Ukraine / Metals

Kryvorizhstal

How Much Is Synergy Worth?

BUY

07 Nov 2005 — **USD 0.76**

12m Target — **USD 0.93**

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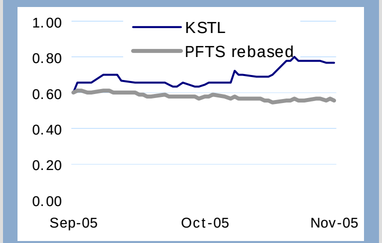
KSTL Mid-Market, USD



Market Information	
PFTS	**KSTL**
Bloomberg	**KSTL UZ**
No of Shares, mln	**3,859.5**
Market price, USD	**0.76**
MCap, USD mln	**2,933.2**
Free Float, %	**3.5%**

Stock Ownership	
Mittal Steel	93.0%
The state	1.7%
Other	5.3%

Ratios 2004	
EBITDA Margin	**29%**
Net Margin	**20%**
Net Debt/Equity	**-0.21**

Mittal Steel's acquisition of a 93.02% stake in Kryvorizhstal for USD 4.79 bln has opened new opportunities for the company's development. We attempted to estimate the effect of the acquisition-related synergies and production expansion, and our research led us to revise our target upward to USD 0.93 per share. The upside implied by the new target is 22.4%. BUY.

Iron Ore Is King. Our calculations show that Mittal Steel would benefit the most from its investment in Kryvorizhstal if they capitalized on the company's iron ore reserves. Specifically, Mittal Steel would be able to create value for its whole steel conglomerate by procuring iron ore from Kryvorizhstal's pits for its steel making assets in Eastern Europe. Kryvorizhstal would benefit from larger sales of iron ore. We adjusted our target upward in anticipation of this additional value.

Ample Room For Future Synergies. We also identified a number of other possibilities for Kryvorizhstal to increase its value. However, we did not analyze them in detail due to the lack of guidance from Mittal Steel. In our view, Mittal's plan to boost steel output to 10 mln mt can only be value adding if other measures to improve Kryvorizhstal's operational efficiency are taken up simultaneously. According to our rough estimates about half of the amount Mittal Steel paid in excess of the post-tender market price will be realized by improving Kryvorizhstal's value in the future.

KEY FINANCIAL DATA*, USD mln

	Net Revenue	EBITDA	Net Income	DPS, USD
2004	1,905.6	553.7	379.7	0.034
2005E	1,838.4	459.7	283.4	0.029
2006E	1,952.9	484.0	288.6	0.030
Spot Exch Rate		5.05		

**Projections do not factor in synergy effects*

KEY RATIOS

	EV/S	P/E	EV/EBITDA	Div Yield
2004	1.51	7.72	4.92	4.5%
2005E	1.58	10.35	5.94	3.9%
2006E	1.45	10.16	5.73	3.9%

Why So Much?

The whopping USD 4.79 bln Mittal Steel paid on October 24, 2005 for the re-privatized 93.02% stake in Kryvorizhstal, has led us to revisit our valuation of the stock. The key aspect of the analysis we want to emphasize here is that the company's value for a strategic investor should be higher than that for minority shareholders. This is due to Mittal Steel's ability to create additional value by integrating the Ukrainian asset into the production chain of its global steel group.

Sum-Of-The-Parts Approach

A critical issue in valuing Kryvorizhstal is to properly take into account its self-sufficiency in raw materials and vertical integration. Apart from the steel mill itself, the company's other major assets include Novokryvorizky GOK, an open cast iron ore complex, the Artem iron ore mine and the Kryvyi Rig coking plant. We attempted to estimate the value of Kryvorizhstal's entire complex by splitting it into three distinct parts and determining their worth on a stand-alone basis.

What Is Being Valued

The Steel Segment

We derived the rough value of Kryvorizhstal's steel business implied by the average MCap/Output 2004 multiple for its Ukrainian peer group as of October 21, 2005, just prior to the privatization tender. By using top-line multiples, we were able to factor out the higher margins provided by Kryvorizhstal's vertical integration, and thus, appraised only its steel segment. The number we received is ~ USD 1,766 mln.

