

## Ukraine Hit for six, with 66% upside potential

- **In our view, the investment opportunities in Ukraine cannot be described as anything but positive.** We have seen strong economic growth, averaging over 7% in real terms over the past three years, and expect this trend to continue in 2008, with our current forecast for real GDP growth at 6.9%. The economic drivers are broadly based, as fixed capital investment and consumer expenditure remain robust. We expect industrial production, for example, to be up 7.9% in 2008, on the back of a strong 2007 forecast of 10.2%. The consumer sector is also likely to remain buoyant. Retail sales have grown in excess of 20% over the past three years, and we expect this to continue in 2008 where we forecast growth of 24.3%.
- **The market is acknowledging this broad-based growth.** The PFTS was the second-best performing market in the world in 2007, with a 135% return. Despite this strong run, we believe Ukrainian stocks offers substantial upside potential. Our estimated 2007 P/E for the PFTS is 21.2x, decreasing to 18.5 x for 2008. Taking into account earnings growth rates, which are accelerating, we think the investment case remains compelling. In 2006, earnings growth was 29.4%. We now see this accelerating to 35% for 2007, and remaining fairly robust, with consensus estimates of 14.5% in 2008.
- **Of the investment opportunities in Ukraine,** we like those with a domestic flavour – real estate, banking, machinery and utilities. In particular, we favour **KDD Group, Forum Bank, Druzhkovsky Machine Building Plant, Motor Sich, Centrengo** and **Ukrproduct**, for which we see overall upside potential of 66%.

Figure 1: Top picks

	BBL ticker	Rating	MktCap mn	Target price	Price	Upside potential
KDD Group	KDDG LN	BUY	\$570.6	\$9.00	\$3.53	155.0%
Bank Forum	FORM UZ	BUY	\$921.2	\$13.50	\$8.22	64.2%
Druzhkovsky	DRMZ UZ	BUY	\$234.2	\$1.66	\$1.13	46.9%
Motor Sich	MSICH UZ	BUY	\$572.0	\$402.00	\$275.36	46.0%
Centrengo	CEEN UZ	BUY	\$1,861.7	\$7.30	\$5.04	44.8%
Ukrproduct	UKR LN	BUY	£31.7	£1.07	£0.77	39.0%
<b>Average</b>						<b>66.0%</b>

Prices as at 7 Feb 2008

Source: Bloomberg, Renaissance Capital estimates

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## KDD Group

### Building the city of tomorrow

- KDD Group is one of Ukraine's leading real estate developers with approximately 2.7mn m2 of commercial and residential space in its portfolio.** The existing portfolio spans the residential, office, hotel and retail segments and runs to 2012 with an estimated development budget of \$2.8bn.
- KDD's development pipeline is one of the largest in Ukraine and currently comprises** three sites designated for residential buildings, two sites for large-scale business centres, two sites for mixed-use property (retail, office and entertainment) and one site for a luxury boutique hotel and super-premium apartments. The bulk of commercial developments are scheduled for delivery before 2010, while two residential properties have a longer gestation period due to their size and the infrastructure involved. However, the portfolio is expected to start generating cash flow as early as Mar 2008 when pre-sales of housing properties kick in.
- KDD's portfolio is focused on excellent locations with the potential to become major business/retail hubs.** The company seeks to create top-class office and mixed-use properties of striking design and scale as well as distinctive residential properties that should contribute to its image as a developer of landmark projects in Ukraine and place it in the top ranks of the Ukrainian real estate market.
- We value the company's equity at \$1,454mn or \$9.0 (£4.5) per share as of end-2008, implying a current upside of over 155% to the current price.** We believe, once confidence returns to the markets, CIS real estate equities will be well positioned to rally sharply. With this in mind, we believe that the discount to forward NAV estimate, at which KDD's shares are currently trading, is far too large to be ignored by the market for long and reiterate a **BUY** rating

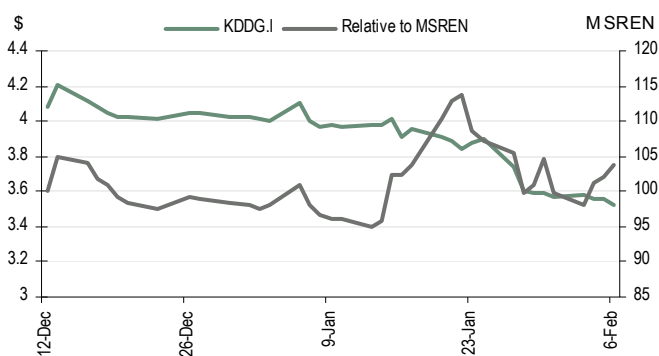
<b>Report date:</b>	<b>12 February 2008</b>
Rating	BUY
Target price (comm), \$	9.0
Target price (pref), \$	n/a
Current price (comm), \$	3.53
Current price (pref), \$	n/a
MktCap, \$mn	571
EV, \$mn	719
Reuters	KDDG.I
Bloomberg	KDDG LN Equity
ADRs/GDRs since	n/a
ADRs/GDRs per common share	n/a
Common shares outstanding, mn	161.88
Change from 52 week high:	-13.6%
Date of 52 week high:	30/01/2008
Change from 52 week low:	1.4%
Date of 52 week low	17/01/2008
Web:	www.kddgroup.com.ua
Free float in \$mn	112
Major shareholder with shareholding	A. Levin 22.63%
Average daily traded volume in \$mn	0.040
Share price performance over the last	1 month -10.59%
	3 months
	12 months

#### Summary valuation and financials, \$mn

	Total income	EBITDA	Net income	EPS, \$	EV	Net debt	NAV	BV	EV/EBITDA	P/E	P/NAV	P/BV	EBITDA/NAV	ROCE
2006	222.4	222.1	167.2	1.0	583	12	510	407	2.6	3.4	1.1	1.4	43.5%	40.1%
2007E	398.9	396.9	298.1	1.8	487	-84	1,253	1,166	1.2	1.9	0.5	0.5	31.7%	37.7%
2008E	166.9	160.8	113.8	0.7	719	148	1,454	1,262	4.5	5.0	0.4	0.5	11.1%	9.4%
2009E	513.2	506.2	349.7	2.2	1,072	501	2,025	1,762	2.1	1.6	0.3	0.3	25.0%	20.9%

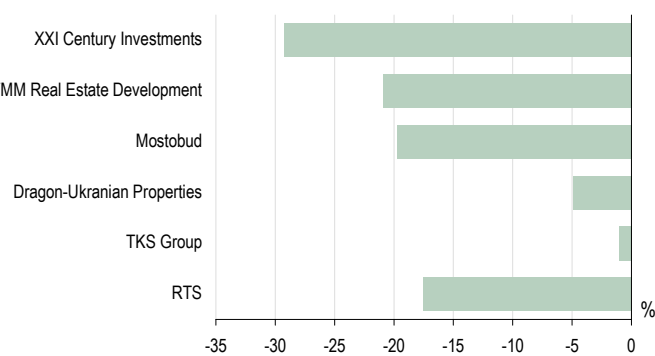
Source: Renaissance Capital estimates

Figure 1: Price performance – 52 weeks



Source: MSCI, Bloomberg

Figure 2: Sector stock performance – three months



Source: RTS, Bloomberg

# Investment summary

KDD Group is a real estate developer with 2.7mn m2 of total space under development in its portfolio. It ranks among the top-five Ukrainian developers by total portfolio size.

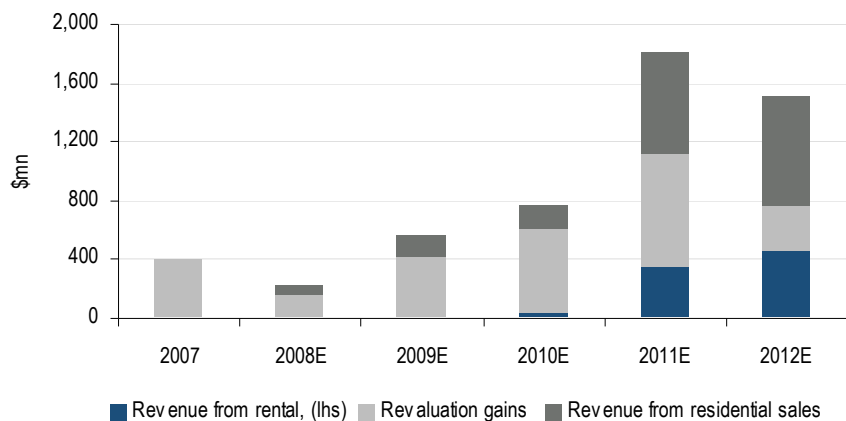
KDD has eight projects in the residential (24% of total space), office (48%) and retail/mixed use (28%) segments (see Figure 9). Four of these are under construction, and three more are expected to enter the construction phase by YE08. The company's five-year development schedule extends to 2012, however the majority of projects will be delivered by YE10, with only Zazimye and Diplomat Park remaining under construction after that (primarily due to their complexity and large scale).

Management has an extensive track record of project delivery. It has completed four properties, including three premium residential buildings and an office property in central Kiev. We believe KDD management has the necessary experience and ambition to see the project portfolio through to completion.

## Earnings outlook

KDD will retain properties in its portfolio for operational management, unless it is able to attract an experienced international property manager to run them on completion. In the next two years, we expect the proceeds from residential sale to be the only source of revenues for the company. The first inflows will start in Mar 2008 with the launch of the PecherSKY building into pre-sale. Rental revenues will start in 2010 after the WTC office property is put into operation.

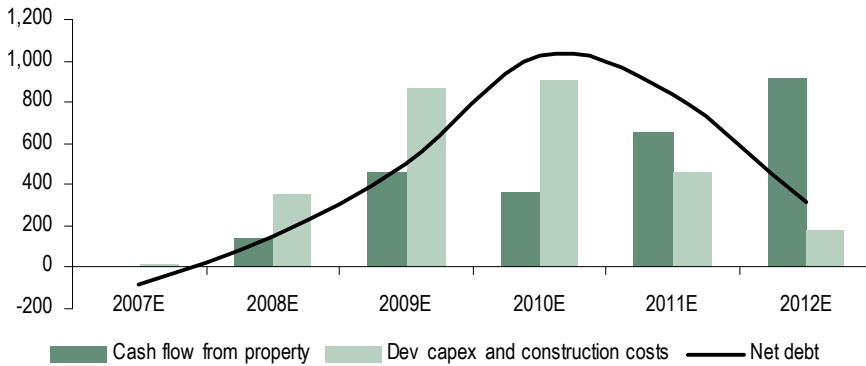
Figure 3: Revenue schedule, 2007-2012E



Source: Company data, Renaissance Capital estimates

The expense side is more front-loaded due to heavy spending on commercial property construction. Residential properties are essentially self-funding through apartment pre-sales.

Figure 4: Expense schedule, 2007-2012E, \$mn

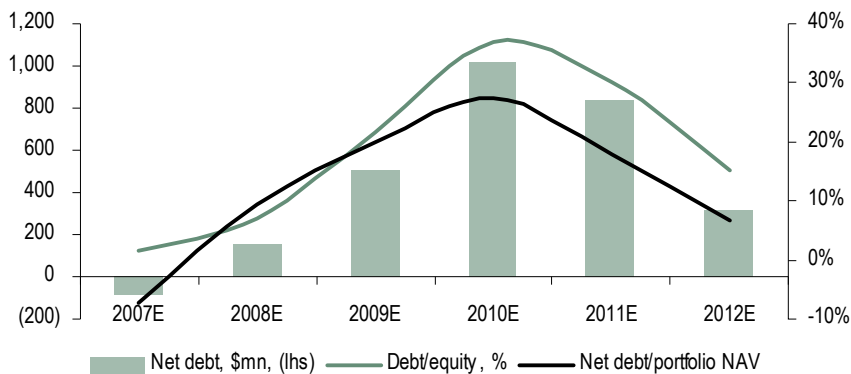


Source: Company data, Renaissance Capital estimates

KDD raised \$124mn net in new equity from its recent IPO (Dec 2007), and these funds will be fully dedicated to current project development. In addition, the company has already secured over \$50mn in bank funding (Jan 2008).

Its capex schedule calls for about \$80-90mn more for 2008, which we consider easily manageable *via* bank debt. We expect leverage to be 6.8% debt/equity for YE08, assuming no debt funding. The company's funding strategy also includes the possible sale of equity stakes in some of its properties. However, KDD is likely to be very selective in choosing a strategic partner, and will seek a buyer able to secure additional bank funding and assist in attracting high-quality large tenants to its properties.

Figure 5: Debt requirements vs. leverage, 2007-2012E



Source: Company data, Renaissance Capital estimates

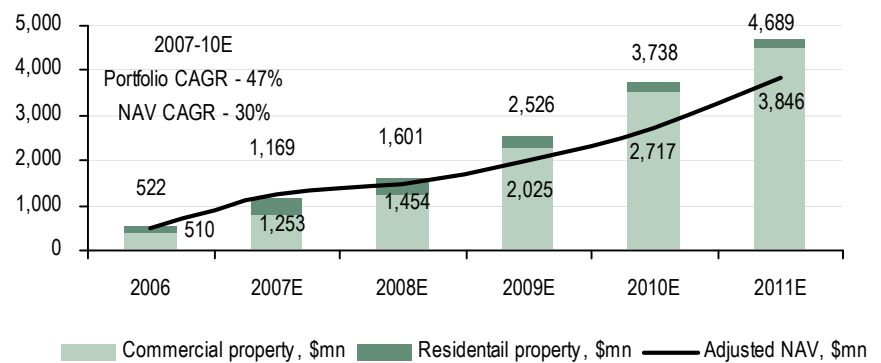
## Valuation

We value KDD based on our forecast portfolio value of \$1.6bn for YE08, adjusted for \$147mn net debt. We base our portfolio valuation on the company's input for the construction start and end dates and the company's expected NOI per project or

average sale price for residential properties (see Figure 9). In addition, we apply a single 13% discount rate to all projects.

We forecast a 76% increase in the company's portfolio value to \$1.6bn at YE08. This compares with the latest reported \$0.91bn in Sep 2007 primarily due to progress in project construction during 2008. At the current market price, the stock trades at a 60% discount to its YE08E NAV, which we believe is unjustified for a company that is fully funded to meet its targets for 2008. We set a \$9.0/share target price, which implies 155% upside potential, and rate the stock a **BUY**.

Figure 6: NAV forecast, 2007-2012E



Source: Company data, Renaissance Capital estimates

## Summary of IPO

Figure 7: KDD IPO summary

IPO price, \$	4.1
Shares sold, mn	31.5
Post IPO number of shares, mn	161.9
IPO Size, \$mn	128.5
IPO date	13 Dec 2007
Performance since IPO	-11.5%
PFTS performance since IPO	66.6%
Free float size	19.5%
Free float value, \$mn	112
<b>Total IPO proceeds</b>	<b>124.2</b>

Source: Company data, Renaissance Capital estimates, Bloomberg

## Summary financials

Figure 8: KDD Group balance sheet, IFRS, \$mn

	2006	2007E	2008E	2009E	2010E	2011E	2012E
Investment property and property under development	522	1,169	1,259	2,268	3,510	4,490	4,801
Advances to constructors	1	18	44	46	23	9	-
Prepayments for land plots	11	12					1
Plant & equipment	2	3	4	6	9	14	21
Intangible assets							
Deferred tax assets							
<b>Total non-current assets</b>	<b>536</b>	<b>1,202</b>	<b>1,307</b>	<b>2,320</b>	<b>3,543</b>	<b>4,513</b>	<b>4,823</b>
Financial assets	6	6	6	6	6	6	6
Trade and other receivables	13	10	7	6	4	3	2
Income tax receivable							
Inventories	0	-	377	662	911	1,160	1,344
Cash and cash equivalents	2	98	5	5	4	49	181
<b>Total current assets</b>	<b>21</b>	<b>114</b>	<b>395</b>	<b>679</b>	<b>926</b>	<b>1,218</b>	<b>1,533</b>
<b>Total assets</b>	<b>557</b>	<b>1,315</b>	<b>1,702</b>	<b>2,999</b>	<b>4,468</b>	<b>5,732</b>	<b>6,356</b>
<b>Shareholders funds</b>	<b>407</b>	<b>1,166</b>	<b>1,262</b>	<b>1,762</b>	<b>2,388</b>	<b>3,949</b>	<b>5,158</b>
Deferred income tax liability	122	119	113	219	363	556	634
Long-term debt	1	1	126	444	939	817	461
Finance lease liabilities	1	1	1	1	1	1	1
Other long-term Liabilities	3	3	3	3	3	3	3
Liabilities under construction contracts		-	140	476	670	324	65
<b>Total non-current liabilities</b>	<b>127</b>	<b>124</b>	<b>383</b>	<b>1,143</b>	<b>1,976</b>	<b>1,702</b>	<b>1,164</b>
Short-term borrowings	12	12	26	62	88	74	35
Finance lease liabilities							
Trade & other payables	10	13	31	33	16	7	-
<b>Total current liabilities</b>	<b>23</b>	<b>25</b>	<b>58</b>	<b>94</b>	<b>104</b>	<b>81</b>	<b>35</b>
<b>Total equity &amp; liabilities</b>	<b>557</b>	<b>1,315</b>	<b>1,702</b>	<b>2,999</b>	<b>4,468</b>	<b>5,732</b>	<b>6,356</b>
Net debt	11.6	(84)	148	501	1,022	842	314
Gross debt	13.4	13	153	506	1,026	892	496
BV YoY growth, %		186.4%	8.2%	39.6%	35.6%	65.4%	30.6%
ROE	41.1%	37.9%	9.4%	23.1%	20.3%	26.6%	16.8%
ROA	30.3%	32.2%	8.1%	16.3%	13.2%	18.1%	13.6%
ROCE	40.1%	37.7%	9.4%	20.9%	17.3%	22.4%	15.7%
Debt/Equity	3.3%	1.7%	6.8%	21.8%	36.9%	30.3%	15.2%
Net debt/portfolio NAV, %	2.2%	-7.2%	9.2%	19.8%	27.3%	18.0%	6.6%

KDD Group profit & loss statement, IFRS, \$mn	2006	2007E	2008E	2009E	2010E	2011E	2012E
Total revenue	0	0	0	142	190	1,039	1,204
Cost of sales	(0)	(0)	(0)	(52)	(82)	(566)	(400)
Net rental and other Income	0	0	0	90	108	473	805
Fair value adjustment of investment properties	222	399	167	423	578	771	311
Total operating expenses	(0)	(2)	(7)	(8)	(39)	(27)	(32)
<b>EBITDA</b>	<b>222</b>	<b>397</b>	<b>161</b>	<b>506</b>	<b>648</b>	<b>1,218</b>	<b>1,086</b>
<b>Operating profit</b>	<b>222</b>	<b>397</b>	<b>160</b>	<b>506</b>	<b>647</b>	<b>1,217</b>	<b>1,083</b>
Net financial items	1	1	(9)	(39)	(84)	(95)	(64)
PBT	223	397	152	466	563	1,122	1,020
Tax	(56)	(99)	(38)	(117)	(141)	(281)	(255)
<b>Net profit</b>	<b>167</b>	<b>298</b>	<b>114</b>	<b>350</b>	<b>422</b>	<b>842</b>	<b>765</b>
<b>Adjusted net profit</b>	<b>1</b>	<b>(1)</b>	<b>(11)</b>	<b>32</b>	<b>(11)</b>	<b>264</b>	<b>532</b>

