CONCORDE CAPITAL

Ukraine / Electricity

Dniproenergo

AGM: They Did It

August 31, 2007 **USD 373**
12M Target: **USD 410**

HOLD

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Bloomberg	DNEN UZ
Xetra	DPG

Market information

No of Shares, mln	5.97*
Reg S GDR to Ord.	4:1
Market Price, USD	373
52Wk H/L, USD	456.4/79.9
MCap, USD mln	2,226
Free float	5.7%
Free float, USD	127.3

** After additional share issue*

Ownership, current

State	76.0%
DTEK holding	15.3%
Other	8.7%

Ratios 2007E

EBITDA Margin	17.0%
Net Margin	7.5%

As expected, Dniproenergo's AGM on Aug. 27 approved the company's restructuring: a 52% capital increase will be exchanged for a company backed by USD 208 mln in cash:

- **DTEK will accumulate 44% of Dniproenergo, effectively paying a 46% discount to the market for the new shares**
- **Deprived of the option to subscribe, minority stakes will be diluted 34%**
- **As part of the deal, an additional USD 200 mln will be contributed by DTEK in CapEx over five years**

Solid operational backing:

- **1H07 EBITDA margin increased by 7.5% yoy**
- **Having been idle for the last three years, Dniproenergo's gas-fueled power unit started working in August**

With cleared debt, heavy CapEx coming, access to cheap coal through DTEK's mines, our outlook for Dniproenergo is quite favorable, while its shares are cheaper than its local peers.

Key financials, USD mln

	Sales	EBITDA	Net income
2006	551.2	56.6	2.5
2007E	690.0	117.3	51.8
2008E	834.9	154.5	72.1

Multiples

EV/S	EV/EBITDA	P/E	EV/Capacity USD/kW
4.2	40.5	890	312
3.3	19.5	43	310
2.7	14.5	31	305

AGM's main issues

Restructuring process

As a part of its six-year financial recovery process, the AGM approved the restructuring of Dniproenergo in the following way: Dniproenergo will issue new shares for USD 10.11 mln and exchange these shares for 100% of the charter fund of Investment Company Ltd (equal to USD 10.11 mln). Founded by two coal mines affiliated with DTEK, Investment Company Ltd was registered in July 2006 and has USD 208.3 mln in cash on its balance sheet. After the merger, the cash will be transferred to Dniproenergo’s balance sheet to repay outstanding payables and restructured debt. The AGM also obligated the founders of Investment Company Ltd (i.e. DTEK) to invest an additional amount of not less than USD 20 mln in Dniproenergo.

Buyout for those who not agree

The AGM also obligated Dniproenergo to buy out shares of those that did not vote for restructuring (or were not present at the AGM) and apply to sell their shares by Sept. 27, 2007. The buyout price is USD 315.3 per share, which is a 13% discount to the PFTS bid price, which makes selling shares to the market a better alternative than selling to Dniproenergo.

Changes in the supervisory board: DTEK in

The AGM also changed Dniproenergo’s supervisory board and audit commission. Its new supervisory board consists of four representatives from the NC ECU and three from DTEK (previously, there were only state and local administration representatives). This replacement is in line with Dniproenergo's shareholder structure post-restructuring, and with the NC ECU’s policy for companies it controls to not elect representatives of minority shareholders.

Minority stakes diluted

Based on the approved decisions, the number of Dniproenergo’s shares will grow by 52%. Shareholders will not have pro-rata subscription rights, diluting their stakes. DTEK will increase its stake in Dniproenergo by 29%.

Dniproenergo shareholder structure

	Current	After restructuring
State	76.0%	50.0%
DTEK	15.3%	44.3%
Other	8.7%	5.7%

Source: Company data, Concorde Capital calculations

Could the restructuring be reversed?

Opposition leader Yulia Tymoshenko pledged to revise the decisions of Dniproenergo's AGM if she returns to power after the September parliamentary elections. However, we believe that no matter the composition of the government, a reversal will be difficult since all of the stages of the restructuring process (including the AGM decisions) adhere to Ukrainian legislation.

It appears that the most likely challenge will be in regards to a Presidential decree from August 2, 2007, which obliges the Cabinet to:

- not allow for the disposal of state assets in the energy sector (including via additional share issues) without privatization
- privatize energy companies/objects only through open tenders

The approved restructuring, though, maintains the state's current number of shares in Dniproenergo and therefore it might be a stretch to coin it as the disposal of state assets. The state will retain its control of a 50%+1 stake in Dniproenergo. Moreover, the *restructuring* can hardly called *privatization:* it is a method of completing its financial recovery process with the help of a strategic investor. This process was approved by the Zaporizhzhya region economic court and the decisions made at AGM were in accordance with the Cabinet of Minister’s decree of June 13, 2007.

Additional investments from DTEK: USD 200 mln

In their AGM decision, Dniproenergo shareholders obligated DTEK to spend "not less than **USD 20 mln**" on the company's reconstruction.

Dmitriy Tevelev, the financial recovery manager of Dniproenergo, said that DTEK has – in fact - agreed to invest an additional **USD 200 mln** on Dniproenergo’s for reconstruction over the next five years - an amount that corresponds to the company’s CapEx program till 2012. We see several reasons for DTEK to invest the entire USD 200 mln:

- Legal reason
A mechanism for ensuring additional investments was included in Dniproenergo's financial recovery plan whereby its financial recovery process can be completed only after a legal agreement is signed between Dniproenergo and its board of creditors. According to Tevelev, the USD 200 mln investment obligation by DTEK will be part of this legal agreement. This implies that the board of creditors will not allow the company to finish its financial recovery unless the investment of USD 200 mln is committed to.

