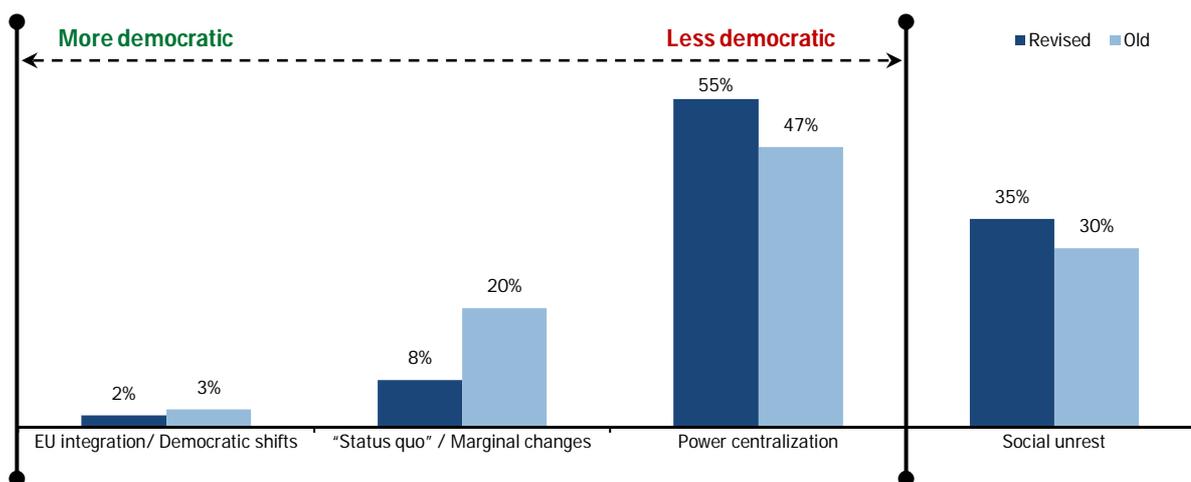


Politics: The whisper of “Gleichschaltung”¹ becomes too loud

With increased probabilities of “Power centralization” (55%) and “Social unrest” (35%) scenarios we see the negative political feedback loop in action over 2012. From the one side, ruling authorities continue to consolidate the power. From the other side, such actions together with accompanying scandals decrease the number of Party of Region’s supporters. As a result, many observers underline that social pressure rises and the President is trying to consolidate his elite’s power even more to cope with possible social unrest by means of defense, media and other spheres’ control. While in the medium-term such interconnection is very likely to result in centralization scenario’s consequences (see our side-note from Aug’11), many suppose that would not be sustainable in the long-run. Given moderate prospects of accelerated economic growth in the next 5 years, we think both monetary and political factors would likely to stimulate pro-democratic transition. For now most business communities see gradual rise of new opposition leader, public protests demanding an exchange of “militocracy” into “meritocracy” and more active EU actions as the most probable long-dated “transition stimuli”.

No wonder there is little change in our previous scenario analysis since Dec’11 issue. Except for an increase in kurtosis of scenarios’ probabilities distribution. **For now we see even higher chances of “Power centralization” scenario (55% vs previous 47%) and “Social unrest” (35% vs previous 30%) in particular.** Earlier we implied more odds in favor of “Status quo” (8% now versus previous 20%) by means of possible constructive talks with opposition and Mrs. Timoshenko’s discharge. But political observers admit there is no even partial accommodation with the opposition’s requests at the moment. Meanwhile, such actions keep ordinary people in suspense, while increased frequency of oppositional activities in Russia could have a domino effect in Ukraine. Thus, we increased the implied probability of “Social unrest” scenario in the medium-term from 30% to 35%.

Probabilities of “Power centralization” and “Social unrest” scenarios are rising again



Source: AYA Capital estimations

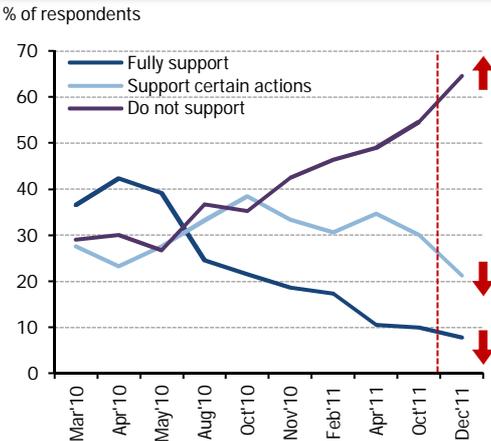
Notes: The probability is estimated by way of assessment of business communities’ expectations (mass media analysis, personal discussions etc.)

