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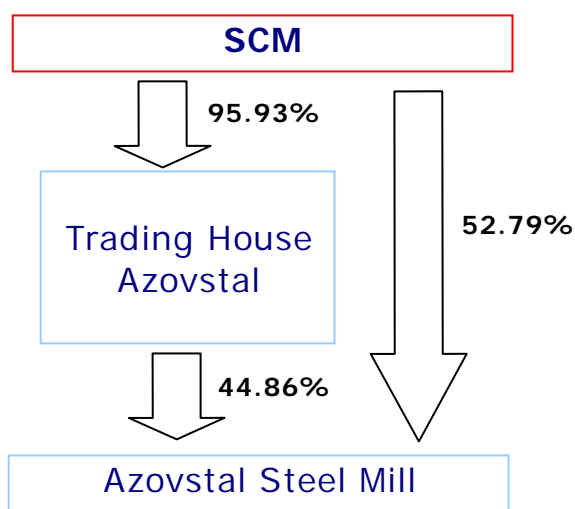
Analyst's Notebook

Ukraine / Metallurgy
May 5, 2006

Azovstal Consolidating Its Trading Company

Cross-Holding Puzzle

According to the agenda of Azovstal's EGM scheduled for May 19, 2006, the shareholders will consider the joining of a closed joint stock company Trading House Azovstal to the steel mill Azovstal (**AZST**). The trading house is 95.93%-owned by System Capital Management (SCM) which is also a controlling shareholder in Azovstal. SCM directly or through its affiliated companies holds a 97.65% stake in Azovstal. The trading house owns a 44.86% stake in Azovstal.



What Is being Consolidated?

In 9M05, Trading House Azovstal posted zero sales and a net loss of USD 0.2 mln. This entity did not accumulate any profits from selling Azovstal's products. Rather, Azovstal directed a portion of its sales through other companies such as Leman Commodities and Leman Ukraine. The company's total assets totaled USD 136 mln and 99% of these were financial investments, which we believe were stakes in SCM-controlled companies Azovstal (44.86%), First Ukrainian International Bank (48.89%) and a number of smaller assets. We think that after the transfer to Azovstal of the financial investments that now belong to the trading house, SCM will employ accounting techniques that will limit these investments from having any meaningful return. Rather, SCM will use the company as a special purpose vehicle (SPV) to keep the stakes of other assets on Azovstal's balance sheet and will be able to transfer these holdings to its other companies at any time by purchasing them for cash at par or replacing them with other assets such as promissory notes. Given the financials of the trading house its consolidation will not be value adding for Azovstal's shareholders and should be viewed as a technical measure to restructure ownership within SCM.

How Will They Do The Consolidation?

According to the agenda of the EGM, the consolidation of the trading company with the steel mill will be carried out through a share swap. The par values of both AZST's and the trading house's shares are equal to USD 0.05 (UAH 0.25), and we believe that the share exchange will be completed at a one-to-one ratio based on the par values. This is common practice in Ukraine and Azovstal has already integrated a coke plant, Markokhim, into its structure through a par value based share exchange.

Theoretically, Azovstal's controlling shareholders have the option to exercise the exchange of shares without a sizable share issue by Azovstal. This could be done by Azovstal's SCM-related shareholders (excluding the trading house), who hold 52.8% in Azovstal, exchanging their stakes in the company for the shares of the trading house. The trading house's charter fund is approximately equal to 53.7% of Azovstal's charter fund, which enables this kind of swap to happen with only a small additional share issue by Azovstal. This approach would imply practically no dilution of minority stakes and would not affect AZST's market price.

However, the procedure proposed by Azovstal calls for an increase of the company's charter fund by 53.7% through an additional share issue. The increase is exactly equal to the trading house's charter fund. Minority shareholders will not be able to subscribe for the additional share issue, the full amount of which will be swapped. This is reminiscent of the recent initiative by another steel mill, Zaporizhstal, to consolidate its trading houses via an additional share issue where minority shareholders were also deprived of the right to subscribe.

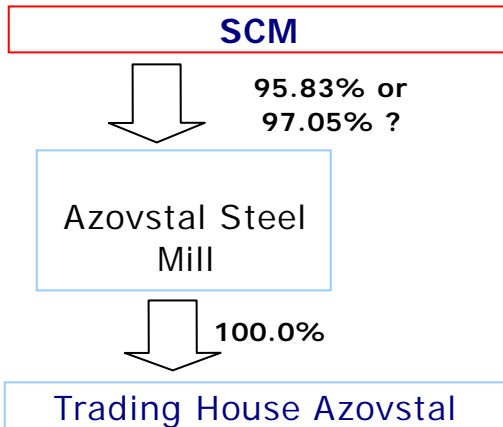
More Azovstal Shares On The Market?

Shares of Trading House Azovstal are traded OTC outside the PFTS system. We estimate their free float at 4.07%. We believe that Azovstal will attempt to consolidate all 100% of its trading house, just like it did with Markokhim. In this case, minority shareholders of the trading house will receive Azovstal's shares in exchange for their stakes in the trading house which will increase AZST's free float in terms of the number of shares traded. However, what will happen to the percentage of free float is a more complex matter, and will depend on what Azovstal does with the financial investments it obtains after the share swap.

