



CONCORDE CAPITAL

Ukraine/ Oil & Gas

Ukrnafta

Oil Extraction Royalties Raised Again

Hold

11 Jul 2005

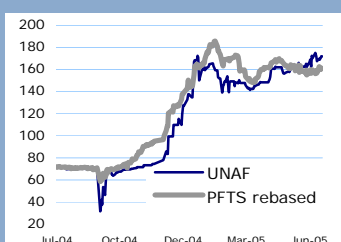
USD 33.0

12m Target

USD 35.7

Andriy Gostik
+380 44 206 8370
ag@con-cap.com

UNAF Mid-Market, UAH



Market Information

Bloomberg UNAF UZ
Reuters UNAF.PFT

No of Shares, mln 54.2
Reg S GDR to Ord. 1:6

Market price, USD 33.00
52Wk H/L, USD 5.92/34.65
MCap, USD mln 1,789.5
Free Float, % 8%

Stock Ownership

State 50%+1
Privat Group 42%
Minorities 8%

Ratios 2004*

EBITDA Margin 62%
EBIT Margin 49%
Net Margin 34%

Net Debt/Equity 0.06

**Based on adjusted sales*

In addition to 2004 dividend payments, Ukrnafta's 2005 operating cash flows will be further drained by the 83% hike in oil extraction royalties, which will take effect in August 2005. However, we believe that the government will lower royalties to a reasonable level in 2006. If our expectations are correct, the stock will still have upside potential. At this point though, we are wary about relying on our optimistic scenario (DCF yielded USD 42.3 12 month fair stock value) due to the uncertainties we discussed in our June 2005 note. We have downgraded the stock to HOLD without revising our target price, as the current market price has nearly met our target price of USD 35.7.

Higher Royalties To Fund 2005 State 'Social' Budget. On July 7, the Rada passed a law on changes to the 2005 state budget, which raised oil extraction royalties 83%, to UAH 550 per mt (~USD 14.86 per bbl) effective Aug 1, 2005. In addition, royalties for condensate extracted from deep wells (wells deeper than 5 km) were reduced by 17%, to UAH 250 per mt (~USD 6.2 per bbl). The royalty increase will significantly enlarge Ukrnafta's fiscal burden. The company's operating cash flows are already being used to make huge dividend payments of USD 266.5 mln.

Law On Oil And Gas Extraction Royalties Must Be Implemented. If royalties are maintained at their current level, this may lead to the collapse of Ukraine's entire oil & gas industry in the medium term. Therefore, we believe that the government will finally put the law on differentiated oil and gas extraction royalties into effect in 2006. This law was adopted in March 2004, but its implementation was subsequently suspended in 2004 and 2005. The law introduces a formula for royalty calculation based on the prevailing market price for hydrocarbons and their economic recoverability. This is expected to boost development in the industry and attract more investments. Yet it remains to be seen whether the upcoming Parliamentary elections in 2006 will again result in an inflated 'social' budget for 2006.

We adjusted our forecasts as summarized below:

	Net Revenues USD mln	EBITDA USD mln	EBITDA margin %	Net Income USD mln	Net Income margin %
Scenario 1. Differentiated Royalties Introduced In 2006					
2005	1,475.6	640.8	43.4%	334.0	22.6%
2006	2,287.6	866.3	37.9%	485.9	21.2%
Scenario 2. High Royalties Maintained In 2006					
2005	1,475.6	640.8	43.4%	334.0	22.6%
2006	2,040.1	618.8	30.3%	312.6	15.3%
Previous Projections					
2005	1,523.6	688.8	45.2%	367.6	24.1%
2006	2,287.6	866.3	37.9%	485.9	21.2%

KEY FINANCIAL DATA, USD mln

	Net Revenue	EBITDA	Net Income	DPS, USD
2004	736.0	459.0	253.3	4.670
2005E	1,475.6	640.8	334.0	2.463
2006E	2,287.6	866.3	485.9	2.240
Spot Exchange Rate		5.05		

KEY RATIOS

	P/S	P/E	EV/EBITDA	Div Yield
2004	2.43	7.07	4.07	14.2%
2005E	1.21	5.36	3.22	7.2%
2006E	0.78	3.68	2.27	6.8%