¹ Concise Oxford English Dictionary © 2008 Oxford University Press: “Gleichschaltung” is the standardization of political, economic, and social institutions as carried out in authoritarian states.

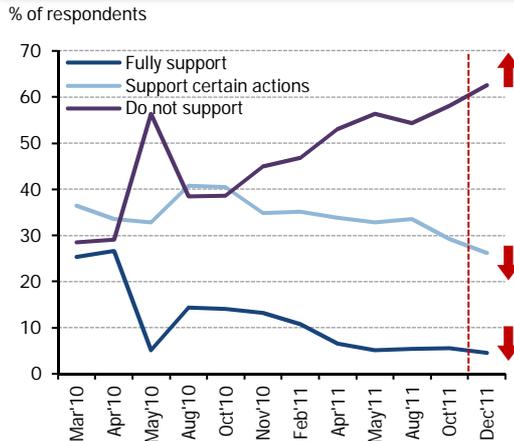
Two years have passed after Mr. Yanukovich has entered much desired position of Ukrainian President. It took two years for Alexander the Great to conquer Asia Minor and Egypt, for Gustave Eiffel to build his favorite "la tour" and for Georgia to improve its WB's ranking in Ease of Doing Business from 112 to 18 place in 2006-2008. As for Mr. Yanukovich, it took two years for more than twofold increase in the share of his and Government's non-supporters (see graphs below)².

There is a twofold increase in the share of Mr. Yanukovich's and Government's non-supporters since Mar'10

Public approval rating of V. Yanukovich continues to deteriorate...



..with twofold increase in his government's non-supporters since Mar'10



Source: Razumkov Center's opinion polls

Most business communities say **the depicted above breakdown of public opinion is explained by continuing pro-centralization actions** of the President's team, which is disappointing believers in democratic reforms (declared in 2010). Moreover, public discontent rises due to appearance of permanent or pervasive political rows.

Market participants complain the pattern of these changes has not changed recently. **In Dec'11-Mar'12 there were highly instructive occurrences for our political analysis and consequent increase in probability of "Power centralization"**.

First, the PACE has issued its resolution on Ukraine on 26-Jan'12 that was like litmus with warnings on significant malfunctions of democratic institutions in the country. Its paragraph 18 says that PACE calls for urgent reforms so that Ukraine can implement its commitments to the Council of Europe. If Ukraine fails to comply with its commitments within a reasonable time frame, this will cast doubt on the authorities' regard for the principles of democracy and the rule of law, which will prompt the appropriate response from the assembly. Later on PACE representatives named opposition leaders' imprisonment as "political vendetta" with a violation of the "rule of law" in Ukraine. As long as the concept of the "rule of law" is associated with democracy or autocracy in a simple manner, such **PACE's statements are additional testimonies to pro-authoritarian changes in Ukraine.**

PACE's January statements are additional testimonies to pro-authoritarian changes in Ukraine

² AYA Capital cannot completely evaluate objectivity and reasonability of methodology of public opinion polls, mentioned in this research paper. Presented outcomes of sociological research are described "as is", solely on the basis of published results of opinion polls (carried out by cited Ukrainian research centers). While reasonable care has been taken to ensure that the poll information contained herein is not incorrect, AYA Capital makes no representation that it is accurate or not misleading.

Second, politologists say **the ruling elite continued their a la "Gleichschaltung" actions in both political life and the economy:**

