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Analyst's Notebook

Ukraine / Metallurgy
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****Editor's Note:** In order to keep our coverage of the Ukrainian market as up to date as possible Concorde Capital is launching a new product – Analyst's Notebook. Unlike our more in-depth desk notes and reports, Analyst's Notebook provides rapid feedback on breaking news in the Ukrainian market. Analyst's Notebook gives you our analysts' first impressions of a situation and may set the table for further investigation. Our analysts will use their experience in their sectors to take a look at the situation and provide insight or speculate on possible scenarios. We want to emphasize however, this product consists mostly of the analyst's intuition and may require further analysis.

Yuzhny GOK To Increase Charter Fund?

Court Fight

On March 2, 2006 the Kyiv Economic Court ruled in favor of an allegedly Privat-affiliated company Metallotehnika, and did not cancel a decision made at Yuzhny GOK's (**PGZK: BUY**) AGM on April 26, 2005. The decision approved a three-fold increase in its charter fund through an additional issue of 4.3 bln of new shares. The State Property Fund of Ukraine (SPFU), which earlier challenged the AGM's decision in court in an attempt to revise PGZK's privatization, has already stated that it may appeal to the Supreme Court to challenge the recent Kyiv Economic Court ruling.

What's Stirring Up The Waters

In our view, Privat Group, which controls Yuzhny GOK together with Russia's Smart Group, was clearly behind the new attempt to increase the company's charter fund. While the exact purpose of the additional share issue is not clear, we think it may have to do with a possible sale of the company to a strategic buyer, as rumors about its takeover are in the air. Potential buyers could be Mittal Steel, Russia's MetallInvest and possibly some Russian steel majors. The proceeds from the subscription would then be a partial payment by the new owner for the GOK, if current controlling shareholders decide to forfeit their preferential right to subscribe for the new shares.

The Odds The Share Issue Will Occur

The SPFU's involvement in Yuzhny GOK's share issue is related to the privatization of the state's stake in the iron ore holding Ukrrudprom in 2004. As a part of this privatization, Privat group obtained an additional 25.78% stake in Yuzhny GOK. In 2005, the new authorities started a crackdown on the shady privatization deals completed during Kuchma's presidency. Law suits were filed against a number of new owners of the privatized Ukrainian ore makers, Including Yuzhny GOK. In an attempt to secure its control over the GOK, Privat group decided to dilute a disputed stake in the company by an additional share issue. However, the SPFU managed to block this endeavor by taking PGZK and Privat-related companies to court. Nonetheless, eventually the state failed to revise Ukrrudprom's privatization and Privat's control over Yuzhny GOK was no longer in jeopardy, although the issue was still pending in the court. The recent Kyiv Economic Court ruling enables PGZK's controlling shareholders to conduct the share issue, and there are indications that they will push for it. Although the SPFU headed by socialist Valentina Semenyuk may attempt to block it again, this time via the Supreme Court, we think there is not enough political will to stop the share issue. Thus, we believe it is very likely to take place. The proposed subscription period is March 20, 2006 – April 7, 2006, with the first stage to be from March 20 to April 3.

Peer Valuation Per Old Number Of Shares

To adequately explore the effect of a share issue on PGZK's stock price, we updated our valuation of Yuzhny GOK based on a peer comparison as of March 7, 2006.

International Peers	MCap, USD mln	P/S		EV/EBITDA		P/E		EV/mt, USD
		2005E	2006F	2005E	2006F	2005E	2006F	2006F
Yuzhny GOK	**493.0**	**2.0**	**1.5**	**11.9**	**8.2**	**89.6**	**32.9**	
BHP Billiton	107,163	3.6	3.1	10.4	7.2	16.9	11.4	
CVRD	47,024	3.1	2.8	6.9	5.2	9.1	7.2	
Rio Tinto	71,873	4.3	3.4	9.5	6.7	16.7	11.6	
Kumba Resources	5,565	3.0	2.5	7.7	6.2	14.3	10.4	
Cleveland-Cliffs	1,973	1.1	1.0	3.9	2.8	5.9	6.1	
Portman	729	2.8	1.9	5.9	2.5	9.5	5.2	
Assmang	1,380	1.9	2.1	5.5	6.5	9.0	12.4	
Average		2.8	2.4	7.1	5.3	11.6	9.2	
Median		3.0	2.5	6.9	6.2	9.5	10.4	
Implied price by Avg, USD		**0.33**	**0.36**	**0.15**	**0.16**	**0.03**	**0.06**	
Upside (Downside)		42.7%	54.9%	(36.5%)	(30.2%)	(87.0%)	(72.1%)	
Implied price by median, USD		**0.35**	**0.38**	**0.14**	**0.19**	**0.02**	**0.07**	
Upside (Downside)		50.3%	64.0%	(38.8%)	(18.9%)	(89.4%)	(68.4%)	
Russian Peers								
Mikhailovsky GOK	2,278	2.6	2.3	6.2	5.3	8.2	6.9	145.1
Lebedinsky GOK	3,712	3.8	3.4	6.1	5.1	8.9	8.1	157.2
Average		3.2	2.9	6.2	5.2	8.5	7.5	151.1
Implied price by Avg, USD		**0.37**	**0.43**	**0.13**	**0.16**	**0.02**	**0.05**	**0.55**
Upside (Downside)		60.1%	85.0%	(45.0%)	(77.2%)	(90.5%)	(77.2%)	139.6%
Ukrainian Peers								
Poltava GOK	1,452	2.7	2.6	9.9	9.3	17.3	16.6	190.7
Implied price, USD		**0.31**	**0.39**	**0.20**	**0.28**	**0.04**	**0.12**	**0.70**
Upside (Downside)		36.8%	69.2%	(12.1%)	22.7%	(80.7%)	(49.6%)	202.3%

