

Initial investing training

Instruction

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1. Financial instruments of stock market

Most of companies begins its existence from either own funds or funds of founders. Frequently, for start-up period it is enough to have own funds but for the further company development it is necessary to expand production. That means, for example, to buy new equipment, to provide new service, to arrange PR-measures. Company has sufficiently small income, so during start-up period it can apply to a bank and to take out a loan. That would be the one of the simplest borrowing ways to the company itself, still one of the most expensive ones, due to bank gives limited high-interest loans from 20% to 25% per annum. Firstly, the reason to it is that in most cases bank evaluates fixed company assets only (office, machine or computer), soft assets usually are not evaluated by the banks. Besides taking out bank loans during the initial stage of company development the company can go in for private borrowings by using such an instrument as a bill. To the company, the bill means the same borrowing as bank loan, except for the bill can be sold to anyone. So, by issuing the bill, the company can borrow money from a private investor for lower interest than if being borrowed from bank. In that case the interest ratio could be from 14 to 24%. Certainly, it is not advantageous for the company to have unpaid credit interests as well as bill's for the reasons following:

1. Amount of money borrowed is limited significantly enough, it makes about 100 mln of RUB;
2. high rate of interest;
3. If evaluating company, creditors do not evaluate soft assets.

Advantages for credit and bill borrowings:

1. To take out the loans in bank and place its own bills, the company's form of ownership can be arranged as a limited liability company (LLC);
2. It is possible that company doesn't have a credit report.

In process of working on bank and bill debts, company starts to create a positive credit reputation, which can allow moving to cheaper loans and borrowings. As soon as company has a positive credit reputation and a financial community begins to confide in company, the organization can go ahead with bonded loans by issuing bonds at the market. In that case, though a bond is the same debt instrument as a bill, it still has a variety of key and distinct points:

- a bond is an issue grade security (when being issued, a bond should be registered in FFMS), a bill is not;
- bonds are traded, while bills are not.

Since a bond is issued under the FFMS strict control (Federal Financial Markets Service), it is permitted to entry into organized market, i.e. stock exchange. According to these securities, reliability guarantees to potential investors are fixed. Since the security is traded on the exchange, company has an opportunity to attract significant financial resources among numerous investors which it couldn't afford if working with bills. Besides, if company that entries into the bond market already has credit report on bills and loans, it is able to place its own bonds on low profitability rates for investors. Profitability reduction on bonds is based on the fact that the investor is certain that the financial assets would be definitely returned. Working in credit (debt) market, doesn't matter would it be credit at bank, a bill or a bond, the basic indicator is still an annualized gain. For example, a gain of the company that issues a bond is about 6-7% per annum, would investor buy a bond if he can deposit his money in a bank and get a higher interest without any risks? No, he wouldn't, because potential investor wants to earn more than in bank and the company would be forced to increase its profitability percentage up to 11-12% per annum in order to get the investor interested. If company is a well-known and safe one and has a perfect credit reputation, then the profitability percentage against its bonds can be more or less equal to the bank's profitability ratio; but in case when a company is not well-known and its credit reputation is not so mature, then to find investors, it would be forced to increase profitability rates to the higher level than bank's. Besides using of debt instruments, to attract finances a company can also use equity instruments, that means to issue (to sell, in other words) own shares. By selling own shares as well as by selling bonds, company attracts finances, the main difference is that a bond is a debt which should be cleared (should be paid back) while a share is a part of company, which gives rights to manage company and to get a part of its profit. A back side of possibility to run company by buying its shares is that we don't get profit guarantee if selling them (as distinct from selling of bonds). The advantage (positive smth) of shares issuing is that company receive money that are not to be paid back (share sale is not a debt). Disadvantage (negative smth) is that by selling shares, the company owners lose

partly their control over business. That happens because investor, who bought shares, gets the right to run company according to his share.

2. Types of stock market

2.1. Primary market

If a company decides to issue shares, then in most cases it contacts a professional – underwriter, who deals with all questions concerning placement (sale) of shares:

1. Accounting.
2. Arranging of qualified corporate governance.
3. Working out of a deal structure.
4. Company valuation.
5. Company shares placing.

An underwriter mediates between a company (issuer of securities) and a prospective investor. Initial public offering market is usually called primary market. This market's feature is that it is only here that a company (an issuer) takes money for its shares, in the other market (secondary one) a company will no more take money.

2.2. Secondary market

Secondary market is a market where stocks or other securities broking between the market players is taking place. Secondary market can be on-exchange as well as off-exchange. At the on-exchange secondary market broking operations with securities are taking place in specially equipped places, called exchange houses. At the off-exchange market broking is effected either over the counter, or through broker company. On exchange price considered to be fair (market one) due to the great number of participants, while for off-exchange market the price is defined only by mutual agreement made between a buyer and a seller directly. Note that as soon as a share is on the secondary market, the company-issuer doesn't take money any more whatever its price is.

3. Placements.

In the primary markets companies effect initial securities distribution as well as secondary distribution. Primary and secondary securities issue is carried out in form following:

1. public offering including public announcement, advertising and issue prospectus listing;
2. private offering without public announcement, advertising and issue prospectus listing.