Company	Share Price Oct 21, USD	Mcap, USD mln	MCap/ Output 2004
KSTL	**0.68**	**2,624**	**369.6**
MMKI	0.56	1,877	272.1
AZST	0.49	1,555	271.2
ZPST	1.07	903	202.7
Average			248.7
Median			271.2
Premium/ (Discount)			49%
Implied MCap, USD			1765.7

Source: Company data

In our view, the MCap/ Output multiple is more reliable than P/S because sales from Ukrainian steel mills are undercut by various degrees of transfer pricing. It appears most market players are aware of this situation. We believe transfer pricing should be regarded as a temporary phenomenon, and its downside impact on future cash flows will be lower than the negative effect on historical cash flows, which is already accounted for in the market price.

The Iron Ore Segment

Novokryvorizky GOK, Kryvorzhstal's key iron ore mining division, is not traded separately and its financials are not disclosed to the public. We attempted to estimate the unit's value by using the average of output- and reserve-based market multiples from Ukraine's most liquid ore mining industry stock, Poltava GOK. The latter's MCap as of October 21, 2005, amounted to USD 693.6 mln.

	Est. Proven reserves, mln mt	Ore Output 2004, mln mt	MCap/Res., USD/mt	MCap/Output, USD/mt
Poltava GOK	4,500	19.7	455.3	598.6
Novokryvorizky GOK	2,954	17.0	-	-

Source: Company data; Concorde Capital estimates

Our analysis shows that based on market multiples Novokryvorizky GOK should be worth at least USD 527 mln.

The Coke Segment

A price signal from Markokhim helped us to value Kryvorizhstal's coke plants. Markokhim is in the process of merging with Azovstal, which consumes all of the company's coke output. The agreement made this previously illiquid stock one of the best performers in 2005, and we believe, led the market to correctly evaluate the asset. Kryvyi Rig Coke is already integrated with Kryvorizhstal and is comparable in size with Markhokhim, whose MCap totaled USD 242 mln as of October 21, 2005. Hence, the market-implied value for Kryvyi Rig Coke is USD 280 mln.

	Coke Output 2004, mln mt	Price, USD	MCap, USD mln	MCap/Output, USD/mt
Markokhim	2,382.8	1.5	241.8	101.5
Kryvyi Rig Coke	2,759.6	-	-	-

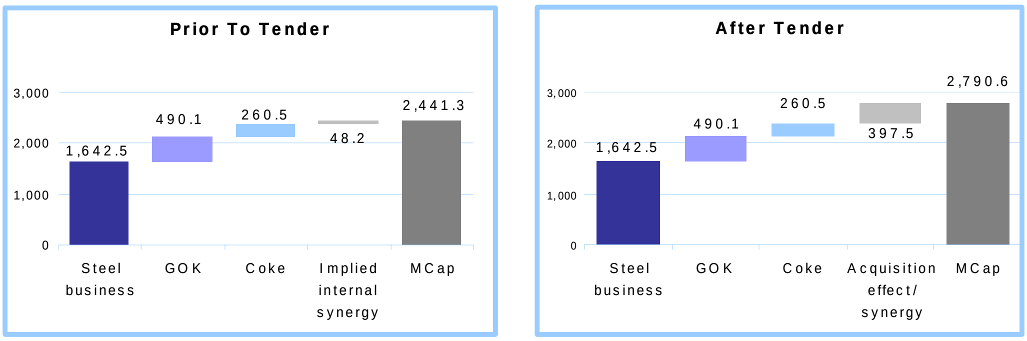
Source: Company data; Concorde Capital estimates

Where Synergy Comes Into Play

The Minority View

After examining the key parts of Kryvorizhstal's business we concluded that the company is worth at least USD 1,766 mln + USD 527 mln + 280 mln = USD 2,573 mln, or ~USD 2,393 mln for the 93.02% stake. On October 21, 2005, the stake's market value was USD 2,441 mln, or ~USD 48 mln higher than our estimate, and after the tender it was almost USD 400 mln higher. In our view, this means that before the Kryvorizhstal sale, most market participants did not ascribe much value to Kryvorizhstal's internal synergy, estimating its worth at about USD 52 mln (USD 48 mln per the 93.02% stake), or alternatively, the positive impact of synergy was largely offset by the negative perception of transfer pricing and re-privatization uncertainty and therefore, netted just ~USD 52 mln.

