, Ryazan, Barnaul, Ulyanovsk, Pyatigorsk, and Bryansk. In addition, Medsi had Medical Assistance Centers in Nizhnevartovsk, Nizhny Novgorod, Volgograd, Ryazan, Barnaul, and Ulyanovsk.

Key acquisitions during 2007 included the May purchase of 100% of American Hospital Group by Sistema, which runs clinics under the American Medical Center brand as well as Medexpress, Russia's largest chain of private primary care clinics and operator of ambulance and emergency services. In October 2007 the Group acquired 100% of Family Medicine Corporation (FMC), a leading provider of family primary medical care at home.

During the late 2007 and early 2008 Sistema completed the restructuring of its healthcare assets and their consolidation within the Medsi Group. Under the restructuring, Medsi consolidated 100% of Medexpress, 100% of American Hospital Group and 100% of FMC. Following the acquisitions of Medexpress and American Hospital Group and the consolidation of assets within the group, Medsi is now able to offer the full range of paid services for prevention, diagnostics, and treatment of illnesses.

Medsii Group's strategy is designed to build on the existing competitive strengths of the group, including its well-known Medsi and American Medical Center brands, its pool of highly-qualified staff, and a highly-experienced and successful medical team. The high profile of Medsi II as a leading Russian pediatrics clinic has strengthened the brand and attracted new insurance contracts, and Medsi is establishing relationships with the leading VMI providers. The group is increasing the number of VMI providers it works with, as some 50% of its business is currently with ROSNO.

The strategy of Medsi Group through 2010 and beyond is aimed at creating the leading provider of private healthcare services in Russia with the largest network of clinics.

<sup>1</sup> Sources: Russian Ministry of Healthcare and Social Development, RBC, Snegiri-Group

From 2008 the Group's clinics are being developed under a single unified brand with common high standards of technology, care, and client service. Over the next three to five years, Medsi plans to increase its chain of clinics to 100 family clinics.

Sistema is planning to expand its medical portfolio through acquisitions and organic growth in Russia. The expansion strategy makes Sistema the top player and consolidator on the Russian private healthcare market.

Major projects were carried out during 2007 to implement the Group's long-term strategy. The construction of a major extension of the flagship Medsi multi-profile clinic and diagnostic center was continued. Due to be completed in the end of 2008, the extension will include a new state-of-the-art Diabetes Treatment Center, and will more than double the existing floor-space of the healthcare center. Medsi opened a clinic at the Derbenevskaya Embankment Business Center, a new center with major Russian and multinational businesses as leaseholders, located in the heart of Moscow's leading business district and in close proximity to Paveletskaya Station, a major rail and metro interchange. The clinic offers 'walking-distance' care in a convenient location, as well as services such as arranging doctors' visits to the workplace. The clinic's location, range of services, and the lack of competitive offerings allows Medsi to build on its existing and potential corporate client base in the very center of Russia's economic boom.

Another major initiative for the group is FMC, which provides medical consulting and services in the home. With a central office and call center based in Moscow, this service is primarily aimed at individual high-income clients, and had an established clientele of around 7,000 adults and children by the end of 2007. The service includes a 24-hour dispatch center and a company-owned as well as leased fleet of vehicles for round-the-clock emergency care, including sending doctors to visit the home and accompanying patients to hospital. Covering Moscow and Moscow Oblast with FMC has positioned Medsi as a leader in the VIP client segment and provided a strong and growing network with leading specialists, clinics, and hospitals in Russia.

Other important segments of the healthcare market include medical tourism and wellness centers. Beginning in December 2007, Medsi began offering clients treatment at specialist hospitals and clinics overseas. In the Fitness and Wellness segment, four fitness centers were acquired from Intourist by the end of 2007 and will be rebranded and relaunched to offer medical services during 2008.

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# Other Businesses

# Pharmaceuticals

Binnopharm manages Sistema's assets in the Pharmaceutical and Biotechnology businesses. The company was established in 2006 following a merger of existing and newly-acquired assets. The Russian market for finished pharmaceuticals has grown by an average rate of 20% per annum in recent years and reached a value of \$11 billion in 2007.<sup>1</sup> Market growth has been driven by people's rising disposable incomes and increased government healthcare spending through the introduction of the Supplementary Medicines Provision (DLO) program in 2005. The primary driver, however, is a growing consumer strength, which fuels demand for more expensive and sophisticated treatments.

