Ukraine / Oil & Gas

Concern Galnaftogaz

Strategic Focus On Quality

BUY

26 Oct 2005	**USD 0.0100**
12m Target	**USD 0.0124**

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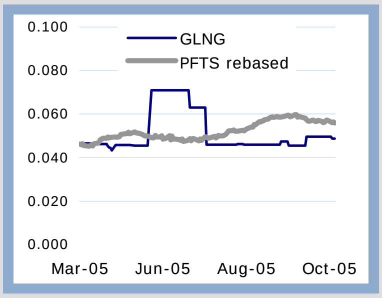
GLNG Mid-Market, UAH



Market Information

PFTS	**GLNG**
Bloomberg	**GLNG UZ**
No of Shares, mln	**16,000**
Ord/ADR	**500:1**
Market price, USD	**0.0100**
ADR Price, USD	**5.00**
MCap, USD mln	**160.0**
Free Float, %	**13.8%**

Stock Ownership

Financial & Investment Energy Holding and related companies	78.2%
The Antonov Family	4.1%
Other	17.7%

Ratios 2004

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

Our improved insight into Galnaftogaz's business has made us conclude that the company's prospects are better than we previously expected. This is mainly due to the pay-off from Galnaftogaz's investments in its OKKO brand and a more conducive market environment which will result in larger retail mark-ups. Our new DCF-based 12-month target is USD 0.0124, a 24% upside to the current market price. We upgrade our recommendation from HOLD to BUY.

Favorable Market Environment Boosts Value. Prices for oil products have grown even more than we expected this year and we believe in the midterm, they will continue to go up. We have revised our price forecasts upward for the next five years. We have also projected larger retail mark-ups, and increased our estimates of the company's future operating cash flows, which contributed to the upward revision of Galnaftogaz's valuation.

Branding To Further Improve Retail Sales. The strong operating performance of Galnaftogaz's OKKO-branded stations in 7M05 has lead us to raise our projected daily sales volumes per station for subsequent years. The company's investment in its brand development appears to be paying off and is expected to be a key value driver.

Focus On Quality Will Preserve Value. We believe that Galnaftogaz's commitment to improve the competitiveness of its service stations is a winning strategy. In our view, pure oil product retailing will be less profitable in long term from 2009 onward. With this in mind, we do not expect the company to expand its network above its 2008 target of 291 units. Getting a competitive edge in the convenience goods and services segment will allow Galnaftogaz to stay on top in the industry in terms of margins and preserve value.

KEY FINANCIAL DATA*, USD mln

	Net Revenue	EBITDA	Net Income	DPS, USD
2004	241.3	8.4	2.7	0.000
2005E	319.5	18.2	7.6	0.000
2006E	389.9	31.8	15.1	0.000
Spot Exch Rate		5.05		

KEY RATIOS

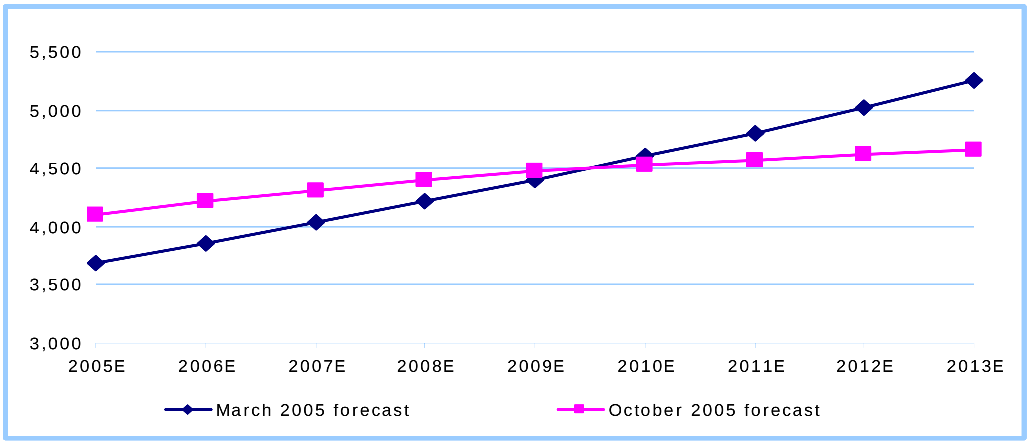
	P/S	P/E	EV/EBITDA	Div Yield
2004	0.66	60.25	21.93	0.0%
2005E	0.50	21.04	10.89	0.0%
2006E	0.41	10.60	6.79	0.0%