Value Of The 93% Stake In Kryvorizhstal - Minority Investor Perspective



Source: Concorde Capital estimates

After the acquisition the stock started to trade at a ~15% higher price. We believe this is due to expectations that after the acquisition, Mittal will streamline Kryvorizhstal's operations and let its internal synergies work in full. Furthermore it is anticipated that the acquisition will create additional synergies within the Mittal group per se, and the incremental value thereby created will, at least in part, be transferred to Kryvorizhstal. This value increment is captured in our analysis as acquisition/synergy effect and is estimated at ~USD 427 mln (~USD 398 mln as per the 93.02% stake).

The Controlling Shareholder Perspective

A straightforward estimate of the amount Mittal paid above the sum-of-the-parts value for Kryvorizhstal is ~USD 2,400 mln. We are tentatively calling this the implied synergy for the group, because in addition to the real synergy effect, it may contain the amount Mittal overpaid for Kryvorizhstal if any.

However, a more careful look reveals the hidden value of Mittal's acquisition. If the company places Kryvorizhstal in the production chain of its entire group, it will be able to decrease input costs for the plant and also secure markets for Kryvorizhstal's products. More importantly, Kryvorizhstal would be able to sell more than just steel. It would also be able to expand its coke and iron ore output beyond the level needed for internal consumption and supply Mittal's other plants or sell to third parties using Mittal's dealerships. This means more strategic value for Mittal.

For simplicity, we kept the market values of Kryvorizhstal's business segments per unit of their respective outputs constant in our analysis of expansion opportunities for the company under Mittal's ownership. Therefore we caution, that output-based market multiples may be significantly different from those used here when Kryvorizhstal's production increases.

The Steel Segment: Expansion In Question

According to media reports, Mittal Steel will increase steel production at Kryvorizhstal to 10 mln mt. The Ukrainian company melted 7.1 mln mt of crude steel last year, 95% of its capacity. To increase Kryvorizhstal's capacity by a third, Mittal Steel will need to install either electric arc furnaces (EAF) or additional oxygen converters. The latter option would likely require the modernization of Kryvorizhstal's blast furnaces (BF) to ensure a sufficient supply of pig iron, as currently the plant can only produce 7.8 mln mt of it.

We believe that installation of EAFs is not a feasible option for Kryvorizhstal, as this technology requires scrap or directly reduced iron/ hot bracketed iron (DRI/ HBI) as a feedstock. Scrap metal is expensive and scarce in Ukraine, while production of DRI/ HBI is gas intensive, and launching of their production under the specter of significant gas price increases is unlikely.

On the other hand, mounting additional oxygen converters and concasters together with BF upgrades may cost as much as USD 1 bln. Based on current market multiples, additional value from a ~3 mln mt increase in steel output does not exceed USD 0.75 bln. We do not believe Mittal would invest in projects with negative NPV. Thus, although Mittal Steel may know how to create value by investing in the expansion of Kryvorizhstal's steel capacities, we do not possess enough information yet to make a competent judgment and have not considered this possibility separately in our analysis.

The Coke Segment: Minor Impact On Value

Mittal Steel, in theory, will be able to realize synergies in the coke segment by importing coking coal from Kazakhstan, where its steel making subsidiary, Mittal Steel Temirtau, owns coal mines.

However, given constantly rising prices for coking coal and high transportation costs, we think it will not be economical to increase coke output at Kryvorizhstal beyond the amount needed for its own pig iron production. In our view, synergies applicable to Kryvorizhstal's coke segment, will not be significant if any, and, therefore, we do not focus on them.