At present, the Russian pharmaceutical market is dominated in value terms by foreign pharmaceutical companies, which control around 75% of the market. This dominance has appeared due to the opening of the Russian pharmaceutical market to foreign competition, the strong research and development base of multinational players, and the scale of production of international generics makers. Russian producers require substantial investment in upgrading their production facilities in order to meet international safety and quality standards, such as Good Manufacturing Practices (GMP). In 2007 and early 2008 the Russian government has begun discussions on the introduction of an industrial policy aimed at fostering domestic production and reducing the country's dependence on generally more costly foreign-made medicines.

Binnopharm, as a Russian producer of high-quality medicines, is working to revive the domestic production sector. During 2007 Binnopharm was restructured into a vertically integrated pharmaceutical and biotechnology holding. The company's strategy is focused on the development of three areas of its business: R&D, the production of its own high margin drugs, and outsourcing production of generics though the company also performs trade operations, primarily import of pharmaceutical goods and substances. The company has three production sites in Moscow and is about to complete the construction of a new GMP-compliant production and logistics facility at Zelenograd. The new center will produce medicines in tablet, capsule, aerosol, and ampoule forms.

Sistema has already established a track record of innovation in pharmaceutical business. In 2005 the predecessor of Binnopharm called MTH-holding launched mass production of a vaccine for Hepatitis B, and became the first Russian company to carry out full-cycle production of the vaccine from active substance to finished form. The company has since expanded its range of immuno-biological medicines.

At the end of 2007 Binnopharm itself owned three innovative drugs. Besides, in 2007 its Swiss-based subsidiary Mapichem AG registered 15 more generic drugs, which are being produced in China for the Russian market.

The Pharmaceuticals business saw revenues increase 17.3% in 2007, reaching \$63 million, compared to \$53.7 million in 2006.

<sup>1</sup> Source: RMBC

# Convergent Services

TS Retail is Sistema's operating company in the Convergent Services business. The company was founded in January 2007 to manage a major new retail project, a network of ideas and solutions called 'Tochka' ('The Point'), as well as a development of a chain of exclusive showroom stores for MTS.

Developing the brand and the retail concept are primary parts of the project to create a new player on the Russian retail market. With the cooperation of leading global retail consultant Fitch, TS Retail has created a totally new retail format under the name 'Tochka Store of Ideas and Solutions'. The stores bring together services and products that might seem incompatible at first glance. Examples include digital photography equipment and credit cards, tourist packages, mobile telephones, interactive television and games. All of these products are brought together by the concepts of ease, comfort, and convenience available at Tochka.

Ultimately, Tochka is the place to visit to see the latest in technology and test out new devices and services. Tochka offers service contracts for MTS, Comstar, MTT, SkyLink, telecommunications equipment and accessories, as well as Intourist's travel services and banking services from MBRD. Experienced sales consultants offer customers such products as cards for buying flights on discount airliner Sky Express, tickets for spectator events from a giant reservation system, and more. Tochka is also pioneering leading merchandizing and retail technology in its stores, including self-service terminals for services such as adjusting device settings, managing subscriptions, making payments, and more.

TS Retail has been set up along eight geographic affiliates: Center, North-West, Black Sea, Volga, Urals, South, Siberia, and Far East. The first stage of openings covers large macro-regional and regional centers, including such large cities as Moscow, St. Petersburg, Voronezh, Krasnodar, Rostov-on-Don, Samara, Nizhny Novgorod, Yekaterinburg, Omsk, Krasnoyarsk, Novosibirsk, Khabarovsk, and Vladivostok.

By the end of the first quarter of 2008, TS Retail managed a total of 245 retail points, including 222 exclusive MTS showrooms and 23 Tochka Stores for Ideas and Solutions. During the first quarter of 2008 85 stores were opened, including 14 Tochka Stores in St. Petersburg, Petrozavodsk, Stary Oskol, Krasnodar, Abakan, Barnaul, Omsk, Saratov, Syzran, Perm, Yekaterinburg, Khabarovsk, and Vladivostok.

TS Retail is another example of exploiting synergies in the goods and services across its primary businesses. In November 2007 the share of MTS in the charter capital of TS Retail was reduced from 100% to 25%, with the remaining shares divided evenly (15%) among the following five entities: Sistema, Comstar UTS, MBRD, Sistema Mass Media, and Intourist.



# Innovation & Venture Capital

## R&D Centers

As Russia's leading consumer-focused technology group, Sistema requires continuous innovation to maintain and enhance its competitive edge. As a part of its long-term corporate strategy, Sistema began establishing research and development (R&D) centers in each of its main businesses in 2006. The creation of these centers is driven by a single scientific and technological policy oriented towards focused, market-driven innovation. The centers will engage in the development and introduction of new technologies for the operating companies in their businesses area. R&D centers will look at the 'bigger picture', not just following innovation in the global marketplace but driving it through cooperation with global technology leaders and exploiting the Corporation's own significant scientific potential.