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

Rising Oil Product Prices Bode Well For The Company...

Oil product prices in Ukraine have grown almost 40% YTD. Moreover, the anticipated price increases for Russian crude, on the one hand, and the government's shift towards more liberal economic policies, on the other, make us confident prices will remain high in the medium term. As a result, we have revised our forecast upward for the next five years. However, after consulting with Galnaftogaz's management and receiving a better understanding of the business we decided to adjust our long term price forecast and now project slower price growth in subsequent years.

Average Retail Oil Products Price (VAT Inclusive), UAH/mt



Source: Concorde Capital projections

Higher prices for oil products translated into higher absolute retail mark-ups for Galnaftogaz. The average mark-up is expected to exceed USD 82 per mt in 2005 as opposed to USD 57 in 2004. The two primary factors that make the mark-ups grow despite the increase in input costs are as follows:

...As A New Trading House And Low Competition...

Firstly, the launch of a trading house in April 2005 (see our September 23, 2005 note) allowed Galnaftogaz to minimize its purchase costs. As a result, the company's mark-up in percentage terms did not change much from the previous year as of 8M05, in dollar terms it increased 44.6%, on par with the purchase price.

	2004	2005E	2006E	2007E	2008E
Purchase Price Rail Tariffs Inclusive, USD/mt	411.7	592.9	611.7	625.0	638.6
Retail Mark-Up, USD/mt	57.0	82.4	83.8	84.4	85.0
Selling Price Before VAT, USD/mt	468.7	675.2	695.5	709.4	723.6
Retail Mark-Up, %	12.2%	12.2%	12.1%	11.9%	11.8%

According to our analysis, Galnaftogaz's retail mark-up will decline in relative terms but will keep slowly growing in dollar terms up until 2008 due to rising oil product prices. This growth will be possible because of the lack of competition in the high quality service station segment where Galnaftogaz operates. In our view, the level of competition will remain relatively low in the medium term. When the market matures and becomes highly price competitive, we believe Galnaftogaz should concentrate on its other competitive advantages, as discussed below in the section 'Investment Strategy: Quality Over Quantity'.

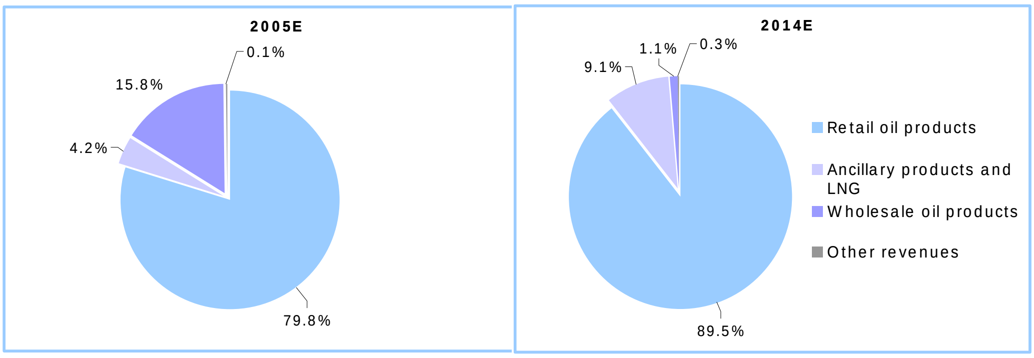
...Coupled With Supply Diversification Bolster Mark-Ups

Secondly, after the price crisis on the oil products market last spring, the company diversified its supplies, which reduced its business risk and enabled it to improve control over purchase prices. Specifically, in June – October 2005 Galnaftogaz purchased ~ 42% of its oil products from four non-Ukrainian refineries – Mazeikiu Nafta (Lithuania), Mozyr and Novopolotsk refineries (Belarus) and Rafa (Romania). Conversely, its purchases from Ukrtatnafta (Kremenchuk refinery) fell from 76.5% in 2004 to 45.7% in June – October 2005.

