



Management's discussion and analysis of financial condition and results of operations for the first six months of 2008

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Management's discussion and analysis of financial condition and results of operations for the first six months of 2008 represents management's opinion in relation to the Group's operating and financial results, including discussions of:

- key performance indicators of certain business units and subsidiaries;
- financial position as at 30 June 2008;
- issues of liquidity, solvency and capital sources; as well as
- significant events of the Company.

This discussion should be read in conjunction with the consolidated financial statements for 1H 2008, prepared in accordance with International Financial Reporting Standards (IFRS).

1. The Group's operating results

1.1. Summary of performance results

USD' 000	1H 2008	1H 2007 (restated)	1H 2007
Gold sales revenue	505 730	309 360	309 360
Other revenue	13 179	8 689	
Cost of gold sales	(301 855)	(204 410)	(204 410)
Other costs	(13 230)	(7 964)	
Gross profit, including:	203 824	105 675	104 950
Gross profit on gold sales	203 875	104 950	
Gross profit margin, including:	39.3%	33.2%	33.9%
Gross profit margin on gold sales	40.3%	33.9%	
Operating expenses	(56 241)	(199 986)	(196 982)
Operating profit	147 583	(94 311)	(92 032)
Operating profit margin	29.2%	(30.5%)	(29.7%)
Income/(loss) from financial and investment activities	23 062	39 074	16 755
Income before income tax	170 645	(55 237)	(75 277)
Pretax margin	33.7%	(17.9%)	(24.3%)
Income tax expense	(38 206)	(19 622)	(18 142)
Net profit for the year	132 439	(74 859)	(93 419)
Minority interest	(312)	650	319
Net profit attributable to shareholders of the parent company	132 751	(75 509)	(93 738)
Net profit margin	26.2%	(24.2%)	(30.2%)
EBITDA	240 130	123 775	117 941
EBITDA margin	47.5%	40.0%	38.1%

1.2. Gold sales revenue

In the reporting period Polyus Gold's revenue from gold sales reached a historical high level and totaled USD505 730 thousand, having increased by 63.5% as compared to 1H07.

The positive revenue dynamics resulted from significant growth in gold output (18.9%), as well as from favorable market conditions.

In the first six months of 2008 Polyus Gold produced 559 thousand ounces (17.4 tonnes) of refined gold, compared to 470 thousand ounces (14.6 tonnes) during the same period in the previous year. The achieved growth in production resulted from increased output at Olimpiada mine, which became possible thanks to the launch of Mill-3 at the mine, putting into processing additional volumes of oxidized ores, which were operationally accreted at Vostochny pit, as well as putting into operation ores from Olenie deposit, mined in 2007.

In the reporting period the Company sold all the produced volumes of gold, therefore, the volumes of the metal sold in 1H2008 amounted to 559 thousand ounces (17.4 tonnes), compared to 470 thousand ounces (14.6 tonnes) in 1H 2007.

During the reporting period the gold price on the global market showed a 9.9% increase. On January 2, 2008, the first business day of the reporting period, the gold price was USD 846.75¹ per ounce. On June 30, 2008, the last business day of the second quarter 2008, the gold price amounted to USD 930.25² per ounce.

The Company's policy of selling gold at spot market prices made it possible to reflect the growth in the gold price in full in the financial results of 1H 2008. The weighted average gold price grew up to USD 908.7 per ounce in 1H 08, compared to USD 659.7 per ounce in 1H 2007.

The sales structure changed significantly. In 1H 2008 the Company sold the metal on the domestic market only. The decision not to continue working under export contracts was made basing on more attractive conditions of contracts with Russian banks.

	1H2008	1H2007	Change
Gold sales (USD thousand)	505 730	309 360	63%
Gold sales (thousand troy ounces)	559	470	19%
In the domestic market	559	453	23%
For export	0	17	(100%)
The weighted-average gold selling price (USD per troy ounce)	908,7	659,7	38%
The average evening fixing price in London (USD per troy ounce)	910.86	658.12	38%
Excess of weighted-average selling price over average evening fixing price, USD	(2.16)	1.58	-

In the period under review the produced metal was sold under once-off deals within general contract. Within the centralized distribution system CJSC Polyus sold both its own gold and the metal of Group's subsidiaries on the basis of agency agreements signed with these subsidiaries.