A general observation is that PGZK is apparently undervalued on P/S and EV/mt multiples across its peer groups and overvalued on P/E and to a lesser extent EV/EBITDA multiples. We believe this is due to the company's poor reporting practices, as Privat group who controls PGZK is known for an extensive use of "tax minimization" schemes. We see improvements in the company's disclosure of its true financials based on comparison of 9M05 and 9M04 numbers, although we believe that its margins and to a lesser extent sales are still underreported.

What Multiple Is Better?

We attempted to establish a band for PGZK's stock value based on different multiples. The lowest values ensue from the P/E multiple comparison and the highest ones are based on EV/mt.

We interpret the valuation results as follows.

Value of PGZK's business based on fundamentals rather than official accounting numbers is reflected in EV/mt. We compared PGZK to its Russian counterparts, Mikhailovsky and Lebedinsky GOKs, and to Poltava GOK, on EV/mt multiple. However, iron ore products made by Poltava GOK (pellets) have a higher value added and price than PGZK's sinter and concentrate. Thus, PGZK should trade at some discount to Poltava GOK on EV/mt. That is, the upper bound for PGZK's undiluted share price should not exceed USD 0.55.

On the other hand, P/E multiple would give the lowest possible bound for the derived PGZK's value depressed due to severely under-reported accounting profits.

In estimating PGZK's true value for a minority shareholder we rely on valuations by EV/EBITDA and P/S metrics rather than P/E and EV/mt. Ukrainian companies usually do not pay dividends, and EBITDA is a proxy of the company's cash flows theoretically available for distribution to all shareholders. In addition, EBITDA from an official P&L is usually less distorted than net income. At the same time, top-line is even less affected by untoward accounting practices than EBITDA and thus can be used as a valid valuation metric provided there is no significant transfer pricing. In addition, using sales-based multiples is also preferred over output-based multiples when products of the companies compared differ in price considerably.

Target Price

Given that minority shareholders will not capture the value generated by Yuzhny GOK's operations in full until the company becomes transparent, we base our target for PGZK on P/S-2006E and EV/EBITDA-2006 multiples. We assigned weights 0.7 and 0.3 respectively to the above multiples to reflect our belief that Yuzhny GOK will turn to a good faith disclosure practice in the mid-term, due to both evolution of business culture in Ukraine and preparation of the company for sale to a strategic investor. Thus, our undiluted target price for the stock is USD 0.33, up 33% from the previous target. This target may be revised upward when we see a confirmation of the company turning transparent and reporting true margins.

Effect On Price And Return

We expect that the share issue if conducted will be subscribed for at par, or USD 0.05 per share. This yields total proceeds of USD 212.2 mln. Other things held constant, under the efficient market assumption, the price for the stock would accommodate to the new number of shares by falling from current USD 0.23 to USD 0.11 per share and our target would be adjusted from USD 0.33 to USD 0.14.

Understanding that the market will not adjust to the increased number of shares in perfect accordance with any definite formulae, we nevertheless simulated what return investors can expect on their investment into PGZK depending on the price they bought their shares at.

Our simulation employs current market price for PGZK's share of USD 0.23 and may require modification when market price changes. Based on the analysis below, we suggest:

(A) fix your profits now if you do not want to participate in the subscription

OR

(B) subscribe at par (which is 4.5 times below current market price) and benefit from a future upside ahead.

		Expected upside to weighted cost of purchase		
		No share issue	Share issue conducted	
Stock purchased	**Current return**	**Current upside**	**Adjusted, with subscription**	**Adjusted, w/o subscription**
@, USD	Market price = USD 0.23	Target price = USD 0.33	Adj. target price=USD 0.14	
0.07	229%	376%	156%	106%
0.09	156%	270%	129%	60%
0.11	109%	203%	107%	31%
0.13	**77%**	**156%**	**89%**	**11%**
0.15	53%	122%	74%	-4%
0.17	35%	96%	61%	-15%
0.19	21%	75%	50%	-24%
0.21	10%	59%	40%	-31%
0.23	0%	45%	31%	-37%

Our simulation indicates that subscription for the additional shares provides upsides for any given purchase price due to a low investment per share after the new shares are purchased at par. On the other hand, keeping the shares without subscribing for the new ones would result in a downside for a purchase price of above USD 0.13 per share place (compare green fields in the table above).

Those lucky ones who managed to acquire PGZK's shares at a price below 0.11 will be better off if they fix profits now provided they believe that the subscription will take place (compare blue fields in the table above).

Summing up, our recommendation for PGZK remains **BUY** assuming investors willing to retain their investments in PGZK subscribe for the additional issue, with a target USD 0.33 (or USD 14 diluted after the additional share issue).