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# Local equity strategy

## Opportunities for the 2014 AGM season

The 2014 AGM season in Ukraine will be active as usual as it opens the door to multiple opportunities for holders of locally listed stocks. The straightforward play is dividends, while we note that a significant change in the list of potential dividend payers has occurred. Others are related to a specific item that is included in the agendas of some companies' AGMs – the approval of “significant deals”. This item creates two opportunities for minority shareholders: to sell illiquid stocks back to the issuer at a fixed price and to use the speculative opportunity of arbitrage.

**Dividend plays for 2014** are changing from the traditional iron ore, pipe and machinery companies (SGOK, CGOK, PGOK, HRTR, DNVM) to power utilities (GenCos and DisCos): **DOEN, ZAEN, CEEN, KIEN, ZOEN,** and **CHEN**; maybe DNEN, DNON, DOON and ZAON.

**Put option plays**, a new class of opportunities that emerged in 2011 and tested in the 2012 and 2013 seasons, are another opportunity for portfolio investors.

We are reintroducing to investors the notion of the TEPO (temporarily embedded put option) that is granted to a shareholder voting against a “significant deals” item at a company's AGM. By law, a company whose shareholders approved significant deals (any deal that exceeds 25% of a company's total assets) is obliged to buy back the shares of those who voted against, at a price not lower than the market price on the day before the announcement of the shareholder meeting. Those who voted “against” receive the right (not obligation) to offer their shares to the issuer within 30 days after the vote. We identified at least 17 stocks (and up to 22) that might be subject to this option in the 2014 AGM season. It offers two opportunities for investors:

- Getting rid of illiquid or non-prospective stocks by selling them at near-market prices directly to the issuer: 15 stocks;
- Using an arbitrage opportunity in case the share price falls below the implied strike price of the option. Theoretically, the maneuver can be applied to some more-or-less liquid stocks. At the moment, this opportunity is open for HRTR, if you are able to buy this stock by the end of today.

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### Summary of 2014 AGMs

Ticker	AGM date	Proposed action plan
HRTR	08-Apr	Buy today to get 39% TEPO arbitrage
SMEN	08-Apr	Sell to the issuer
DGRM	09-Apr	Sell to the issuer @ UAH 0.25
AVDK	10-Apr	Look for TEPO arbitrage
HOEN	10-Apr	Sell to the issuer
LTPL	10-Apr	Look for TEPO arbitrage
ZACO	11-Apr	Sell to the issuer
KION	11-Apr	Sell to the issuer @ UAH 0.42
DRMZ	11-Apr	Sell to the issuer @ UAH 0.25
HMBZ	12-Apr	Sell to the issuer
AZST	14-Apr	Look for TEPO arbitrage
MZVM	15-Apr	Sell to the issuer @ UAH 0.09
CHEN	16-Apr	Sell to the issuer @ UAH 1.15
AZGM	18-Apr	Sell to the issuer
DKOK	18-Apr	Sell to the issuer @ UAH 0.6
KIEN	22-Apr	Get 24% dividend yield
KVBZ	24-Apr	Get 9% dividend yield
ZAEN	24-Apr	Get 11% dividend yield
YASK	24-Apr	Sell to the issuer @ UAH 0.27
CEEN	25-Apr	Hope to get 7% dividend yield
ZHEN	25-Apr	Sell to the issuer @ UAH 0.7
DOMZ	25-Apr	Sell to the issuer @ UAH 0.015
DOEN	26-Apr	Get 16% dividend yield
ZOEN	29-Apr	Sell to the issuer

## DIVIDEND PLAYS

### New dividend stocks – utilities with a state stake

Ukraine's legislation stipulates that companies with a state stake should pay at least 30% of their income in dividends. For this reason, lots of electricity companies should pay dividends. As soon as most of the power generation companies report record-high profit this year, a lot of them should be generous dividend payers, such as Donbasenergo (**DOEN UK**), Zakhidenergo (**ZAEN UK**) and Kyivenergo (**KIEN UK**). Good dividend yields should also be demonstrated by some illiquid power DisCos, like Zakarpattiaoblenergo (**ZOEN UK**) and Chernivtsioblenergo (**CHEN UK**).

At the same time, we see some risk that GenCo Centrenergo (**CEEN UK**) will try to avoid paying dividends this year as it has a good reason not to pay – it spent much in 2013 and 2014 on the reconstruction of the burnt Uglegorsk Power Plant.

So far, there is no information on AGMs for Dniproenergo (**DNEN UK**), Dniprooblenergo (**DNON UK**), Kharkivoblenergo (**HAON UK**) and Zaporizhiaoblenergo (**ZAON UK**), which also could be generous dividend payers.