1.3. Cost of sales

In the first six months of 2008 the cost of gold sales increased by USD 97 445 thousand and totaled USD 301 855 thousand.

Cash operating costs

USD' 000	1H 2008	1H 2007 (restated)
Cash operating costs	246 435	177 318
Materials and spares	68 608	48 338
Payroll	84 946	63 616
Fuel	36 912	25 821
Power	7 787	6 489
Tax on mining	34 209	20 209
Other cash operating costs	13 973	12 845

¹ PM gold price fixing in London

² PM gold price fixing in London

The main reason of the increase in cost of sales is the increase of cash operating costs within all the Group's production entities. In the period under review, cash operating costs included in costs of sales amounted to USD 246 435 thousand, compared to USD 177 318 thousand in 1H 2007.

In the first six months of 2008 the payroll expenses were the main item included in cash operating costs. In 1H 2007 the payroll expenses for production staff amounted to USD 63 616 thousand, whereas in 1H 2008 those expenses grew to USD 84 946 thousand. The 33.5% increase approximately equals the overall labour costs increase in Russia for the 12 months period ended June 30, 2008.

At the beginning of the reporting period the total number of mining trucks working at the Group's production units was 251, with the combined tonnage of 15.2 thousand tonnes. In total, 105 excavators worked at the Company's mines, with the combined hoe capacity of 724.9 cubic meters.

The second largest item included in cash operating costs are expenses on spare parts for these trucks and excavators, as well as for construction machinery, expenses on rolled metal products and cables, technological materials for plants and other materials and spares, used in mining, smelting and concentrating. In the first six months of 2008 the cost of materials and spares amounted to USD 68 608 thousand, compared to USD 48 338 thousand in 1H 2007 (41.9% increase). The increase is a result of the growth in ore processing. The major contributor of the increase in ore processing is Olimpiada mine, the Group's largest production unit. Furthermore, the cost of a number materials and spares, purchased by the Company in the reporting period, also increased.

A significant portion of cash operating costs was formed with expenses on diesel oil, fuels and lubricants for trucks and excavators. In addition to that, Olimpiada mine is going to have its own power plant, working on crude oil; there is an oil-fired power plant already operating at Nezhdaninskoye deposit. Expenses on fuel grew 43.0% year-on-year to USD 36 912 thousand.

Due to increased gold production and growth in gold price the Company paid USD 34 209 thousand as tax on mining, which is USD 14 000 more than in 1H 2007. Concentrates and other semi-products containing gold are liable to the tax at the rate equal to 6% of the cost of these semi-products. The cost is determined based on the taxpayer's selling prices for the relevant tax period.

External market factors effecting the cost of sales

All the costs included in the Group's cost of sales, and many operating costs directly or indirectly depend on the prices for oil and steel, as well as on the exchange rate of the national currency to USD.

In the first six months of 2008 the Company had to operate in worse market conditions as compared to the same period of the last year.

In 1H 2008 oil and steel prices showed a significant increase, compared to 1H 2007.

Average price/ rate	1H2008	1H2007	Change
Oil (Brent brand) (USD per barrel)	102.72	62.46	64.5%
Steel (hot rolled), (USD per tonne)	760.00	535.00	42.1%
Average USD/RUB rate	23.94	26.08	(8.21%)

Source: Bloomberg, the Central Bank of the Russian Federation

An increase in oil prices resulted in an increase of expenses on fuel. Steel forms the basis for the price of all rolled metal products, pipes, machinery and vehicles.

The Group receives settlements with respect to gold sales either in USD or based on USD whilst most of the Group's costs are denominated in Russian Rubles. The devaluation of the USD versus the Ruble results in a decrease of profitability.

Depreciation of property, plant and equipment

Depreciation of property, plant and equipment included in cost of sales grew by 9.0% - from USD 48 457 thousand to USD 52 805 thousand.