History Of Oil & Gas Extraction Royalty Revisions

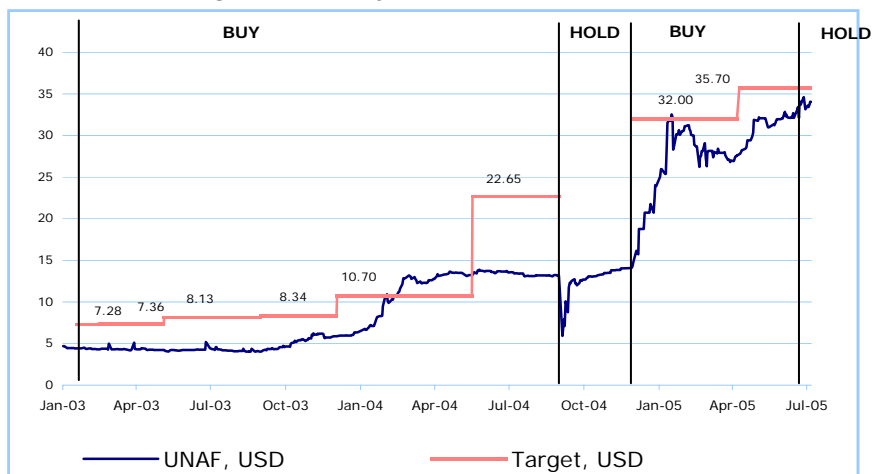
	Before 2002	Jan-02	May-03	Dec-04	Mar-05	Aug-05
Oil Royalties, UAH/mt	17.34	52.01	160	300	300	550
Condensate Royalties, UAH/mt	0	0	104.4	104.4	300	250-300
Gas Royalties, UAH/1,000 cm	28.9	28.9	30.6	30.6	30.6	30.6

New Payment Rules Will Sap Working Capital. Earlier, in January 2005, The Cabinet of Ministers introduced a new royalty payment procedure. Specifically, royalties have to be paid on a monthly basis in three installments based on the projected hydrocarbon extraction for that month. This system of advance payments effectively reduces the working capital of oil and gas extractors. Yet, the additional upstream burden will spur Ukrnafta to finalize its VIOC transformation so that if upstream operations worsen they will not cripple the company's business.

Analyst Certification

I, Andriy Gostik, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

Stock Price And Target Price History, USD



Andriy Gostik

Date	Target Price, USD	Closing Price, USD
20-Jan-03	7.28	4.43
17-Feb-03	7.36	4.32
07-May-03	8.13	4.23
03-Sep-03	8.34	4.05
05-Dec-03	10.70	5.87
19-May-04	22.65	13.23
06-Sep-04	Pending	5.93
03-Dec-04	32.00	15.17
11-Apr-05	35.70	27.75

Concorde Capital
72 Chervonoarmiyska St.
2nd entry, 6th floor
Kiev 03150, UKRAINE

Tel +380 44 206 8370
Fax: +380 44 206 8366
www.concorde.com.ua
office@con-cap.com

CEO

Igor Mazepa

im@con-cap.com

Chief Operating Officer

John David Suggitt

js@con-cap.com

Chief Investment Officer

Steven Cheshire, CFA

steven.cheshire@con-cap.com

Corporate Finance

Maxim Bougriy

mb@con-cap.com

Head of Equity Sales

Peter Bobrinsky

pbobrinsky@con-cap.com

Equity Sales Department

Marina Martirosyan

mm@con-cap.com

Lucas Romriell

lr@con-cap.com

Head of Research, Strategy

Konstantin Fisun, CFA

kf@con-cap.com

Utilities (Telecommunications, Energy)

Alexander Paraschiy

ap@con-cap.com

Oil & Gas, Pipes, Non-Ferrous Metals

Andriy Gostik

ag@con-cap.com

Ferrous Metals

Viktor Koval

vk@con-cap.com

Machine Building, Chemicals

Olga Pankiv

op@con-cap.com

Editor

Nick Piazza

np@con-cap.com

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