2005 Margins Will Be Distorted By Large Bulk Sales

Despite significant improvement in retail performance, we expect that margins in 2005 will be lower than previously estimated. According to Galnaftogaz's management, the company's sales structure in 2005 includes a relatively large share of wholesale sales (~15.8%), which we projected to be smaller in our March 5, 2005 report. Most wholesale sales are in large bulk, with about zero mark-up. These are the oil products the company's gas station chain did not have enough capacity to distribute, and this inventory had to be sold in bulk to third parties. However, Galnaftogaz plans to halt large bulk sales in the future, as it will have enough stations to retail all the volumes purchased by its trading house and thus will fully focus on the retail segment with only minor revenues coming from small bulk sales.

Projected Sales Breakdown



Source: Concorde Capital projections

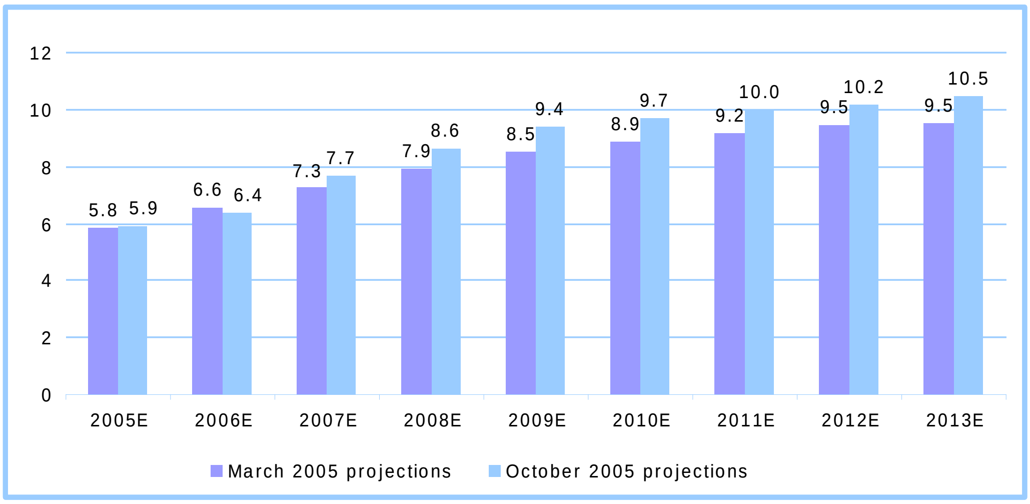
OKKO Brand Outperforming

As we reported in our September 23, 2005 note, Galnaftogaz significantly improved daily sales in 7M05 thanks to the performance of its OKKO branded stations. The number of high-yielding OKKO-branded gas stations grew from 94 at the beginning of the year to 107 in August, while the total number of units only increased from 164 to 167. By 2009, all Galnaftogaz's service stations will bear the OKKO brand.

After a shortage in March – April, demand for oil products sold by Galnaftogaz remained strong due to their price-quality characteristics, as import duties were canceled and the company was able to import high grade gasoline from Mazeikiu Nafta.

The company's success in developing its brand has led us to raise our projected daily sales per station to 10.5 mt in 2013, or 11% higher than our previous estimate.

