

Dniproenergo

Ripe for speculation

Event: Privatization anticipated in 4Q10-1Q11

A State Property Fund spokesperson announced this summer that either Dniproenergo or Zakhidenergo would be offered for privatization in the fourth quarter of this year.

Implications: DNEN likely to move on the news

We believe it very likely both generators will be sold, most probably to DTEK, in the last quarter of this year or the first quarter of 2011. The current fiscal deficit provides the government with a strong incentive to speed up the privatization process. Fueled by privatization rumors, Zakhidenergo has outperformed the UX Index while Dniproenergo continues to lag. Based on historical precedent, we expect Dniproenergo to move up sharply following any privatization announcement.

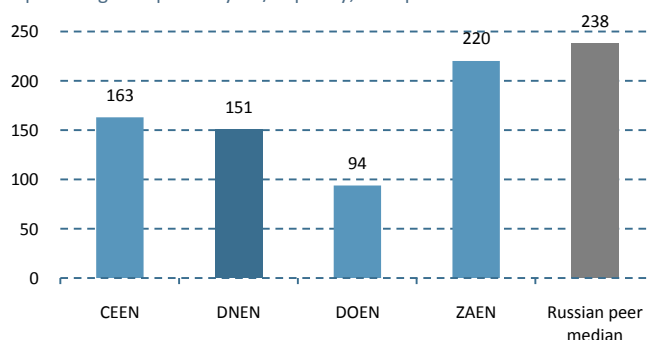
Risks: Low liquidity & transfer pricing

Dniproenergo is the least liquid Ukrainian generation company and we can see the major shareholder reducing free float further. Transfer pricing is also a concern, as DTEK, the majority shareholder, is supplying the plant with coal at above market prices in order to capture profits. However, we believe the majority shareholder could curtail transfer pricing policies after purchasing the state's stake.

Valuation

We set our target for Dniproenergo based on comparison with Zakhidenergo, the other privatization candidate. We use the EV/capacity metric, which is conservative given Dniproenergo's greater level of efficiency and lower fuel costs compared to Zakhidenergo. Our target of USD 200 per share implies 51% upside. We recommend this stock as a short-term investment only for investors ready to face illiquidity risk.

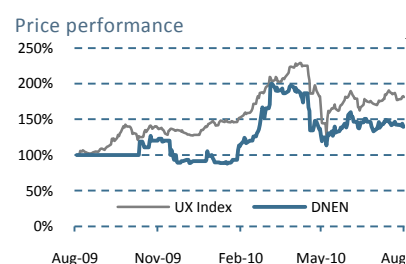
Dniproenergo vs. peers by EV/Capacity, USD per kW



Source: Bloomberg, Company data, Concorde Capital

Report date	19 Aug 2010
Bloomberg	DNEN.UK
Reuters	DNEN.PFT
Recommendation	BUY
Price (19 Aug 10), USD	132.9
12M price target, USD	200
No of shares, mln	5.97
DRs per ord share	4
Market Cap, USD mln	793.1
52-week performance	40%
52-week range, USD	82.5/187.5
ADT, 12M, USD mln	0.036
Free float, %	2.45%
Free float, USD mln	19.4

Prices as of Aug. 19, 2010



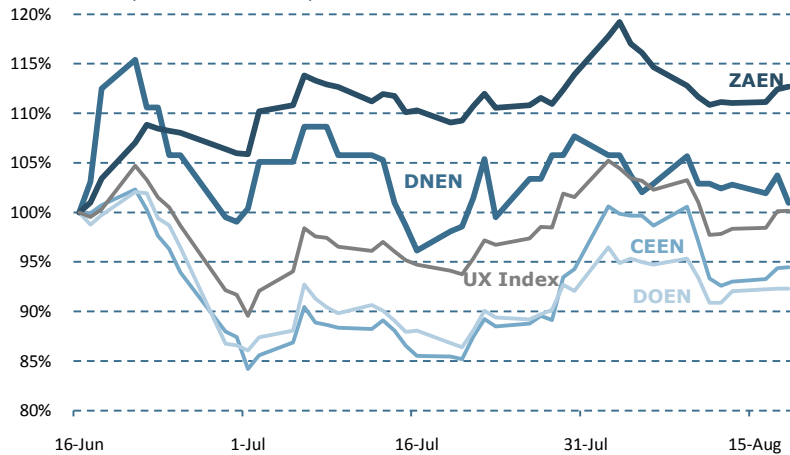
Source: Bloomberg

Privatization anticipated in 4Q10-1Q11

In June, Ukraine's State Property Fund announced that either the state's 50% stake in Dniproenergo or its 76% stake in Zakhidenergo would be privatized in the fourth quarter of this year. Both companies are likely to be of interest to DTEK, the energy giant in Eastern Ukraine that already controls 47.5% of 5.8GW Dniproenergo and 100% of 4GW Vostokenergo.