KDD Group cash flow statement, IFRS, \$mn	2006	2007E	2008E	2009E	2010E	2011E	2012E
Net cash flow from operations before working capital changes	(0.736)	(1.0)	(14.7)	43.7	(13.9)	352.8	711.9
Aggregated changes in working capital, net	4.4	(15)	61	210	174	148	11
Other adjustments	(1.1)	(0.6)	(2.9)	(20.6)	(17.4)	(111.8)	(194.6)
<b>Net cash from operations</b>	<b>3</b>	<b>(17)</b>	<b>44</b>	<b>233</b>	<b>143</b>	<b>389</b>	<b>528</b>
<b>Net cash from investments</b>	<b>(32)</b>	<b>(12)</b>	<b>(276)</b>	<b>(586)</b>	<b>(664)</b>	<b>(209)</b>	<b>0</b>
<b>Net cash from financing</b>	<b>31.2</b>	<b>124</b>	<b>139</b>	<b>353</b>	<b>521</b>	<b>(135)</b>	<b>(396)</b>
Increase/(decrease) in cash and equivalents	1.6	96	(93)	(0)	(0)	45	132
Cash, period beginning	0.1	1.7	97.7	4.8	4.6	4.4	49.2
<b>Cash, period end</b>	<b>1.7</b>	<b>97.7</b>	<b>4.8</b>	<b>4.6</b>	<b>4.4</b>	<b>49.2</b>	<b>181.2</b>
Net cash after investments	(29.5)	(28.2)	(232.2)	(353.1)	(520.9)	179.5	527.9
Excess cash		87.9	4.3	4.2	3.9	44.3	163.1

Source: Company data, Renaissance Capital estimates

Figure 9: KDD Group: portfolio

	Construction start date	Est completion date	GLA, m2	Est rent/sale price, \$/m2 pa / room rate per day	NOI, \$mn	Est. exit yield, %	Est market sale value, \$mn (completed)	Est sale price at completion, \$/m2	Outstanding dev-nt costs, \$mn	Outstanding dev-nt costs, \$/m2 of GLA	Gross margin on sale, %	Gross rental yield on dev-nt costs, %	Beneficial ownership, %	Value as of end-2007	Value as of end-2008	As % of total portfolio
<b>Residential properties</b>																
PecherSKY	Mar 2008	Dec 2009	40,038	4,277	NA	NA	171	4,277	43	1,078	73%	NA	100%	88	45	2.8%
Diplomat Park	Sep 2008	May 2012	149,913	2,712	NA	NA	407	2,712	237	1,580	42%	NA	100%	87	57	3.6%
Zazimye	June 2008	May 2012	626,056	1,874	NA	NA	1,179	1,874	758	1,211	36%	NA	100%	163	219	13.7%
<b>Total residential properties</b>			<b>816,007</b>				<b>1,756</b>	<b>2,152</b>	<b>1,038</b>	<b>1,272</b>	<b>41%</b>			<b>338</b>	<b>322</b>	<b>20.1%</b>
<b>Office properties</b>																
ZAGS	Mar 2008	Sep 2010	170,316	457	72.5	7.5%	966	5,675	297	1,743	68%	24%	100%	281	432	27.0%
WTC Kyiv	Dec 2007	June 2010	126,488	439	51.7	7.5%	689	5,450	216	1,709	67%	23%	100%	230	343	21.4%
<b>Total office properties</b>			<b>296,804</b>	<b>449</b>	<b>124</b>	<b>7.5%</b>	<b>1,656</b>	<b>5,579</b>	<b>513</b>	<b>1,728</b>	<b>67%</b>	<b>23%</b>		<b>511</b>	<b>775</b>	<b>48.4%</b>
<b>Mixed-use properties</b>																
Zhytomir Highway	June 2008	Dec 2010	228,610	249	49.4	8.0%	618	2,701	426	1,865	27%	11%	100%	85	109	6.8%
Metro City	Oct 2008	June 2011	426,140	350	131	8.0%	1,635	3,836	785	1,843	52%	17%	100%	198	336	21.0%
<b>Total mixed-use properties</b>			<b>654,750</b>	<b>315</b>	<b>180</b>	<b>8.0%</b>	<b>2,252</b>	<b>3,440</b>	<b>1,212</b>	<b>1,851</b>	<b>45%</b>	<b>15%</b>		<b>283</b>	<b>445</b>	<b>27.8%</b>
<b>Hotel properties</b>																
Kureni hotel	Jan 2008	Dec 2009	5,160	500	5.0	8.0%	62	12,069	22	4,270	65%	38%	100%	22	39	2.5%
Kureni apartments	Jan 2008	Dec 2009	2,000	17,852	NA		36	17,852	8.5	4,270	76%			14	20	1.3%
<b>Total hotel properties</b>			<b>7,160</b>		<b>5.0</b>		<b>98</b>	<b>13,685</b>	<b>31</b>	<b>4,273</b>	<b>69%</b>			<b>36</b>	<b>60</b>	<b>3.7%</b>
<b>Total portfolio</b>			<b>1,774,721</b>		<b>309</b>		<b>5,762</b>	<b>3,247</b>	<b>2,794</b>	<b>1,574</b>	<b>51%</b>			<b>1,169</b>	<b>1,601</b>	
Net debt														84	-148	
<b>Adjusted NAV</b>														<b>1,253</b>	<b>1,454</b>	

Source: Company data, Renaissance Capital estimates

## Forum Bank

- **The market underestimates the impact of the acquisition-related turnaround in our view. We believe** Bank Forum will remain one of the fastest growing banking institutions on the market but we also expect its efficiency to be improved by Commerzbank, making this growth profitable.
- **We model asset growth at a 2006-2012E CAGR of 48%.** Retail loans should be the main growth driver with a 2006-2012E CAGR of 82%. We expect the growth in corporate loans to be 44%.
- **NIM should improve to 5.0% in 2008** from 4.5% in 2006. We believe access to cheaper Western funds and a higher percentage of current customer accounts will contribute to this increase. We expect this NIM to be sustained for the next three to five years.
- **Bank Forum trades at a 36% discount to Raiffeisen Bank Aval** and a 13% discount to the Polish BRE Bank based on 2008E P/B. With profitability growth, the discount on the price/earnings multiple should emerge in 2009. Using the dividend discount model (DDM) valuation, we set a target price of \$13.5 per share and rate the stock **BUY**.

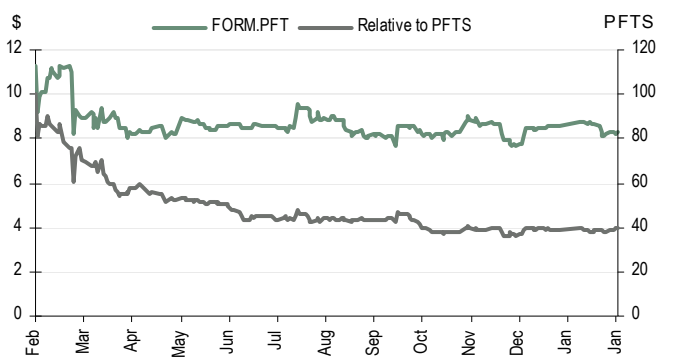
<b>Report date:</b>	<b>12 February 2008</b>	
Rating	BUY	
Target price (comm), \$	13.5	
Target price (pref), \$	n/a	
Current price (comm), \$	8.31	
Current price (pref), \$	n/a	
MktCap, \$mn	931	
EV, \$mn	n/a	
Reuters	FORM.PFT	
Bloomberg	FORM UZ Equity	
ADRs/GDRs since	2005	
ADRs/GDRs per common share	1.00	
Common shares outstanding, mn	112.00	
Change from 52 week high:	-30.0%	
Date of 52 week high:	27/11/2007	
Change from 52 week low:	11.8%	
Date of 52 week low:	05/02/2007	
Web:	www.forum.com.ua	
Free float in \$mn	115	
Major shareholder with shareholding	Leondi Yurushev 86%	
Average daily traded volume in \$mn	0.050	
Share price performance over the last		
	1 month	-3.00%
	3 months	-2.33%
	12 months	-32.15%

### Summary valuation and financials, \$mn

	Net interest income	Total income	Net income	EPS, \$	Cost/Income	Total assets	Earnings growth	Net interest margin	ROE	ROA	P/E, x	P/B, x
2006	45	59	2	0.034	68.8%	1,452	-56%	4.5%	1.9%	0.2%	453	6.5
2007	83	112	12	0.106	61.1%	2,800	469%	5.1%	5.9%	0.6%	79.7	3.7
2008E	164	195	41	0.369	50.0%	3,932	249%	5.2%	12.7%	1.2%	22.8	2.4
2009E	238	291	72	0.640	50.0%	5,751	74%	5.1%	16.6%	1.5%	13.1	2.0

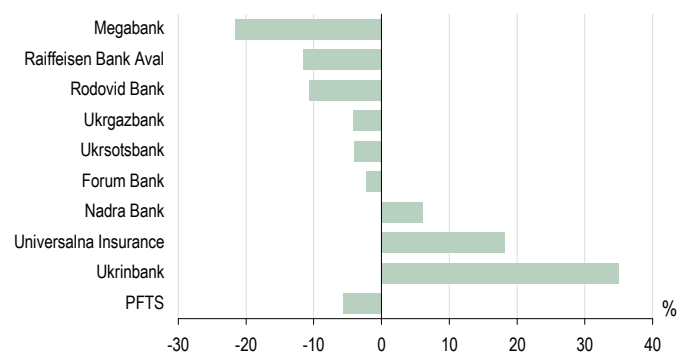
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Figure 1: Price performance – 52 weeks



Source: PFTS, Bloomberg

Figure 2: Sector stock performance – three months



Source: PFTS, Bloomberg

# Summary

Bank Forum is Ukraine's 11<sup>th</sup> largest bank by total assets, with a market share of 2.4%. Forum is a universal bank, with a business model focused on lending to small and medium-sized corporate clients. Retail lending became one of the bank's top priorities in 2006, and in 2007 its retail loan portfolio grew 170% YoY. Bank Forum runs a branch network of 300 affiliates located across Ukraine. It employs about 3,800 professionals. In September 2007 Germany's Commerzbank announced the acquisition of a 60%+1 share of Bank Forum for \$540mn, valuing the bank at \$900mn. Both Ukraine's National Bank and the Antimonopoly Committee have already granted Commerzbank permission to buy the 60% stake. Commerzbank has declared that it will close the deal by the end of 1Q08. The free float in the name is 14%. Commerzbank has not commented on what it intends to do with the free float.

We rate Bank Forum a **BUY**, and our target price is \$13.5/share (\$9.4/share on a fully diluted basis).

# Investment thesis

In our investment case for Bank Forum, we assume Commerzbank will be able to replicate in Ukraine the success of its Polish investment, BRE Bank.

Commerzbank has identified the following priority areas for Forum Bank. Strategic goals, listed in the acquisition-related presentation, are:

- Efficiency in customer service and product development
- Strategic focus on the high-margin retail segment and SME franchise
- Development of the branch network to 370 outlets by 2009 and 410 by 2011
- Development of client-related securities business
- Development of a data warehouse and CRM system

More specifically, Commerzbank targets a 4% market share in the medium term (2x growth from Forum's current level). As the first German bank to set up a full-scale banking operation in Ukraine, Commerzbank expects to become the primary bank serving trade between the two countries.

Bank Forum is a universal bank with greater emphasis on corporate clients. At YE07, its retail loan portfolio accounted for 23% of the total loan portfolio. Given Commerzbank's retail emphasis, we expect this segment to grow at 2006-2012E CAGR of 82% vs a 44% growth for the corporate loans. As a result, Forum's retail loans will account for 45% of the bank's loan portfolio by 2012.

Bank Forum has a history of being one of Ukraine's fastest-growing banking institutions. In 2007, asset growth was 95%, vs a 76% average for the industry. This growth does not threaten asset quality, in our view. Unlike some other listed Ukrainian banks, Bank Forum has a rather conservative NPL reserve policy with a bad loan provision/NPL ratio of 365% at YE07.

We expect Forum, under Commerzbank's management, to retain its status as one of the fastest-growing banks. At the same time, we expect it to become profitable. Our model suggests profitability could be improved in a number of ways, including, but not limited to, the following:

- Rationalisation of the bad loan provisioning policy. Historically, Bank Forum has allocated 70% of its operating profit to the NPL reserves, a much higher proportion than the 40% industry average.
- Access to cheaper western funds. This is a direct benefit from the association with Commerzbank. Western funds can be 200-300 bpts cheaper than Forum's current funding sources.
- An increase in the proportion of current accounts. In the last IFRS report (2006), the current account stood at 14% of total deposits, while at some other banks, the level of current accounts may be as high as 40%. This funding source is directly related to the number of clients a bank has. Commerzbank, with its aspiration to become the first stop for German

businesses in Ukraine, has significant opportunities to improve this situation for Forum.

Finally, we do not expect the new shareholder to tolerate the ROE of 1.9% that Bank Forum reported in 2006 (and the 5% expected for 2007). In view of the measures outlined above, we expect ROE to grow to 11.6% in 2008, and to 18.7% in 2009.

We rate Bank Forum a **BUY**, with a target price of \$13.5/share (\$9.4/share on a fully diluted basis).

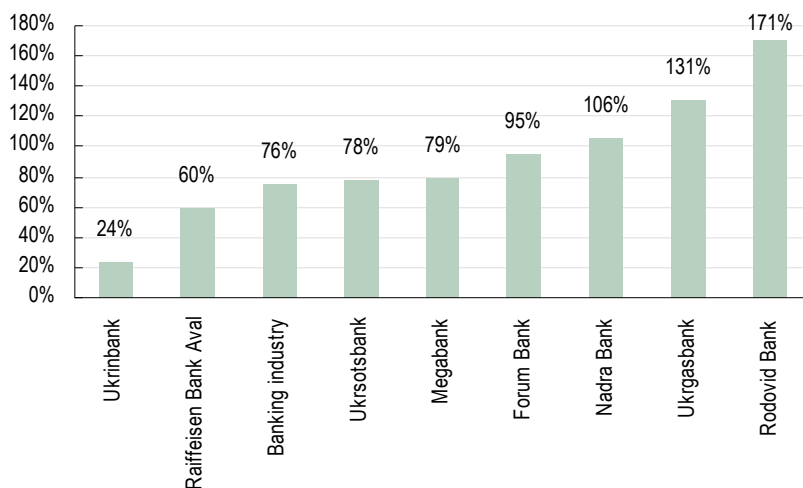
# Forum vs Ukraine banks in 2007

Strong growth in assets, deteriorating loan portfolios and stagnating profitability margins are, arguably, the main trends that arose from the recently published 2007 UAS financial statements of Ukrainian banks. In the context of the industry as a whole, Bank Forum confirmed its status as one of the fastest-growing institutions, attentive to issues of asset quality, often at the expense of profitability.

## Asset growth

Bank Forum increased its asset base 95% in 2007, beating industry average growth levels for the seventh consecutive year. The smaller banks grew at a faster relative pace, which is explained by the lower comparative base (Figure 3).

Figure 3: Ukrainian banks growth in net assets, 2007 YoY

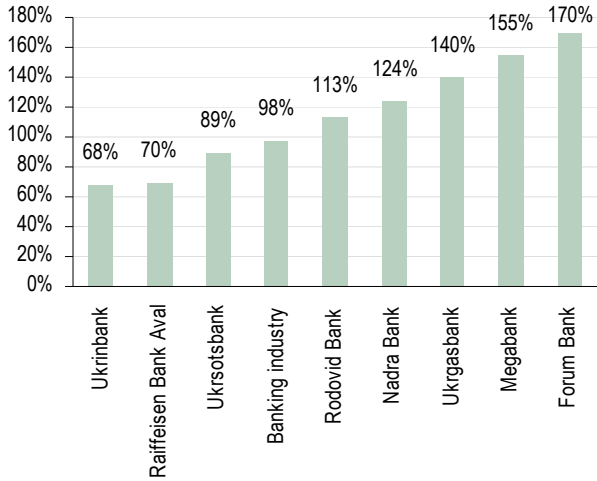


Source: Company data, National Bank of Ukraine, Renaissance Capital estimates

In absolute terms, the increase in the growth of assets of Raiffeisen Bank Aval was the largest among all the listed banks. In addition, the loans/net assets ratio at RBA is the highest among all the listed banks – 81%, vs an average of 69% for the industry. Rodovid Bank was the growth leader in 2007, among the listed banks, with a 171% increase in the balance of the assets.

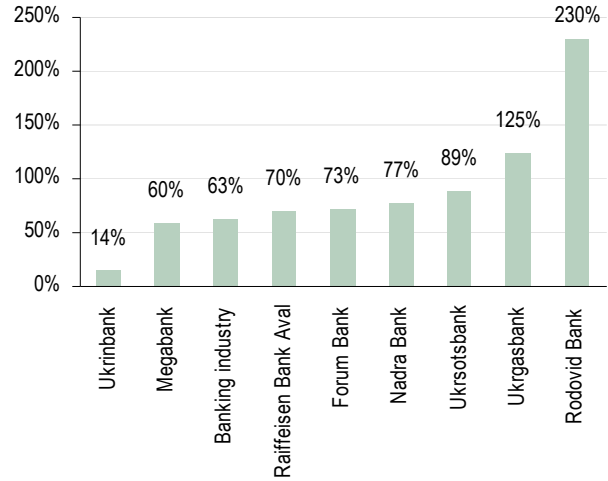
Bank Forum did the best job out of all the listed Ukrainian banks in growing its retail loan portfolio, increasing it by 170% YoY (Figure 4). This growth, however, was achieved from a relative low comparison base.