Iron Ore Goldmine Will Build Value

We believe that Novokryvorizky GOK's vast iron ore reserves will be the most valuable for Mittal Steel. The latter owns a number of steel producers in Eastern Europe, the largest being located in the Czech Republic, Poland and Romania. Their close proximity to Ukraine and total dependency on imported iron ore will make for excellent synergies with Kryvorizhstal which will be able to increase its iron ore output and ship ore to these Mittal companies.

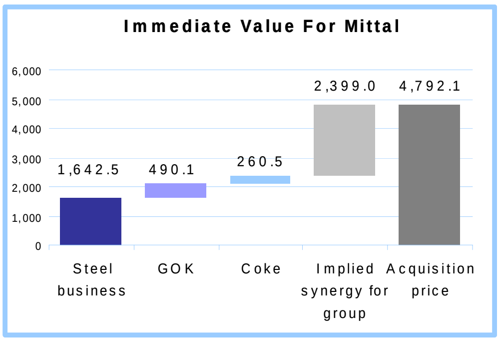
2003, ths mt	Production	Export	Import	Apparent Consumption
Czech Republic	0	0	8,221	8,221
Poland	0	0	8,744	8,744
Romania	217	0	6,978	7,195

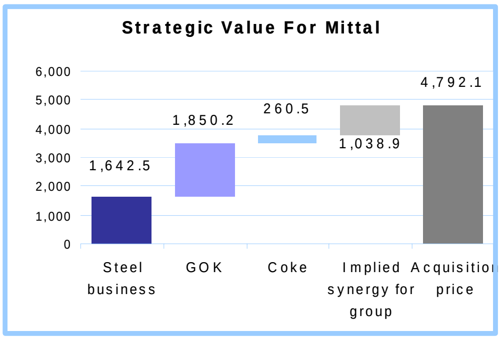
Source: IISI

Mittal's steel plants in the Czech Republic, Poland and Romania are all equipped with sintering machines so Kryvorizhstal could supply concentrate there without the additional processing required to make it into pellets. We think that Novokryvorizky GOK would be able to increase iron ore extraction in its open pits and further process it to concentrate without having to make large investments.

To fully meet the needs of Mittal's three eastern European plants, Kryvorizhstal would have to increase its ore extraction nearly four-fold. Using the average of output and reserve market multiples for Poltava GOK, we estimate that in this case a proportionate 93% share in Novokryvorizky GOK would be worth ~USD 1,850 mln. This value could either be accumulated at Kryvorizhstal if it were to sell the iron ore at market prices, or, alternatively, be transferred to Mittal's eastern European holdings in the form of a massive reduction in iron ore costs. Either way, Mittal Steel would capture it.

Kryvorizhstal's Value Breakdown, Mittal Steel Perspective





Source: Concorde Capital estimates

Target Price Upgraded

According to our analysis, the difference between the implied synergy for Mittal Steel and the acquisition/ synergy effect perceived by the market is USD 641 mln=USD 1,039 mln-USD 398 mln. This amount includes potential value from synergies not recognized by us and the possibility that Mittal over-paid.

We have found several ways Mittal Steel could realize the synergies which we did not account for in the analysis above:

- laying off the company's excess work force which would make investment in the steel segment justified
- crackdown on embezzlement
- streamlining the plant's operations
- mining and exporting more iron ore than we projected
- developing coke production.

We believe that despite its investment commitments and the requirement to maintain Kryvorizhstal's headcount at the prior-to-privatization level, Mittal Steel will only invest in projects with positive NPV and be able to optimize its labor cost. This is due to both Mittal's track record of successful lobbying efforts in other countries and the fact that obligations assumed upon the privatization were too generic and allow for numerous loopholes.

Thus, in establishing a new target price for Kryvorizhstal, we have taken a balanced position in regards to Mittal Steel's future plans for the company and made two assumptions:

- at least half of the value stemming from the increase of iron ore output projected above will be retained by Kryvorizhstal
- at least half of the 'Implied synergy for group' residual will be realized as added value at Kryvorizhstal.