1.4. Selling, general and administrative expenses

During the first six months of 2008 selling, general and administrative expenses decreased by USD 116 088 thousand from USD 181 042 thousand in 1H 2007. This was mainly a result of the expenses relating to the exercise of the share option plan, reflected in 1H 2007 administrative expenses.

Payroll

The payroll for administrative staff didn't change significantly compared to 1H07 and amounted to USD 31 265 thousand.

Taxes, other than mining tax and income tax

In addition to mining tax and income tax the Group pays property tax, VAT, unified social tax and other taxes. In 1H 2008 the Group expensed USD 9 711 thousand to the Russian federal budget and the regional budgets in the form of tax payments other than mining tax and income tax. It is 85.4% more than in 1H 2007. This is due to an increase of non-recoverable VAT. The amount of non-recoverable VAT increased significantly at CJSC Polyus (Krasnoyarsk business unit) which made contributions to the share capitals of new subsidiaries in non-monetary form. In addition to that, due to the growing volumes of construction and exploration works the property tax increased.

USD'000	1H2008	1H2007
Taxes, other than mining tax and income tax	9 711	5 237
VAT	2 314	762
Property tax	5 858	3 213
Other taxes	1 539	1 262

Other selling, general and administrative expenses

Other selling, general and administrative expenses (in which for the purpose of this review we include rental and communication costs, professional and banking service fees, and repair and maintenance costs) increased by USD 8 772 thousand and amounted to USD 23 978 thousand.

Other selling, general and administrative expenses increased mainly due to professional and banking services that grew 82.8% to USD 11 637 thousand. The one-time increase of these expenses is related mainly to consulting services provided on the project on exploration assets carve-out.

1.5. Research and development and exploration costs

These expenses increased by USD 1 005 thousand and amounted to USD 4 430 thousand, mainly due to the increased volumes of exploration activities in Krasnoyarsk and Irkutsk alluvial business units.

1.6. Other operating income and expenses

Other operating income in 1H 2008 amounted to USD 20 587 thousand, which is USD 19 450 thousand higher than in 1H 2007. The increase is a result of recognition as part of other expenses a change in valuation of deferred consideration for acquisition of a subsidiary in the amount of USD 15 746 thousand, as well as a result of the profit on disposal of property, plant and equipment. In addition to that, write-off of obligations under the share option plan was made for the amount of USD 2 715 thousand.

Other operating expenses reduced significantly and amounted to USD 7 444 thousand, compared to USD 16 656 thousand in 1H 2007. In the period under review the company disposed fixed assets with profit, compared to the loss on disposal of fixed assets for the sum of USD 5 564 thousand in 1H 2007.

1.7. Income/loss from financial and investment activity

Income from financial and investment activity in the reporting period amounted to USD 23 062 thousand, which is USD 16 012 thousand more than in 1H 2007 – USD 39 074 thousand.

USD'000	1H2008	1H2007 (restated)	1H2007
Finance income/(expenses)	(2 335)	(2 667)	(2 667)
Investment income/(expenses)	25 047	34 801	28 416
Foreign exchange gain/(loss)	350	6 940	6 933

1.8. Income tax

In 1H 2008 the Group accrued USD38 206 thousand as income tax, compared to USD 19 622 thousand in the same period last year. The effective income tax rate (ratio of current and deferred tax to IFRS income before tax and minority interest) in 1H2008 was 22.4%, whereas the statutory income tax rate in Russia was 24.0%.

1.9. Other revenues and cost of sales

Revenues received by the Group from the sale of other products (other than gold) and services increased substantially (51.7%) compared to 1H 2007 and amounted to USD 13 179 thousand.

In 1H 2008 the cost of sales of other products and services was higher than the revenue from their sale and amounted to USD 13 230 million. It had a negative impact on the Group's gross profit, which was USD 203 824 thousand compared to USD 203 875 thousand, without non-core operations.

A gross loss on sale of other products and services was not substantial, which is explained by the fact that revenue and cost of sales include heterogeneous works and services.

