Ukraine / Oil & Gas

Concern Galnaftogaz

CONCORDE CAPITAL

Information Note

HOLD

23 Sep 2005 **USD 0.0100**

12m Target **USD 0.0105**

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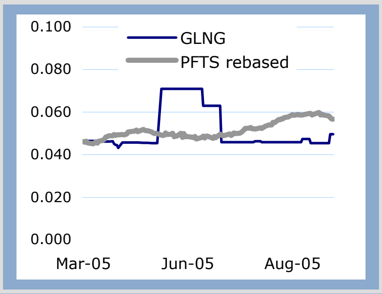
GLNG Mid-Market, UAH



Market Information	
PFTS	**GLNG**
Bloomberg	**GLNG UZ**
No of Shares, mn*	**16,000**
Market price, USD	**0.0100**
MCap, USD mn	**160.0**
Free Float, %	**23.7%**

Stock Ownership**	
Financial & Investment Energy Holding and related companies	70.9%
Other	29.1%

Ratios 2004	
EBITDA Margin	**3.5%**
EBIT Margin	**2.4%**
Net Margin	**1.1%**
Net Debt/Equity	**0.67**

Galnaftogaz is enjoying a positive market outlook due to high prices for oil products. It posted healthy sales in 1H05 and reported improved margins despite unfavorable governmental regulations in April – May 2005. However, our target remains unchanged due to the uncertainty with the company's network expansion program which has not lived up to our projections for 2005. Given that the stock's price rose to USD 0.01 per share, we downgrade our recommendation to HOLD.

Price Caps Lifted, Market Position Strengthened. Since our initial report on Galnaftogaz in March 2005, the company has successfully recovered from the adversity it faced as a result of governmental regulation of the market. In late May the government lifted its caps on gas prices, that had been hurting GLNG's business. Also, the government cut back its taxes and lifted customs duties on imported oil products. This enabled GLNG to diversify its supplies and strengthen its market position.

Soaring Prices Lift Financials. On the back of booming oil product prices, that have grown nearly 39% since the beginning of the year, the company saw its sales grow 74% in 1H05. An increase in the number of 'OKKO'-branded gas stations from 94 to 107 was another factor that greatly contributed to this. GLNG's margins also improved thanks to higher markup per tonne sold and the launch of a trading house.

Beefing Up Credit History On Eve of IPO. The company continued its cooperation with international financial institutions, namely, IFC and EBRD. Thereby Galnaftogaz not only obtained cheap financing but also contributed to the development of its credit history. Coupled with the issuance of corporate bonds with a yield much lower than in 2004 (12% vs. 17%), this will help Galnaftogaz save on interest expense.

KEY FINANCIAL DATA*, USD mn

	Net Revenue	EBITDA	Net Income	DPS, USD
2003	176.7	5.5	2.1	0.000
2004	241.3	8.4	2.7	0.000
2005E	318.0	16.3	7.8	0.000
Spot Exch Rate		5.05		

KEY RATIOS

	P/S	P/E	EV/EBITDA	Div Yield
2003	0.91	76.96	32.24	0.0%
2004	0.66	60.25	21.93	0.0%
2005E	0.50	20.51	11.44	0.0%

*2004 IFRS financials have been adjusted for capitalized interest first reported in 2004. This effectively reduced 2004 net income from USD 4.2 to USD 2.7

Leaving Obstacles In The Rearview Mirror

The Ukrainian oil product market has changed dramatically since March 2005, when we initiated coverage of Galnaftogaz. Russian oil price has been increasing from the beginning of the year, which put pressure on the oil product market. The oil product price spurt was triggered by a seasonal increase in demand for diesel fuel in late March. To contain the price surge, on April 9 the government introduced caps on retail oil prices and later imposed caps on wholesale prices as well. Retail mark-up, as defined by the government, was limited by 13%, which, in effect, was somewhat below Galnaftogaz's level.

