



CONCORDE CAPITAL

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Monetary Aggregates, eop

| | 2004 | 1H05 |
|----------------------|-------|-------|
| Cash, UAH bln | 42.3 | 51.3 |
| Money Supply UAH bln | 125.8 | 171.0 |
| NBU rate, % | 9.0 | 9.0 |

Macro Indicators

| | 2004 | 1H05 | 2005E |
|------------------------|------|------|-------|
| GDP gr, % | 12.1 | 4.0 | 5.0 |
| Industry gr, % | 12.5 | 5.0 | 6.0 |
| Trade balance, USD bln | 3.4 | 1.9 | 3.2 |
| CPI, % | 12.3 | 6.4 | 13 |
| PPI, % | 24.1 | 9.2 | 16 |

The windfall from the Kryvorizhstal sale is unprecedented in Ukraine's privatization history: USD 4.8 bln (22% of the revenue from the 2005 budget). Nearly 44% of this amount has already been earmarked for fixed expenses. How the remaining 56% is spent may determine the country's macro stability. We believe that a combination of consumption and investment scenarios may give a large boost to consumer-related industries and a shot in the arm to non-consumer industries.

SOLD: USD 4.8 bln. Kryvorizhstal (**KSTL: BUY**) was sold to Mittal Steel for USD 4.8 bln, a ~100% premium to the market price. The government expected more than its initial price of USD 2 bln, however, the results exceeded even the most optimistic expectations. Now the government has funds equivalent to 6% of the country's estimated GDP for 2005 at its disposal.

Slicing The Pie: A Difficult Task. After the sale, the allocation of the KSTL money immediately became a sticking point for the government, Rada and business circles. If this substantial sum of money is spent frivolously it could lead to imbalances in the economy.

A Fork In The Road. There are two ways to go:

The Consumption option, popular with politicians on the eve of elections, will mean the funds are channeled to consumers through a variety of social programs. This scenario, if not supported by investments, would cause inflation to skyrocket, leading to serious distortions in the economy.

The Investment option will provide the government with an opportunity to start restoring the consumption/investment balance that was destroyed over the course of the year by efforts to pump extra funds into the budget in support of social programs.

President Yushchenko has established a political council, made up of Cabinet members, the presidential secretariat and leaders of parliamentary factions to decide how to spend the USD 4.8 bln the government received from the sale of Kryvorizhstal. **WATCH**

A Threat To The Dollar?

One of the first questions after the sale of Kryvorizhstal was “what’s going to happen to the dollar?” The sum, USD 4.8 bln exceeds monthly trading volumes on the interbank FX market and represents more than one half of the FX deposits in Ukrainian banks. However, the National Bank of Ukraine (NBU) announced that the exchange rate would remain stable. The NBU will buy out all USD 4.8 bln from its reserves without allowing this amount to get to the interbank FX market. The NBU believes this will allow them to avoid pressure on the UAH/USD exchange rate.

The Finance Ministry is pushing for its own plan to avoid the deterioration of the UAH/USD exchange rate. The ministry wants to keep part of the amount in US Dollars without converting it into hryvnias. This amount will then be used to make early debt repayments. Ukraine has several USD-denominated debts from the late 1990’s at much higher interest rates than are currently available.

Overall, we believe the NBU will manage to **keep the UAH/USD exchange rate stable** and do not foresee any sharp fluctuations from the current 5.05 level.

Divvying Up The Spoils

More challenging is figuring out how the USD 4.8 bln KSTL pie is going to be divided. However, there are some funds already earmarked for immediate use:

USD 860 mln will be returned to the previous owners of Kryvorizhstal, the Industrial Metallurgical Union (IMU). The group is associated with the Ukrainian tycoons Viktor Pinchuk and Rinat Akhmetov. This amount was the IMU’s winning bid at the first KSTL privatization auction in August, 2004.

USD 1.25 bln will be directed to the 2005 privatization program, for which USD 1.4 bln is planned in the budget. Before the KSTL sale, privatization receipts were dragging well behind the plan: the USD 140 mln in privatization revenues from 9M05 were only 10% of the annual plan. The KSTL money has bailed out the government’s plan to cover this year’s USD 1.4 bln budget deficit with privatization revenues.

USD 2.7 bln is what remains after the above mentioned payments. The government’s use of this money may be directed two ways: consumption or investment. We believe it is unlikely that the entire amount will go one direction, a combination of both scenarios is more probable. Below we scrutinize these scenarios separately and outline the consequences of both.

The Consumption Option

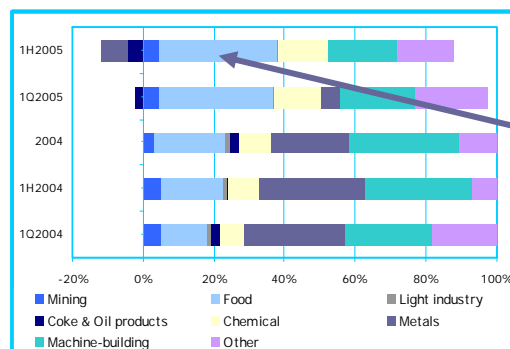
On the eve of Parliamentary elections, in March, 2006, it will be difficult for politicians to resist the popular support spending on social programs would provide them.