Average Daily Sales Per Station, mt



Source: Concorde Capital projections; company data

Investment Strategy: Quality Over Quantity

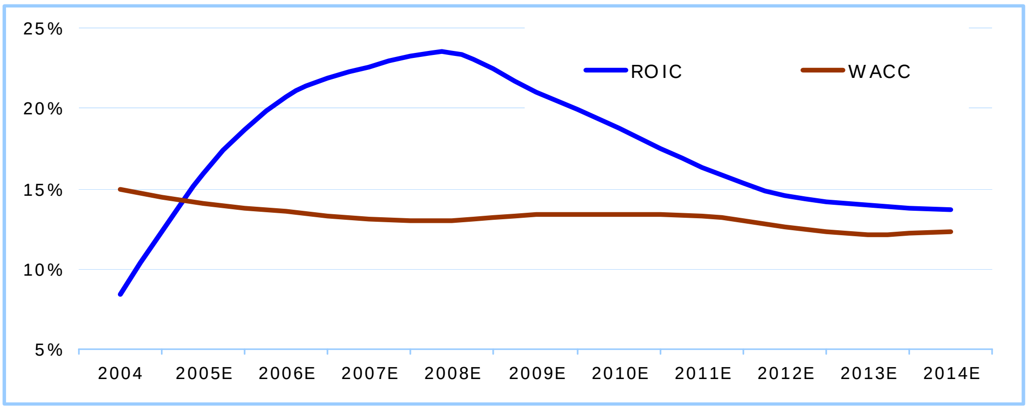
In our view, Galnaftogaz's strategy to focus on improving its OKKO brand and the development of its convenience products and services segment is a justified move. It will enable the company to keep its margins high by industry standards even when the industry matures.

We believe the market will become increasingly more competitive from 2009 onward when big players such as Russian majors, along with Ukrnafta and Naftogaz Ukrainy become more active in expansion. In addition to their size, these companies will be able to control their costs better, as they either own refineries or can extract their own crude, an outright advantage over pure retailers such as Galnaftogaz. We think that in 2009 - 2012 oil retailers' margins are likely to drop sharply, as the industry will mature and gas station chains will begin competing for product and service quality, not just price. This would make investment in pure oil product retail unfeasible.

From 2009 forward, we project a gradual fall in Galnaftogaz's EBITDA margins, as they will be squeezed by competitive pressure. However, due to the development of the convenience products and services market, the company's EBITDA margin will stabilize at the level of 5.1% in 2014.

In the medium term, low market saturation and weak competition make retailing oil products an attractive business in Ukraine and Galnaftogaz will remain among the leaders in the market due to its superior service and ability to charge sufficiently large retail mark-ups.

The effect of industry growth followed by the maturity phase on Galnaftogaz's business prospects is captured by the ROIC-WACC analysis below:



Why Fewer Stations?

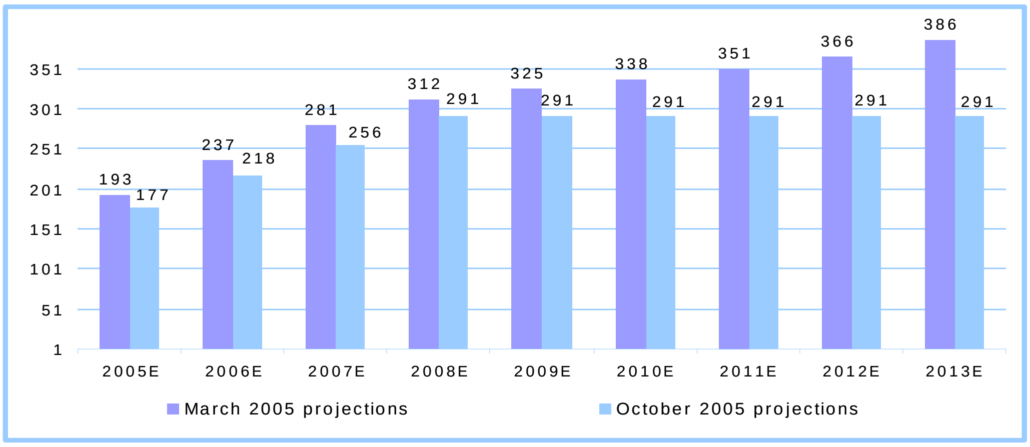
After receiving more accurate information from the company's management, we lowered our forecast for the number of gas stations in Galnaftogaz's retail network and respective CapEx projections. When we initiated our coverage of the company on March 5, 2005, Galnaftogaz's expansion strategy was not worked out in detail, and the company only approved its long term investment plan in April.

