CONCORDE CAPITAL

Ukraine / Iron & Steel

Alchevsk Iron & Steel

Related-Party Sales Risk High

HOLD

30 Jun 2006 **(ASK) USD 0.10**

12m Target **USD 0.07**

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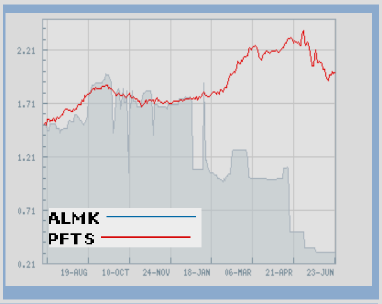
Alchevsk Iron & Steel's 2005 results confirm our concerns about the risk of insider transactions within its parent group. Based on an updated peer comparison, we slightly reduce our target price to USD 0.07, which is between the ask and bid quotes. Because the abnormally large spread has not resolved, we take the ask quote to be the market price and downgrade the stock from BUY to HOLD.

ALMK Mid-Market, UAH



Market Information	
Bloomberg	ALMK UZ
No of Sh., mln	**10,775.3**
Market price, USD	**0.10**
52Wk H/L, USD	1.99/0.31
MCap, USD mln	**1,066.8**
Free Float, %	**7%**

Stock Ownership	
IUD (est.)	93%
Minorities	7%

Ratios 2005	
EBITDA Margin	13.8%
Net Margin	7.9%

Financials Weak in 1Q06, But Set To Improve. ALMK's sales slipped 17% yoy in the first quarter, its EBITDA margin halved to 6.6% and its net margin fell from 8.4% in 1Q05 to -0.5% in 1Q06. However, we expect strong second and third quarters on the back of surging steel prices, which should result in a considerable improvement in ALMK's financials by the end of the year. We expect the company's sales to grow 17% yoy, but its EBITDA and net margins to be lower than in 2005, at 11% and 4%, respectively.

USD 400 mln Capital Raised. To finance its modernization program, ALMK took on ~USD 200 mln in 1Q06, its only long-term debt, giving it a debt-to-equity ratio of 0.27. Another ~USD 198 mln was raised through a nearly completed share issue that increases the company's charter capital 14-fold. The market reacted by dropping the bid quote by 14.4 times, while the ask price decreased by 3.8 times. This large spread has been shrinking since April 2006 and we expect it to reach a more normal level within a few months. ALMK could pursue more share issues in the future to meet its capital needs, but the potential for dilution of minority stakes would be much less given the enlarged charter fund.

Murky Financing Schemes Pose a Transfer Pricing Threat. The company's 2005 results confirm our concerns about the financing of ALMK's new equipment and insider transactions within its parent group, the Industrial Union of the Donbass. ALMK's reported increase in fixed assets was much lower than the cost announced earlier by IUD of new equipment launched at ALMK in August 2005. We conclude that some of the new equipment is at least partly owned by other companies within IUD. We are concerned that these entities will be able to claim a portion of ALMK's revenues and that the terms might not be favorable to ALMK.

KEY FINANCIAL DATA, USD mln

	Net Revenue	EBITDA	Net Income	DPS, USD
2005	922.7	136.5	78.4	0.0
2006E	1161.5	127.8	46.5	0.0
2007E	1277.6	153.3	76.7	0.0
Spot Exchange Rate		5.05		

KEY RATIOS

	EV/S	P/E	EV/EBITDA	Div Yield
2005	1.25	13.61	9.11	0.0%
2006E	1.09	22.94	9.91	0.0%
2007E	0.99	13.91	8.26	0.0%

Sales to Grow, Margins to Slip

1Q06 Financials Disappointing…

In 1Q06, ALMK reported a 17% yoy drop in sales, while its EBITDA margin slid from 13.0% to 6.6%. Its net margin fell by even more, from 8.4% to -0.5%, in part due to high interest costs (81% of reported EBIT) and taxes payable (37% of EBITDA).

	1Q05				1Q06			
	Sales, USD mln	*EBITDA mgn*	*Net mgn*	Output, ths mt	Sales, USD mln	*EBITDA mgn*	*Net mgn*	Output, ths mt
Mittal Steel Kryvy Rig	571.5	*27.9%*	*17.9%*	1,731.2	558.8	*25.2%*	*15.7%*	1,693.1
MMK Illicha	792.9	*22.4%*	*14.4%*	1,757.2	550.0	*2.6%*	*-2.2%*	1,628.9
Azovstal	582.7	*16.5%*	*9.6%*	1,464.2	481.7	*9.7%*	*2.2%*	1,301.7
Zaporizhstal	412.8	*17.3%*	*11.5%*	1,107.7	332.0	*14.2%*	*6.5%*	1,070.0
Alchevsk Iron & Steel	**226.7**	***13.0%***	***8.4%***	**944.5**	**188.1**	***6.6%***	***-0.5%***	**911.4**

Source: Company data

… But Poised to Improve in the Course of the Year

ALMK's management announced at the AGM in May that they expect sales in 2006 to be USD 1,139 mln (up 15% yoy) and EBT to be USD 15.8 mln (one seventh of 2005 EBT), which allows us to infer a net margin of some 1%. Even after accounting for the need to service long-term debts, we think the EBT forecast is artificially depressed, and signals an intent to cook the books. However, in view of Yulia Tymoshenko's appointment as prime minister, Ukrainian business groups including IUD will be pressed to report more realistic sales and profits.