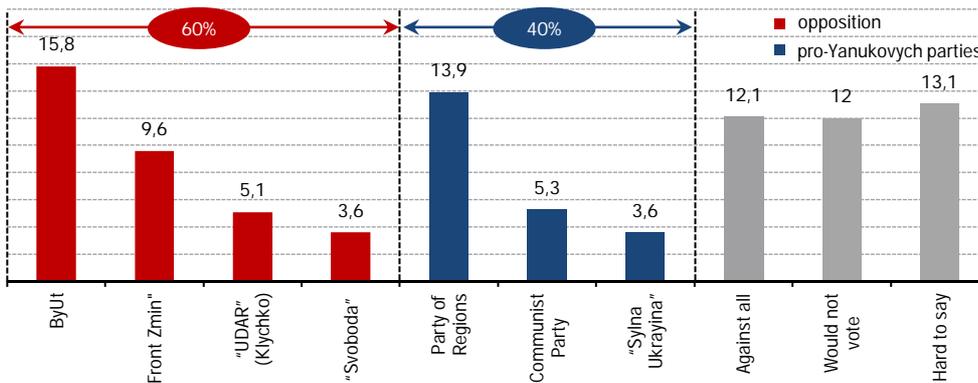
- a) another bundle of President's loyalists have entered top positions in central state bodies (appointments of Mr.Kalinin as the Head of SBU, Mr.Salamatin as Minister of Defense, Mr.Kolobov as Minister of Finance etc.);
- b) even though in past years the Constitutional Court rejected government's claims to pay social benefits with the latter's notion (as such case violates Constitution), in Dec'11 the Court has approved the similar entitlement;
- c) "whisper of censorship" has arisen again (e.g., recent withdrawal of the whole Tyzden weekly issue, suspension of "Road control" web-site etc.);
- d) Mr.Akhmetov, the leading Ukrainian oligarch and Mr.Yanukovych's main sponsor in the past, has received a concession for a virtually monopolistic export of electricity³;
- e) President's 38-year-old son acquired a few more industrial assets and entered the lists of Ukraine's top hundred richest men.

Third, **the recent "Zabzaliukgate"⁴ could be a testimony not only to the continuing exploiting of old system of "vote-for-bribe" in the parliament, but also to some hints at how the regime is going to stage the parliamentary elections later in Oct'12.** Given elections tricks, mentioned during the scandal, our reiterated concerns about continuing abuses of so-called "administrative resources" and 2011 changes in the elections legislation, we still foresee the "official" victory of current ruling majority in Oct'12. Many observers also suppose the latter is feasible even in spite of low Party of Regions' ratings, proved by recent opinion polls. E.g., 61% seats in the parliament could be taken by the opposition parties under the proportional system (or 60% in case of 3% threshold), the survey held by Razumkov Center in Dec'11 witnesses.

The ruling elite continues to consolidate economic and political power

We still foresee the "official" victory of current ruling majority in Oct'12 parliamentary elections

Political parties' ratings as of Dec'11 (implied proportion of seats in the parliament is denoted in ovals)



Source: Razumkov Center's opinion poll
 Notes: the question was "If parliamentary elections were held next Sunday how would you vote?"

Meanwhile, **we do not really suppose that existing speculations on cancellation of parliamentary election could be true** as long as elections can be cancelled only during national emergency or warlike situation according to Ukrainian Constitution. Moreover, changes to the constitutional norms on elections require no less than two-thirds of the constitutional composition of Verkhovna Rada and should be proved by an all-Ukrainian referendum (see Constitution of Ukraine, art. 156). Thus it would be easier and less costly for the ruling elite to use its "administrative resource" again (like during local elections in 2010) to win in Oct'12.

³ <http://www.epravda.com.ua/publications/2011/12/15/309807/>
⁴ <http://www.telekritika.ua/doc/images/news/69665/page%2012-15.pdf> ; <http://www.kommersant.ua/doc-rss/1878997>

Fourth, **there was no easing in treatment of Mrs.Tymoshenko**. Politologists explain that with authorities' fear of her political "vengeance" in case of discharge. As far as there are no longer serious contenders from the opposition with Mrs.Tymoshenko out of the picture, there is no so charismatic leader to lead massive protests during October elections. Moreover, current leadership may think her release would be seen as a sign of authorities' weakness.

There is no longer a serious contender from the opposition as with Mrs.Tymoshenko out of the picture

Public support of some political celebrities – ruling force becomes more and more "electorally deprived"

	Political actor	Support or partly support			Political actor	Do not support	
		Dec'11	Oct'11			Dec'11	Oct'11
1	A.Yatsenyuk	44,6	46,6	1	P.Symonenko	69,1	68,7
2	Y.Tymoshenko	37,6	36,4	2	N.Azarov	68,7	61,8
3	V.Yanukovych	29,1	40,0	3	V.Lytwyn	68,3	64,1
4	S.Tygytko	25,9	31,0	4	S.Tygytko	66,8	61,6
5	N.Azarov	25,4	32,6	5	V.Yanukovych	64,6	54,6
6	V.Lytwyn	23,4	27,0	6	Y.Tymoshenko	54,9	56,7
7	P.Symonenko	22,4	21,5	7	A.Yatsenyuk	45,9	44,2