3.1. *IPO*

IPO (Initial Public Offering) is the company's offer for own issue-grade securities. Although IPO term includes all securities (shares, bonds, units and depositary receipts), but practically the IPO term is used for shares mostly. Generally, IPO includes stages following:

Preliminary stage: at this stage, company analyses it's financial and economic state, organizational structure and structure of assets, informative and financial visibility, corporate governance practice and other aspects. According to the results of the analysis, company aims to remove weaknesses and disadvantages found out, which can impede successful IPO realization.

Preparatory stage: IPO team is selected (trading platform, partners (advisors, brokers, underwriters)), who agreed upon program and IPO configuration.

An advertising campaign is getting launched (as of road-show, that means publicity tours of issuer's management) in order to raise the prospective investors' interest in securities offered.

Main stage: at the main stage book building happens, as well as pricing – price determination (in case that it's still not determined), allotment, and public offering summary.

Final stage: beginning of exchange securities circulation. Final IPO evaluation.

Usually, initial public offering attracts investment banks and companies as underwriters. Road-show usually goes before IPO and means a company's representatives meetings with prospective investors, during these meetings a company's presentation is performed, including main indicators of operation of a company and replacement characteristics.

3.2. *Secondary public offer*

Secondary public offering is a procedure of additional securities issue. By secondary offering, a company can place own shares (can sell) on exchange as well as on the primary market. Secondary offering procedure is no different from initial offering one.

3.3. *Issue and placement of shares illustration*

What is the company interested in when its shares are traded on the exchange? Let's consider a specific example. Company-issuer decided to sell 5% of shares. A company shares' total amount is 100, that means that the company is going to sell 5 shares. Having evaluated the company, underwriter finds out that it's total price is 1000 RUB, so unit price should be 10

RUB. By having sold 5 shares to the investor, company managed to realize 50 RUB and to give 5 % of own property. When shares do enter the exchange, their unit price amounts to 10 RUB. That is exactly what is called initial public offering. After exchange replacement being made, the shares begin to be traded “on their own” i.e. between traders. Suppose that within a year a unit price for the share would reach 50 RUB. In case that company has own shares and they are traded, then the company has an actual cost. An actual cost of company is composed of total share amount price. So, with unit price of 50 RUB the total evaluated price of the company is 5000 RUB. We can get this figure by the way of multiplication of 100 shares (total company shares amount) by exchange unit price of 50 RUB. Now, with such an evaluated company price, it can easily attract bonded loans and bill credits for much bigger sum of money, that is 5000 RUB, while the year before that sum could be no more than 1000 RUB. Suppose, that after one more year company exchange shares price reached 100 RUB. In this case a company can go ahead with additional securities issue procedure (to sell 5 more shares). The company contacts the underwriter again and offers him shares for 95 unit price. As a rule, a price get fixed a little bit lower than a price of exchange in order to give to underwriter a possibility to earn money as well as to have possibility to sell the whole block of shares. Such a deal (additional securities issue) resulted at 475 RUB profit for company which sold 5 shares only! If company sells 10 shares at the price of 10 RUB each in the process of initial public offering then it would get 100 RUB only. That is the way a lot of foreign and domestic companies are working. The best example of it was Sberbank follow-on offering in 2007. When exchange unit price was 91 300 RUB, after follow-on offering unit price was 89 000 RUB.

4. Bond.

A bond is an issue-grade security that fixes the right of its owner to get from the bond issuer on the terms specified its nominal value or other equivalent in property. Bond can also provide its owner's right to get fixed percentage of its nominal value, or other property rights. Bond yield are percentage and/or discount.

5. Share

A share is an issue-grade security that fixes the right of its owner (shareholder) to get a part of the profit of joint-stock company as dividends, the right to manage company and the right to get a part of property left after its liquidation. A share is a registered security. From the definition it follows that as soon as you buy a share, you're becoming at once the owner of this company. It gives you the right to get profit (dividends) and the right to manage this company(to be among its shareholders). But in practice the situation looks a little bit different, you must admit, that if you buy one share of “Norilsky Nickel” company for the price at 5000 RUB, your voice on

meeting of shareholders and your dividends will be humble enough. Such shareholders are usually called minority shareholders. Due to the reason that “Norilsky Nickel” company has millions of shares while you have only one, that composes one millionth percent of company’s value.

Shares are divided into two types: ordinary share and preferred share.

5.1. Ordinary share

Ordinary shares give a right to manage company that means that one share corresponds to one voice at the meeting of shareholders and participates in distribution of joint - stock company’s profits. Source of dividends’ payment for the ordinary shares is a joint-stock company’s net profit. Dividends are defined by the board of the company and are recommended to the general meeting of shareholders, which can only decrease the sum of dividends according to sum recommended by the board of the company.

5.2. Preferred share

Preferred share can limit participation in company’s management and can give also additional rights in it, but yields dividends constantly.

Preferred share dividends can be paid out from profits as well as from the other sources. Currently, according to the Russian law, if dividends on preferred shares are not paid out, then the shareholders are given a right to vote at the general shareholders meeting.