In our opinion, the mill's sales this year will be ~2% greater than ALMK's management has planned due to higher than anticipated steel price growth (25-75% YTD, depending on the steel product type) and strong export demand. Our projections for 2006 are more optimistic than ALMK management's guidance. However, our forecasts do not reflect the company's full economic potential due to corporate governance problems.

	Sales	**EBITDA mgn**	**Net mgn**
2005	992.7	13.8%	7.9%
2006E	1,161.5	11.0%	4.0%

Source: Company data; Concorde Capital

Benefits From New Intra-Group Synergies Ambiguous For ALMK

Looking beyond 2006, ALMK should be able to increase its output as IUD's mills in Poland (Huta Czestochowa) and Hungary (Dunaferr) start buying its slabs. IUD's strategy is to use Alchevsk to produce semi-finished products for further processing at IUD's plants within the EU. While this strategy is beneficial for the parent group, it is less so for ALMK which will be producing low-value-added products and thus earning low margins.

Transfer Pricing Risk To Remain

We feel that despite inevitable corporate governance improvements resulting from IUD's business evolution and from regulators' pressure, IUD will not fully eliminate transfer pricing at its Ukrainian plants, which will restrain ALMK's reported sales and margins' growth.

Funds Needed To Finance Extensive CapEx

Leverage Increasing Significantly

ALMK has been raising both debt and equity capital in order to realize its declared investment plan of USD 1.7 bln by 2010. In 2006, IUD plans to invest USD 570 mln in new equipment at ALMK, up 22% yoy. In 3Q05, the company took on USD 173.3 mln in long-term debt, which had been zero. In 1Q06 long-term debt grew further to USD 199.8 mln. That gave the company a debt-to-equity ratio of 0.27, still much lower than the international peer average of 0.47. Given its low debt/equity ratio and IUD's relatively easy access to debt capital, ALMK is likely to increase its debt financing to meet this year's CapEx target.

New Equity Capital Received

Overall, since 3Q05, ALMK has raised nearly USD 400 mln in debt and equity. On September 30, 2005 ALMK's EGM approved an additional share issue worth USD 198 mln, and on May 25, 2006 a new AGM approved the subscription for the additionally issued shares. The Securities & Exchange Commission (SEC) recently registered the issue, which effectively increased the company's charter fund nearly fourteen-fold.

Risk Of Dilution Reduced

We do not rule out the possibility of additional share issues in the mid-term. However, any such share issues would not pose such a high dilution risk to minority investors as the previous issue did, because they would not as dramatically increase the company's charter fund. For example, if ALMK wanted to raise another USD 200 mln, it would only need to increase its charter fund by 98%, not by 14 times.

High Risk Of Related-Party Schemes

Third Parties Involved in ALMK's CapEx Funding

It is our belief that ALMK's declared CapEx has been financed jointly by the company and its holding corporation IUD. This suggests that the equipment installed is now partly owned by IUD-related entities other than ALMK.

Since 2003, Alchevsk Iron & Steel has undertaken several CapEx projects. The most extensive was the construction of the company's first continuous casting machine with a capacity of 2.5 mln mt of crude steel at an estimated cost of USD 400 mln. The concaster was launched in August 2005.

IUD has said its total CapEx expenditures at ALMK in 2005 came to USD 468 mln. However, the company's reported fixed assets (net) grew by only USD 180 mln throughout the period of 2003-2005. This leads us to believe that the concaster put into operation last year does not belong wholly to ALMK.