Figure 4: Retail loan portfolio growth, 2007 YoY



Source: Company data, National Bank of Ukraine, Renaissance Capital estimate

Figure 5: Corporate loan portfolio growth, 2007 YoY

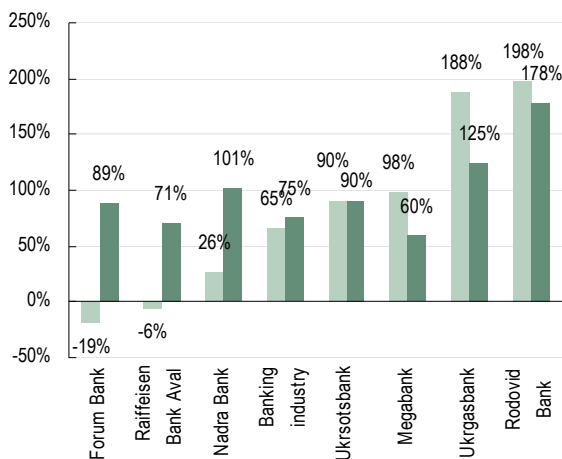


Source: Company data, National Bank of Ukraine, Renaissance Capital estimates

### Asset quality

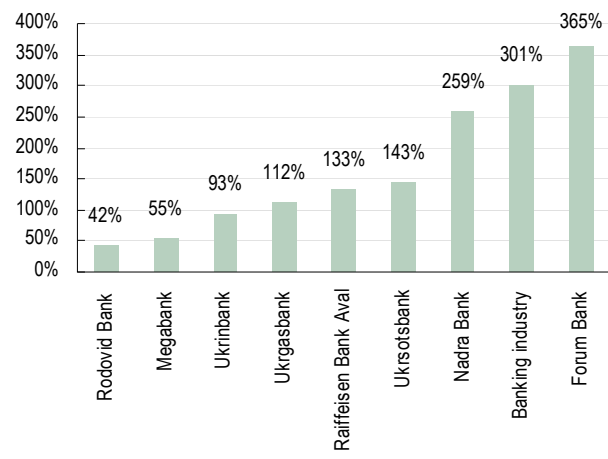
Bank Forum and Raiffeisen Bank Aval were two banks among the listed names that reported a reduction in the volume of NPLs in 2007, by 19% and 6%, respectively (Figure 6). Alternatively, the balances of negatively classified loans for Rodovid Bank, Ukrigasbank and Megabank grew faster than the corresponding growth in the loan portfolio.

Figure 6: Growth in loan portfolios and NPLs, 2007 YoY



Source: Company data, National Bank of Ukraine, Renaissance Capital estimates

Figure 7: NPL reserves vs NPL balances, 2007



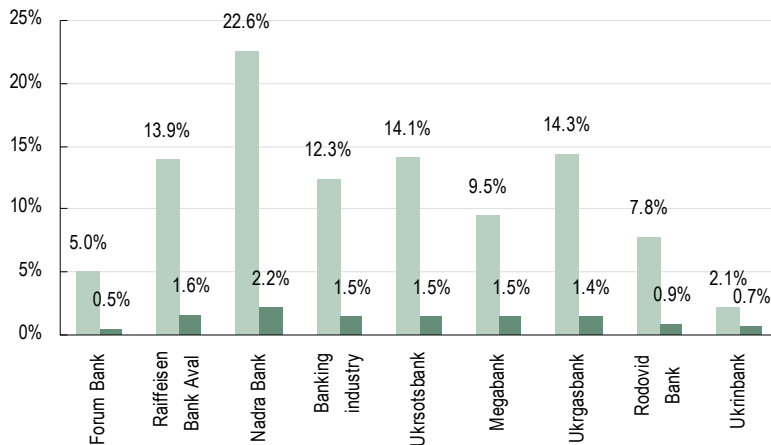
Source: Company data, National Bank of Ukraine, Renaissance Capital estimates

In our universe of listed banks, Bank Forum seems to be the most conservative in terms of its attitude to bad loan provisioning (Figure 7). On the other side, Rodovid Bank stands out as having the lowest level of NPL reserves to the balance of NPLs.

## Profitability stagnates

Bank Forum's net profit in 2007 increased 89%, vs 54% growth in net profit for the industry as a whole. In relative terms, however, profitability remained rather low, with Bank Forum's ROE at 5.0%, vs the industry average ROE of 12.3%.

Figure 8: Ukrainian banks relative profitability, 2007



Source: Company data, National Bank of Ukraine, Renaissance Capital estimates

The explanation for this is that, in order to maintain the capital adequacy level, the banks have to ask shareholders for new capital every year. Forum itself raised \$100mn in new capital in 2007, which was 38% of the bank's equity at the beginning of the year. This way the equity value is diluted, leading to a lower ROE level. As indicated in Figure 8, the notable exception from the average ROE level is Bank Nadra, which was the only bank among the listed institutions that did not issue new shares in 2007.

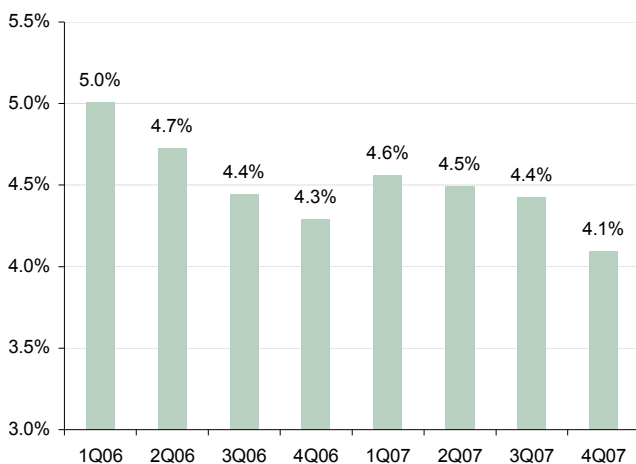
# Earnings outlook

We prepare our financial model for Bank Forum based on the IFRS financials. Still we find its UAS financials, published on 30 Jan 2008, provide useful guidance. This is especially true with regard to asset growth trends. We therefore update our model for Bank Forum based on the UAS numbers.

Despite updating our model, the main investment idea remains intact. We expect Forum to retain its status as one of the fastest-growing banks on the market. In our view, the arrival of Commerzbank should help translate this growth in more profitable for the shareholders.

- We leave our 2006-2012E asset CAGR unchanged at 48%. The 2007 UAS asset growth of 95.4% suggests the bank may outperform our original IFRS forecast of 84.5%. This hike, however, may be explained by Tymoshenko's government making significant social payments in the last weeks of 2007 which is unlikely to be sustainable in 2008. We therefore lower our asset growth forecast for 2008 to 43%. The bank's management has indicated that its target would be 61% asset growth in 2008.
- The key driver of asset growth will be retail and corporate loans. We slightly increase our 2006-2012E forecast retail loans CAGR to 82%, up from 80%, due to the very strong 175% YoY UAS growth in retail loans. We keep our forecast for corporate loans growth unchanged at a 44% 2006-2012E CAGR. We also increase the percentage of the retail loans in the total loan portfolio to 45% at YE12, up from 43%.
- Interest-earning liabilities should grow in line with interest-earning assets or at a 2006-2012E CAGR of 48% (previously 43%).

Figure 9: Bank Forum - net interest margin, UAS, 12-month trailing



Source: Company data, Renaissance Capital estimates

Figure 10: Bank Forum - net interest margins, IFRS



Source: Company data, Renaissance Capital estimates

- Our forecast NIM for Bank Forum for 2007 was 5.0%. According to the UAS financials, the NIM dropped to 4.1%, a 20 bpts decline vs YE06 (see Figure 9). We have therefore revised our model accordingly, by reducing the forecast 2007 NIM to 4.3% (IFRS, -20 bpts YoY). We still believe the net interest margin will start growing, to 5.0% 2008E and to 5.4% in 2010E.

While we expect little improvement on the gross margin side, we do expect some reduction in the cost of funding for Bank Forum. This may happen because of the following. First, we see the share of current customer accounts increasing to 24% of the total deposits in 2012 from 14% in 2006. Customer accounts are a cheaper source of funds for the bank, compared with term deposits. Second, we expect Commerzbank to facilitate access to western funds. This is not a new model in Ukraine and will be a replication of the funding story we already observe at Raiffeisen Bank Aval and Ukrsibbank/BNP Paribas.

- Bank Forum reports a 91% increase in income from fees and commissions (UAS). Our forecast for 2007 was 61%. We still expect fees and commissions income to account for 30% of total income in 2012E (up from 15% in 2006), based on Commerzbank's announced intention to develop fee earning services like client securities business.
- Despite a large investment programme (with the opening of some 100 branches) Bank Forum managed to improve its cost/income ratio to 61% in 2007 from 69% a year previously. We model a further improvement in the cost/income ratio in 2008E to 53%.
- Finally, we expect a 138% 2006-2012E CAGR in net profit. The figure is impressive, but we note that the net profit of the bank in 2006 was only \$2mn, implying an ROE of 1.9%.

A summary of these and other forecasts is provided in Figure 12.

Figure 12: Bank Forum financials and forecasts

Balance sheet, \$mn	2006	2007E	2008E	2009E	2010E
<b>Assets</b>					
Interbank	346	634	760	912	1,095
Securities	20	99	20	20	20
Net loans	978	1,848	2,901	4,504	6,665
Gross loans	978	1,915	3,001	4,638	6,842
Interest earning assets	1,345	2,581	3,681	5,436	7,779
Total assets	1,452	2,819	4,024	5,812	8,270
<b>Liabilities</b>					
Interbank	403	657	792	1,008	1,310
Securities	109	179	409	659	909
Deposits	633	1,449	2,259	3,555	5,200
Interest bearing liabilities	1,145	2,285	3,461	5,223	7,420
Total liabilities	1,307	2,559	3,626	5,332	7,530
Shareholders equity	145	260	398	480	740
<b>Income statement, \$mn</b>					
Interest income	122	230	393	574	814
Interest expense	(76)	(144)	(232)	(330)	(452)
Net interest income	45	86	161	244	362
Net fee income	9	19	32	58	103
Trading income	4	9	6	7	8
Other income	1	1	1	1	2
Total revenues	59	115	201	310	474
Staff costs	(18)	(36)	(62)	(97)	(135)
Other costs	(22)	(33)	(44)	(54)	(59)
Total costs	(41)	(68)	(106)	(151)	(194)
Operating profit	18	46	94	159	281
Provisioning charge	(15)	(33)	(43)	(49)	(66)
Other pre tax items	-	-	-	-	-
Pre-tax profit	3	14	51	109	215
Tax	(1)	(3)	(13)	(27)	(54)
Minorities	-	-	-	-	-
Other post tax gains/losses	-	-	-	-	-
Net profit	2	11	38	82	161
Dividend on ordinary shares	-	-	-	-	-
Dividend on pref shares	-	-	-	-	-
<b>Key YoY growth rates, %</b>					
Loans	106.7	89.0	56.9	55.3	48.0
Interest earning assets/	104.9	91.9	42.6	47.7	43.1
Deposits	47.2	128.8	55.9	57.4	46.3
Interest bearing liabilities	92.9	99.5	51.4	50.9	42.1
Assets	96.2	94.1	42.7	44.4	42.3
Fee income	39.1	112.2	75.2	78.2	77.9
Revenues	64.5	94.6	74.9	54.4	53.2
Costs	92.3	68.3	55.6	42.2	28.3
Operating profit	24.7	152.5	103.3	68.1	77.0
Net Profit	(56.0)	410.2	259.6	115.1	96.0
<b>Per-share data, \$</b>					
Number of ordinary shares, mn	62	112	162	162	162
EPS	0.034	0.095	0.236	0.507	0.993
DPS	-	-	-	-	-
BVPS	2.339	2.323	2.453	2.959	4.563

Balance sheet ratios, %	2006	2007E	2008E	2009E	2010E
Loans/assets	67	66	72	77	81
Deposits/liabilities	48	57	62	67	69
Loans/deposits	154	128	128	127	128
Equity/assets	10.0	9.2	9.9	8.3	8.9
<b>Capital ratios, %</b>					
Tier 1	12	13	14	11	10
Tier 2	1	3	2	2	3
Total	13	16	16	13	13
<b>Asset quality</b>					
NPLs, \$mn	11	15	30	50	70
NPL reserves, \$mn	40	67	101	134	178
NPLs/gross loans, %	1.14	0.78	1.00	1.08	1.02
Reserves/NPLs, %	3.6	4.5	3.4	2.7	2.5
Credit charge, %	2.09	2.3	1.83	1.33	1.18
<b>Margins, %</b>					
Asset margin	12.1	11.5	12.2	12.3	12.0
Liability margin	9.14	8.6	8.9	9.0	8.8
NIM	4.53	4.3	5.0	5.2	5.4
Spread	3.01	2.9	3.3	3.3	3.3
<b>Costs, %</b>					
Cost/income	68.8	59.5	53.0	48.8	49.8
Cost/Average assets	3.7	3.2	3.1	3.1	2.8
Effective tax rate	35.6	22.0	25.0	25.0	25.0
<b>Profitability ratios, %</b>					
ROAE	1.9	5.2	11.6	18.7	26.4
ROAA	0.2	0.5	1.1	1.7	2.3
<b>Other P&amp;L ratios, %</b>					
Interest income/revenues	77	75	80	79	76
Fees/revenues	15	16	16	19	22
Trading income/revenues	7	8	3	2	2
Fees/staff costs	48	52	52	59	76
Fees/total costs	22	27	31	38	53
Payout ratio, %	-	-	-	-	-
<b>Number of:</b>					
Employees	643	856	1,530	2,432	2,500
Branches	8	11	23	27	30
Mini/sub branches	-	-	72	167	234
ATM's	-	-	117	230	293
Bank cards, mn	-	-	0.1	0.2	0.2

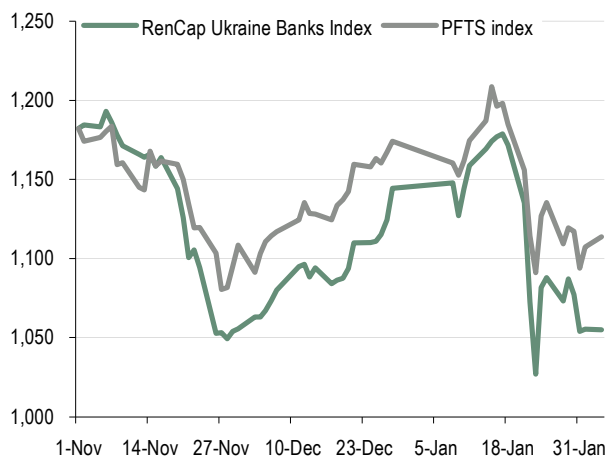
Source: Company data, Renaissance Capital estimates

# Valuation

## Share price performance

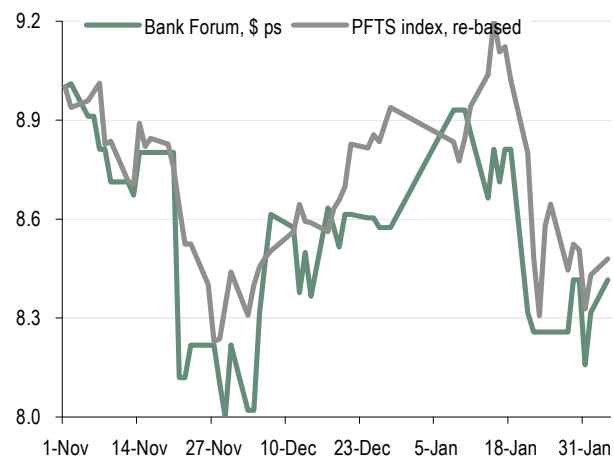
Our index of Ukrainian banks has dropped 7.8% since the beginning of 2008. For the three months the decline in the index was 11% and 21.5% since its all-time-high on 24 July 2007. The declines in prices for Bank Forum were 1.8%, 6.6% and 9.6%, respectively.

Figure 13: Ukraine banks index vs PFTS index, 3 months



Source: PFTS, Renaissance Capital estimates

Figure 14: Bank Forum vs PFTS index, 3 months



Source: PFTS, Renaissance Capital estimates

## Trading multiples

The above decline in the prices for the Ukrainian banks has led to corresponding reductions in the valuation multiples. Average 2007 P/B is now 4.4x, down from 5.0x at the beginning of the year (Figure 16). Similarly, Ukrainian banks trade at a premium to CEE and CIS banks based on 2007E-2009E P/E. One factor that positively differentiates Ukrainian banks from their peers in the region is growth in earnings. Earnings growth is expected to be 2-3x times higher in Ukraine than for CEE and CIS banks.

Bank Forum trades at 2008E P/E of 24.7x, in line with its Ukrainian peers. P/E declines to 11.5x in 2009E, putting the current valuation of Bank Forum at a discount to its Ukrainian peers and in line with the CEE banks' P/E for that year. Bank Forum's 2008E P/B of 2.4x is already competitive among both Ukrainian and CEE banks, although one should remember that this is achieved due to the share emission. A \$100mn capital raising exercise is scheduled to begin on 17 Mar 2008.

## Bank Forum DDM valuation

To arrive at our 12-month target price for Bank Forum, we use a variation of the DDM which involves comparing the ROE offered by the bank with its cost of equity (COE), while taking into account future growth (g) opportunities. The variation on the model sets out two stages, where we include the short-term, forecast strong-growth

phase of Bank Forum's story six years out, before making a longer-term growth assumption for the bank. Combined with a relative valuation of comparable bank stocks, we believe the model provides a simple and flexible tool to value a bank stock while taking into account the more fundamental parameters of risk, return and growth.

1. **Risk/COE** – To the current Ukrainian bond yield we add an equity risk premium (ERP) of 6.25%
2. **Return/ROE** – is based on the average of our 2012E/2013E forecast ROE for the bank
3. **Growth/g** – Near-term growth is a function of our forecasts, and is embodied in the six-year book value we use in our valuation. The growth function we use in the perpetuity calculation is 3%

Figure 15: Bank Forum - dividend discount model valuation

Stage one (short- to medium-term growth)	2007E	2008E	2009E	2010E	2011E	2012E	2013E
BVPS, \$	2.323	2.453	2.959	4.563	6.109	8.421	11.362
Growth (short term)	-1%	6%	21%	54%	34%	38%	35%
Stage two (perpetuity)							
Risk free rate, %							6.25
Risk premium, %							7.50
COE, %							13.75
ROE, %							29.7
g, %							3
Target P/B							2.4
Annual target price, \$							20.4
COE, %							13.75
Total discount factor, %							0.46
12-month target price, \$							9.4

Source: Renaissance Capital estimates

This \$9.4 result is based on the fully diluted number of shares of the bank, i.e. accounting for the \$100mn share emission which was approved on 1 Feb 2008 and which should begin on 17 Mar 2008. In essence, this is a recalculation of our existing price of \$13.5/share to the new number of shares.