Source: Razumkov Center's opinion polls

Notes: % of respondents. Color codes: pro-ruling force's actors, positive changes vs Oct'11, negative changes vs Oct'11

With a significant decrease in share of supporters some observers also consider that the ruling group could have expected its popularity drop in the year 2011. It is well explained by the introduction of unpopular measures such as pension reform and taxation codes, whereas 2012 may bring better fortunes (not least through the hosting of the popular soccer competition, Euro-2012). **Perhaps of more importance is the evident tolerance of the EU for the abuses of power in Ukraine, in contrast to sanctions it has applied to Belorussian officials.** Market participants admit that during the annual EU-Ukraine summit in Dec'11 European representatives had not looked ready to demonstrate tougher approach in condemnation of Kyiv's increasingly authoritarian behavior. Nevertheless, they were at least reluctant to a make a deal on Ukraine-EU Association Agreement with Ukrainian authorities, which make us perceive even lower probability of "EU Integration scenario" (2% versus previous 3%).

During the annual EU-Ukraine summit in Dec'11 European representatives had not looked ready to demonstrate tougher approach in condemnation of Kyiv's increasingly authoritarian behavior

It is quite important that **ruling authorities may feel themselves comfortable with the US, as this largest pro-democratic "warrior" together with the EU is quite busy with other issues like Iran and domestic economy.** According to Steven Pifer (former US ambassador in Ukraine), US is unlikely to engage with Ukraine at the highest level until after the 2012 presidential elections. Given such inactive position of the EU and the US, the ruling elite have in effect "carte blanche" to stick to the current regime in at least 2012.

Meanwhile, as the number of Party of Region's supporters is declining and social pressure rises, there are signs that the President is trying to consolidate his elite's power even more to cope with possible social unrest. Thus **we suppose there is a negative political feedback loop in action right now.** Moreover, we expect it will last at least in 2012 (see the scheme below) and that's why we increase the probability of "Social unrest" scenario from 30% to 35%. Some observers say that the President could be really anxious about social unrest and losing his power. Recent appointment of Mr.Salamatin as the Minister of Defense is perceived by some observers as Mr.Yanukovych's reliance on complete outsiders⁵, as long as he is expecting serious trouble at home in the coming year and doesn't think native cadres can do the job.

⁵ Mr.Salamatin was born in Kazakhstan and moved to Ukraine in 1999 as Russian citizen. It remains a mystery for local observers how he acquired Ukrainian citizenship. His promotion in Ukraine has led some to speculate on the "Russian hand" in Ukrainian politics and Mr.Yanukovych's readiness to settle down in Moscow in case of public disturbances. We assume that it's more likely that Mr.Yanukovych does not trust his party bosses in domestic defensive affairs (namely in coping with possible public protests), relying instead on some kind of "praetorian guard"

Negative political feedback loop in action



There is a negative political feedback loop in action right now – more centralization brings more social tensions and vice versa

As demonstrated on the scheme above, within such course the President may try to consolidate his power even more by means of defense, media and other spheres' control. **While in the medium-term such interconnection is very likely to result in centralization scenario's consequences (see our side-note from Aug'11), many suppose that would not be sustainable in the long-run.**

In this context, 2012 will prove to be a critical year for the incumbent ruling force. An absence of a trusted lender of last resort, in a challenging macro environment and substantial funding needs, will complicate the government's tasks and considerably increase the chances of a social uprising. Our comparative analysis with those peers, recently involved in revolutionary changes (namely Tunisia, Egypt, Libya) demonstrate that **most economic variables have not reached their critical level for massive protests yet, still providing some room for Ukrainian authorities to continue the current regime**, however.

Meanwhile, we reiterate our expectations that authorities will try to contain critical problems that bother population the most (inflation, low incomes and unemployment). Despite high chances of Power centralization scenario, politologists say the latter is still explained both by the fear of massive social unrest due to economic reasons and by the political ego of Mr.Yanukovich (namely fear of losing traditional support from the Donbas). There are some signs that authorities still do not want to disturb a society with tough economic decisions (e.g., suspended gas prices increase despite repeated requirements of the IMF), still using monetary stimuli simultaneously (e.g., recent "social initiatives" of the President by increasing pensions, promise of partial repayment of USSR Sberbank's deposits etc.)