In 2006 the first R&D center was created in the Telecommunications business on the base of Intellect Telecom, which concentrated the R&D centers of each of the operating companies in the business (MTS, Comstar, MGTS). The R&D center is a key resource for maintaining and enhancing market leadership in the fast-changing telecommunications marketplace and for creating conditions for long-term profit-driven growth in each of the operating companies.

In 2007 Intellect Telecom focused on developing R&D and technical strategies and solutions for products and services for Sistema's telecommunications companies. Reconstruction of Intellect Telecom's facilities is due to be completed in September 2008 with the new R&D center equipped according to highest global technological standards.

During the year Intellect Telecom developed and received a positive evaluation for the construction of a domestic and international long-distance network for Comstar UTS and MTS, which was successfully deployed in the first quarter of 2008. The center developed systems projects for the Moscow networks of Comstar and MGTS. It developed a concept for an inter-linked network for the companies of the Comstar group with the application of Next Generation Network (NGN) solutions. A set of principles were developed for the creation of a public safety system, called Project 112, at the request of MTS. Work was also

carried out to implement energy-conservation and ecology-friendly technologies for MTS.

In addition, as part of a project for creating a nationwide cellular network in India for Shyam Telelink, Intellect Telecom created a financial model for the development of the network, and conducted an evaluation of capital expenditures and an evaluation of the effectiveness of investment over a ten-year period. Intellect Telecom's experts also played an important role in 2007 in work on the commercialization of products and services using GLONASS technology. Proposals were developed for a range of unique products and services based on global positioning technology.

Also during 2007, a concept was developed for the creation of an R&D center for the Radar and Space business. The new R&D center will be located at the Moscow headquarters of RTI Systems, and reconstruction of the building is planned to house the new, high-technology facility that will lead research on cutting-edge technology and plan its subsequent commercialization. It will focus on radar, laser, fiber-optic, navigation, communications technologies, robotics, and other key areas of technology. The R&D center will be the scientific-research 'core' of the disbursed, clustered R&D complex. Regional clusters will be established at enterprises in the Radar and Space business that will be able to make full use of local scientific resources.

Another R&D center is also being created in the Technology business with plans to create a new Sitronics NII (a scientific research institute) jointly with the Institute for Information Transmission Problems of the Russian Academy of Sciences in Moscow. The center will develop technology with future commercial potential for Sitronics and its main business divisions, and develop prototypes for data-transmission systems, wireless networks and voice-recognition systems, among other technologies.

## Technoparks and Special Economic Zones

Sistema is also playing a leading role in the development of technical parks and special economic zones (SEZs) in Russia. The Corporation is participating in these projects because they create valuable infrastructure for developing projects for different businesses in fast-developing regions. The parks provide a focus for developing 'knowledge centers' that coordinate the potential of research institutes and other technology parks as well as a simplified platform for rapid development and commercialization of newly-developed products. The parks also provide a locus for specific state-financed projects through Federal Target Programs, simplifying the Corporation's work within these projects.

In Dubna, Sistema is planning to build an Engineering Center for RTI-DMZ (Dubna Machine-building Factory) and a Nanotechnology Center for use by Sitronics, Rosnanotech, and the United Institute for Nuclear Research (OIYaI) as well as housing, including two 50-storey apartment blocks. Among the main goals of the Engineering Center at Dubna is to develop aviation and rocket technologies and products, systems for information and energy interaction, heat and energy supply systems, security systems, and so forth. The estimated investment is \$17 million.

In Zelenograd, there are plans to build a technology park for innovation on the base of the National Research Institute for Precise Engineering (NIITM) and a Center for Nanoelectronics, jointly with Rosnanotech. The park will develop Zelenograd as Russia's 'Silicon Valley', with a micro-chip design center, a hosting center for European design bureaus and the development of special equipment for the production of microchips. Investment is also planned in the construction of housing, including high-rises and cottages. Initial investment levels and the beginning of reconstruction of NIITM and housing will amount to around \$18.6 million.

A technology park is also being developed in Tomsk, with Sistema and its subsidiaries contributing to the construction and technical equipage of a 6,000 square-meter building as well as housing in two campuses. Sistema is also contributing to the management of the park. The estimated level of financing in the first stage of the project is estimated at \$7.1 million.