According to the company's investment plans, Galnaftogaz will develop a network of at least 291 gas stations by 2014. This is significantly fewer than the 386 units we previously expected. Galnaftogaz has already budgeted for 291 stations from 2005 to 2008. The company has already determined where the stations will be built and held preliminary negotiations with local authorities concerning the purchase of the land for the new stations.

New Forecasts More Robust

We believe that actual number of Galnaftogaz's stations will not differ significantly from the budgeted plan until 2009. The company conducted an in-depth feasibility study while selecting the locations, which resulted in the final list of 291 stations. Galnaftogaz will have enough funds to implement its plan given the management's proven aptitude to tap the debt market (see our note from September 23, 2005) and expected inflow of equity capital as a result of its anticipated IPO in 2007. The company will certainly look for new opportunities to build up its network after 2008 and later will likely revise its expansion plans upward.

Number Of Gas Stations



Source: Company data

However, given the risk that profitable opportunities in the retail oil product business will be scarce in the long term, we adopted a more conservative approach than in our report from March 5, 2005 and refrained from projecting Galnaftogaz's chain growth beyond 291 units despite the possibility that construction of some new gas stations after 2008 may in fact be value-adding.

Summary Of Changes To Key Financial Forecasts

		2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E
Net Sales USD mln	Old	279	394	535	675	786	885	994	1,118	1,239
	New	**319**	**390**	**560**	**729**	**809**	**846**	**884**	**919**	**956**
EBITDA USD mln	Old	21	32	42	52	58	62	64	67	68
	-margin	*7.5%*	*8.1%*	*7.8%*	*7.7%*	*7.4%*	*7.0%*	*6.4%*	*6.0%*	*5.5%*
	New	**18**	**32**	**46**	**60**	**65**	**61**	**55**	**51**	**50**
	-margin	***5.7%***	***8.1%***	***8.1%***	***8.2%***	***8.0%***	***7.2%***	***6.2%***	***5.5%***	***5.2%***
CapEx USD mln	Old	34	40	36	30	20	20	20	21	21
	New	**27**	**34**	**32**	**30**	**9**	**9**	**9**	**8**	**8**
FCFF USD mln	Old	(18)	(18)	(6)	10	28	28	29	31	32
	New	**(15)**	**(13)**	**(6)**	**5**	**38**	**37**	**33**	**30**	**29**

Valuation

Two key factors caused an increase in Galnaftogaz's valuation. Firstly, higher expected oil product prices in the medium term translate into larger retail mark-ups. Secondly, the projected performance of Galnaftogaz's stations improved in the long term due to their OKKO branding and development of convenience goods and services segment. These factors increased our projected operating cash flows which more than offset a reduction in estimated cash flows stemming from the downward revision of the company's network expansion.

The updated DCF analysis below yields a current fair stock value of USD 0.0105 per share and a 12-month target of USD 0.0124 per share, which implies a target MCap of ~ USD 200 mln. Thus, the upside potential from the current market price of USD 0.010 per share is 24%. We change our recommendation from HOLD to **BUY.**

Discounted Cash Flow Valuation

Valuation date **Oct 26, 2005**

For the purposes of forecasting local currency is used (UAH mln)