Other revenues include sales of power, transportation and loading services, storage services.

Sale of electricity to third parties accounts for most of other revenues – USD 5 941 thousand. The majority of the sales were made by CJSC Vitimenergosbyt, a Group subsidiary located in Bodaibo district of Irkutsk region.

1.10. Profit for the period

In 1H 2008 the company's net profit amounted to USD 132 751 thousand. USD 52 037 thousand were allotted to finance the programme of capital investments, and the remainder was reflected on the company's balance as accumulated retained earnings.

2. Calculation of key performance indicators not stipulated by IFRS standards

For analysis of financial statements many analysts and investors use key performance indicators which are not envisaged by IFRS but which are nevertheless calculated on the basis of financial statements prepared in accordance with IFRS.

EBITDA

EBITDA (Earnings before Interest, Tax, Depreciation and Amortization) is a key performance analytical indicator comprising of income before interest expenses, payment of income tax and depreciation charges.

The Group's EBITDA in the 1H2008 was USD 240 130 thousand, which is USD 116 355 thousand more than in 1H 2007. The Group calculates EBITDA as follows:

USD'000	1H2008	1H2007 (restated)	1H2007
Income for the period	132 439	(74 859)	(93 419)
+ Income tax paid	38 206	19 622	18 142
+ Depreciation and amortization for the period	55 633	50 620	50 952
+ Interest expenses	2 335	2 667	2 667
- Interest income	10 494	30 264	30 264
- Income on disposal of investments	14 553	2 109	2 109
-/+ Foreign exchange gain/(loss)	(350)	(6 940)	6 933
-/+ Loss from disposal of property, plant and equipment and work-in-progress	(1 951)	5 564	5 564
- Impairment of property, plant and equipment	-	68	68
+ Reversal of environmental obligations	-	-	0
+ Excess of the acquisition price of the subsidiary over the fair value of net assets acquired at date of acquisition	-	-	0
+ Change of provision for VAT receivable	-	3	3
+ Losses from stock option plan obligations	-	132 548	132 548
- Retention of deferred consideration for acquisition of subsidiaries	15 746	-	-
+ Excessive stripping	54 611	26 991	26 991
EBITDA	240 130	123 775	117 941

TCC

TCC (Total cash costs) is a key performance indicator reflecting the cost of goods sold adjusted for non-cash costs for depreciation, change of provision for vacation payments and provision for land rehabilitation, and stated in the report per troy ounce of the gold sold.

TCC	1H2008	1H2007
Cost of sales (USD thousand)	301 855	204 410
- property, plant and equipment depreciation (USD thousand)	52 805	48 457
- provision for annual vacation payment (USD thousand)	7 116	1 667
- provision for land rehabilitation (USD thousand)	618	549
+ non-monetary changes in inventories (USD thousand)	307	3 624
TCC, (USD thousand)	241 009	157 361
Gold sales, thousand troy ounces	559	470
TCC, USD/oz.	431	335
TCC without excessive stripping, USD/oz.	333	277
TCC without excessive stripping, RUB/oz.	7 983	7 235

Management deems it reasonable to present TCC calculation net of excessive stripping. Starting 2007, the Group significantly increased the volume of stripping work at one of its key mining entities, Olimpiada mine. This fact relates to depletion of oxidized ore reserves and beginning of sulfide ore mining. Sulfide ore has a lower gold grade.

In order to mine sulfide ore, the Group began a major program of mine preparation work which does not relate to the ore mined in the period and is called excessive stripping. Until now, the Group accounted for this work in the cost of gold produced and sold for the period for the purposes of IFRS consolidated financial statements.

Furthermore, it is reasonable to consider TCC with regard for USD exchange rate decrease. When presenting TCC (without excessive stripping) in Russian rubles, we can see that real growth of TCC was 10.3%, while in USD it was 20.2%.

Capex

Capex (Capital expenditures) represent the Company's investment into the purchase and modernization of property, plant and equipment and the costs connected with the service of loans used for the purchase of property, plant and equipment.