Since the June 16 announcement, Zakhidenergo has appreciated by 13% while the UX has been flat. Zakhidenergo currently trades at USD 220 per kW of installed capacity, or a 46% premium to local peers, while Dniproenergo is valued at USD 151 per kW of installed capacity. Within the peer universe, only Donbasenergo trades lower at USD 94 per kW of installed capacity.

GenCo stock performance since privatization announcement



Source: Bloomberg

Dniproenergo likely to move on news

We believe that Dniproenergo could offer an attractive short-term trading opportunity given its historical response to privatization-related news. The stock currently trades at a 34% discount to Zakhidenergo, and in the past has reacted sharply following public discussion of privatization. In 2007, when DTEK increased its stake in the company from 17% to 42% via an additional share issue and privatization was widely anticipated, the stock traded at a 20%-100% premium to local peers on EV/capacity.

DNEN premium/discount to sector average on EV/capacity



Source: Bloomberg, Company data, Concorde Capital calculations

Strongest fundamentals among local peers

Dniproenergo is the most efficient generator in the sector, using 381 g of fuel equivalent per kWh vs. 426 g for Donbasenergo in 1H10. Given this level of efficiency, the company is also the most profitable. Its EBITDA margin was 13% in 1H10 versus 5% for Centrenergo.

Moreover, sector-wide growth in margins (by 17-21 pp qoq in 2Q10), the result of a 29% yoy increase in electricity prices, could contribute to further stock appreciation, as we believe the market has not yet priced in the recovery in fundamentals.

Potential risks to upside

- **Illiquidity.** Free float is limited to 2.45%, or USD 19.2 mln at current prices. Trading volume is the lowest among generators, at an average USD 1 mln per month so far this year compared to USD 10.5 mln for CEEN.
- **Forced buyout.** The Ukrainian parliament is currently considering a draft law that would allow owners of stakes equaling or exceeding 95% to compel minority shareholders to sell. Given that we believe DTEK is likely to accumulate a 97.5% stake, minorities could be looking at forced buyout in 2011-12 should parliament pass the law. Although the draft law stipulates that the buyout should take place at the six month average price, we do not expect the forced buyout price to be attractive to minorities.
- **Transfer pricing.** Since DTEK has been able to install its own management team at Dniproenergo, the company has become the generator's exclusive supplier of coal, which constitutes 90% of total costs. Given that the contracted price is 20% above that typically paid by other generators, the arrangement is clearly a mechanism to facilitate the transfer of profit from Dniproenergo to wholly DTEK-owned entities.

The experience of Komsomolets Donbasa, a 96% DTEK-owned coal company, is illustrative: roughly half of its profit goes to DTEK while the other half is retained by the company. DTEK is part of SCM; other group companies have historically demonstrated a willingness to share profits with minorities rather than employ damaging transfer pricing schemes.

Appendices

Analyst certification

I, Yegor Samusenko, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

DNEN ratings history

Date	12M target price, USD	Market price, USD	Rating	Action
13-May-05	88	75	HOLD	Initiate
26-Sep-05	99	67	BUY	Upgrade
26-Jun-06	123	76	BUY	Maintain
15-Nov-06	131	109	BUY	Maintain
28-Nov-06	131	109	BUY	Maintain
22-Dec-06	134	126	HOLD	Downgrade
21-Mar-07	383	288	BUY	Upgrade
2-Apr-07	383	347	HOLD	Downgrade
22-Jun-04	432	400	HOLD	Maintain
23-Jul-07	432	366	HOLD	Maintain
31-Aug-07	410	373	HOLD	Maintain
10-Sep-07	410	383	HOLD	Maintain
10-Oct-07	516	512	HOLD	Maintain
24-Mar-08	516	424	BUY	Upgrade
10-Apr-08	516	430	HOLD	Downgrade
28-May-08	580	417	BUY	Upgrade
26-Nov-08	265	69	BUY	Maintain
2-Feb-09	284	61	BUY	Maintain
8-Apr-10	325	183	BUY	Maintain
19-Aug-10	200	133	BUY	Maintain

** Until July 2009 the company was covered by Alexandr Paraschii. In July 2009, Yegor Samusenko took over coverage*

Investment ratings

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