Figure 16: Trading multiples – Ukrainian banks vs CEE and CIS peers

		MktCap (\$mn)	PER			Earnings growth			ROE			PBR, x		
			2007E	2008E	2009E	2007E	2008E	2009E	2007E	2008E	2009E	2007E	2008E	2009E
Russia	Sberbank	79,957	20.7	13.1	11.3	26	58	17	20.5	21.3	20.5	3.1	2.5	2.1
Russia	VTB	26,897	19.2	16.8	13.9	23	14	21	12.5	9.6	10.7	1.7	1.6	1.4
Russia	Vozrozhdenie	1,608	24.2	14.8	11.7	126	63	26	19.7	20.6	20.9	3.4	2.7	2.2
Kazakhstan	KKB	4,356	10.6	9.6	8.6	87	10	12	18.4	17.4	17.4	1.7	1.6	1.4
Kazakhstan	Halyk	4,104	11.3	8.0	6.9	71	42	16	32.7	33.8	30.2	3.2	2.6	1.9
Georgia	Bank of Georgia	747	18.7	10.6	8.0	163	99	32	15.7	20.1	18.6	2.6	1.7	1.3
<b>CIS banks weighted average</b>			<b>19.7</b>	<b>13.7</b>	<b>11.6</b>	<b>31.8</b>	<b>46.0</b>	<b>17.6</b>	<b>19.0</b>	<b>18.9</b>	<b>18.5</b>	<b>2.7</b>	<b>2.3</b>	<b>1.9</b>
<b>CIS banks median</b>			<b>18.9</b>	<b>11.8</b>	<b>9.9</b>	<b>78.9</b>	<b>50.1</b>	<b>18.8</b>	<b>19.0</b>	<b>20.3</b>	<b>19.5</b>	<b>2.8</b>	<b>2.1</b>	<b>1.7</b>
Poland	PKO Bank Polski	18,618	17.3	14.6	12.5	25	18	17	24.2	24.7	24.7	3.9	3.4	2.9
Poland	Pekao	13,894	15.8	13.6	11.8	20	16	15	23.2	24.8	25.9	3.5	3.2	2.9
Poland	BZ WBK	5,750	14.1	12.3	10.7	40	15	16	24.0	23.5	24.0	3.1	2.7	2.4
Poland	BRE Bank	4,742	16.5	13.8	11.4	82	19	21	24.6	23.0	22.6	3.6	2.9	2.3
Poland	Millenium	2,821	15.2	12.0	9.7	59	27	24	18.8	21.5	22.9	2.7	2.4	2.0
Hungary	OTP	11,939	9.7	8.5	7.2	11	14	18	25.2	23.4	23.2	2.2	1.8	1.5
Czech Rep.	Komerční Bank	8,436	14.3	13.1	11.8	12	10	11	19.9	20.3	20.5	2.8	2.5	2.3
CEE	Raiffeisen International	18,121	15.5	12.3	9.8	27	26	25	18.1	18.2	19.1	2.4	2.1	1.7
Turkey	Akbank	14,659	10.0	8.3	6.9	29	21	20	24.2	23.1	24.0	2.1	1.8	1.5
Turkey	Garanti	14,172	8.4	8.1	6.9	91	4	17	36.9	27.7	26.1	2.5	2.0	1.6
Turkey	Is Bank	14,364	11.0	8.6	7.2	18	28	19	14.9	17.1	18.2	1.6	1.4	1.2
Turkey	YKB	8,555	13.1	9.7	6.9	62	35	40	20.3	21.6	24.3	2.4	1.9	1.5
<b>CEE banks weighted average</b>			<b>13.2</b>	<b>11.1</b>	<b>9.3</b>	<b>35.1</b>	<b>19.1</b>	<b>19.7</b>	<b>23.1</b>	<b>22.4</b>	<b>22.9</b>	<b>2.7</b>	<b>2.3</b>	<b>2.0</b>
<b>CEE banks median</b>			<b>14.2</b>	<b>12.1</b>	<b>9.8</b>	<b>28.1</b>	<b>18.7</b>	<b>18.3</b>	<b>23.6</b>	<b>23.1</b>	<b>23.6</b>	<b>2.6</b>	<b>2.3</b>	<b>1.9</b>
Ukraine	Raiffeisen Bank Aval	4,437	37.0	23.3	14.8	50	58	57	15.3	17.4	22.4	4.5	3.7	3.0
Ukraine	UkrSotsbank	2,665	33.3	25.0	17.5	72	33	43	16.3	14.8	15.3	4.3	3.2	2.3
Ukraine	Bank Forum	943	88.9	24.7	11.5	410	260	115	5.2	11.6	18.7	3.6	2.4	2.0
Ukraine	Rodovid Bank	680	37.9	26.2	25.1	283	45	4	11.3	10.7	8.5	3.0	2.7	1.8
Ukraine	UkrGasbank	683	48.3	28.4	16.1	459	70	76	10.7	11.5	14.0	4.1	2.7	1.9
Ukraine	Bank Nadra	2,135	30.9			87			22.6			5.6		
Ukraine	Megabank	158	33.2			114			9.5			2.5		
Ukraine	Ukrinbank	178	99.1			24			2.1			2.1		
<b>Ukraine banks weighted average</b>			<b>40.8</b>	<b>24.5</b>	<b>16.1</b>	<b>127.6</b>	<b>71.4</b>	<b>56.4</b>	<b>15.3</b>	<b>15.2</b>	<b>18.4</b>	<b>4.4</b>	<b>3.3</b>	<b>2.5</b>
<b>Ukraine banks median</b>			<b>37.4</b>	<b>25.0</b>	<b>16.1</b>	<b>100.2</b>	<b>58.5</b>	<b>57.2</b>	<b>11.0</b>	<b>11.6</b>	<b>15.3</b>	<b>3.8</b>	<b>2.7</b>	<b>2.0</b>

Source: Bloomberg, Reuters, Renaissance Capital estimates

# Druzhkovsky Machine-Building Plant

## Top pick

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- **Strategic position in the key Ukrainian sector.** Ukraine has huge proven coal reserves (117bnt), and many coal mining companies supply this primary energy resource to industrial users and coal-fired power plants. The coal mining sector is considered a key strategic asset, and we think DRMZ is well placed, with the largest share (30%) of the Ukrainian mining equipment market. A significant increase in spending on mining equipment is likely as the demand for coal grows.
- **State support for coal mines investing in modernisation.** In our view, the company is best positioned to capture increases in state subsidies spent on the modernisation of mining equipment. Recent accidents in Ukrainian coal mines have raised public awareness of the requirement to increase state support.
- **Upside potential of 48% to our TP of \$1.66.** We value the company at \$1.66/share, implying 48% potential upside. The company showed considerable improvements in 2007 and reported a 2x increase in revenues, from \$54.6 in 9M06 to \$109mn in 9M07. 9M07 gross profit margin has also increased by 8 pts, to 20.1% from 11.7%.

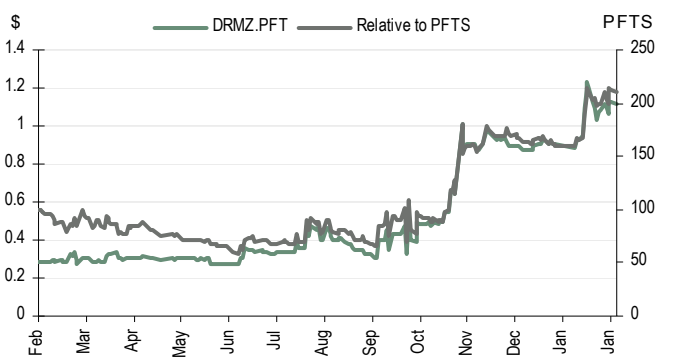
<b>Report date:</b>	<b>12 February 2008</b>
Rating	BUY
Target price (comm), \$	1.66
Target price (pref), \$	n/a
Current price (comm), \$	1.12
Current price (pref), \$	n/a
MktCap, \$mn	232
EV, \$mn	277
Reuters	DRMZ.PFT
Bloomberg	DRMZ UZ Equity
ADRs/GDRs since	n/a
ADRs/GDRs per common share	n/a
Common shares outstanding, mn	207.54
Change from 52-week high:	-13.1%
Date of 52-week high:	05/02/2007
Change from 52-week low:	465.0%
Date of 52-week low:	17/01/2008
Web:	na
Free float in \$mn	8.00
Major shareholder	SCM
with shareholding	65%
Average daily traded volume in \$mn	0.050
Share price performance	
over the last	
1 month	21.24%
3 months	25.11%
12 months	320.00%

### Summary valuation and financials, \$mn

	Revenue	EBITDA	Net income	EPS, \$	EBITDA margin, %	EV	Net debt	EV/Sales	EV/CF	EV/EBITDA	P/E	P/CE	EV/IC	ROIC/WACC
2005	90.0	8.5	0.3	0.002	9.4	111.8	58.3	1.24	-	13.2	162.3	16.0	3.23	0.1
2006	85.5	3.3	2.3	0.011	3.9	121.7	56.3	1.42	5.1	36.4	28.1	11.2	4.17	0.5
2007E	121.5	18.3	15.5	0.075	15.0	276.7	44.7	2.28	9.8	15.1	14.9	12.1	6.15	2.9
2008E	150.6	22.7	18.2	0.088	15.1	263.8	31.8	1.75	10.7	11.6	12.8	10.7	4.21	2.41

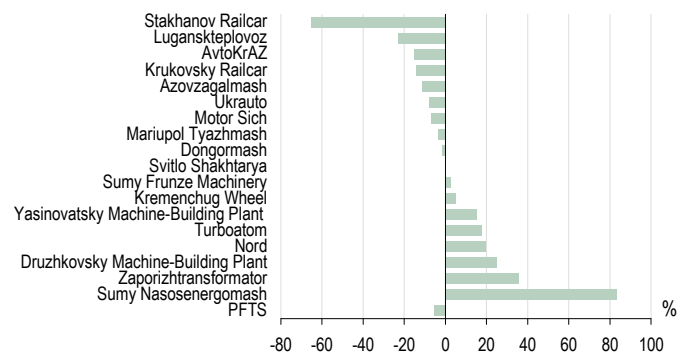
Source: Renaissance Capital estimates

Figure 1: Price performance – 52 weeks



Source: PFTS, Bloomberg

Figure 2: Sector stock performance – three months



Source: PFTS, Bloomberg

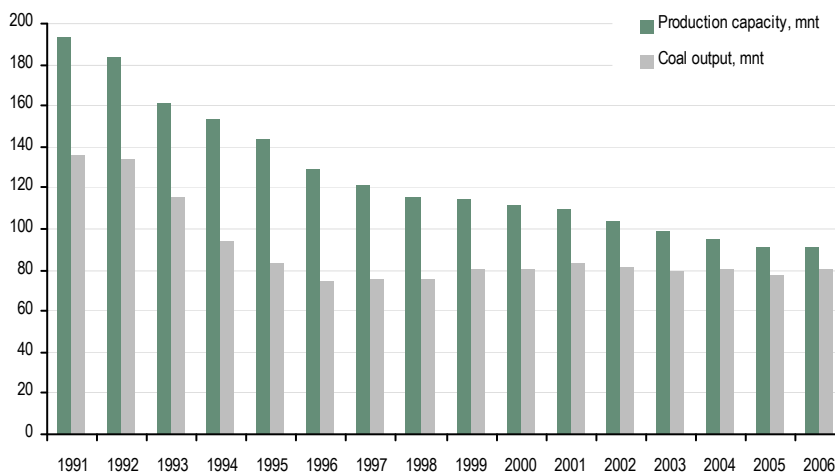
# Investment summary

Druzhkovsky Machine-Building Plant (DRMZ) is a major producer of equipment for the coal mining industry, strongly focused on the Ukrainian and Russian markets. The company is located in the Donetsk region (eastern Ukraine) in close proximity to its major customers, coal mining companies. The product line includes but is not limited to, mine cars; electric mine locomotives; powered roof and shield supports; automatic supports; foundry press forgings; breaking props; suspension devices; headgear sheaves and conjugate supports. Around 80% of output is supplied to domestic clients.

## Rising coal demand the key driver

Coal output plummeted during the early 1990s and only marginally recovered after 1997 (see Figure 3). The number of coal mines declined from 283 in 1991 to 166 in 2006.

Figure 3: Coal output vs production capacity in Ukraine



Source: Ministry of Fuel and Energy, Renaissance Capital estimates

At the same time, demand for coal has been increasing in recent years. In the past few months, some Ukrainian thermal power generators have been forced to switch to more expensive natural gas, due to insufficient coal supply. Low coal supply effectively threatens energy security during the peak winter season.

We believe the imbalance between supply and demand will inevitably lead to investment in coal mines and mining equipment required to increase coal supplies.

## Higher coal prices spell an increase in orders for DRMZ

The low coal prices do not create sufficient incentives for investment in mines. Overall, current coal prices do not cover costs, and the government has resorted to subsidising the coal industry. It appears that the current approach has proved

inefficient and the government intends to address the challenge of falling coal supplies.

In the short term, we expect increasing output, and rising coal prices and state subsidies. Hence, we expect capex in mining equipment to increase. In the medium term, the government is likely to opt for further privatisation of the coal mining industry to attract necessary investments and ensure sufficient coal supplies.

Recent events confirm this view. The government-approved Energy Balance with coal prices rising 36% (from \$66/tonne in Jan 2008 to \$90/tonne in May the same year). This implies that the average price for thermal coal will be \$85/tonne. We expect that an increase coal prices will increase the purchasing power of coal mines, which will place more orders to DRMZ in order to increase in coal output and improve safety.

### **State subsidies to coal mines could result in more orders**

We think Ukrainian engineering companies (such as DRMZ) supplying and repairing mining equipment are likely to benefit from increased funding to the coal industry. We believe that previous underinvestment in state-owned mines has accumulated huge capex requirements, which will be finally translated into new orders for the engineering sector over the medium term. We estimate that state subsidies will increase by 21% from \$1,150mn in 2007 to 1,386mn in 2008.

### **Corporate governance**

Corporate governance and management efficiency, particularly with regard to marketing, have a significant impact on the company's value. This pertains to optimising operations and sales to maximise value for all shareholders, including those with minority stakes. If the company's profits are dented by low margins, the value of the company could decline in the eyes of minority shareholders.

At the same time, we believe controlling shareholders will eliminate transfer pricing, as the company may need to access capital markets, which have high corporate standards.

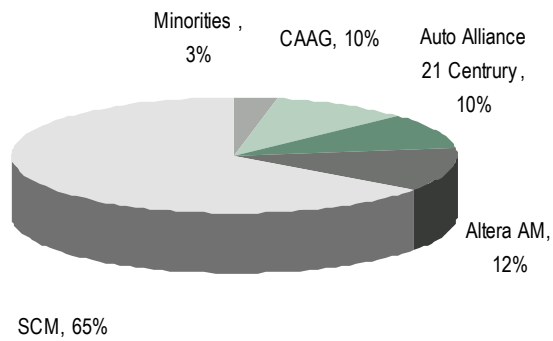
In other words, we think transfer pricing risk is minimised in the medium-to-long term, due to System Capital Management Group's (SCM) aspirations to attract funds for future development. We think corporate governance and reporting standards will be optimised to attract such funds.

### **Ownership structure**

SCM acquired 45% of the company, before increasing its stake to 65.3%. Production coordination and marketing are undertaken through a dedicated company, Ukrvuglemash Holding, which also manages the production and marketing activities of Gorlovsky machine-building plant, Donetskirmash, Donetsk

Energomash and Novgorodsky machine-building plant. DRMZ is being reorganised to boost its operations and commercial activities.

Figure 4: Ownership structure



Source: SMIDA, Renaissance Capital estimates

## Integration into SCM secures orders from group mines

Integration with privately owned coal mines (controlled by SCM) ensures that the company will receive most of its orders from SCM-owned coal mines.

# Earnings outlook

## Earnings set to grow

The current regulatory environment limits the purchasing power of Ukrainian coal mines because they cannot cover their costs at current coal prices. Today, the state effectively subsidises the coal industry to reduce cost pressures on coal-fired power plants. This, in turn, minimises funding for coal mines. At the same time, inadequate investment in the coal industry has resulted in reduced coal supplies, and a number of accidents have signalled that the situation is unsustainable. We think the government will have to allow higher coal prices if the safety and security of coal supplies are to be addressed.

**Looking at the big picture**, worldwide demand for coal is expected to grow 2.2%/year until 2030, faster than that for oil or natural gas, according to the International Energy Agency. As a result, coal mining companies will likely have to increase supplies and fuel their production with investments in new equipment or, at the very least, the modernisation of existing facilities.

**Increasing demand for coal mining equipment** does not only come from the domestic market. DRMZ is also positioned to capture demand from Russia and some other CIS countries. Any increase in orders, either from domestic or international markets, is likely to create shareholder value, in our view.

As indicated in Figure 5, the company's output has varied from year to year, registering a peak in 2004.

Figure 5: Production output

	2002	2003	2004	2005	2006
Mechanic supports, units	29	33	34	24	24
Electromotive, units	34	24	41	14	35
Lorries, units	2756	1782	2323	1520	1842

Source: Company data

We believe fluctuations in production output have been caused primarily by changes in demand and the purchasing power of mining companies.

Latest production statistics are not regularly disclosed to the public. Our working assumption links production output to our estimates of machinery production growth indicated Figure 6.

Figure 6: Macroeconomic parameters

	2002	2003	2004	2005	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E
Ukrainian GDP growth, YoY	5.2%	9.4%	12.1%	2.7%	7.1%	6.9%	6.9%	6.6%	6.2%	5.9%	5.9%	5.8%
Industrial production growth, YoY	7.0%	15.8%	12.5%	3.1%	6.2%	8.2%	7.9%	7.5%	7.3%	7.3%	7.3%	7.3%
Ukrainian CPI, YoY	-0.6%	8.2%	12.3%	10.3%	11.6%	15.7%	11.0%	7.8%	7.1%	7.1%	6.3%	6.2%
Ukrainian PPI, YoY	5.7%	11.1%	24.0%	9.6%	14.2%	20.7%	15.0%	11.2%	8.9%	8.1%	7.3%	6.9%
Machinery production growth, YoY	11.3%	35.8%	28.0%	7.1%	11.8%	15.8%	11.9%	11.3%	11.0%	11.0%	11.0%	11.0%
Exchange rate, USD/UAH, eop	5.33	5.33	5.31	5.05	5.05	5.05	5.00	5.15	5.25	5.20	5.00	4.90
Exchange rate, USD/UAH, period average	5.33	5.33	5.32	5.12	5.05	5.05	5.03	5.08	5.20	5.23	5.10	4.95

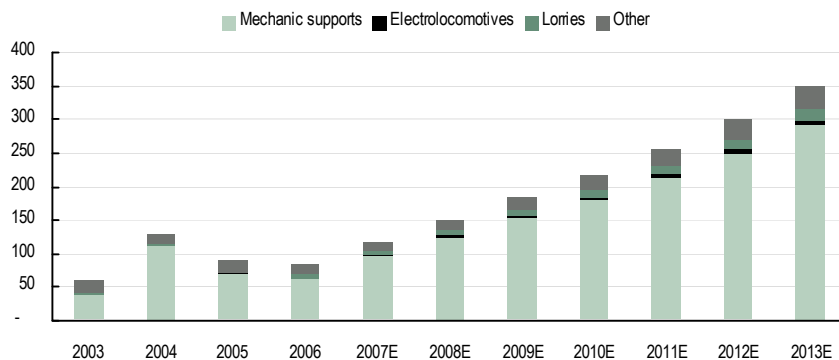
Source: Ukrstat, Renaissance Capital estimates

In our valuation, we conservatively assume the company will need to invest around \$40mn in capex during 2010-2011 to increase its production capacity. See figure 8.

