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# Analyst's Notebook

**Ukraine / Metallurgy**
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## The Future Bodes Ill for Donetsk Coke

New target: **USD 0.08**
Downside: **20%**
Recommendation: **SELL**

Various mass media (Delovaya Stolitsa, Delo, etc) reported this week that Donetsk Coke is planning to stop three operating batteries at its Rutchenkivsky plant by the end of the year. This information has been confirmed by the company's management. We have accordingly revised the target price for the stock and downgraded it from HOLD to SELL.

### Capacity Is Being Cut

As we mentioned in our coke report on Aug. 23, 2006, Donetsk Coke consists of three separate plants – Rutchenkivsky, Donetsky and Smolianivsky, all located in the city of Donetsk. The Rutchenkivsky plant already stopped one of its four batteries in April, and the only battery at the Smolianivsky plant was stopped in August. The remaining three batteries at Rutchenkivsky plant will be halted by the end of the year. Two coke batteries at the Donetsky plant that have an annual design capacity of 492 ths mt are still in operation.

### The Markets are Dwindling

The official justification for cutting DKOK's capacity is the lack of coking coal, a principal feedstock for coke production. However, we believe the real reason for this is DKOK's inability to support sales. DKOK's largest customer historically, Mariupol Illicha (MMKI) steel mill (~60% of DKOK's sale), switched to sourcing coke primarily from Yasynivsky Coke since January 2006. Export markets are still weak for Ukrainian coke makers due to the influx of cheap Chinese coke into Europe and the comparatively-low quality of Ukrainian coke. DKOK, whose facilities are among the most aged in Ukraine, is especially disadvantaged in terms of export opportunities. The company's revenue and earnings halved in 1H06 and its coke output was down 39% in 9M06.

### Hope For Recovery Is Bleak

DKOK's capacities appear to be redundant within the business structure of its majority owner, System Capital Management (SCM). SCM also controls four other coke plants that can already produce enough to meet the group's internal coke needs. A possible way out for DKOK would be to sell the controlling stake of its SCM-related owners to MMKI, which previously expressed interested in acquiring DKOK. MMKI currently does not possess the capability to produce coke in-house and already holds a 13% stake in DKOK. However, since MMKI is a rival to SCM's steel business, we believe such a transaction is unlikely.

DKOK's only plant that is currently generating enough sales is the Donetsky plant. Another steel business group, Donetskstal, sources coke from it. The Donetsky plant is located in close proximity to Donetskstal, which makes it the mill's preferred coke supplier. However, now that the Smolianivsky plant has been closed and with the Rutchenkivsky plant to follow shortly, prospects for the Donetsky are unclear.

Since Donetskstal can be considered a rival to SCM, it is possible that at some point DKOK's major shareholders will stop supplying coke to Donetskstal, which will necessitate the closure of DKOK's Donetsky plant as well. In terms of coke production, the Donetskstal group controls two other coke producers, Yasynivsky Coke and Makiyivka Coke, and could theoretically be self-sufficient.

## Stock Valuation Downgraded

In our August report, we considered the scenario of DKOK shutting down, but after the news this week, in our opinion, the likelihood of this happening has increased. Opposition from DKOK's trade unions is unlikely to prevent the plant's eventual closure and we now estimate the probability of it closing at 80%, as opposed to our previous estimate of 50%. Our resultant scenario-weighted target price is USD 0.08, a downside of 20% to the current mid-market price of USD 0.10. We downgrade the stock to SELL.