In Sarov, the Sistema-Sarov Innovation and Technology Park is being developed, with the planned construction of infrastructure, a scientific and technical center, a scientific and production complex, as well as recreational facilities for residents. The Corporation has earmarked RUR 240 million in spending by the end of 2008 on the project. Sistema will have the opportunity to manage a business incubator built with state financing. Plans are being developed for the creation of a Scientific and Production Cluster as part of a cooperation agreement between Sistema and Rosatom, with RTI Systems, Sitronics, and Intellect Telecom participating and opening affiliates in Sarov.

## Venture Capital

In 2007 Sistema took the decision to withdraw from especially high-risk investments in the cities of Moscow, Perm, and the Republic of Mordova.

Sistema continues to participate in the CORAL-Sistema Strategic Fund. In the CORAL/Sistema Strategic Fund 2006, Sistema and its operating companies MTS, Comstar UTS, and Sitronics have committed a total of \$75 million. As of the end of 2007, the fund had invested \$16 million in four portfolio companies developing technology with potential application by Sistema's businesses: Fon, Exanet, Firetide, Red Bend.

Fon is a major Wi-Fi provider. Exanet is developing technologies for the storage of large volumes of information. Firetide is creating new-generation wireless networks, and Red Bend is developing programming support for mobile devices as well as their delivery.

## Corporate University

The human resources play a significant role in the development of every high-tech company. That is why Sistema has made a decision to create its own Corporate University, capable of training the world-class specialists. In 2007 the University has been launched. As of the beginning of the 2008, more than 300 on-site education students and 4,450 off-site education students took part in the educational programs of the University.

## Petrochemicals

During the second half of 2005–2006 Sistema had acquired minority shareholdings in six raw-oil-processing and oil-extracting companies located in the Russian Republic of Bashkortostan. The total acquisition costs were around \$600 million. The acquisition of the shareholdings represented an opportunity to put shareholders' funds into a financial investment for the short to medium term, while awaiting opportunities to conduct future M&A deals to boost key core businesses.

At the end of 2007 Sistema had 21% of the charter capital of oil-extracting company Bashneft (amounting to 26% of the voting shares). It has 27% shares of the charter capital of Novoil (30% of the voting shares), 23% of the charter capital of Ufaneftekhim (29% of the voting shares), and 24% of the charter capital of Ufimskiy NPZ (28% of the voting shares), all oil-processing companies. In addition, Sistema had acquired 25% of the charter capital of Bashkirnefteprodukt (27% of the voting shares), a company involved in the retail sale of oil products, and 23% of the charter capital (26% of the voting shares) of oil chemicals company Ufaorgsintez.

The companies occupy leading positions in the oil-energy market in the region and operate across the production chain, from oil extraction to petrochemicals refining. Sistema's management continues to believe that equity participation in the companies provides the Corporation with the ability to make efficient use of shareholder funds.

The priority area of business activity in 2007 was increasing the capitalization of the Bashkir companies, by means of creating and maintaining growing dividend payments from the shares in the companies to ensure a partial return on previously invested funds, while at the same time increasing the overall value of the assets. During 2007 the net revenue on dividends from the Bashkir petroleum enterprises amounted to RUR 1,959 million after taxes.

## Entertainment

RWS manages Sistema's assets in the film and television production sector. Founded in December 2007, the company is a joint venture of the former Russian World Studios (RWS) group and Sistema. RWS's contribution to the venture took the form of all of the media-assets of the group, including a film studio facility in Moscow, creative content library, and management. Sistema contributed a studio facility in St. Petersburg, the launch of which is due in fall 2008, as well as the library of feature films produced for the European and US markets, in which the Group has invested up to €50 million over the last four years.

The former RWS group of companies was originally founded in 1998. RWS is one of the largest independent production companies in Russia and the leader in the film production services market. Since its foundation, the RWS group of companies has carried out more than 400 television and film projects, including 20 international ones. Among the studio's partners are the leading entertainment companies, including Sony Pictures Television International, Hallmark Entertainment, HBO Films, Beacon Pictures, and many others.

With established leadership in film production services, the strategy of RWS today is to develop strong positions in other segments of the entertainment marketplace. Constructed to match high international standards, the company's studio facilities have been successfully meeting the growing market needs. The number of projects annually serviced by RWS has risen over the years, crossing the 300 mark in 2005. In 2007 RWS produced more than 300 hours of creative content in-house.

Having become a part of the Sistema corporation, RWS has the ability to more actively develop the core lines of its business: creation and efficient use of the content library (Production division), provision of film-production services (studio facilities), and distribution of content across current and emerging media platforms (Distribution division). The revenues of RWS in 2007 reached \$1.7 million.

The strategy of Sistema in the Entertainment business is to create a leader in the development, production, distribution and licensing of all forms of creative content and in related businesses.



riding the consumer wave

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