USD'000	1H2008	1H2007 (restated)	1H2007
Acquisition of subsidiaries, net of cash acquired, and increase of ownership in subsidiaries	22 128	-	-
+ Deferred payments for acquisition of subsidiaries	20 069	22 677	22 677
- Proceeds from disposal of subsidiary, net of cash disposed of	-	-	-
+ Purchase of property, plant and equipment	230 101	162 094	156 194
- Proceeds from sale of property, plant and equipment	(4 635)	(4 146)	-
+ Interest expenses capitalized	-	-	-
Total capital expenditures	267 664	180 625	178 871

In the reporting period the Group spent USD 267 664 thousand on its Capex program. 86.0% of these investments were used for purchase of property, plant and equipment, including equipment for mills under construction, mining and construction equipment, rolled metal products. The program was financed with the operating cash flow (in the amount of USD 128 015 thousand), cash and liquid investments (in the amount of USD 72 860 thousand) and net profit of the reporting period (in the amount of USD 52 037 thousand).

3. Summary table of performance results by business units

1H2008	Revenue	Production	Sales
	USD '000	000 oz	000 oz
Krasnoyarsk business unit	405 901	449	449
Irkutsk hard rock business unit	10 561	11	11
Irkutsk alluvial business unit	26 861	31	31
Yakutia business unit	62 407	68	68
Group total	505 730	559	559

4. Analysis of balance sheet items

4.1. Analysis of balance sheet items

Assets

Non-current assets

In the first six months of 2008 the Group's assets structure did not go through significant changes. Whereas in the 1H 2007 non-current assets accounted for 48.6% of all the assets, in the reporting period their share increased up to 53.1%.

It is primarily due to the increase of the carrying value of all types of property, plant and equipment. In the 1H2008 the Group was actively involved in geological exploration and construction works, therefore the capitalized expenses for exploration and evaluation works (33.4% increase) and assets used in construction-in-progress works (67.5% increase) increased more than any other property, plant and equipment. The value of the most significant group of assets – mining assets – increased by 7.2% and amounted to USD 1 697 622 thousand.

The long-term portion of reimbursable VAT increased significantly (+212.7 %) and equaled to USD 36 975 thousand.

Current assets

The structure of current assets changed essentially in the reporting period.

As at 30 June 2008 the value of short-term investments and other financial assets decreased by 40.8% and amounted to USD 752 122 thousand compared to USD 1 270 918 thousand as at 31 December 2007. This primarily refers to the fact that by the end of the reporting period the Group has redeemed the promissory notes of Rosbank, withdrawn its investments in securities and closed its investment account at Rosbank. These funds were partly used in Capex program financing, and partly distributed to current banking accounts and deposits.

Due to such redistribution cash and cash equivalents on the Group's accounts increased by 197.2%. As at 30 June 2008 the Group's balance sheet was presented with USD 672 110 thousand of cash compared to USD 226 174 thousand as at 31 December 2007.

Inventories increased insignificantly by 6.5% and amounted to USD 247 007 thousand compared to USD 231 985 thousand as at 31 December 2007. Materials and spare parts which account for 75% of the total inventories value, grew by 8.0% compared to the 1H 2007 and amounted to USD 184 081 thousand. The volumes of diesel fuel, grinding balls and spare parts purchased for mining equipment increased significantly. It is explained by the fact that there was a 18.3% increase in the volumes of processing at the Olimpiada mine. The cost of gold under processing hasn't changed substantially and amounted to USD 61 780 thousand.

Capital and liabilities

During the reporting period the structure of the Group's capital and liabilities did not change significantly.

Share capital and reserves

As at 30 June 2008 the share capital and reserves amounted to USD 3 447 968 thousand compared to USD 3 236 183 thousand as at 31 December 2007.

Due to the change in ruble-dollar exchange rate, translation reserve has increased by USD 124 286 thousand, and retained earnings grew by USD 80 714 thousand.

Long-term liabilities

The largest group of non-current liabilities is represented by deferred tax liabilities which at 30 June 2008 amounted to USD 190 795 thousand compared to USD 183 356 thousand at the beginning of the reporting period.