Minority Shareholders To Suffer From Insider Deals

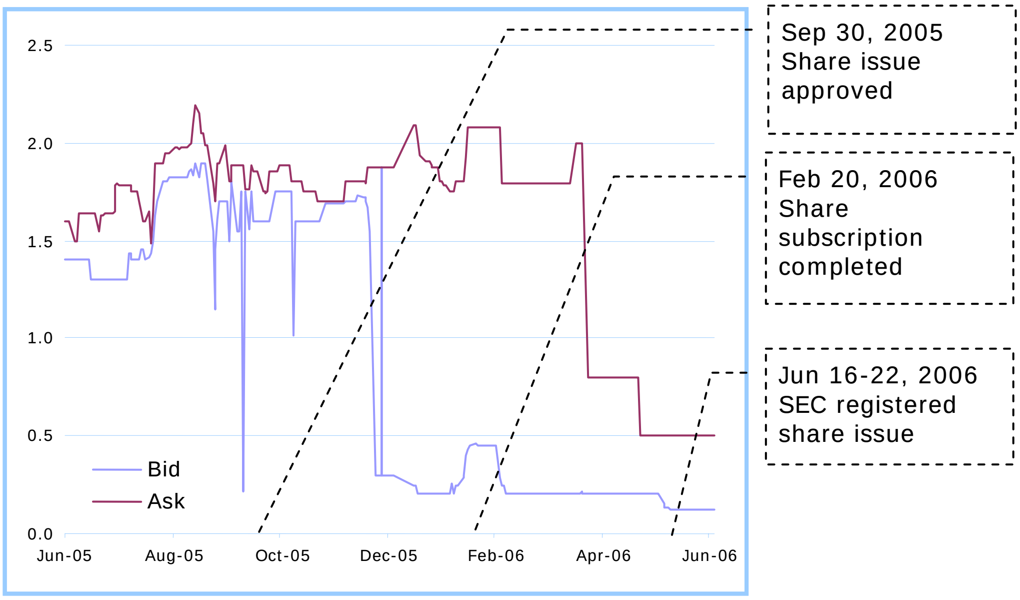
Given ALMK's successful efforts to raise capital in 2006, we think this year's CapEx expenditures will be put on ALMK's balance sheet, thus adding to the company's value. In future years, however, it is likely that some of the equipment that IUD plans to install will not be owned by ALMK. Earlier this year IUD said that two planned electricity and heat co-generation units would be owned by a joint venture of IUD and other entities involved in financing the project.

In our view, IUD's practice of financing some of ALMK's major CapEx projects via separate entities is not beneficial for the company's minority shareholders, as these entities are likely to claim an unfair portion of ALMK's sales through related-party transactions.

New Valuation Less Favorable

Our usual practice is to define the market price as the average of bid and ask quotes. However, due to ALMK's abnormally large spread (75% of the ask), we have decided to use the ask quote as the market price. The large spread is the result of uncertainty over whether the company would succeed in pushing through its share issue despite resistance from minority shareholders. It reflects the slow adjustment of the market price to the anticipated new number of shares. This situation is similar to what we observed with Pivdenny Iron Ore (**PGZK:BUY)**; (please refer to our April 13, 2006 notebook). We expect ALMK's ask quote to come down in the next few months and the spread to shrink to a more normal level of 10-15%.

ALMK Bid and Ask Quotes (UAH)



Source: PFTS; Intefax

Peer Comparison, 2006 Multiples*

Company	Current Price, USD	MCap, USD mn	EV/S	EV/EBITDA	P/E
ALMK	0.10	1,067	1.09	9.9	23.0
International Peers					
INI Steel	35.3	2,999	0.81	5.9	6.3
Bluescope Steel	6.0	4,204	0.88	7.1	12.9
Tangshan	0.5	977	0.40	3.4	6.8
Maanshan	0.4	1,653	0.84	5.3	6.1
IPSCO	93.4	4,481	1.62	7.1	12.4
CSN	27.6	7,507	2.37	5.4	10.8
SSAB	51.9	3,474	1.04	6.7	12.6
Average			1.14	5.6	9.3
Median			0.88	5.9	10.8
Implied price by average, USD			**0.10**	**0.05**	**0.04**
Implied price by median, USD			**0.08**	**0.05**	**0.05**
Upside (downside) by average			5%	-51%	-60%
Upside (downside) by median			-23%	-48%	-53%

Source: Company data; Concorde Capital; Bloomberg
**ALMK's MCap is calculated based on ask price and the new number of shares after the recent share issue.*

The target price implied by peer comparison is in the range of USD 0.04-0.10 based on EV/S, EV/EBITDA and P/E metrics. We tend to rely on the first two multiples, as net income is most subject to accounting manipulations distorting valuation by P/E. Our target, as implied by EV/S and EV/EBITDA, is USD 0.07. Given that it falls between the bid quotation of USD 0.025 and the ask quotation of 0.10, we downgrade the stock from BUY to **HOLD**. Since the change in recommendation is due to market technicalities rather than changes in the company's fundamentals, we may revise the recommendation when the bid-ask spread normalizes.

Appendix: Highlights of ALMK's Investment Plan

The investment program that started in 2003 envisages a complete overhaul of sintering, blast furnace and steel making production, as well as construction of an in-house power plant and the implementation of new environmental protection measures. It is expected to double the mill's capacity by 2010 to 7.4 mln mt of crude steel per year. The CapEx announced by IUD for the near term includes:

- mounting two basic oxygen furnaces (BOFs) by 2008 at a total cost of ~EUR 150 mln
- construction of a co-generator power plant with a capacity of 300 MW and an estimated cost of over USD 300 mln
- installation in 2006-2007 of a second continuous casting machine with a capacity of 2.5 mln mt of crude steel for ~USD 400 mln
- installation by 2009 of a pulverized coal injection (PCI) unit at blast furnace #1, expected to require ~USD 60 mln.

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