Another state-controlled company, Ukrnafta (**UNAF UK**), generates a good bottom line usually but ignores the requirement to pay dividends by simply having avoided scheduling an AGM since 2012. We expect this year will not be an exception, but if so, it will have to pay hefty dividends.

### Traditional dividend-yielding stocks

Most of the traditional dividend payers that used to distribute up to 100% to shareholders – the iron ore companies of Metinvest and power DisCos of VS Energy (including CGOK, SGOK, KION, ZHEN, SMEN) – stopped paying dividends last year, and there is low chance that they will resume their generous dividend policy this season.

Thus, among traditional payers, we see some chance that Kryukiv Railcar (**KVBZ UK**) will continue paying about half of its profit to its shareholders.

### Estimated dividend yields for 2013 season

Name	Ticker	AGM date	Est. div. payout ratio	Est. DPS, UAH	Est. div. yield	Market price, UAH	Probability of dividends
Chernivtsioblenergo	CHEN UK	16-Apr	30%	0.10	7.9%*	1.25*	High
Kyivenergo	KIEN UK	22-Apr	30%	2.78	23.8%*	11.70*	High
Kryukiv Railcar	KVBZ UK	24-Apr	50%	1.48	8.6%	17.20	Medium
Zakhidenergo	ZAEN UK	24-Apr	30%	13.57	10.7%	127.00	High
Centrenergo	CEEN UK	25-Apr	30%	0.40	7.4%	5.45	Medium
Donbasenergo	DOEN UK	26-Apr	30%	6.74	16.5%	40.81	High
Zakarpattiaoblenergo	ZOEN UK	29-Apr	30%	0.20	19.6%*	1.00*	High

\* Yield is based on indicative price – real market price may differ

Source: Company data, Concorde Capital research

## “SIGNIFICANT DEALS” PLAYS

### TEPO possibilities

We are reintroducing the notion of the TEPO (temporarily embedded put option). A TEPO is granted to a shareholder who votes against a “significant deals” item at a company’s shareholder meeting.

#### TEPO summary

##### **How to buy TEPOs:**

- *Make sure the AGM of a company contains the “significant deals” clause. The TEPO opportunity is applied only to the stocks of companies whose AGM contains this item (or share capital increase item).*
- *Sign up for the AGM and vote “against” the significant deals item. Note that the AGM recording day is the fourth business day before the AGM.*

##### **How to use TEPOs**

- *By law, you have a right (not obligation) to offer your shares to the issuer within 30 days after voting “against”. After that, your TEPO expires. That’s why it is temporary.*
- *By law, the issuer has an obligation to buy back the offered shares within 30 days of receiving the offer.*

##### **Strike price of TEPOs**

- *By law, the price at which the issuer has to buy back its shares – from those who voted against significant deals – cannot be lower than (i.e. is close to) the market price on the day prior to the AGM announcement. For reference, the latest available stock exchange price before the AGM announcement can be used.*

##### **What is a “significant deal” and why shareholders vote for them**

- *In our context, a significant deal is a contract worth more than 25% of a company’s total assets as of the last reporting year. By law, such deals should be approved by shareholder meetings.*
- *Significant deals are typical for all System Capital Management (SCM)-related stocks, as the holding company is actively using intercompany deals to optimize cash flows within the holdings. The deals are common for members of holdings that are involved in large borrowings. The practice is also common for the machinery sector, which is focused on a small group of suppliers or customers, and it is inherent for power generation companies that sign large coal supply contracts.*

So far, we identified at least 17 stocks which might be subject to a TEPO opportunity in the 2014 AGM season.

## Opportunity 1: get rid of illiquid stocks or those without prospects

The most straightforward opportunity provided by TEPO is the possibility to sell your shares to the issuer. This is clearly a good exit chance for holders of those stocks that have little prospects on the market, either due to their poor liquidity or worsening fundamentals.

While this option is applicable to all TEPO stocks, below we present a list of stocks for which we strongly recommend this opportunity.