The rest of non-current liabilities changed insignificantly.

Current liabilities

The current liabilities structure slightly changed. First of all, the unsettled liabilities under the share option plan were partly settled (50% of liabilities), and partly attributed to other operating income from unrealized share option plan. At the beginning of the reporting period these liabilities amounted to USD 5 357 thousand, which corresponds to the fair value of the option for 0.1% of the shares of the Company.

Trade payables amounted to USD 56 713 thousand compared to USD 21 651 thousand by 31 December 2007. Other payables and interest payable as at 30 June 2008 were USD 54 992 thousand compared to 83 932 as at the beginning of 2008. Furthermore, in the reporting period the Group reflected a dividends payable obligation in the sum of USD 22 721 thousand. The decision was made on the General Shareholders' meeting on the 26th of June 2008.

Current income tax liabilities more than doubled and amounted to USD 28 579 thousand. This is mainly due to a significant growth of revenues. At the end of the reporting period current other tax liabilities equaled to USD 25 405 thousand compared to USD 21 187 thousand as at 31 December 2007. The growth mainly occurred on account of unified social tax (+117.9%) and personal income tax (+127.2%) liabilities. The unified social tax and personal income tax liabilities increased as a result of the growth of wages of production staff.

4.2. Analysis of profitability

USD'000, unless otherwise indicated	30/06/2008	1H2007 (restated)	30/06/2007
	Net profit	132 439	(74 859)
Net profit adjustment		132 548	132 548
Adjusted net profit	132 439	57 689	39 129
Assets	3 937 032	3 821 979	3 821 979
Equity attributable to shareholders of the parent	3 402 633	3 032 925	3 032 925
Non-current and current loans and borrowings	-	11 316	11 316
Asset profitability, %	3.4%	1.5%	1.0%
Equity profitability, %	3.9%	1.9%	1.3%
Invested capital profitability, %	3.9%	1.9%	1.3%

Profitability of both assets and equity as well as invested capital has improved significantly. It is mainly due to the fact that gross profit almost doubled and gross margin has increased from 34.2% to 40.3% while the balance structure virtually did not change.

4.3. Cash flow analysis

USD'000	1H2008	1H2007 (restated)	1H2007
Cash provided by operations	128 015	112 769	61 580
Cash provided by/(used in) investing activities	323 922	8 979	60 232
Net cash (used in)/ provided by financing activities	(20 835)	(2 956)	(2 956)
Effect of translation to presentation currency	14 835	7 730	7 666
Net increase in cash	445 936	126 522	126 522
Cash, beginning of year	226 174	294 197	294 197
Cash, end of year	672 110	420 719	420 719

In the reporting period the Group has generated income before tax in the amount of USD 170 645 thousand, compared to a loss of USD 55 237 thousand in the 1H2007. Thus, operating profit before working capital changes amounted to USD 182 718 thousand, which is 61.7% higher than in the 1H2007. USD 25 050 thousand were used for working capital financing, specifically, the value of current assets and advances to suppliers increased. In the 1H 2008 net cash generated from operating activities increased by USD 15 246 thousand and totaled USD 128 015 thousand.

During the reporting period the Group substantially increased its capital expenditure by 48.2%. Capex amounted to USD 267 664 thousand compared to USD 180 625 thousand in the analogous period of the previous year. However, while the capital expenditure was high, the company had cash inflow from investments, as closed positions on Rosbank promissory notes, as well as a number of deposits and a number of trust management contracts for the total amount of USD 574 506 thousand. As a result in the 1H2008 the Group has received USD 323 922 thousand of net cash generated from investing activities³, compared to USD 8 979 thousand generated in 1H2007.

In the reporting period the Group has repaid the loan obtained by its associated company OJCS “SVMC” for the total amount of USD 19 843 thousand. This resulted in increased net financing cash outflow in the sum of USD 20 835 thousand compared to an outflow of USD 2 956 thousand in the 1H 2007.

³ Capital expenditure represent a portion of money spent on investment activities