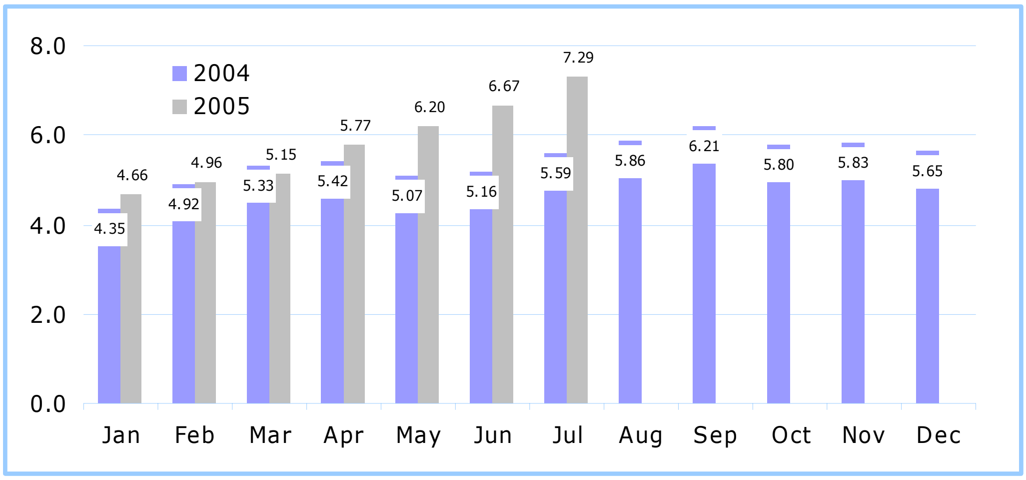
Nevertheless, the company's hardships came to an end in late May, when all restrictions on oil product prices were lifted. Moreover, the government canceled extra dues of EUR 10 to the Pension Fund collected from every tonne of imported oil products, reduced excise tax on sales of oil products and eliminated the customs duties on imported gasoline and diesel fuel. This was a major blessing for Galnaftogaz, who could now import more high grade, high octane gasoline from Mazeikiu Nafta (Lithuania) and Mozyr refinery (Belarus). As a result, at the time of the oil product shortage on the Ukrainian market, the company strengthened its OKKO brand by offering high quality products at its gas stations.

In addition, Galnaftogaz reduced its business risks by diversifying oil product supplies to its retail network. In 2004, Ukrtatnafta's products comprised 76.5% of Galnaftogaz's supplies, while the Mazeikiu and the Mozyr refineries accounted for 2.9% of its supplies. By July 2005, purchases from Mazeikiu and Mozyr already provided 30% of Galnaftogaz's inventory. The opening of a Galnaftogaz's subsidiary, Trade House Galnaftogaz Ltd., in April, helped the company to optimize its purchases and eliminate concentration risk, as previously a single dealer not related to Galnaftogaz would deliver oil products to the company's storage depots. The Trade House took over the deliveries.

2005 Financials Boosted By Surging Prices

Oil product prices have grown by ~39% since the beginning of the year. After a shortage in March – April, demand for oil products sold by Galnaftogaz remained strong due to their price - quality characteristics. Also, the company's gas stations were able to increase tonnage sales per station thanks to branding more of them as 'OKKO', which has become a well-recognized brand now. Specifically, the number of OKKO-branded gas stations increased from 94 at the beginning of the year to 107 in August, while the total number of gas stations increased only from 164 to 167.

Galnaftogaz's Average Daily Sales Of Oil Products Per Gas Station, mt



Source: Company data

Galnaftogaz's oil product sales in 7M05 grew a hefty 61% due mainly to higher prices, but also to increased volumes sold.

Oil product sales	7M04	7M05	Growth
In tonnes	191.2	208.0	8.8%
In USD mln	92.4	148.7	61.0%

As a result of a favorable market, cancellation of price restrictions and station branding, the company managed to improve its 1H05 sales significantly:

Financials According To Ukrainian Standards*, USD mln

	1H04	1H05	Change
Sales	90.2	156.5	73.5%
EBITDA	4.2	7.4	78.1%
EBITDA margin	*4.6%*	*4.8%*	
Net Income	2.8	5.0	80.4%
Net margin	*3.0%*	*5.2%*	

EBITDA and net income are adjusted to include net Other Income, which represents a portion of operating income
Source: Company data

As for the margins, we ascribe their improvement in 1H05 to two factors:

1) launch of a trading house, as discussed above;
2) favorable market conditions that allowed for a higher retail markup – USD 71 per tonne in the summer months of 2005 as opposed to USD 56 per tonne in 2004. The markup is projected to grow to USD 72 – 73 per tonne by the end of the year.