After the consolidation of 100% of the trading house is completed, it will probably cease to exist as a separate legal entity. Azovstal will be given ownership of its shares that are currently in the hands of the trading house. After putting these shares on its treasury stock account, Azovstal will have the choice of either extinguishing them after a one year period or selling them to a third party like SCM. Different possible shareholder structures for Azovstal following the consolidation are depicted below:

	At present		Shares extinguished after consolidation		Shares sold to SCM after consolidation	
	# of shares, mln	Stake	# of shares, mln	Stake	# of shares, mln	Stake
SCM	3,571.8	97.65%	3,815.0	95.83%	5,455.9	97.05%
Former minority shareholders of trading house	-	-	79.9	2.01%	79.9	1.42%
Azovstal's initial minority shareholders	86.0	2.35%	86.0	2.16%	86.0	1.53%
Total	3,657.8	100.00%	3,980.9	100.00%	5,621.8	100.00%
Free float	86.0	2.35%	165.9	4.17%	165.9	2.95%
Minorities' Dilution				8.1%		34.9%

After the consolidation, the cross-holdings of SCM's assets will look like this:



What Will The Dilution Effect Be?

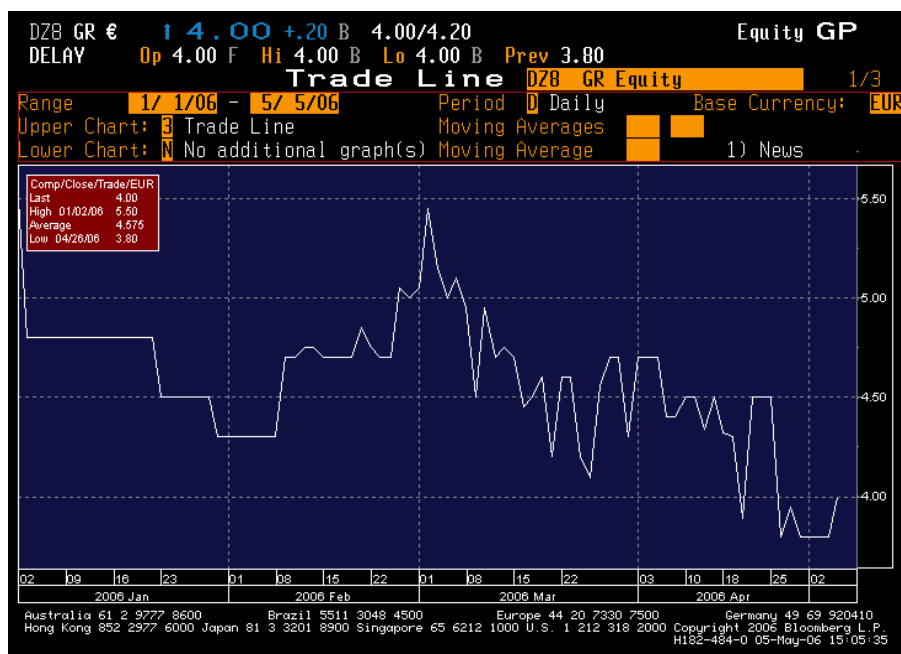
If Azovstal opts for the extinguishment of its shares, received after the consolidation of its trading house, we calculate that the dilution effect will be relatively minor at ~8%. Effect of this dilution on the share price will be even less pronounced at around 5%: the company's value should fall by less than 8% due to the receipt of financial investments (stakes in the bank and other assets) which are likely to be repurchased by SCM at par value (estimated proceeds of USD 53 mln).

If the shares are not terminated but instead sold to SCM, we estimate that minority stakes will be diluted by 35% and the share price will fall by some 26%, with a partially offsetting effect coming from the receipt of proceeds from the share repurchase at par (USD 81 mln) and expected proceeds from the repurchase financial investments (USD 53 mln).

The worst case scenario would entail SCM stripping the trading house of its financial assets before consolidating it with the steel mill. In this case, the effect on AZST's price would be a 35% reduction.

What Was The Market Reaction?

Quotes both for local shares and GDRs, despite a preceding three month downward trend, showed signs of revival in the last few trading days, contrary to the expected negative impact of the consolidation news.



What To Expect

After examining the situation, it looks likely that Azovstal will eventually pass the stock it receives from the consolidation on to SCM. Although it is also possible that Azovstal will extinguish its shares. We estimate probabilities of these two scenarios at 55% and 40%, respectively. The best way for Azovstal to treat its minority shareholders would be to offer to buy out its shares at market price. At this point, the company has disclosed neither the price nor the procedure for a possible buy-out. We contacted SCM's officials but did not receive any clarification of this aspect and were told that SCM will comment on the issue only after the EGM.

Given that SCM recently declared its commitment to increasing transparency and improving corporate governance practices we can reasonably expect that the market price will be offered at repurchase. We will be watching how the situation develops and for the time being **SUSPEND** our recommendation for the stock. Speculative investors may consider buying shares of the closed joint stock company Trading House Azovstal in the hope of earning a quick, reasonably-sized return after the share swap.

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