# Valuation

In our valuation model, we assume the price for equipment will increase in line with PPI, and production growth will outstrip industrial production growth in Ukraine by 1.5x (See Figure 6).

Figure 7: Druzhkovsky revenues breakdown, \$mn



Source: Company data, Renaissance Capital estimates

Figure 8 indicates our valuation results, with a 12-month target price of \$1.66, implying 88% upside potential, and a **BUY** rating.

Figure 8: Druzhkovsky DCF model, \$mn

	2007E	2008E	2009E	2010E	2011E	2012E	2013E
EBIT	15	19	22	23	25	31	38
EBIT less taxes	10	13	15	17	18	22	27
Capex	4	4	5	16	18	7	8
Depreciation	4	4	4	5	6	6	6
Change in working capital	11	5	7	8	16	18	18
Free cash to firm	20	18	21	14	22	38	42
WACC	14.0%						
Terminal WACC	11%						
CF growth rate	3%						
DCF value	420						
Net debt	32						
Market capitalisation	388						
Number of shares outstanding, mn	208						
Fair price com, \$	1.66						
Upside	43%						

Source: Renaissance Capital estimates

Based on 1H07 results, we estimate the company will be able to boost its gross margin up to 24% in 2007. At the same time we do not believe this will be sustainable, and we assume gross margins will gradually decline to 18% in 2013E (see Figure 9).

We also expect net margins to improve to an average of 10% during 2007-2013 as a result of improved corporate governance.

# Summary financials

Figure 9: Druzhkovsky income statement under UAS, \$mn

	2004	2005	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E
Total sales	123	90	86	121	151	179	207	238	277	321
Total CoGS	96	68	72	93	117	140	166	195	227	263
Gross profit	27	22	13	29	34	39	41	43	50	58
Gross margin	22%	24%	15%	24%	23%	22%	20%	18%	18%	18%
C&A expenses	15	16	13	14	15	17	18	19	19	20
EBITDA	13	8	3	18	23	26	28	31	37	44
EBITDA margin	11%	9%	4%	15%	15%	14%	13%	13%	13%	14%
EV/EBITDA				14.9	12.0	10.7	9.9	8.9	7.4	6.2
Operating profit	13	5	0	15	19	22	23	25	31	38
Operating margin	10%	6%	0%	12%	13%	12%	11%	10%	11%	12%
EV/EBIT				18.5	14.2	12.5	12.0	11.1	8.9	7.1
Total operating/ non-operating revenues/losses	-13	-4	4	7	6	5	3	4	7	9
Pre-tax profit	0	2	3	21	24	26	25	28	36	46
Income tax	0	2	0	5	6	6	6	7	9	11
Net profit	0	0	2	16	18	19	19	21	27	34
Net margin	0%	0%	3%	13%	12%	11%	9%	9%	10%	11%
Price earnings ratio				15.5	13.3	12.5	12.9	11.5	8.8	7.0

Source: Company data, Renaissance Capital estimates

Figure 10: Druzhkovsky balance sheet, \$mn

	2004	2005	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E
Cash and equivalents	1	2	1	8	9	4	12	9	10	18
ST investments	0	0	8	27	32	56	55	75	108	141
Accounts receivable	44	60	59	77	94	109	112	115	119	125
Inventories	33	37	67	55	52	47	48	49	49	53
Other current assets	5	13	6	9	11	13	15	17	19	23
Current assets	82	113	141	175	197	228	241	265	306	360
Long-term investments	2	4	4	2	2	2	2	2	2	2
Construction in progress	4	5	5	3	6	5	5	4	5	5
Fixed assets	28	27	27	29	31	34	48	63	67	71
Intangible assets	0	0	0	0	0	0	0	0	0	0
Other long-term assets	0	0	1	0	0	0	0	0	0	0
Total long-term assets	33.6	35.7	36.6	33.6	38.2	41.0	54.6	68.7	73.5	78.2
<b>Total assets</b>	<b>130</b>	<b>148</b>	<b>177</b>	<b>209</b>	<b>235</b>	<b>269</b>	<b>296</b>	<b>334</b>	<b>380</b>	<b>438</b>
ST debt	21	60	58	53	41	36	30	24	18	12
Accounts payables	76	53	90	111	132	151	165	188	213	243
Other current liabilities	0	0	0	0	0	0	0	0	0	0
Total current liabilities	98	114	148	164	173	187	195	212	231	255
LT debt	0	0	0	0	0	0	0	0	0	0
Total equity	33	35	29	45	63	82	101	122	149	184
<b>Total liabilities and capital</b>	<b>130</b>	<b>148</b>	<b>177</b>	<b>209</b>	<b>235</b>	<b>269</b>	<b>296</b>	<b>334</b>	<b>380</b>	<b>438</b>

Source: Company data, Renaissance Capital estimates

# Motor Sich MSICH

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- **We estimate the company has 47% upside potential**, and think it has solid growth potential, supported by strong demand for aircraft engines in CIS and other emerging markets.
- **Huge production capacity is in place.** Legacy production capacity enables the company to boost its output without a commensurate increase in capex.
- **Outstanding performance in 2007.** Preliminary FY07 results indicate that the company managed to increase its net profit 6.3x from \$7.5mn in 2006 to \$46.8mn in 2007, on the back of increased orders from the CIS.
- **Strategic partnership with Design Bureau Progress and cooperation with Russia is a catalyst.** Integration of DB Progress with the company could increase Motor Sich's value, as R&D is, in our view, key to a sustainable future for the company.
- **Minorities respected – dividends paid.** FY07 results, with net margin reaching 14%, illustrate that transfer pricing is not a material issue. Moreover, the company intends to pay dividends from June 2008.

**Report date: 12 February 2008**

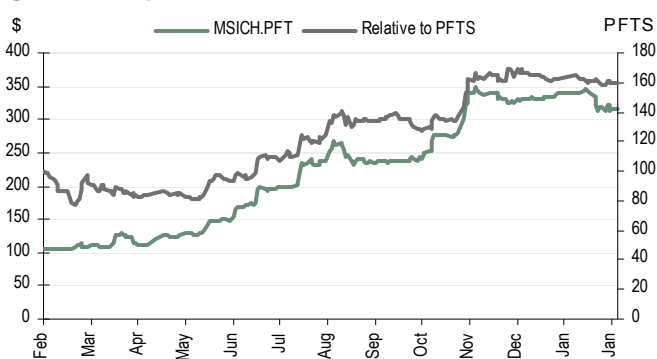
Rating	BUY
Target price (comm), \$	402
Target price (pref), \$	n/a
Current price (comm), \$	274
Current price (pref), \$	n/a
MktCap, \$mn	568
EV, \$mn	687
Reuters	MSICH.PFT
Bloomberg	MSICH UZ Equity
ADRs/GDRs since	2007
ADRs/GDRs per common share	0.10
Common shares outstanding, mn	2.08
Change from 52-week high:	-11.8%
Date of 52-week high:	22/02/2007
Change from 52-week low:	204.0%
Date of 52-week low:	06/11/2007
Web:	www.motorsich.com
Free float in \$mn	153
Average daily traded volume in \$mn	
Share price performance over the last	
1 month	-8.00%
3 months	-6.99%
12 months	201.81%

Summary valuation and financials, \$mn

	Revenue	EBITDA	Net income	EPS, \$	EBITDA margin, %	EV	Net debt	EV/Sales	EV/CF	EV/EBITDA	P/E	P/CE	EV/IC	ROIC/WACC
2005	213.0	46.7	10.5	5.057	21.9	249.3	59.3	1.17	27.1	5.3	18.1	5.5	0.90	0.4
2006	245.1	52.7	7.5	3.586	21.5	242.5	71.8	0.99	23.8	4.6	22.9	4.4	0.84	0.3
2007E	314.1	93.7	43.6	20.961	29.8	587.5	19.1	1.87	11.1	6.3	13.0	8.0	1.61	1.2
2008E	374.7	105.6	48.6	23.405	28.2	592.9	24.6	1.58	10.3	5.6	11.7	7.4	1.46	1.2

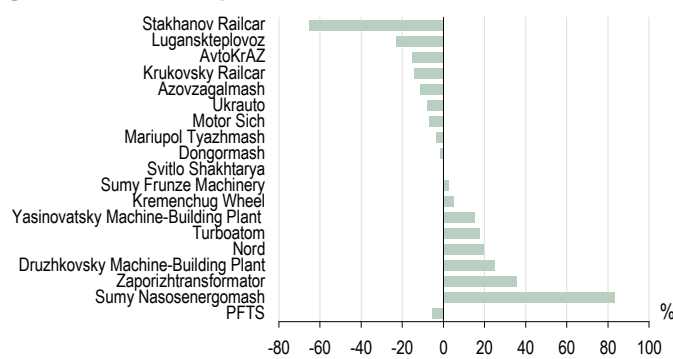
Source: Renaissance Capital estimates

Figure 1: Price performance – 52 weeks



Source: PFTS, Bloomberg

Figure 2: Sector stock performance – three months



Source: PFTS, Bloomberg

# Investment summary

## Legacy manufacturer with huge production capacity

Motor Sich (MSICH) is the only company in Ukraine developing and manufacturing aircraft engines. The company also produces gas turbine power units, separators, motor cultivators and outboard engines; and provides services for engine repairs, passenger and cargo air transportation. During the Soviet era, Motor Sich produced about 5,400 engines per year. By 2003-2004, output had fallen to fewer than 1,500 engines per year (400-500 new engines, and around 900 repaired engines).

In 2005-2006, the production of new engines and maintenance services remained at approximately the same level of 356 and 329 engines, respectively. 2007 results are expected to show a considerable improvement in output production as preliminary results suggest that revenues increased by around 30%.

By 2003, Motor Sich had produced about 31,600 aircraft engines, in operation worldwide. The repair and maintenance of these engines is a continuing source of earnings. The company exports its products and provides services in 106 countries.

Production facilities can practically operate 24 hours a day, seven days a week, employing several shifts of workers each day. This indicates that the company has **enormous potential to boost its production without significant investment** in new capacity, while the current capacity utilisation rate is estimated at around 30%.

## Sales structure

We estimate that more than 40% of sales come from the production of new engines, while revenues from maintenance and servicing existing engines account for around 30%. The remaining 30% comes from services and consumer goods. We believe Motor Sich has the potential to boost revenues from maintenance services by increasing its client base. More than 50% of all revenues are derived from sales to Russian customers, including sales of parts and maintenance services; while approximately 30% and 20% come from other international markets and Ukraine, respectively. Overall, more than 86% of revenues come from international markets.

## The company serves rapidly growing economies

The company's intrinsic value depends primarily on demand for aircraft engines and its ability to meet this demand. The latter, to a great extent, depends on the volatile aviation sector, which is tied to the global economy and local peculiarities. Globalisation and rapidly growing demand for air transportation offset the detrimental effect of tightening airline regulations and increasing fuel costs. Airlines are placing ever greater numbers of new aircraft orders and, subsequently, aircraft engine manufacturers, including MSICH, are benefiting from these orders.

CIS and Asia, the main markets for MSICH products, are rapidly growing. Their increasing demand for air transportation and high purchasing power can potentially translate into higher sales output at higher prices. Subsequently, Motor Sich's backlog and selling price are clear value drivers for the company. It has received a number of orders from Chinese customers, and we think it could find a good market

for its engines in China. In 2007 China accounted for approximately 18% of the company's exports. The company is negotiating with CATIK and TALY about using Ukrainian-built engines on Chinese aircraft. On Dec 27 2007, Motor Sich opened an office in United Arab Emirates to serve customers in the Middle East and Africa. The company is also planning to add a maintenance service centre in the same region.

## Uncertainty about Russian orders in the long term

Russian aircraft manufacturers have been historically using MSICH-made engines on a number of aircraft. Most of Russian civil helicopters are equipped with Ukrainian engines. However, recent political tensions are raising long-term concerns that Russia may minimise its cooperation with the company. Particularly, Russia has revealed plans to organise serial production of TV3-117 and VK-2500 engines in Russia in order to minimise imports from Ukraine. These engines account for a major proportion of Russian orders. We estimate that construction of alternative Russian production capacity may take several years before full scale serial production comes online. Until then, we expect Motor Sich to benefit from increasing Russian orders as demand for aircraft grows.

While we have no doubt about Russia's ability to build alternative production capacity, we remain cautious on the economic feasibility of this project. It will take years to complete, and by that time new technology might be needed.

## R&D strategy

We believe that the only way of maintaining and growing its competitive position is via R&D.

For instance, the company is working on the new, more powerful D-18T engine, which will be used in the modification of the famous An-124-100 Ruslan. Possible revival of this project may add to the existing backlog and increase the value of the company.

The company can obtain exclusive rights to produce new engines, for example those developed by Ukraine-based state-owned Design Bureau Progress-Ivchenko (DB Progress). Currently MSICH is outsourcing most of its R&D to this company. **Integration with DB Progress** or the reinforcement of Motor Sich's in-house design bureau could potentially trigger the value of the company. We estimate that reinforcing the in-house design bureau could take decades. Therefore, integration would be a much more realistic option. In Jan 2007, Motor Sich and DB Progress signed an agreement to create the Ivchenko corporation. This agreement had to be approved by the government as DB Progress is a state entity. Yet, the government did not approve the agreement and included DB Progress in the state holding Ukrainian Aviation in 2007, as per decree of Cabinet Ministers dated 14 Mar 2007. This considerably reduced the chances of DB Progress being integrated with MSICH.

However, in Nov 2007, the District Administrative Court in Kiev issued an injunction stopping implementation of the decree with respect to DB Progress being included

in the state holding. Therefore, we expect that DB Progress is likely to be excluded from the state holding and cooperation with MSICH will be reinforced.

Although privatisation of DB Progress is not currently on the agenda, having a joint venture in the form of corporation with state-owned DB Progress would still provide considerable leverage for development of both companies. New engine designs and exclusive rights to use these designs for serial production can ensure sustainable growth of Motor Sich.

Overall, the aviation sector is one of the most complex sectors and requires long-term planning and enormous R&D and capex. We believe Motor Sich has prudently made long-term investments in R&D. DB Progress is the key entity developing much of Motor Sich's engine design. To keep up with changing market trends, MSICH also invests in reconstruction and modernisation. In 2006, the company invested almost \$10mn in reconstruction (+20% YoY). During the same period, modernisation funding increased almost 2x, to \$15mn. In 2007, the company continued to invest in the modernisation of its equipment which would allow increasing efficiency.

### **Strategic partnership is a catalyst**

Strategic partnerships can rein-in competition and boost production. Motor Sich could lose the market of Russian engines if Russia initiates full-scale production of helicopter and jet engines domestically. If it forms strategic alliances with Russian partners, it could expand its position as an engine supplier for Russian-built aircraft. In our view, a potential partnership with Sikorsky could become a major value driver should MSICH obtain an outsourcing contract for engines used on the S-76 helicopter.

### **Vast asset base**

The company has several structural units: sub-divisions, plants and affiliate companies, most of which are a legacy of the Soviet era.

These assets were not priced in our valuation and present a potential upside, in our view.

Figure 3: Company's plants, sub-divisions and affiliate companies

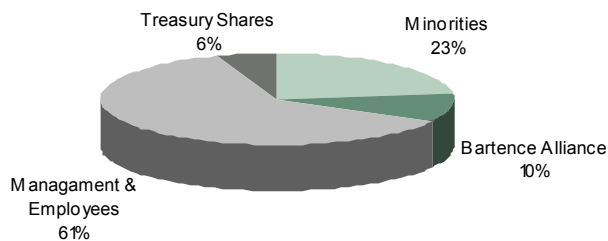
Plants, Sub-divisions and affiliates	Business role
Zaporizskiy engine-building plant	Engine design, development and production
Zaporizskiy machine-building plant	Engine testing, blades manufacturing, gas turbine power units,
Snizhnyanskiy machine-building plant	Blades manufacturing, other production
Volochiskiy machine-building plant	Manufacturing various parts for aircraft engines,
Administration for construction and social development	Construction
Catering plant	Providing food for employees
Five health-centres and Sport-Complex	Recreation activities
Motor Sich Airline	Regular passenger, charter passenger and cargo transportation
Gulyapiysky machine-building plant	Development and batch production preparation
Gulyapiysky mechanical plant	Production of various mechanical goods
Lebedinsky motor-building plant	Development and organisation of production of various machinery products
Volochiskiy mineral water plant	Production of clear mineral water

Source: Company data

## Ownership structure

Management and employees of the company have the largest stake in MSICH. Unfortunately, the Ukrainian state stock commission does not provide all the relevant details, and ownership updates are frequently fragmented. According to our estimates, the current ownership structure is as indicated in Figure 4.

Figure 4: MSICH ownership structure



Source: SMIDA, Company data

Management and employees of the company hold a controlling stake which provides incentives for them to ensure best performance by the company.

## The company intends to pay dividends

According to company, shareholders will decide on the payout ratio at an AGM on 20 Mar 2008. Dividends payout is scheduled to start in June 2008. Assuming a 50% payout ratio, dividend yield should approach 3.6%.

## Project with potential upside

Motor Sich has the capacity and technology to build engines for a number of aircraft (such as the An-124) that simply do not have competitors. The revival of the An-124 cargo aircraft project is likely to be a major source of new orders for large jet engines. Russia-based Volga-Dnepr and MSICH have already formed a joint venture to resume construction of the aircraft. The stakes of Volga-Dnepr and Motor Sich are expected to be 59% and 41%, respectively.

## Earnings outlook

The company had outstanding results in 2007.

Preliminary FY07 results indicate that the company managed to increase its net profit 6.3x from \$7.5mn in 2006 to \$46.8mn in 2007, on the back of increased orders from CIS. We expect the FY07 top line will be slightly higher than our estimate of \$314mn showing a growth of more than 30%.

We also expect the company will be able to show net margin of around 14% for FY07. At the same time we are cautious on the sustainability of such growth. The company is likely to see cost pressure from manufacturers of parts for engines. Motor Sich also faces foreign currency risks because the local currency appreciates while the company's contracts with Asian countries are normally pegged to the dollar.

Therefore, we assume somewhat conservative revenue growth and reduced margins, as indicated in Figure 7.

Most of its placement proceeds of \$31mn were used to fund capex requirements in 2007. We expect that the company will have to increase its capex going forward (up to \$46mn in 2013) in order to sustain its competitive technological advantage.

Despite our conservative assumptions, our DCF-based model shows that the company has 30.6% upside potential to the current price of \$308.

## Valuation

Based on the latest performance and management estimates, Figure 5 indicates our forecast production output.

Figure 5: Production forecast

	Units	2007E	2008E	2009E	2010E	2011E	2012E	2013E
Engine production	units	441	494	549	604	658	711	760
Repair of engines	units	408	423	437	450	462	473	483

Source: Company data, Renaissance Capital estimates

Figure 6 summarises our DCF valuation, with a 12-month target price of \$402, implying 30.6% upside potential, and a **BUY** rating.