### Stocks for which using TEPO is the best way out

Name	Ticker	Est. exit price, UAH	AGM date, 2013	Probability of TEPO emerging
Sevastopolenergo	SMEN UZ	14.000*	08-Apr	Unclear**
Donetsk Hirmash	DGRM UK	0.250	09-Apr	High
Khersonoblenergo	HOEN UK	0.430*	10-Apr	Unclear**
Zaporizh Coke	ZACO UK	2.219*	11-Apr	High
Kirovohradoblenergo	KION UK	0.420	11-Apr	Unclear**
Druzhkivka Machinery	DRMZ UK	0.250	11-Apr	High
SvitloShakhtaria Machinery	HMBZ UK	0.400*	12-Apr	High
Mariupol Heavy Machinery	MZVM UK	0.094	15-Apr	High
Chernivtsioblenergo	CHEN UK	1.147	16-Apr	Unclear**
Azovzahal mash	AZGM UK	4.342*	18-Apr	High
Donetsk Coke	DKOK UK	0.600	18-Apr	High
Yasynivka Coke	YASK UK	0.274	24-Apr	High
Zhytomyroblenergo	ZHEN UK	0.700	25-Apr	Unclear**
Donetsk Steel Plant	DOMZ UK	0.015	25-Apr	High
Zakarpattiaoblenergo	ZOEN UK	0.675*	29-Apr	Unclear**

\* Very rough estimate

\*\* Company AGM agenda contains an item of deals approval without the word "significant"

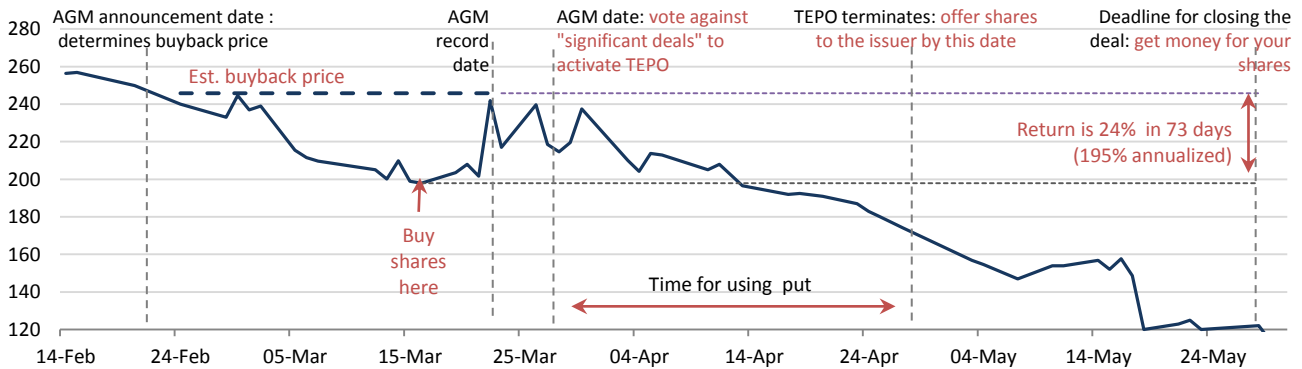
Source: Company data, Ukrainian stock exchanges, Concorde Capital research

## Opportunity 2: play TEPO arbitrage

It might happen that a share price falls after a company's AGM announcement. Given that a strike price under TEPO is fixed (as it is defined as the market price prior to the AGM announcement), such stock weakness allows for gaining arbitrage profit.

This real-life example of how arbitrage profit could have been earned in the 2012 season is demonstrated below.

### TEPO arbitrage: how it could have been done with Zakhidenergo (ZAEN) stock in 2012



Source: UX, company data, Concorde Capital

This is the fourth season in which TEPO arbitrage is available. Maybe for this reason, the number of stocks that offer an arbitrage is very small. Thus far, we see only three stocks than offer a potential arbitrage, with only one being liquid enough to use this opportunity: Khartsyzsk Pipe.

#### Stocks for which TEPO arbitrage chance emerging

Company	Ticker	Market price, UAH	Strike price under TEPO, UAH	TEPO arbitrage profit	AGM date	Register date
Khartsyzsk Pipe	HRTR UK	0.725	0.988	39.2%	08-Apr	02-Apr
Azovzahal mash	AZGM UK	2.500*	4.342**	73.7%	18-Apr	14-Apr
Dontesk Coke	DKOK UK	0.362*	0.600	65.7%	18-Apr	14-Apr