Consequences For The Economy:

- Personal incomes will experience accelerated growth. All social disbursements benefit low-income groups which have a high propensity to spend. So the funds distributed through social programs will quickly find their way to the consumer market, boosting retail trade and consumer-related (CR) industries.
- Imports could absorb an estimated 1/4 of the USD 2.7 bln (USD 670 mln), judging by the structure of the consumer basket. Our current forecast for the foreign trade balance this year is USD 3.2 bln. However, given current foreign trade dynamics (imports are substantially outpacing exports), the further stimulation of imports could cause the trade balance to erode to ~USD2 bln by the end of 2005, from USD 6.9 bln in 2004.
- CR industries could ingest the rest (~USD 2 bln). The consumer-related (CR) sector is sizeable enough to quickly and effectively absorb significant cash inflows. We estimate the entire share of the CR-segment in all industries to be ~20%. Food processing alone accounts for 44% of total industrial growth (based on results from 1H05). After accounting for VAT and intermediary mark-ups, inflows to the CR segment could potentially reach ~ USD 1 bln.

Following a hypothetical assumption that all of the KSTL pie goes consumption, according to our estimates, the additional increase in growth rates for CR industries due to the effect of the new capital, could reach 7% -- quite significant when compared to 2004's annual growth rates: food industry 12.4%, light industry 13.6% and total industrial output at 12.5%.

Contribution To Industry Growth By Sector



The food sector, a major component of the consumer segment, has been an important contributor to industry growth this year.

Source: State Statistic Committee, Concorde Capital

- The service segment, in particular, mobile telecommunications and banking, could also vie for a portion of the KSTL money through government social programs.
 - **The USD 1.4 bln mobile telecom** sector alone is growing at unprecedented rates (subscriber base growth exceeded 100% in 2004), it would be able to swallow up a significant share of the Kryvorizhstal pie.
 - **Ukrainian banks** are another sector that could potentially benefit from accelerated growth in personal incomes. Many banks have intensified their efforts to raise funds from individuals and the retail segment has become the focus of most Ukrainian banks. The population's burgeoning confidence in the banking system resulted in the growth of individual deposits from 28% in 2004, to 48% in 9M05. Having this additional

capital in the banking system would allow the NBU greater control over the money supply and thus avoid extra pressure on prices. However the low-income segment of the population, which will benefit the most from social payments, has more propensity to consume than save and we doubt that a significant portion of the KSTL money would come to the retail banking sector.

An Inflation Hurricane On The Horizon? Any major expenditures on social programs, above those set in the budget, would entail the same risk as in the run up to the Presidential elections in 2004. In 4Q04 the government made additional social disbursements of USD 850 mln. As a result, the consumer inflation rate surged to 12.3% yoy with 6.3% in 4Q04 alone. Now consumers could receive up to three times more than in 2004, and given the current economic slowdown this could lead to catastrophic inflation rates.

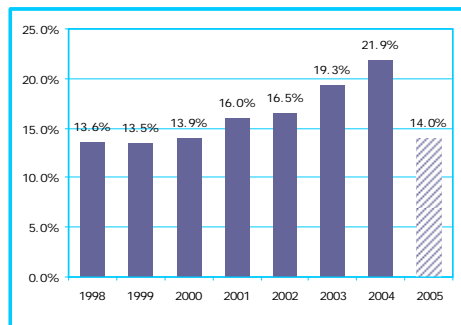
The social scenario would lead to high inflation, which if not supported by investments would lead to serious economic distortions. In spite of the temptation to boost political support by spending on social programs, we doubt the government will take such a big risk. However, some social initiatives will be part of next year's budget.

The Investment Option

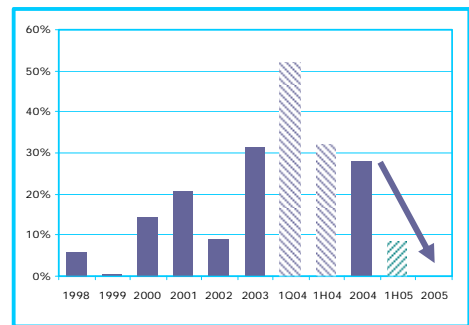
It is likely the upcoming parliamentary elections will have an noticeable influence on the decision making process concerning the KSTL money. This means socially important sectors including housing, communal construction and agriculture are likely to benefit from additional funding.

Stimulating investments became a top-priority issue for the government after an almost four-fold drop in the fixed capital investment growth rate in 1H05.

Fixed Investments/GDP



Fixed Investments Change, yoy



Source: State Statistic Committee, Concorde Capital estimates

Currently the government has a large variety of state-supported investment projects where the funds could be channeled:

Coal mining: The draft strategy for fuel-energy sector (FES) development calls for USD 6 bln during a 30-year period for a major overhaul of the coal mining sector.

Nuclear power: The FES strategy also envisages the opening of up to 17 (the exact number is still being discussed) additional energy generation blocks in 2006-30. Given that the cost of one generation block is ~USD 1 bln the funds needed could reach USD 17 bln.

Railways: An infrastructure development project costing USD 900 mln is also currently in the pipeline.

The aviation industry: The ANTONOV consortium (created earlier this year to build and market the AN-148 regional carrier) needs financial support to compete with its Russian rivals.

What Does Yushchenko Say?

The President has explicitly stated his position. He strongly opposes any extra social payments not already in the budget. On November 1, 2005 the President outlined how the government wants to direct USD 4.8 bln from the Kryvorizhstal sale:

1. The government will return USD 860 mln to KSTL's previous owners
2. USD 1.25 bln will be used to finance this year's budget deficit
3. USD 1.6 -1.8 bln will be used to cover next year's budget deficit
4. The remained ~USD 1 bln is expected to be invested in energy-saving projects, housing construction, manufacturing and privileged lending programs for the agricultural sector

Despite being pro-investment, the program contains hidden threats. Until specific investment projects are announced the last part of the program, could allow for the funds to be misused. The opposition is openly talking about making direct social disbursements, and we would not exclude that some forces, close to the President, would also be tempted to find a way to indirectly funnel the unexpected cash into a pre-election campaign under the cover of a vague "energy-saving" program or other options highlighted by the President.

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