Figure 6: Motor Sich DCF model, \$mn

	2007E	2008E	2009E	2010E	2011E	2012E	2013E
EBIT	76	87	98	109	117	123	128
EBIT less taxes	62	71	79	87	93	97	100
Capex	31	22	29	33	37	41	46
Amortisation	18	18	18	18	18	18	20
Change in working capital	-9	-12	-10	-11	-6	-6	-6
Free cash to firm	38	55	59	61	67	69	69
WACC	13.0%						
Terminal WACC	10.0%						
CF growth rate	3.0%						
DCF value	860						
Net debt	25						
Market capitalisation	835						
Shares outstanding, mn	2.08						
Fair share price, \$	402.0						
Upside	46.7%						

Source: Renaissance Capital estimates

Figure 7: Motor Sich income statement under UAS, \$mn

	2003	2004	2005	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E
Total sales	217	204	213	245	314	375	441	513	580	655	738
Total COGS	127	130	142	151	181	223	272	326	381	443	513
Gross profit	90	74	71	94	133	151	169	187	200	212	224
Gross margin	42%	36%	33%	38%	42%	40%	38%	36%	34%	32%	30%
Commercial & administrative expenses	54	46	42	59	57	64	71	78	83	89	96
EBITDA	53	44	47	53	94	106	116	126	135	142	148
EBITDA margin	24%	21%	22%	21%	30%	28%	26%	25%	23%	22%	20%
EV/EBITDA					6.3	5.6	5.1	4.7	4.4	4.2	4.0
Operating profit	36	27	29	35	76	87	98	109	117	123	128
Operating margin	17%	13%	14%	14%	24%	23%	22%	21%	20%	19%	17%
EV/EBIT					7.8	6.8	6.0	5.5	5.1	4.8	4.6
Total operating/non-operating revenues/losses	-8	-18	-17	-28	-23	-24	-25	-26	-27	-27	-27
Pre-tax profit	32	13	17	14	58	65	76	86	96	104	112
Income tax	10	3	7	6	15	16	19	22	24	26	28
Net profit	22	10	11	7	44	49	57	65	72	78	84
Net margin	10%	5%	5%	3%	14%	13%	13%	13%	12%	12%	11%

Source: Company data, Renaissance Capital estimates

Figure 8: Motor Sich balance sheet under UAS, \$mn

	2002	2004	2005	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E
Cash and equivalents	5	9	14	11	39	23	13	5	16	41	66
ST investments	0	3	0	8	8	38	38	38	38	38	38
Accounts receivable	51	34	45	56	65	75	84	98	111	125	141
Inventories	104	126	138	164	176	200	223	245	262	277	292
Other current assets	3	4	3	3	3	4	5	6	6	7	8
Current assets	163	176	201	242	292	340	363	392	434	489	545
Long-term investments	25	36	38	38	40	46	86	136	166	196	226
Construction in progress	21	28	25	27	29	26	26	26	26	26	26
Fixed assets	105	121	137	142	156	160	171	187	206	228	255
Intangible assets	0	0	1	0	0	0	0	0	0	0	0
Other long-term assets	4	0	0	0	0	0	1	1	1	1	1
Total long-term assets	155.4	186	201	207	226	233	284	350	399	452	508
<b>Total assets</b>	<b>318</b>	<b>362</b>	<b>402</b>	<b>449</b>	<b>518</b>	<b>573</b>	<b>647</b>	<b>745</b>	<b>836</b>	<b>944</b>	<b>1053</b>
ST debt	33	50	63	71	51	41	36	41	36	41	36
Accounts payables	61	58	64	90	102	125	149	175	199	224	250
Other current liabilities	-	-	-	-	-	-	-	-	-	-	-
Total current liabilities	95	109	126	161	154	166	185	216	235	265	286
LT debt	9	7	11	11	6	6	6	6	6	6	6
Total shareholders equity	215	246	265	277	352	401	458	523	595	672	756
<b>Total liabilities and capital</b>	<b>318</b>	<b>362</b>	<b>402</b>	<b>449</b>	<b>518</b>	<b>573</b>	<b>647</b>	<b>745</b>	<b>836</b>	<b>944</b>	<b>1053</b>

Source: Company data, Renaissance Capital estimates

# Centrenergó CEEN

- **Stock performance** In difficult markets, share prices of Ukrainian generating companies (gencos) have fallen around 4% over the past three months. Centrenergó, whose share price performance was modest relative to other Ukrainian GenCos, in 2007, proved to be defensive, with a slight share price increase over the same three-month period.
- **The company still trades at a discount.** Centrenergó at \$5.13/share or \$275/kW of installed capacity offers a 42% discount to our target price of \$7.30. The company also trades at a discount of 25% to its closest comparable Ukrainian peer company, Dniproenergó.
- **Demand for electricity is rising.** Net electricity demand has been steadily rising over the past few years, registering an impressive 3.7% CAGR for 2003-2007. We expect this trend to continue in the future with thermal power plants capturing most of the incremental demand.
- **Ukraine to liberalise electricity market.** The company is trading on expectations of higher returns resulting from liberalisation of the electricity market. Recent news suggests the new Ukrainian government has already begun working on a legal framework to create price incentives for investment in the power sector.

**Report date: 12 February 2008**

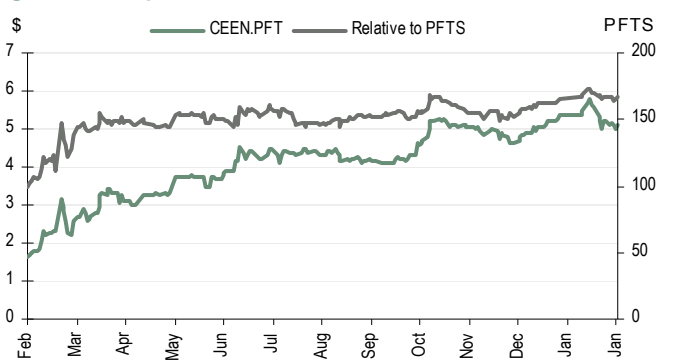
Rating	BUY
Target price (comm), \$	7.30
Target price (pref), \$	n/a
Current price (comm), \$	5.13
Current price (pref), \$	n/a
MktCap, \$mn	
EV, \$mn	2,072
Reuters	CEEN.PFT
Bloomberg	CEEN UZ Equity
ADRs/GDRs since	1998
ADRs/GDRs per common share	0.10
Common shares outstanding, mn	369.41
Change from 52-week high:	-12.6%
Date of 52-week high:	08/02/2007
Change from 52-week low:	199.7%
Date of 52-week low:	15/01/2008
Web:	www.centrenergó.com
Free float in \$mn	417
Major shareholder	state
with shareholding	78%
Average daily traded volume in \$mn	0.50
Share price performance	
over the last	
1 month	-5.13%
3 months	0.58%
12 months	213.94%

Summary valuation and financials, \$mn

	Revenue	EBITDA	Net income	EPS, \$	EBITDA margin, %	EV	Net debt	EV/Sales	EV/CF	EV/EBITDA	P/E	P/CE	EV/IC	ROIC/WACC
2005	379.6	38.2	11.9	0.032	10.1	400.7	181.2	1.06	8.6	10.5	18.5	6.1	0.66	0.1
2006	525.0	69.8	17.3	0.047	13.3	719.8	228.4	1.37	-	10.3	28.4	11.4	1.05	0.3
2007E	620.8	82.6	28.1	0.076	13.3	2,072.5	184.9	3.34	28.7	25.1	67.2	34.9	3.13	0.5
2008E	784.8	87.7	32.0	0.087	11.2	2,068.8	181.2	2.64	39.0	23.6	58.9	32.8	2.88	0.5

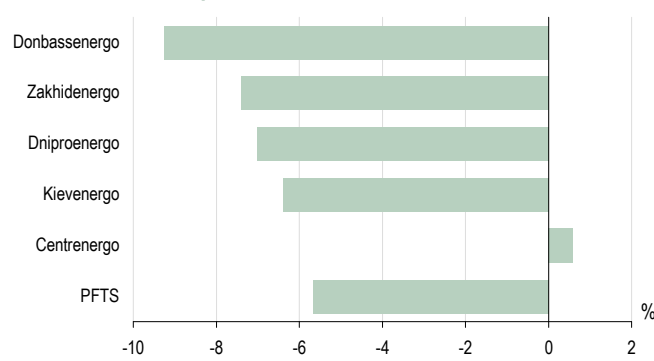
Source: Renaissance Capital estimates

Figure 1: Price performance – 52 weeks



Source: PFTS, Bloomberg

Figure 2: Sector stock performance – three months



Source: PFTS, Bloomberg

# Contents

## Stock performance

Share prices of Ukrainian gencos have fallen more than 4% over the past three months. Centrenerg, a company with modest share price performance relative to other gencos in 2007, proved to be the most defensive investment, with a slight rise in the share price.

## Company trades at a discount

Centrenerg trades at \$275/kW of installed capacity – a 25% discount to its closest peer, Dniproenerg. Our fair value for Centrenerg is \$7.30/share, which implies potential upside of 42% to the current price of \$5.13. (See details in our report *Ukrainian GenCos, Waiting for economic growth*, dated 14 Dec 2007)

## Strategic market position

Centrenerg is Ukraine's second-largest thermal power generator in terms of output with a 7% market share and 13,860 GWh sold in 2007, up 7% YoY. The company is also the second-largest thermal power plant in terms of installed capacity, with 7,550 MW of capacity.

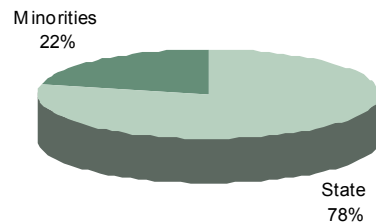
The company owns three large power plants in highly developed parts of the country: Vuglegirska (3,600 MW) in the Donetsk Region, Zmiivska (2,150 MW) in the Kharkiv Region, and Trypilska (1,800 MW) near Kiev.

Close proximity to major industrial users in these highly developed parts of the country suggests that shareholders may benefit from the potential for acquisition by an energy-intensive industrial enterprise. We believe that after the electricity market is changed to a liberalised model, those industrial companies which consume large volumes of electricity would be interested in integrating some Centrenerg plants into their production cycle. This would reduce costs associated with electricity losses in the distribution grid. Integration with coal suppliers, such as has occurred in Russia is also possible. We therefore see Centrenerg as a possible target for Ukrainian industrial groups, such as SCM, which recently increased its share in Dniproenerg.

## Ownership

Centrenerg is part-privatised, with the state owning a 78% stake. The national energy strategy approved by the government in 2005 ultimately foresees full privatization of thermal power plants. Again, Russia has shown what can happen to the prices of generation assets when the state's stake is put for the sale. Here, prices of up to \$750/kW have been paid by strategic investors determined to gain control.

Figure 3: CEEN ownership structure



Source: SMIDA, Renaissance Capital estimates

### Demand for electricity is rising rapidly

Net electricity demand in the Ukraine has been steadily rising over recent years, with a 3.7% CAGR for the last five years. We expect this trend to continue in the short to medium term future, with thermal power plants capturing most of the incremental demand.

### Liberalisation of electricity market is a catalyst

We believe that long-promised liberalisation of electricity markets is likely to be the major catalyst for genco share price growth, as the current system of regulated prices explicitly minimises profits.

Recent news is that the new Ukrainian government intends to pass a new law on electricity distribution. The new law will pursue two objectives:

- Providing incentives for the companies to invest in the distribution grids
- Preventing monopolies from abusing the system through excessive tariffs

We believe that this is relevant for GenCos because the new law can potentially trigger liberalisation of the entire electricity market.

**Shareholder value** in gencos depends to a large extent on the timing of market liberalisation. We believe investors are valuing the companies on expectations of higher returns. Timing is therefore of crucial importance.

We believe the government will liberalize the sector by 2012. This conclusion is based on demand-supply forecasts, which correspond with decree No1056-p signed by the government on 28 Nov 2007. The decree approves a plan to develop the wholesale electricity market based on:

- Bilateral contracts between market participants
- A balancing spot market.

According to the decree, the regulator (NERC) and the Ministry of Fuel and Energy must create a generation spot market by 2011 and complete implementation of the new model by 2014.

## Coal-fired power plants are the key assets

Centrenergó has relatively efficient generating assets which we believe are in relatively good condition. The low historical utilisation rate of around 26% effectively extends the life of the power units. Most of the 23 power units are coal-fired while some of the units can use gas and fuel oil which gives the company flexibility to switch between coal and gas. In 2007, the company was able to capitalize on this competitive advantage by using natural gas during a period of constrained coal supplies.

## Business description

Centrenergó purchases fuel (coal, gas and fuel oil) to generate electricity, which is subsequently sold to Energorynok, the state-owned wholesale company. Prices for all fuels and for generated electricity are subject to regulation.

## Strategy

The company has a strategy of modernising its power units in the mid-term to improve fuel efficiency and become more competitive on the market.

# Earnings outlook

Centrenerg operates in a heavily regulated environment. Regulated electricity tariff and output volumes are therefore the key drivers of value in the near term.

Figure 4: Selected items from income statement, \$mn

	2003	2004	2005	2006	2007E	2008E	2009E	2010E
Sales	346	307	380	525	621	785	860	903
EBITDA	29	39	38	70	83	88	96	101
EBIT	3	15	14	44	56	62	70	74
Net income	(15)	(6)	12	17	28	32	37	40

Source: Company data, Renaissance Capital estimates

We conservatively assume that until the market is liberalised, (we estimate in 2012), the company will have to live with net margins as low as 4%, effectively imposed by the regulator. At the same time we assume that a large portion of cash generated will be retained. (See Figure 5). Notably, the company announced dividends for 2006 with a 20% payout ratio, implying \$0.70/share.

Capex requirements are assumed at a minimum level, based on historical figures.

Figure 5: Selected items from cash flow statement

	2003	2004	2005	2006	2007E	2008E	2009E	2010E
Depreciation	26	24	24	26	26	26	26	26
Capex	24	(3)	3	(8)	(15)	(34)	(36)	(37)
Operating cash flow	15	24	49	26	72	53	86	99
FCF	(7)	19	37	(7)	57	19	50	62

Source: Company data, Renaissance Capital estimates

## Electricity tariffs

At present, Ukrainian thermal power plants have an average net margin of 2.5%. This low level of profitability is imposed by regulators *via* a mark-up, which is calculated over the sum of fuel and fixed costs. At the same time, this mark-up is calculated to cover all costs, including allowable capex, and obtain at least some minimal profit for the company. As there is only one genco not under state ownership control, there has been little commercial tension between thermal power plants and the regulator (in effect the national government). As a result, the mark-up tends to vary from one year to another, reflecting not the economic cost of supply, but the level of tariff increase judged by state officials to be politically prudent.

Figure 6: Mark-up for thermal power generation, as per tariff structure

	2002	2003	2004	2005	2006
Mark-up, %	15%	10%	12%	12%	15%

Source: NERC

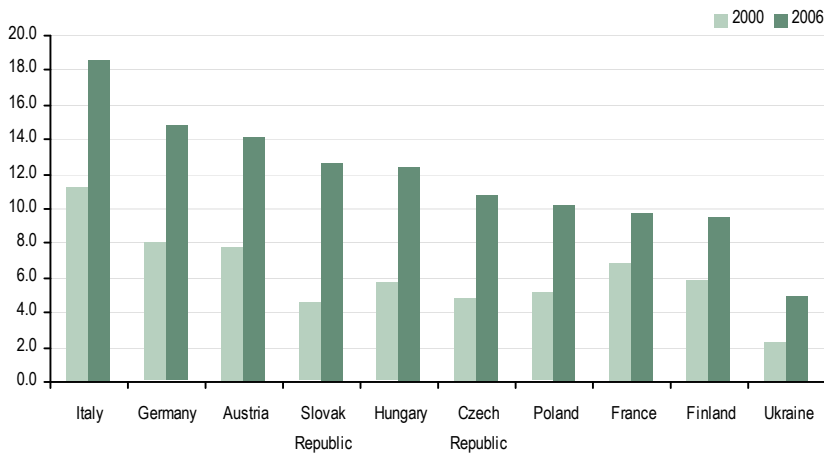
While generation companies remain subject to this kind of price regulation, mark-ups will be the key driver of free cash flow.

At present thermal power plants submit price and volume offers to Energorynok and, within the merit order of generation types discussed earlier, those power plants with the lowest price are included in the production plan to guarantee electricity take-off.

If a genco sells higher-than-forecast volumes and hence collects higher-than-expected revenues which results in a higher net margin, the regulator can reduce the mark-up in the following period. In other words, to meet the obligation of the regulator to keep end-user tariffs as low as possible, profitability out-performance in

any year can be punished with a lower mark-up the following year. The result, as Figure 7 shows, is that Ukrainian consumers enjoy electricity prices which are less than half the levels paid by their Western neighbours.

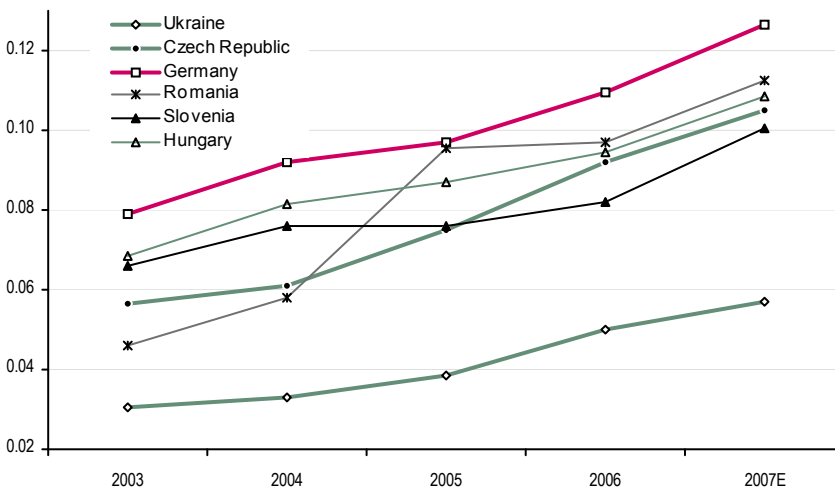
Figure 7: Average end-user tariff, ¢/kWh



Source: US Energy Information Administration

The Energy Strategy of Ukraine explicitly states that electricity prices should be raised to the level of liberalised EU markets “during the next two-five years”. Figure 8 shows that progress towards achieving this aim has not even begun.