So, by buying preferred shares you receive dividends for sure, but you cannot vote at the meeting of shareholders, and by buying ordinary ones you receive a right to vote, but can’t be sure about the sum of your dividends. To specify preferred and ordinary shares it is usually used prefix “sp” and “so” accordingly: Rostelecom-sp and Rostelecom-so. Practically, prices for such shares can differ, for example, Sberbank-so’s unit price is 109 Rub, and Sberbank-sp’s unit price can be 77 Rub. From the speculative point of view, it doesn’t matter, because prices for these shares will behave almost at the same way, if Sberbank-so increases for 15% per

month, that means that Sberbank-sp will change it's cost approximately for 15%.

Sometimes, ordinary and preferred shares are not simultaneous. For example, one preferred share's cost of "Rostelekom" increased due to expectations to receive high dividends for it, what resulted in significant price divergence between ordinary and preferred shares.

6. Stock exchanges in Russia

Stock exchange is a legal entity (company), registered and licensed in Federal Service for Financial Markets, which can be considered as bidding process organizer. It follows from the definition, that there can be lots of stock exchanges in the country, due to they are not-state and can compete between each other. Here is a list of stock exchanges in Russia:

- MICEX – Moscow Interbank Currency exchange;
- RTS – Russian Trading System;
- MSE – Moscow Stock Exchange;
- SpbSE – Saint-Petersburg Stock Exchange;

On the central exchanges (MICEX and RTS) it is usually traded the most marketable shares, bonds, futures and options contracts.

6.1. MICEX

MICEX is divided into several segments: shares, bonds and currency. This exchange is an absolute leader in Russia for the reasons following:

- high technique equipment – trading in electronic form;
- mature clearing – this exchange was among the first ones who implemented delivery versus payment procedure. You get a share as soon as you buy it;
- great number of players due to Internet trading system usage;
- great movement of financial assets and transactions during a day.

6.2. RTS

Trading RTS markets:

1. classical market;
2. exchanging market;
3. FORTS market (RTS futures and options contracts);
4. RTS Start.

6.3. Classical market

Classical RTS market is the oldest organized securities market in Russia, it was opened the 5th of July of 1995. Than players who had RTS terminals could set up quotations for Russian shares and hold negotiations on transactions by the phone. Currently, the main principals for classical market trading are absence of 100% depositing, possibility to choose a date and the way of payment, and settle in foreign currency. There is no need for advance securities and cash transferring to trading, and that provides high efficiency. Classical market transactions are hold with using of RTS Plaza trading terminals. The professional securities market player can play on RTS classical market.

Prices set on RTS classical market are admitted landmark to investors, who make transactions with Russian shares and depositary receipts through RTS as well as through over-the-counter and other exchanges platforms of Russia, Europe and USA. Information on RTS trading is transmitted to the huge number of consumers in Russia and abroad, and is a base to main Russian stock exchange indicator(RTS index) calculation.

There is a wide range of securities on the classical RTS market – about 2000 of shares, bonds and investment units.

6.4 Exchanging market

Trading on the exchanging RTS market got started in November of 2004. New platform was created to trade a wide range of Russian issuers' securities. One of the main directions for exchanging market development is a secondary shares market, upsurge of this market segment liquidity, financial instruments launch, spreading of liquid securities range.

Currently from 30% up to 50% of total trading volume on exchange market is accounted for by secondary market shares. Exchanging RTS market is oriented to all categories of investors, institutional as well as private.

6.5. FORTS market

RTS market of futures and options (FORTS) is a leading Russian forward contracts market.

Currently at FORTS market there are circulating futures and options, base for which are Russian issuers' shares, RTS index, bonds, foreign currency, different rates of interest, oil, gold and so on.

6.6. RTS Start

RTS START is JSC "RTS" exchange securities market segment, that was created especially for small and mid-cap companies. Aims of RTS START:

1. to increase the quantity of the securities circulating at the Russian securities market;
2. to provide small companies with possibility to create and increase capitalization;
3. to provide possibility to attract capital to the real sector of economy through stock exchange.

RTS START function: placement and circulation of securities of small and mid-cap companies (issuers).

7. Brokers and dealers

Dealing activities is account dealing transactions settled on one's behalf and for one's own account by public announcement of purchase/selling price for the matched sale-purchase agreement. Securities trader who carries out dealing activities is called a dealer. It is only legal entity that is commercial organization, which can be a dealer. According to the definition, a

dealer is a specially registered and licensed organization, which trades on exchange its own money at own discretion and on its own account.

Broker activity is civil securities transactions, settled as an attorney or commissionaire, acting under contract of agency or commission agreement, or under Power of Attorney on such transactions settlement also, if there is no instructions on law agent's or commissionaire's attorney in the contract. Securities trader who carries out broker activity, is called a broker. So, it may be concluded, that a broker is a specially registered and licensed organization, which trades on exchange their clients' money and on their own account. So, if we want to buy 10 shares of Sberbank on exchange, we contact a broker with instructions to buy, than a broker himself is buying 10 shares of Sberbank, gives shares to us and receives a commission. A broker is an intermediary.