	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E
EBITDA	**93**	**159**	**228**	**299**	**323**	**304**	**274**	**253**	**249**	**248**
EBIT	75	133	193	258	280	261	231	211	207	207
Tax Rate	25%	25%	25%	25%	25%	25%	25%	25%	25%	25%
Taxed EBIT	56	100	145	194	210	196	173	158	156	155
Plus D&A	18	26	35	41	44	44	43	42	41	41
Less CapEx	(139)	(171)	(160)	(150)	(44)	(44)	(43)	(42)	(41)	(41)
Less change in OWC	(13)	(22)	(50)	(58)	(21)	(9)	(10)	(9)	(10)	(5)
FCFF	(77)	(67)	(30)	26	189	186	163	149	146	151
WACC	14.1%	13.6%	13.1%	13.0%	13.4%	13.4%	13.3%	12.6%	12.2%	12.3%

WACC to Perpetuity	10.0%	Terminal Value	**2,217**
Current Firm Value	**1,027**	Portion due to TV	70.0%
Less Net Debt	(180)	Perpetuity Growth Rate	3.0%
Current Equity Value	**847**	Implied Exit EBITDA Multiple	8.9 x
Curr. Fair Value/Share	**USD 0.0105**	**12-mo Fair Value per Share**	**USD 0.0124**

Source: Concorde Capital calculations

Sensitivity Analysis: Implied 12-Month Share Price, USD

10-Year Discount Rates			**Perpetuity Growth Rate**		
	2.0%	***2.5%***	***3.0%***	***3.5%***	***4.0%***
WACC – 3.0%	0.0142	0.0150	0.0159	0.0169	0.0182
WACC – 2.0%	0.0131	0.0138	0.0146	0.0156	0.0167
WACC – 1.0%	0.0120	0.0127	0.0135	0.0144	0.0154
WACC + 0.0%	0.0110	0.0117	**0.0124**	0.0132	0.0142
WACC + 1.0%	0.0101	0.0107	0.0114	0.0122	0.0131
WACC +2.0%	0.0093	0.0099	0.0105	0.0112	0.0121
WACC + 3.0%	0.0085	0.0090	0.0096	0.0103	0.0111

Source: Concorde Capital calculations

Financial statements are reported according to IFRS

Income Statement Summary, USD mln

	2003	2004	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E
Net Revenues	**177**	**241**	**319**	**390**	**560**	**729**	**809**	**846**	**884**	**919**	**956**	**974**
Change y-o-y	-	*37%*	*32%*	*22%*	*44%*	*30%*	*11%*	*4%*	*5%*	*4%*	*4%*	*2%*
Cost Of Sales	(167)	(227)	(295)	(351)	(504)	(656)	(730)	(768)	(807)	(843)	(877)	(894)
Gross Profit	10	14	24	39	56	73	80	78	77	76	79	81
Other Operating Income/Costs, net	(1)	0	-	-	-	-	-	-	-	-	-	-
SG&A	(4)	(6)	(6)	(7)	(10)	(13)	(15)	(17)	(22)	(26)	(30)	(31)
EBITDA	**5**	**8**	**18**	**32**	**46**	**60**	**65**	**61**	**55**	**51**	**50**	**50**
EBITDA margin, %	3.1%	3.5%	5.7%	8.1%	8.1%	8.2%	8.0%	7.2%	6.2%	5.5%	5.2%	5.1%
Depreciation	(2)	(3)	(4)	(5)	(7)	(8)	(9)	(9)	(9)	(8)	(8)	(8)
EBIT	**4**	**6**	**15**	**27**	**39**	**52**	**56**	**52**	**46**	**42**	**41**	**41**
EBIT margin, %	2.1%	2.4%	4.6%	6.8%	6.9%	7.1%	6.9%	6.2%	5.2%	4.6%	4.3%	4.3%
Interest Expense	(1)	(3)	(5)	(6)	(8)	(8)	(7)	(6)	(4)	(3)	(3)	(2)
Financial income	0	1	-	-	-	-	-	-	-	-	-	-
Other income/(expense)	-	-	-	-	-	-	-	-	-	-	-	-
PBT	**2**	**4**	**10**	**20**	**31**	**43**	**49**	**47**	**42**	**39**	**39**	**39**
Tax	(0)	(1)	(3)	(5)	(8)	(11)	(12)	(12)	(11)	(10)	(10)	(10)
Effective tax rate	*12%*	*29%*	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*
Net Income	**2.1**	**2.7**	**8**	**15**	**23**	**33**	**36**	**35**	**32**	**29**	**29**	**29**
Net Margin, %	*1.2%*	*1.1%*	*2.4%*	*3.9%*	*4.1%*	*4.5%*	*4.5%*	*4.1%*	*3.6%*	*3.2%*	*3.0%*	*3.0%*
Dividend Declared	**-**	**-**	**-**	**-**	**-**	**-**	**11**	**14**	**17**	**19**	**22**	**22**