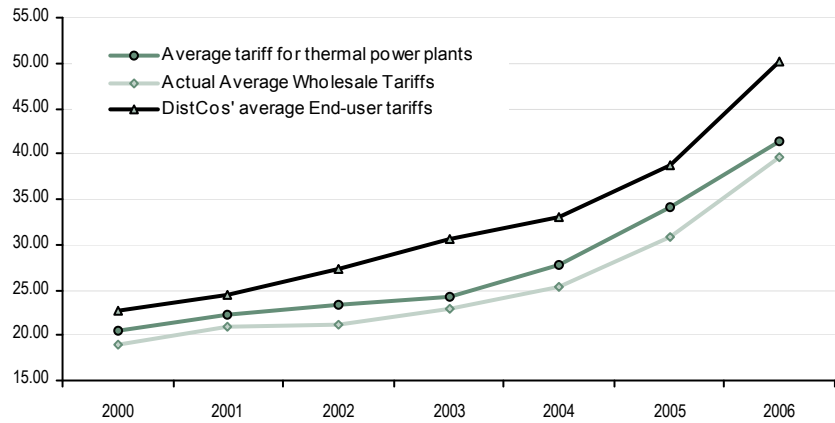
Figure 8: Average end-user tariffs for non-residential customers in some EU countries, \$/kWh



Source: Eurostat, NERC, Renaissance Capital estimates

Average historical tariffs for thermal power plants, including Centrenerg, are shown in Figure 9.

Figure 9: Historical tariffs in Ukraine, \$/ MWh



Source: NERC

We conservatively forecast tariffs for thermal power plants assuming a 12% CAGR in coal prices up to 2009 and flattening thereafter. (See Figure 10). However, according to the 2008 Fuel Balance Forecast, coal prices will increase from \$66/t in Jan 2008 to \$90/t in May 2008, implying an average of \$85/t in 2008.

Figure 10: Forecast tariffs for thermal power plants by fuel type, \$/MWh

Type of the main fuel	2005	2006	2007	2008	2009	2010	2011	2012
Coal-fired power plant	34.20	41.41	47.30	56.79	59.17	59.17	59.17	59.17
Gas-fired power plant	20.16	35.84	49.21	58.97	66.04	71.27	72.97	74.66

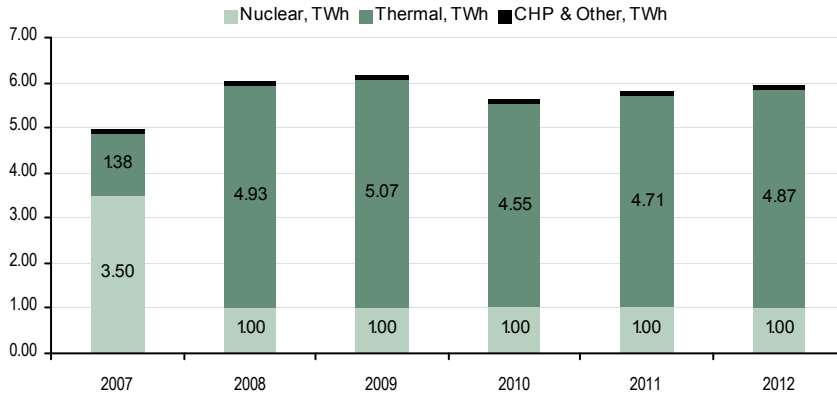
Source: NERC, Company data, Renaissance Capital estimates

We believe rising coal prices will have little impact on the company in current cost-plus regulatory environment. The regulator adopted a practice of including fuel costs in the tariff and allowing for some minimum mark-up, as explained earlier in this section.

## Output

Output electricity volume is the second key component affecting the company's revenues. We estimate that the company will gradually increase its output, sharing plants incremental demand for electricity with other thermal power.

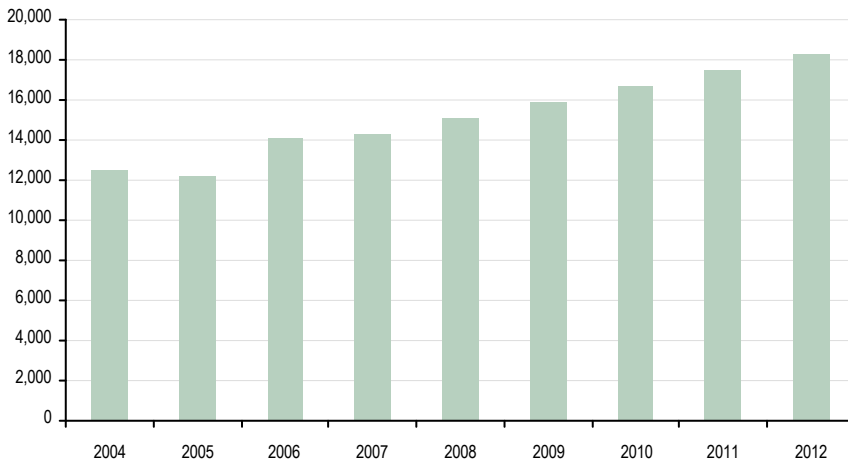
Figure 11: Estimated incremental production by type of generation



Source: Renaissance Capital estimates

In absolute figures, we made the following forecast for the company's total generation volumes until 2012:

Figure 12: Estimated generation volumes, GWh



Source: Renaissance Capital estimates

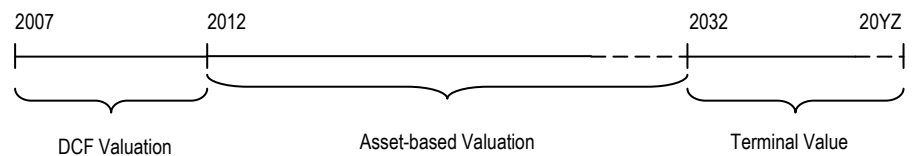
# Valuation

We believe it is rational to use a DCF valuation only for the short-term period, when gencos are operating under the current regulated tariff system.

For the period thereafter, we assume the companies will be operating in a liberalised competitive environment and believe that the assumptions necessary to produce DCF forecasts have such wide margins of error that it is preferable to use an asset-based valuation approach. To estimate terminal value, we have eschewed the normal approach involving terminal growth rate (except for Kievenergo) and have opted for a residual value approach, which we believe more realistically, and more prudently, reflects the situation.

Our three-stage approach is therefore:

1. DCF-derived NPV for the period 2007-2012E (on average, this constitutes around 6% of our company valuations)
2. Discounted 2012E asset-based valuation (on average more than 90% of our company valuations) to capture value out to 2032
3. Discounted terminal value (around 4% of our company valuations)



According to our DCF model, approximately 13% of the company's value is attributed to the period until 2012. We assumed 14.5% discount rate in our model.

Our report *Ukrainian GenCos, Waiting for economic growth*, dated Dec 14, 2007, provides more detail on the valuation of the company.

We valued the company using the EV/capacity multiple, which is commonly used for electricity generating companies. Figure 13 provides a summary of our valuation with a breakdown in relevant time periods.

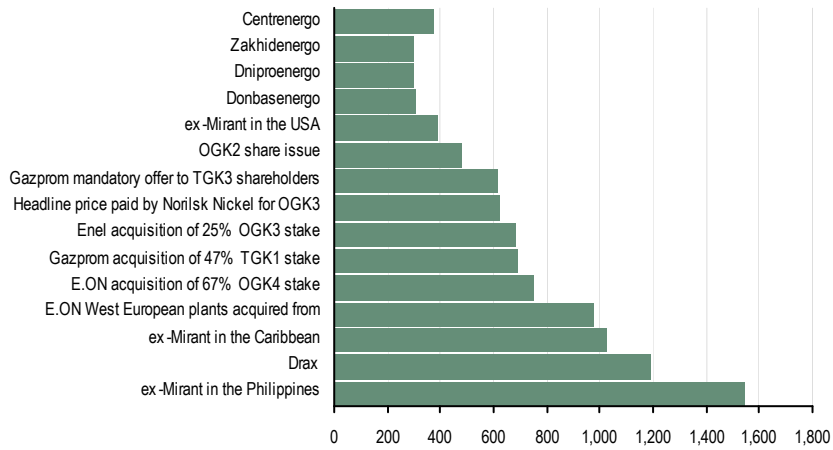
Figure 13: EV contribution, \$/kW

	2007-2012	2012-2032	Terminal value	Total fair EV
Centrenergó	45	327	10.5	382

Source: Renaissance Capital estimates

The company now trades at \$275/kW, implying 42% upside potential to our fair EV estimates. Despite this, our valuation still places Centrenergó at the bottom of the price league table of recent M&A transactions.

Figure 14: Generation values, international benchmarks for, EV/capacity, \$/kW



Source: Company data, Renaissance Capital estimates

## Ukrproduct Group Setting the stage

- Clear strategy in place.** Ukrproduct finished implementing its value-over-volume strategy in 2007, which included repositioning its retail brands. This allowed the company to report gross-margin improvement to 21.8% in 1H07 from 20.6% in 1H06. Going forward, we believe this strategy should help Ukrproduct weather Ukrainian food and raw-milk price inflation with little pressure on earnings.
- Hard cheese launched.** Ukrproduct launched its new hard cheese in Nov 2007. By year end, we estimate it that it had sold 300 tonnes generating GBP0.7-0.8mn in revenues. We believe this is a good start, and the key challenge for 2008 is to roll hard cheese out to all the retail outlets where UKR is present. We expect the company to generate GBP4.6mn in new sales from hard cheese in 2008.
- Industry: WTO will trigger changes.** WTO accession is expected in 1Q08, and it is likely to trigger structural changes in Ukraine's agro and food-production sectors. As a result, we expect at least a 15% increase in raw-milk prices and higher competition in the value-added dairy segment within a year. Ukrproduct's hard cheese is the key target. At worst, we may see lower capacity utilisation (at about 30% vs 55% currently expected in FY08) and thus sales dropping 4.5% from the current forecast to GBP45mn in FY08.
- Valuation: 40% potential upside expected.** At this point, we reiterate our target price of GBP1.07/share and our **BUY** rating on the stock, on the expectation of strong FY07 financial results and sustainable growth

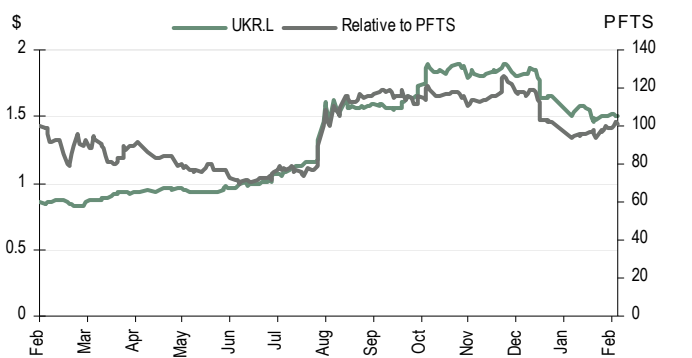
<b>Report date:</b>	<b>12 February 2008</b>
Rating	BUY
Target price (comm), £	1.07
Target price (pref), £	n/a
Current price (comm), £	0.77
Current price (pref), £	n/a
MktCap, £mn	31.7
EV, £mn	35.2
Reuters	UKR.L
Bloomberg	UKR LN Equity
ADRs/GDRs since	n/a
ADRs/GDRs per common share	n/a
Common shares outstanding, mn	41.77
Change from 52-week high:	-18.9%
Date of 52-week high:	03/08/2007
Change from 52-week low:	94.9%
Date of 52-week low:	12/10/2007
Web:	www.ukrproduct.com
Free float in £mn	9.8
Major shareholder with shareholding	A. Slipchuk 35.15%
Average daily traded volume in £mn	0.019
Share price performance over the last	
	1 month 0.00%
	3 months -12.00%
	12 months 77.01%

### Summary valuation and financials, £mn

	Revenue	EBITDA	Net income	EPS, GBP	EBITDA margin, %	EV	Net debt	EV/Sales	EV/CF	EV/EBITDA	P/E	P/ICE	EV/IC	ROIC/WACC
2006	35.05	2.79	1.08	0.026	8.0%	23.88	4.25	0.68	1.49	8.55	18.20	1.23	1.48	0.48
2007E	42.28	5.56	2.59	0.063	13.2%	36.58	4.85	0.87	1.96	6.58	12.27	1.70	1.85	0.99
2008E	47.14	6.19	2.81	0.068	13.1%	35.19	3.46	0.75	1.79	5.68	11.28	1.62	1.61	0.98
2009E	50.28	7.51	3.61	0.087	14.9%	31.83	0.09	0.63	1.65	4.24	8.80	1.64	1.34	1.16

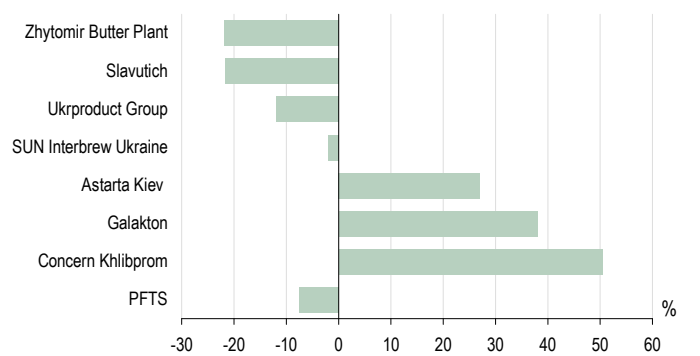
Source: Renaissance Capital estimates

Figure 1: Price performance – 52 weeks



Source: PFTS, Bloomberg

Figure 2: Sector stock performance – three months



Source: PFTS, Bloomberg

# Investment summary

Ukrproduct is a value-added dairy producer, which offers butter, soft and hard cheese under its own retail brands to customers in Ukraine. Its only export product is skimmed milk powder (SMP). The company has four production sites (450 t of raw milk total daily capacity) in Zhytomyr and Khmelnytsk regions, which is rich in raw milk suppliers, gives it a geographical competitive advantage. Zhytomyr and Starokonstantyniv plants are ISO9001-compliant and have been recently modernised. The other two serve as stations for raw milk collection and initial processing.

## Investment thesis

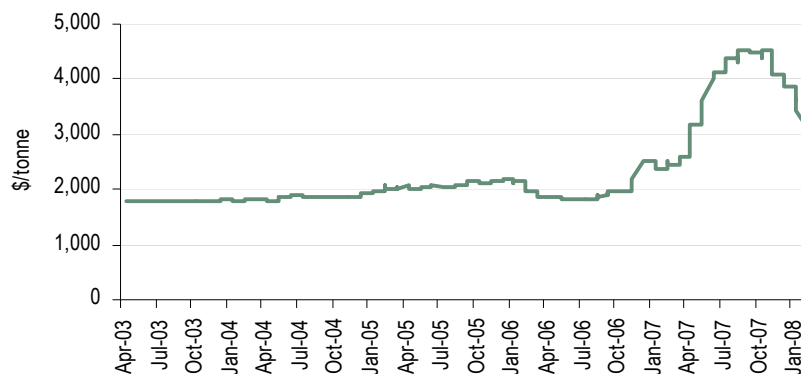
We believe Ukrproduct has a strong product mix, clear strategy and enough production capacity to support its growth in the future (current capacity utilisation rate is 60% on average). In 2007, Ukrproduct successfully completed its brand re-positioning, which we expect to have a long-term positive effect on its profitability margins. We see net margins increasing from 3.1% in FY06 to 7.2% in FY09E. This strategy of margins-over-volume sees the mass market and premium-brand products being treated as two different categories which has allowed for higher retail pricing for its premium brands by 16-20% vs its mass market brands. As a result, the company's gross margin improved to 21.8% in 1H07 vs 20.1% in 1H06. We expect a long-term gross margin of 27%.

Hard cheese launched in Nov 2007. Total sales were about 300 t until year end, and generated revenues of GBP0.7-0.8mn. Though Ukrproduct's efforts to date are commendable, to increase its presence in the hard-cheese market and fill capacity to at least 55% (from 10% in FY07), we envisage that marketing expenses will need to be increased by GBP0.4-0.5mn in 2008. Finally, we expect the company will seek to raise its retail price to a target \$7 per kg in 2008 (\$5-5.5/kg in FY07, we estimate), which will likely put it in direct competition with Polish cheese, but only after the import taxes on all cheese are lowered upon the Ukraine's WTO entry.

Margins-over-volume is the company's strategy, which we believe is fully justified in a time of increasing raw-milk prices and a milk deficit. Going forward, we don't expect major growth in output, but we believe that pricing will be adjusted to maintain the 22%+ gross-margin profitability despite raw-milk price inflation in the next couple of years. Food inflation is the key threat to the company's ability to pass its higher raw-milk cost onto the end product price. However, Ukrproduct is able to adjust its retail prices on a bi-weekly basis.

Skimmed milk powder is the only export product Ukrproduct offers. Despite recent decline, we believe export pricing is still strong at above \$3,000/t which should cover increase in cost of raw milk (+60% YoY in 2007, to UAH1.8/l average price) and gas prices (+38% YoY in 2008) in full. We forecast 13% gross margin on SMP for Ukrproduct in 2008 and beyond, which seems achievable as long as the export price exceeds \$2,500/t.

Figure 3: Skimmed milk powder – price history Apr 2003-Feb 2008, \$/t



Source: Bloomberg

Figure 4: Model assumptions

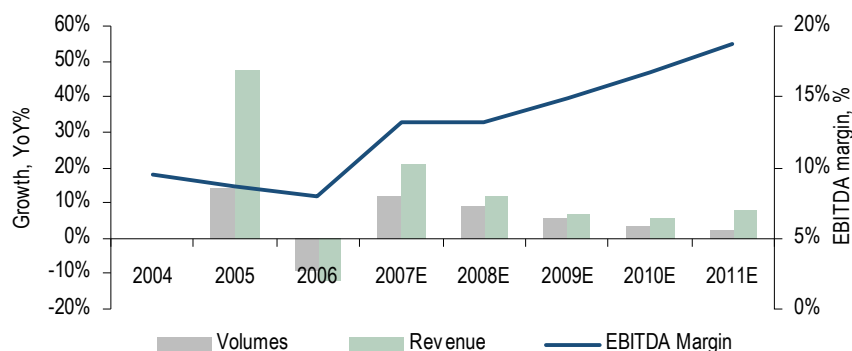
	2004	2005	2006	2007E	2008E	2009E	2010E	2011E	CAGR 2004-06	CAGR 2006-11E
Processed cheese, '000 tonnes	12.0	14.8	11.7	11.0	11.3	11.7	12.0	12.3		
Processed cheese, GBPmn	10.1	16.3	12.7	10.5	11.5	12.5	13.5	14.5	-0.7%	0.9%
Ukrproduct: market share in processed cheese	28.3%	29.6%	23.0%	19.4%	19.8%	20.3%	20.6%	20.8%		
Butter, '000 tonnes	8.4	9.0	9.1	9.3	9.5	9.6	9.6	9.6	2.9%	1.2%
Butter, GBP mn	9.5	11.4	11.7	11.4	12.5	13.6	14.6	15.6	7.0%	6.0%
Ukrproduct: market share in butter	27.1%	28.5%	27.4%	27.1%	26.8%	26.4%	25.7%	25.0%		
Hard cheese, '000 tonnes				0.5	2.0	2.7	3.1	3.4		61.4%
Hard cheese, GBPmn				1.1	4.7	7.0	8.7	10.8		77.5%
Ukrproduct: market share in hard cheese				0.3%	1.2%	1.6%	1.6%	1.7%		
SMP, '000 tonnes	3.7	3.7	4.1	7.0	7.5	7.9	8.2	8.3	3.2%	15.3%
SMP, GBPGPmn	5.5	8.5	7.0	17.2	15.9	14.3	13.1	12.8	8.9%	12.7%
Ukrproduct: market share in SMP	3.5%	3.3%	3.8%	6.4%	6.6%	6.7%	6.7%	6.6%		
Output price processed cheese, GBP/kg	0.84	1.10	1.08	0.95	1.01	1.07	1.12	1.18	9.0%	1.7%
Output price butter, GBP/kg	1.14	1.26	1.28	1.22	1.32	1.42	1.51	1.61	4.0%	4.7%
Output price hard cheese, GBP/kg				2.15	2.35	2.59	2.85	3.15		10.0%
Output price SMP, GBP/kg	1.47	2.28	1.73	2.45	2.12	1.82	1.61	1.55	5.5%	-2.3%
Gross margin, processed cheese	23.4%	23.3%	24.1%	21.2%	22.0%	22.5%	22.5%	22.6%		
Gross margin, butter	12.4%	14.8%	24.7%	25.7%	28.2%	29.3%	29.9%	30.4%		
Gross margin, hard cheese	0.0%	0.0%	0.0%	22.6%	27.8%	32.1%	35.5%	38.3%		
Gross margin, SMP	15.0%	11.4%	12.3%	18.5%	13.5%	13.8%	14.1%	14.4%		

Source: Company data, Renaissance Capital estimates

# Revenue outlook

We forecast 10.2% annual growth in revenues to GBP57mn in 2011E, driven primarily by growth in volume sales of butter, SMP and hard cheese. In terms of pricing, we expect the company to pass increases in the price of raw milk (we forecast an annual 15% price growth for raw milk) to its end products in full, as it has done in the past. We forecast an annual 4.7% price growth for butter and 10% price growth for hard cheese.