Sources Of Financing

Galnaftogaz registered an additional share issue in May this year having raised USD 5.7 mln in equity. The next additional share issue is planned during the time of its IPO in 2007. Galnaftogaz will not start paying dividends until 2009, when dividend payout is projected at 30%.

In the meantime, the company continues to be active on the debt market developing its credit history with international institutions on the eve of its IPO. Thus, in June this year Galnaftogaz signed a USD 25 mln credit agreement with International Finance Corporation (IFC) for a term of seven years. The money will be used for the construction of new and the refurbishment of existing gas stations and oil storage depots. IFC's loans usually bear a low interest rate. We estimate that the floating rate on the credit Galnaftogaz received is currently around 8%. A portion of the IFC's credit, USD 4 mln, is a subordinated debt convertible into Galnaftogaz's shares in three years. In addition, Galnaftogaz signed a term sheet with EBRD for a USD 25 mln credit limit. The company also has credit limits from ING Bank and Black Sea Trade and Development Bank.

In May 2005, Galnaftogaz made a decision to issue ~USD 17.8 mln (UAH 90 mln) worth of corporate bonds (series D, E and F, each amounting to UAH 30 mln). Series D bonds were placed on July 1, series E on August 1, and series F on September 1. They will all mature in 2010. The bonds have a coupon rate of 12% for 2005, but they effectively yielded ~11.5% at the placement. In addition, in September the company reduced the coupon rate on its series A bonds in circulation from 17% to 12%.

As of December 31, 2004, the company had USD 27.3 USD in financial debt on its balance sheet. A portion of this debt, equal to ~USD 5.6 mln (UAH 30 mln), was domestically traded corporate bonds issued in 2003 and maturing in 2006 (series A, B and C). Interest rates on Galnaftogaz's loans denominated in USD ranged from LIBOR+5.25% to LIBOR+8.75% in 2005, while its UAH loan bore an interest of 19%. The company's corporate bonds effectively yielded ~17%, close to the coupon rate for that year.

In effect, in 2005 Galnaftogaz conducted a successful refinancing, which will allow the company to lessen its interest burden. Last year, Galnaftogaz's financial debt-to-assets ratio was 30.5%, according to its IFRS financials. The company's interest coverage ratio adjusted to account for capitalized interest was 2.1 in 2004.

Valuation Pending

The company is not going to fulfill its plan of having 193 gas stations in its retail network in 2005. We estimate that it will be able to expand its chain to only 171 – 177 this year. The uncertainty with the CapEx program prevents us from conducting a meaningful DCF analysis, as the non-fulfillment of the 2005 plan will result in a shift in the CapEx schedule for the next several years and may also lead to a revision of the overall targeted number of gas stations. These are the variables that are essential for determining Galnaftogaz's future cash flows. We expect to receive a detailed and revised investment plan for Galnaftogaz from the company's management shortly and will estimate the stock's fair value with DCF at that time.

IFRS Income Statement Summary, USD mln			
	2003	**2004**	**2005E**
Net Revenues	**176.7**	**241.3**	**318.0**
Gross Profit	10.2	14.2	26.5
EBITDA	**5.5**	**8.4**	**16.3**
EBITDA margin, %	3.1%	3.5%	5.1%
EBIT	**3.6**	**5.9**	**11.5**
EBIT margin, %	2.1%	2.4%	3.6%
PBT	**2.4**	**3.7**	**9.8**
Net Income	**2.1**	**2.7**	**7.8**
Net Margin, %	*1.2%*	*1.1%*	*2.5%*
Dividend Declared	**0.00**	**0.00**	**0.00**

IFRS Balance Sheet Summary, USD mln			
	2003	**2004**	**2005E**
Current Assets	19.9	33.8	68.0
Non-Current Assets	43.2	54.8	70.2
Total Assets	**63.0**	**88.6**	**138.2**
Shareholders' Equity	31.5	37.2	50.7
Current Liabilities	15.3	26.0	54.5
LT Liabilities	16.2	25.4	33.0
Total Liabilities & Equity	**63.0**	**88.6**	**138.2**

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