Balance Sheet Summary, USD mln

	2003	2004	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E
Current Assets	**20**	**34**	**47**	**58**	**87**	**117**	**134**	**141**	**150**	**156**	**163**	**166**
Cash & Equivalents	2	3	3	4	6	7	12	14	18	18	19	19
Trade Receivables	11	17	24	31	48	66	73	76	80	83	86	88
Inventories	3	6	8	10	14	18	20	21	22	23	24	24
Other current assets	4	9	11	14	20	26	28	30	31	32	33	34
Fixed Assets	**43**	**55**	**83**	**112**	**139**	**162**	**162**	**162**	**163**	**165**	**167**	**167**
PP&E, net	34	44	68	97	122	144	146	146	146	146	146	146
Other Fixed Assets	10	11	15	16	17	18	16	16	17	19	21	21
Total Assets	**63**	**89**	**130**	**171**	**225**	**278**	**296**	**304**	**313**	**321**	**330**	**333**
Shareholder Equity	**32**	**37**	**54**	**69**	**92**	**125**	**150**	**171**	**186**	**196**	**203**	**210**
Share Capital	26	28	37	37	37	37	37	37	37	37	37	37
Reserves and Other	6	9	17	32	55	88	113	134	149	159	166	173
Current Liabilities	**15**	**26**	**37**	**44**	**66**	**86**	**95**	**95**	**100**	**106**	**103**	**105**
ST Interest Bearing Debt	2	4	5	6	11	15	16	13	13	16	10	10
Trade Payables	12	21	29	35	50	66	73	76	80	83	86	88
Accrued Wages	-	-	-	-	-	-	-	-	-	-	-	-
Accrued Taxes	0	-	0	0	0	0	0	0	0	0	0	0
Other Current Liabilities	1	1	2	3	4	6	6	6	7	7	7	7
LT Liabilities	**16**	**25**	**39**	**58**	**67**	**67**	**50**	**37**	**28**	**20**	**23**	**17**
LT Interest Bearing Debt	15	24	37	54	61	60	42	28	19	10	14	8
Other LT	1	2	2	4	6	7	8	8	9	9	10	10
Total Liabilities & Equity	**63**	**89**	**130**	**171**	**225**	**278**	**296**	**304**	**313**	**321**	**330**	**333**

Financial statements are reported according to IFRS

Cash Flow Statement Summary, USD mln

	2003	2004	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E
Net Income	2	3	8	15	23	33	36	35	32	29	29	29
Depreciation	2	3	4	5	7	8	9	9	9	8	8	8
Non-operating and non-cash items	(2)	(5)	(1)	1	0	0	0	0	0	0	0	0
Changes in working Capital	1	0	(2)	(4)	(10)	(12)	(4)	(2)	(2)	(2)	(2)	(1)
Operating Cash Flow	**3**	**0**	**8**	**17**	**21**	**30**	**41**	**42**	**38**	**36**	**35**	**37**
Capital Expenditures, net	(20)	(11)	(27)	(34)	(32)	(30)	(9)	(9)	(9)	(8)	(8)	(8)
Other Investments, net	(5)	(1)	0	-	-	-	-	-	-	(2)	(2)	-
Investing Cash Flow	**(25)**	**(12)**	**(27)**	**(34)**	**(32)**	**(30)**	**(9)**	**(9)**	**(9)**	**(10)**	**(10)**	**(8)**
Net Borrowings/(repayments)	11	10	13	18	13	2	(17)	(17)	(9)	(6)	(3)	(6)
Dividends Paid	-	-	-	-	-	-	(11)	(14)	(17)	(19)	(22)	(22)
Other	11	3	7	-	-	-	-	-	-	-	-	-
Financing Cash Flow	**23**	**12**	**19**	**18**	**13**	**2**	**(28)**	**(31)**	**(26)**	**(25)**	**(24)**	**(28)**
Beginning Cash Balance	1	1	3	3	4	6	7	12	14	18	18	19
Ending Cash Balance	2	3	3	4	6	7	12	14	18	18	19	19
Net Cash Inflows/Outflows	**1**	**1**	**1**	**1**	**2**	**2**	**5**	**2**	**3**	**1**	**1**	**0**