Figure 5: Revenue growth vs EBITDA margin, 2004-2011E



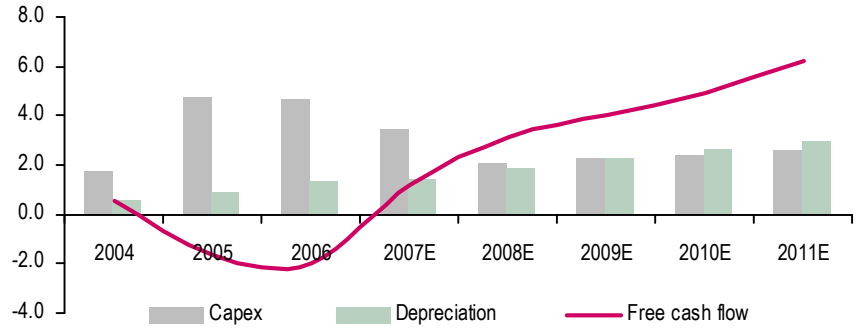
Source: Company data, Renaissance Capital estimates

**Raw milk remains the largest cost component** with 60-65% share of production costs, on average. The gas price is the cost factor for SMP, with about 20% of production cost, the second after raw milk. Ukraine's WTO accession includes commitments to eliminate a zero-VAT tax for agro producers and the introduction of direct funding of the structural reforms by the state. This, in our view, is likely to put pressure on the raw-milk price in Ukraine leading to at least a 15% YoY increase in 2008 (in domestic currency) which we already include in our Ukrproduct model.

Also, we expect more intense competition in the value-added dairy segments after the import duties are lowered after the WTO accession, which will bring import prices closer to those of the domestic producers. For Ukrproduct, **the biggest hit is expected in the hard-cheese segment**. In the worst-case scenario, the company will be able to fill its capacity by only 30% (vs our base-case scenario forecast of 55%) in 2008, and thus generate GBP2mn (4.5%) less in total revenues. However, we don't expect the cheese import price to be heavily discounted upon Ukraine's WTO accession. This will moderate the pressure on Ukrproduct, in our view. We highlight again that we are being conservative with our retail price assumption of \$4.6-5.0/kg vs at least a \$7-8/kg average by Polish manufacturers. Even when import duties are lowered (current duty on hard cheese is 30% of import value), it is unlikely that the imported hard-cheese producers will reduce prices by the full amount, if at all.

**Ukrproduct is yet to fully utilise its hard cheese capacity and milk powder dryer**, launched into operations in 2H07. Therefore, we expect only limited maintenance capex, which we estimate at GBP2.0mn. This is likely to be funded with bank debt and operating cash flows.

Figure 6: Capex vs FCF, 2004-2011E, £mn



Source: Company data, Renaissance Capital estimates

# Valuation

We value Ukrproduct based on forecast FCF for 2007-2011E, a 13.7% discount rate and a 3% terminal growth rate. Our DCF suggested price is £1.07/share, which implies 39% upside potential to the current price.

Figure 7: Ukrproduct DCF model

	2007E	2008E	2009E	2010E	2011E
EBIT	4.13	4.34	5.25	6.20	7.67
Less: Taxation	0.88	0.95	1.22	1.50	1.87
Tax adjusted EBIT	3.25	3.39	4.03	4.71	5.79
Depreciation	1.43	1.85	2.26	2.63	2.98
Less: Capex	-3.50	-2.12	-2.26	-2.38	-2.56
Change in working capital	-1.29	-0.87	-0.52	-0.46	-0.66
Unleveraged free cash flow	1.18	3.12	4.02	4.96	6.21
Discount rate (WACC)	13.7%				
Discount factor	1.01	0.89	0.78	0.69	0.61
Discounted Cash Flow	1.20	2.78	3.15	3.42	3.76
Future cash flow growth rate	3%				
Terminal value	59.9				
Discounted terminal value	36.3				
PV of 2011E enterprise value	50.6				
Net debt 2007E	4.8				
Minority Interest	0.4				
<b>Fair market capitalisation, £mn</b>	<b>45.4</b>				
Number of shares, mln	41.8				
<b>Target price, GBP</b>	<b>1.07</b>				
Current share price, GBP	0.77				
<b>Upside to the fair value</b>	<b>39%</b>				
<b>Implied multiples</b>					
P/E	17.5	16.1	12.6	10.3	8.2
EV/EBITDA	8.9	7.8	5.9	4.6	3.3
EV/Sales	1.2	1.0	0.9	0.8	0.6

Source: Company data, Renaissance Capital estimates

Furthermore, Ukrproduct trades at a 51% discount to Russian and a 63% discount to emerging markets producers of dairy, juice, baby food and other food products on 2008E EV/EBTIDA. We do not believe these discounts are justified for a company with a strong growth outlook and improving profitability. We rate the stock **BUY**.

Figure 8: Dairy sector peer multiples

	Price \$	MktCap \$mn	EV \$mn	Bloomberg ticker	P/E			EV/EBITDA			EV/sales		
					2007E	2008E	2009E	2007E	2008E	2009E	2007E	2008E	2009E
Wimm-Bill-Dann	134.2	4,765	5,239	WBD US	32.0	24.9	18.7	16.3	12.2	9.8	2.17	1.76	1.42
Lebedyansky	92.0	1,876	2,131	LEKZ RU	19.4	16.5	13.7	11.3	9.6	8.1	2.12	1.77	1.48
Nutritek	52.0	828	906	NTRI RU	24.6	20.1	14.1	12.4	10.7	8.0	2.24	2.40	1.75
<b>Russian weighted average</b>					28.0	22.3	16.9	14.6	11.4	9.2	2.16	1.83	1.47
<b>Emerging markets</b>													
Tiger Brands	2,064	3,553	3,813	TBS SJ	10.8	9.9	8.8	7.0	6.4	6.0	1.29	1.19	1.09
Nestle India	33.8	3,214	3,199	NEST IN	31.8	26.4	22.7	19.6	16.1	14.0	3.95	3.38	2.91
Fraser & Neave	3.2	4,565	7,769	FNN SP	15.3	12.7	12.1	11.6	10.0	9.5	2.25	1.97	1.69
Inner Mongolia	3.7	2,606	2,671	600887 CH	46.2	36.5	31.3	17.5	16.7	13.1	0.98	0.78	0.67
Vitasoy	0.4	415	391	345 HK	15.9	13.3	13.4	7.9	6.8	6.7	1.02	0.94	0.88
<b>EM weighted average</b>					30.3	25.0	22.1	13.2	14.9	13.1	2.13	2.38	1.61
<b>Developed markets</b>													
Nestle	512.4	201,410	218,196	NESN VX	17.7	16.3	15.1	11.2	10.1	9.4	1.86	1.73	1.63
Danone	81.6	41,854	47,184	BN FP	22.3	20.5	17.9	13.1	10.5	9.5	2.33	1.92	1.77
Dean Foods	27.0	3,553	8,874	DF US	21.6	18.1	14.1	10.7	9.7	9.0	0.76	0.73	0.73
Yakult Honsha	24.1	4,169	3,830	2267 JP	27.8	28.0	24.8	10.6	9.6	8.7	1.31	1.32	1.27
Meiji Dairies	4.8	1,631	2,373	2261 JP	16.7	17.0	15.3	6.8	6.6	6.4	0.36	0.36	0.36
Bongrain	79.1	1,220	2,403	BH FP	8.6	8.6	7.6	6.5	6.4	5.9	0.47	0.46	0.45
Morinaga Milk	2.7	714	1,722	2264 JP	19.6	17.8	14.8	5.9	12.4	4.9	0.31	0.31	0.31
Robert Wiseman Dairies	994.5	732	818	RWD LN	14.9	13.0	12.2	7.0	6.4	6.1	0.58	0.58	0.56
<b>DM weighted average</b>					18.6	17.2	15.6	11.4	10.1	9.3	1.89	1.72	1.62
<b>Ukrproduct</b>	<b>1.5</b>	<b>62</b>	<b>71</b>	<b>UKR LN</b>	<b>11.9</b>	<b>11.0</b>	<b>8.6</b>	<b>6.4</b>	<b>5.5</b>	<b>4.1</b>	<b>0.85</b>	<b>0.73</b>	<b>0.62</b>
Discount to Russian					-57%	-51%	-49%	-56%	-51%	-55%	-61%	-60%	-58%
Discount to EM peers					-61%	-56%	-61%	-51%	-63%	-69%	-60%	-69%	-62%
Discount to DM peers					-20%	-15%	-30%	-8%	-13%	-32%	45%	27%	10%

Source: Bloomberg, Renaissance Capital estimates

Catalysts for the share price are:

- FY07 reported earnings are above market consensus
- Ukrproduct receives new contracts to supply SMP to large domestic/international buyers (Nestle, World Food Programme)
- Domestic raw milk prices drop 10% (to below \$0.38/l)

Figure 9: Ukrproduct: SWOT analysis

Strengths	Weaknesses
Modern production facilities	Large number of brands for essentially the same product
Diversified product mix	Price taker in the SMP segment
Exposure to predictable b2b market	No experience in the hard cheese segment
Small and flexible	Too big sales division; thus issue with overhead control
Strong core brands	
Dominant share in butter and processed cheese segments	
Opportunities	Threats
Launch of high margin hard cheese product	Entry of large foreign dairy producers
Exclusive SMP supply contracts	Aggressive competitor's strategy to gain market share
Product differentiation by distribution channel	Price dumping by the competitors
Expansion of retail presence across Ukraine	Price fall at the SMP market
	Failure to successfully launch hard cheese product
	Increase in raw milk prices above the forecast
	Increase in electricity tariffs, other operating costs

Source: Renaissance Capital

Figure 10: Ukrproduct IFRS income statement, £mn

	2004	2005	2006	2007E	2008E	2009E	2010E	2011E	CAGR 2006-2011E
Net sales	27.1	40.0	35.1	42.3	47.1	50.3	53.0	57.0	10.2%
CoGS	22.7	33.2	27.8	31.5	35.1	36.4	37.6	39.6	7.3%
Gross profit	4.4	6.8	7.2	10.8	12.1	13.9	15.4	17.4	19.1%
Selling and distribution expenses	1.1	2.1	2.6	3.8	4.6	5.5	6.0	6.5	19.8%
General and administrative expenses	2.3	2.2	2.7	2.8	2.9	2.9	2.9	2.9	1.6%
Depreciation and amortisation expenses	0.5	0.9	1.4	1.4	1.8	2.3	2.6	3.0	17.0%
EBITDA	2.6	3.4	2.8	5.6	6.2	7.5	8.8	10.6	30.7%
EBIT	2.1	2.5	1.4	4.1	4.3	5.2	6.2	7.7	39.8%
Net financial income (loss)	(0.3)	(0.2)	(0.2)	(0.6)	(0.5)	(0.4)	(0.2)	(0.2)	-5.2%
PBT	1.8	2.3	1.2	3.5	3.8	4.9	6.0	7.5	44.3%
Tax	0.3	0.3	0.1	0.9	1.0	1.2	1.5	1.9	73.5%
Net income before minority items	1.5	2.0	1.1	2.6	2.9	3.7	4.5	5.6	38.7%
Minority interest	(0.02)	(0.01)	(0.02)	(0.05)	(0.05)	(0.06)	(0.07)	(0.09)	39.8%
Net income	1.5	2.0	1.1	2.59	2.81	3.61	4.42	5.53	38.6%
EPS	0.04	0.05	0.03	0.06	0.07	0.09	0.11	0.13	
<b>Margins</b>									
Gross margin	16.3%	16.9%	20.7%	25.4%	25.6%	27.5%	29.1%	30.5%	
EBITDA margin	9.6%	8.6%	8.0%	13.2%	13.1%	14.9%	16.7%	18.7%	
EBIT margin	6.5%	5.9%	3.4%	9.8%	9.2%	10.4%	11.7%	13.5%	
Net margin	5.4%	5.0%	3.1%	6.1%	6.0%	7.2%	8.3%	9.7%	
Selling and distribution as % of revenue	3.9%	5.2%	7.5%	9.0%	9.8%	10.9%	11.4%	11.3%	
General and administrative as % of revenue	8.7%	5.4%	7.8%	6.7%	6.1%	5.7%	5.5%	5.2%	
<b>Growth rates</b>									
Volumes		14.3%	-9.4%	11.6%	8.9%	5.3%	3.0%	2.3%	
Revenue		47.4%	-12.3%	20.6%	11.5%	6.7%	5.3%	7.6%	
Gross profit		53.2%	7.1%	48.4%	12.2%	14.7%	11.2%	12.7%	
EBITDA		32.7%	-18.8%	99.0%	11.4%	21.2%	17.8%	20.4%	
Operating profit		23.2%	-43.7%	187.8%	5.2%	20.8%	18.2%	23.5%	
Net income		37.9%	-46.3%	139.8%	8.7%	28.2%	22.5%	25.1%	

Source: Company data, Renaissance Capital estimates

Figure 11: Ukrproduct IFRS balance sheet, GBPmn

	2004	2005	2006	2007E	2008E	2009E	2010E	2011E	CAGR 2006-2011E
<b>Assets</b>									
Cash and cash equivalents	0.30	0.45	0.16	1.13	2.20	4.42	7.08	12.37	138.9%
Receivables (net)	2.02	4.01	3.71	4.59	5.18	5.46	5.68	6.03	10.2%
Inventory	2.33	4.52	2.65	3.43	3.95	4.35	4.73	5.24	14.6%
Other current assets	0.22	0.36	0.12	0.35	0.39	0.41	0.44	0.47	32.2%
Total current assets	4.87	9.40	6.64	9.50	11.73	14.65	17.93	24.12	29.4%
Intangible assets	0.00	1.33	1.24	1.20	1.26	1.32	1.39	1.46	3.4%
Fixed assets	5.02	9.53	10.87	13.01	13.70	14.11	14.24	14.17	5.5%
Other long-term assets	0.12	0.19	0.29	0.00	0.00	0.00	0.00	0.00	
Total long-term assets	5.15	10.77	12.39	14.21	14.96	15.43	15.63	15.63	4.8%
<b>Total Assets</b>	<b>10.01</b>	<b>20.17</b>	<b>19.02</b>	<b>23.71</b>	<b>26.68</b>	<b>30.08</b>	<b>33.55</b>	<b>39.74</b>	<b>15.9%</b>
<b>Liabilities &amp; equity</b>									
Accounts payable, net	1.67	2.61	1.95	2.36	2.63	2.81	2.96	3.18	10.3%
Short-term debt	1.08	3.11	3.54	5.07	4.71	3.52	2.12	1.71	-13.5%
Other current liabilities	0.25	0.16	0.02	1.06	1.06	1.07	1.07	1.08	114.0%
Total current liabilities	3.00	5.87	5.51	8.49	8.41	7.39	6.15	5.97	1.6%
Long-term debt	0.22	0.15	0.10	0.10	0.10	0.10	0.10	0.10	0.0%
Other long term liabilities	1.64	0.99	0.77	0.81	0.85	0.89	0.93	0.98	5.0%
Total long-term liabilities	1.86	0.99	0.87	0.91	0.95	0.99	1.03	1.08	4.5%
Total liabilities	4.86	6.86	6.38	9.40	9.36	8.38	7.18	7.05	2.0%
Minority Interests	0.13	0.25	0.20	0.39	0.42	0.54	0.66	0.83	33.0%
Paid in capital	3.00	4.12	4.12	4.12	4.12	4.12	4.12	4.12	0.0%
Reserves									
IPO proceeds	0.61	5.20	4.18	4.18	4.18	4.18	4.18	4.18	0.0%
Retained earnings	1.41	3.82	4.14	6.34	8.73	11.80	15.55	20.25	37.4%
Total stockholders' equity	5.02	13.14	12.44	14.64	17.03	20.10	23.85	28.55	18.1%
<b>Total liabilities and equity</b>	<b>10.01</b>	<b>20.24</b>	<b>19.02</b>	<b>23.71</b>	<b>26.68</b>	<b>30.08</b>	<b>33.55</b>	<b>39.74</b>	<b>15.9%</b>
Debt/EBITDA	50%	95%	130%	93%	78%	48%	25%	17%	
Debt/Equity	26%	25%	29%	35%	28%	18%	9%	6%	
ROE	29.0%	22.1%	8.4%	19.1%	17.8%	19.4%	20.1%	21.1%	
ROA	14.5%	13.3%	5.5%	12.1%	11.2%	12.7%	13.9%	15.1%	
ROIC	23.0%	12.2%	6.7%	13.1%	12.9%	15.2%	16.9%	18.2%	

Source: Company data, Renaissance Capital estimates

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### Investment Rating Distribution

Renaissance Capital Research		
Buy	135	33%
Hold	86	21%
Sell	45	11%
UR	16	4%
NR	132	32%
	<b>414</b>	

### Investment Banking Relationships

Renaissance Capital Research		
Buy	9	82%
Hold	2	18%
Sell	0	0%
UR	0	0%
NR	0	0%
	<b>11</b>	

\*Companies from which RenCap has received compensation within the past 12 months.

NR – Not Rated  
UR – Under Review

## Investment ratings

Investment ratings are a function of Renaissance Capital's expectation of total return (forecast price appreciation and dividend yield within the next 12 months).

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