Most economic variables have not reached their critical level for massive protests yet

Comparative revolutionary measures

Data not available for all categories or all areas	Median age	Unemployment rate	Income inequality (Gini Index) Higher numbers represent more income inequality	Spending on Food On food consumed at home, as a percent of household spending 2008	Both from the Economist Intelligence Unit's "Democracy Index 2011"		Internet Penetration Users as a percentage of the population, 2010
					Level of Democracy (Scale of 1 to 10)	Regime type	
Tunisia	29.7	14.0	40.0	35.8	2.8	Authoritarian	34.0
Egypt	24.0	9.7	34.4	38.3	3.1	Authoritarian	21.2
Other North African							
Algeria	27.1	9.9	35.3	43.8	3.4	Authoritarian	13.6
Morocco	26.5	9.8	n/a	40.3	3.8	Authoritarian	
Libya	24.2	30.0	n/a		1.9	Authoritarian	5.5
Sudan	18.4	18.7	n/a		2.4	Authoritarian	10.0
Middle Eastern							
Jordan	21.8	13.4	39.7	40.8	3.9	Authoritarian	27.2
Iran	26.3	14.6	44.5	26.3	2.0	Authoritarian	43.2
Yemen	17.9	35.0	37.7	n/a	2.6	Authoritarian	1.8
Oman	23.9	15.0	n/a	n/a	3.3	Authoritarian	41.7
Saudi Arabia		10.8	n/a	23.7	1.8	Authoritarian	38.1
Turkey	28.1	12.4	41.0	24.5	5.7	Hybrid	45.0
Kuwait	26.4	2.2	3.9	14.6	3.8	Authoritarian	39.4
Bahrain	30.4	15.0	n/a	14.5	2.9	Authoritarian	88.0
Syria	21.5	8.3	n/a	n/a	2.0	Authoritarian	17.7
Israel	29.3	6.4	39.2	17.8	7.5	Flawed democracy	71.6
Qatar	30.8	0.5	n/a	12.8	3.2	Authoritarian	51.8
Gaza Strip	17.5	40.0	n/a	n/a	5.0	Hybrid	n/a
West Bank	20.9	16.5	n/a	n/a	5.0	Hybrid	14.2
Iraq	20.6	15.3	n/a	n/a	4.0	Hybrid	1.1
Lebanon	29.4	n/a	n/a	n/a	5.3	Hybrid	24.2
United Arab Emirates	30.2	2.4	n/a	9.0	2.6	Authoritarian	75.9
Cyprus	34.5	6.0	29.0	n/a	7.3	Flawed democracy	39.3
For Comparison							
United States	36.8	9.0	45.0	6.8	8.1	Full democracy	77.3
Ukraine	39.9	8.5	26.4	51.6	5.9	Hybrid	33.7

Source: Data for median age, unemployment rate and income inequality from the CIA's "The World Factbook"; food spending data from the U.S. Census Bureau's "The 2011 Statistical Abstract"; level of democracy and regime type data from the Economist Intelligence Unit's "Democracy Index 2011"; and Internet penetration data from Internet World, internetworldstats.com

Notes: Using Tunisia and Egypt as benchmarks, measures for other areas are red-colored if they meet or exceed those thresholds (In the case of median age and level of democracy, lower numbers are red-colored).

Were the ruling force to succeed in managing macroeconomic risks and placating the population in 2012, many feel the current regime is unlikely to survive in its current form over the long-term. Considering our non-rosy expectations on economic growth, both monetary and political factors are very likely to stimulate pro-democratic transition through social pressure. For now many business communities underline **high chances that a gradual rise of new opposition leader, public protests demanding significant changes in regime and more active EU actions could become long-dated "transition stimuli"**. Moreover, recent Russian upheavals could be something like a domino effect in Ukraine. As soon as the formers' frequency and intensity is deemed to depend on how liberal the new government in Russia would be, its consequences for Ukraine would at least partially depend on Mr.Putin's readiness to be a more reformative leader.

Speaking of the "Big Eastern Brother", we perceive lower probability of successful continuing negotiations with Russia in the short-term (compared with our Dec'11 analysis). Ukraine was in quite inconvenient financial position on the edge of 2012. That's why we assumed rather high probability of cooperation with Russia (45-47% chance of successful talks) and subsequent unobvious nonpublic "conditions precedent" to obtain financial assistance. But due to introduction of some alternative measures to attract funds (selling OVGZ to banks with simultaneous easing of monetary policy, introduction of USD-linked OVGZ), the government has succeeded in covering its financial needs with internal liquidity sources. That was evidently proved in Q1'12 with successful payment of significant OVGZ and IMF loan redemptions.