Ratio Analysis and Per Share Data

	2003	2004	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E
Liquidity Ratios												
Current Ratio	1.30	1.30	1.29	1.33	1.32	1.36	1.40	1.48	1.51	1.48	1.58	1.58
Receivables Collection DOH (est.)		26	24	26	26	28	31	32	32	32	32	33
Inventories Processing DOH (est.)		9	8	9	8	9	10	10	10	10	10	10
Payment Period (est.)		34	31	33	31	32	35	35	35	35	35	35
Cash Conversion Cycle		0	1	2	3	5	6	6	7	7	7	7
Operating Efficiency Ratios												
Total Asset Turnover	2.80	2.72	2.92	2.59	2.83	2.90	2.82	2.82	2.87	2.90	2.94	2.94
Fixed Asset Turnover	4.10	4.40	4.64	4.00	4.46	4.86	5.00	5.21	5.44	5.61	5.76	5.83
Operating Profitability Ratios												
Operating Profit Margin	2%	2%	5%	7%	7%	7%	7%	6%	5%	5%	4%	4%
Net Margin	1%	1%	2%	4%	4%	4%	4%	4%	4%	3%	3%	3%
ROE	7%	7%	17%	24%	29%	30%	26%	22%	18%	15%	15%	14%
Financial Risk Ratios												
Debt-to-Equity Ratio	0.55	0.74	0.77	0.86	0.79	0.60	0.39	0.24	0.17	0.13	0.12	0.08
Total Debt-to-Assets Ratio	0.50	0.58	0.58	0.59	0.59	0.55	0.49	0.44	0.41	0.39	0.38	0.37
Interest Coverage	2.5	2.1	3.2	4.1	5.0	6.3	7.6	9.4	11.4	12.6	14.4	17.6
Du Pont Analysis												
Net Margin (NM)	1.2%	1.1%	2.4%	3.9%	4.1%	4.5%	4.5%	4.1%	3.6%	3.2%	3.0%	3.0%
Total Asset Turnover (TAT)	2.80	2.72	2.92	2.59	2.83	2.90	2.82	2.82	2.87	2.90	2.94	2.94
Fin Leverage Multiplier (FLM)	2.00	2.38	2.40	2.44	2.45	2.32	2.08	1.86	1.73	1.66	1.63	1.60
ROE = NM x TAT x FLM	6.6%	7.1%	16.7%	24.5%	28.7%	30.0%	26.4%	21.7%	17.7%	15.3%	14.5%	14.2%
Per Share Data, USD												
EPS	0.000	0.000	0.001	0.001	0.001	0.002	0.002	0.002	0.002	0.002	0.002	0.002
DPS	0.000	0.000	0.000	0.000	0.000	0.000	0.001	0.001	0.001	0.001	0.001	0.001
BPS	0.003	0.003	0.004	0.005	0.006	0.008	0.009	0.011	0.012	0.012	0.013	0.013

Exchange Rates. UAH/USD

	2003	2004	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E
Average exchange rate	5.33	5.32	5.10	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
Year-end exchange rate	5.33	5.31	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00

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