\* Indicative price, deal price may differ

\*\* Very rough estimate

Source: Company data, Ukrainian stock exchanges, Concorde Capital research

## AGM opportunities summary, as of April 2, 2014

Issuer		Sign deals in AGM agenda	TEPO arbitrage profit	Est. strike price under TEPO, UAH	Current price, UAH	AGM date	AGM register date	Est. DPS, UAH	Div. yield	Action plan(s)
Khartsyzsk Pipe	HRTR UK	yes	39.2%	0.988	0.73	08-Apr	02-Apr			Try using TEPO arbitrage
Sevastopolenergo	SMEN UZ	maybe		14.000*	n/a	08-Apr	02-Apr			Get rid of
Donetsk Hirmash	DGRM UK	yes		0.250	0.30**	09-Apr	03-Apr			Get rid of
Avdiivka Coke	AVDK UK	yes		2.715	3.06	10-Apr	04-Apr			Look for TEPO arbitrage, if any
Khersonoblenergo	HOEN UK	maybe		0.430*	0.90**	10-Apr	06-Apr			Get rid of
Luhanskteplovov	LTPL UK	yes		1.411	1.60**	10-Apr	04-Apr			Look for TEPO arbitrage, if any
Zaporizh Coke	ZACO UK	yes		2.219*	3.00**	11-Apr	07-Apr			Get rid of
Kirovohradoblenergo	KION UK	maybe		0.420	1.30**	11-Apr	07-Apr			Get rid of
Druzhkivka Machinery	DRMZ UK	yes		0.250	0.90**	11-Apr	07-Apr			Get rid of
Svitlo Shakhtarya Machinery	HMBZ UK	yes		0.400*	0.45**	12-Apr	08-Apr			Get rid of
Azovstal	AZST UK	yes		0.712	0.73	14-Apr	08-Apr			Look for TEPO arbitrage, if any
Mariupol Heavy Machinery	MZVM UK	yes		0.094	0.10**	15-Apr	09-Apr			Get rid of
Chernivtsioblenergo	CHEN UK	maybe		1.147	1.25**	16-Apr	10-Apr	0.10	7.9%	Get rid of / Rely on dividends
Azovzahalmash	AZGM UK	yes	73.7%	4.342*	2.50**	18-Apr	14-Apr			Get rid of
Donetsk Coke	DKOK UK	yes	65.7%	0.600	0.36**	18-Apr	14-Apr			Get rid of / Try using arbitrage
Kyivenergo	KIEN UK	yes		7.520	11.70**	22-Apr	15-Apr	2.78	23.8%	Rely on dividends
Kryukiv Railcar	KVBZ UK	-			17.20	24-Apr	17-Apr	1.48	8.6%	Rely on dividends
Zakhidenergo	ZAEN UK	yes		125.238	127.00	24-Apr	17-Apr	13.57	10.7%	Rely on dividends
Yasynivka Coke	YASK UK	yes		0.274	0.75**	24-Apr	17-Apr			Get rid of
Centrenergo	CEEN UK	-			5.45	25-Apr	18-Apr	0.40	7.4%	Hope for dividends
Zhytomyroblenergo	ZHEN UK	maybe		0.700	1.20**	25-Apr	18-Apr			Get rid of
Donetsk Steel Plant	DOMZ UK	yes		0.015	0.08**	25-Apr	18-Apr			Get rid of
Donbasenergo	DOEN UK	yes		37.242	40.81	26-Apr	22-Apr	6.74	16.5%	Rely on dividends
Zakarpattiaoblenergo	ZOEN UK	yes		0.675*	1.00**	29-Apr	23-Apr	0.20	19.6%	Get rid of / Rely on dividends

\* Very rough estimate

\*\* Indicative price (based on last deal)

Source: Company data, Ukrainian stock exchanges, Concorde Capital research

## Risks

**A shareholder could find himself unable to “buy” a TEPO**, i.e. vote against significant deals at an AGM. The first possible reason is a shareholder is unable to sign up for an AGM for objective reasons (due to insufficient/improper set of documents supplied during the signing in) or subjective reasons (a shareholder is not allowed into the AGM due to resistance from the company). In addition, a shareholder’s vote “against” could be miscounted for technical reasons.

**The strike price is not always identifiable.** By legislation, it should not be less than the market price prior to an AGM announcement, but there is no clear definition of the market price. For reference, based on our experience, we use the minimum of the market prices that are available on the day before the AGM announcement, based on data provided by UX, PFTS, INNEX and Perspektiva exchanges. If there is no market price on the reference day, we use the closest available price from the UX.

**It might take more time** for a shareholder to execute his TEPO due to resistance from a company, which could become critical for those having clear time limits (e.g. those counting on high returns from TEPO arbitrage). Eventually, all the companies have to obey the law.

**Shareholders may opt to not vote in favor of significant deals at an AGM (Shareholders may not hold a vote for significant deals at an AGM?),** which would mean a TEPO opportunity would not emerge at all. Such was the case last year with state-controlled GenCos, Centrenergo and Donbasenergo: their AGMs scheduled voting in favor of significant deals, but shareholders did not vote to approve them.

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