Then the fair value of the company will be calculated as:

USD 1,643 mln+USD 1,850 mln/2+USD 261 mln+USD 1,039 mln/2=USD 3,348mln

per 93.02% stake, or USD 0.93 per share.
The implied upside to the current market price of USD 0.76 per share is 22.4%. **BUY**

All financial statements according to Ukrainian Accounting Standards

Income Statement Summary, USD mln **Projections for Kryvorizhstal on a stand-alone basis**

	2003	2004	2005E	2006E
Net Revenues	**1 413**	**1 906**	**1 838**	**1 953**
Change y-o-y	*N/M*	*35%*	*-4%*	*6%*
Cost Of Sales	(991)	(1 261)	(1 287)	(1 367)
Gross Profit	421	645	552	586
Other Operating Income/Costs, net	(11)	(15)	(14)	(14)
SG&A	(68)	(77)	(78)	(88)
EBITDA	**342.1**	**553.7**	**459.7**	**484.0**
EBITDA margin, %	24.2%	29.1%	25.0%	24.8%
Depreciation	(32)	(47)	(55)	(70)
EBIT	**310**	**507**	**405**	**414**
EBIT margin, %	21.9%	26.6%	22.0%	21.2%
Interest Expense	(2)	(0.1)	(0)	(2)
Financial income/(expense)				
Other income/(expense)	(12)	(6)	0	0
PBT	**296**	**501**	**405**	**412**
Tax	(132)	(121)	(121)	(124)
Effective tax rate	*45%*	*24%*	*30%*	*30%*
Extraordinary Income/(loss)	0	0	0	0
Net Income	**163.3**	**380**	**283**	**289**
Net Margin, %	*12%*	*19.9%*	*15.4%*	*14.8%*
Dividend Declared	**-**	**132.8**	**113.4**	**115.4**

Balance Sheet Summary, USD mln

	2003	2004	2005E	2006E
Current Assets	**336**	**593**	**656**	**703**
Cash & Equivalents	92	208	206	195
Trade Receivables	1	25	94	137
Inventories	132	228	225	254
Other current assets	112	133	131	117
Fixed Assets	**626**	**637**	**823**	**1 014**
PP&E, net	505	497	631	895
Other Fixed Assets	120	141	192	119
Total Assets	**962**	**1 231**	**1 478**	**1 717**
Shareholder Equity	**842**	**976**	**1 197**	**1 371**
Share Capital	673	728	728	728
Reserves and Other	17	28	20	20
Retained Earnings	152	219	405	579
Current Liabilities	**120**	**254**	**279**	**318**
ST Interest Bearing Debt	9	0	2	6
Trade Payables	40	29	38	59
Accrued Wages	7	11	11	11
Accrued Taxes	5	8	8	9
Other Current Liabilities	58	338	220	234
LT Liabilities	**0**	**2**	**2**	**28**
LT Interest Bearing Debt			2	28
Other LT	0	2		
Total Liabilities & Equity	**962**	**1 231**	**1 478**	**1 717**

Cash Flow Statement Summary, USD mln

	2003	2004	2005E	2006E
Net Income	163	380	283	289
Depreciation	32	47	55	70
Non-operating and non-cash items	68	71	124	(2)
Changes in working capital	(31)	(283)	(170)	(22)
Operating Cash Flow	233	214	292	334
Capital Expenditures, net	(39)	(35)	(196)	(260)
Other Investments, net	(47)	(55)	0	0
Investing Cash Flow	(86)	(90)	(196)	(260)
Net Borrowings/(repayments)	(25)	(9)	4	30
Dividends Paid			(113)	(115)
Other	(32)	3	0	0
Financing Cash Flow	(57)	(7)	(109)	(85)
Beginning Cash Balance	N/A	93	216	206
Ending Cash Balance	92	208	202	195
Net Cash Inflows/Outflows	91	117	(14)	(11)

UAH/USD Exchange Rates

	2003	2004	2005E	2006E
Average	5.33	5.30	5.10	5.00
Year-end	5.33	5.30	5.00	5.00

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