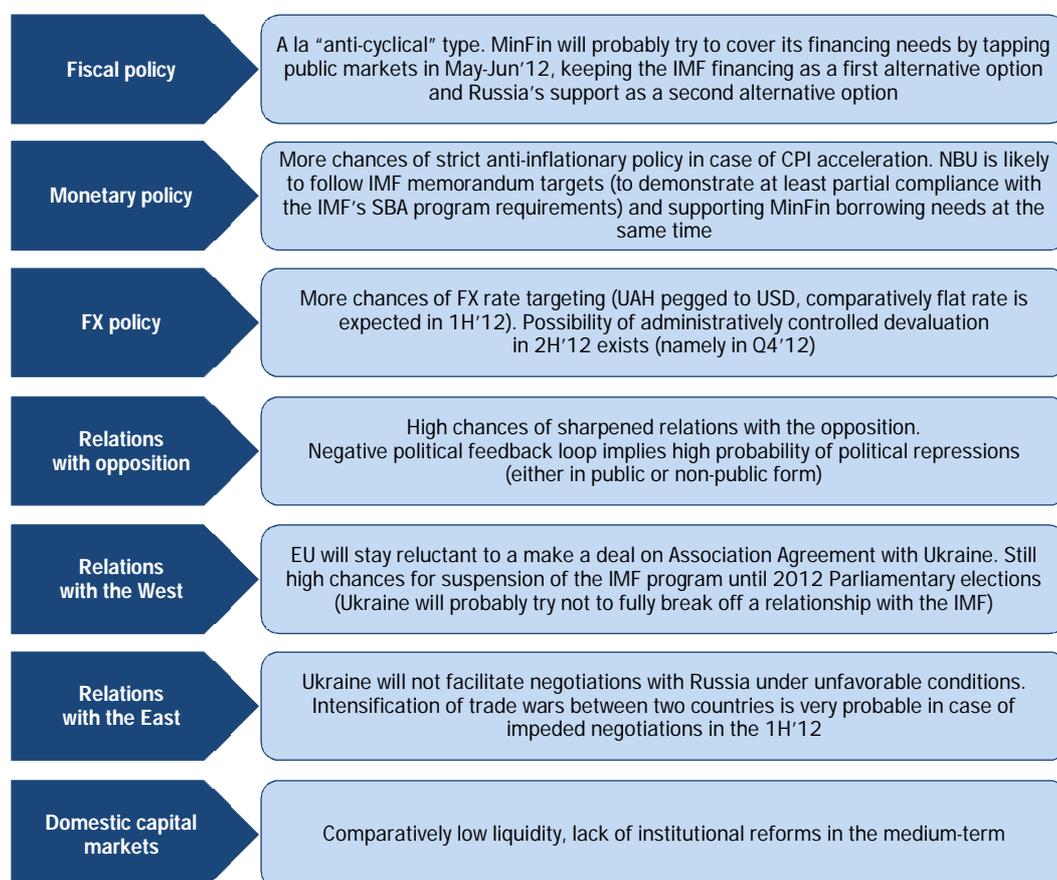
Many observers feel the current regime is unlikely to survive in its current form over the long-term

As of now the debt burden of Ukraine is carried over until May-Jun'12 due to successful short-term OVGZ placement in Feb'12. Meanwhile, slightly improved conditions on external debt markets and better sovereign risk perception towards Ukraine after the first tranche of the IMF loan redemption have made it possible for Ukraine to attract long-term funds on public markets. **Thus we suppose it is very likely that Ukraine will not facilitate negotiations with Russia in the 1H'12 in case of proposal of unfavorable conditions on gas pricing, funds attractions, Customs Union participation etc.** Mentioned time-out in covering Ukraine's financial needs has increased the country's bargaining power, which may result in more friendly options from Russian side. Thus we still expect "cat-and-mouse game" between Russia and Ukraine, with the former trying to achieve its integration objectives and the latter trying to avoid financial trap by tapping public debt markets.

Meanwhile, many politologists still foresee strained relations between Ukraine and Russia. That is well supported by another round of trade wars as the latter country is already "putting grit" in Ukrainian sugar and milk export. "Caramel war", an "aircraft building war", a "pipe war" and other export-import tensions are very probable.

Time-out in covering Ukraine's financial needs has increased the country's bargaining power, which may result in more friendly options from Russian side

Most probable consequences of current scenario analysis



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