If DTEK wanted, it could finish the financial recovery process without the hefty investment obligation. A brief look at the composition of Dniproenergo's board of creditors will suffice: 51% - Ministry of Finance, whose head is close to DTEK’s owner, Rinat Akhmetov; and 7% - Komsomolets Donbasa, which is affiliated with DTEK.

- Image
Nobody forced DTEK to say they are going to invest USD 200 mln. DTEK owners look to be making a case for its reputation as a reliable and proficient strategic partner.

- DTEK can get back up to 80% of the money spent on reconstruction
According to the Ministry of Fuel and Energy’s order from May 24, 2006, up to 80% of loans and *investments* in the modernization of thermal power plants can be repaid with money accumulated from special surcharges to the TPPs’ electricity tariffs. The order does not stipulate any terms for repaying invested money, though it clearly stipulates terms for repaying *borrowed* funds: no sooner than three years after the commissioning of the reconstructed object. We believe that the terms for repaying invested money might be the same, meaning DTEK could re-pocket up to 80% of the money it invests in reconstruction over 2008-2016.

The head of the regulatory body that decides on additional surcharges, the National Electricity Regulation Commission (NERC), is close to DTEK’s owner. We believe it will be relatively easy for DTEK to get approval for the repayment of up to 80% of invested money, at the expense of electricity consumers.

With the NERC's golden stamp, an investment of USD 200 mln over the next five years would be guarantee that DTEK gets back up to USD 160 mln over the next eight-nine years. Assuming *10% cost of capital for DTEK* and that 80% of any investment will be repaid over next five years, DTEK’s discounted investment is only USD 71 mln, which raises the chance that DTEK will be ready to sign the investment agreement with Dniproenergo.

Speculation: Will profits from the investments be shared?

Going one step further, we believe that DTEK has an opportunity to partially compensate minority shareholders for the below-the-market purchase of additional shares by distributing profits from the investment surcharge between all the shareholders. Based on Donbasenergo's restructuring process, money accumulated from investment surcharges went into net income on the company’s P&L. However, Donbasenergo did not distribute this surcharge income because it opted to instead repay part of an EBRD loan. In the case of Dniproenergo, DTEK might honorably agree to distribute income from the investment surcharge (up to USD 160 mln in total over 2008-2016) equally between all the shareholders.

How much DTEK pays for subscription?

In order to increase its stake in Dniproenergo by 29%, DTEK will pay:

A) USD 208 mln up front;
B) USD 200 mln investment in capacity upgrade over the next five years, which assuming a uniform investment and 15% WACC (for portfolio investors), implies a discounted value for the investment of USD 134 mln; and
C) Given that DTEK's investment (B) may be subject to compensation, assuming 80% compensation of invested amount over five years, this implies an additional discounted value of USD 66 mln.

This implies that DTEK will dole out a minimum of USD 342 mln (A+B) or up to USD 408 mln (A+B+C) for the 29% stake in Dniproenergo, which corresponds to the deal's USD 950-1136 mln capitalization, or a 35%-22% discount to the current MCap (or 46%-36% discount to restructuring's pre-announcement MCap) – making the deal a definite bargain for DTEK.

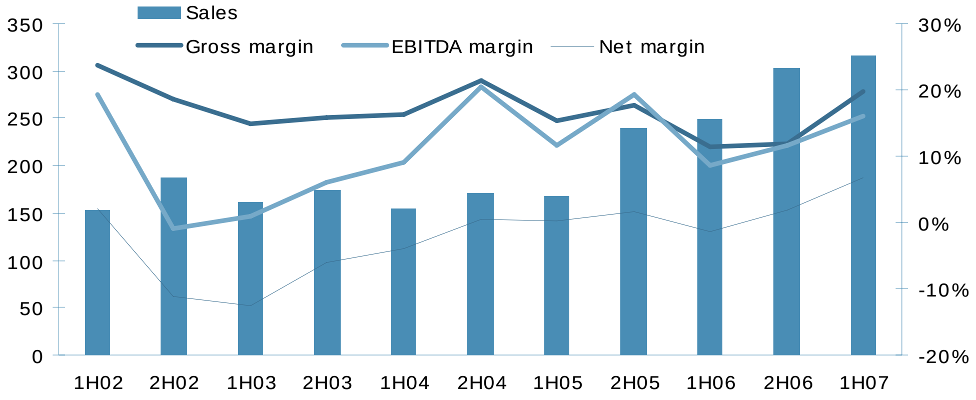
Subscription for additional shares at the low cost is the main thing perturbing minority shareholders: if they have no right to subscribe, the stability of the share price would be protected only if DTEK subscribes for additional shares at the market price. Since this is not the case (DTEK paid only USD 167 per share), DTEK's cash inflow in Dniproenergo does not adequately compensate for the dilution of minorities' stakes. We believe that DTEK will act as an efficient investor and create additional value for shareholders to compensate for dilution in the long-term. Refer to page 7 for more details.

Operational news: All positive

Improved financials

Increased power output in late 2006 and an increase in generation tariffs on the wholesale market has been reflected in Dniproenergo improving its margins.

Half-year financials, USD mln



Source: Company data, Concorde Capital calculations

New life for gas-fueled capacities

In August 2007 the dispatchers started switching on gas-fueled power units that had been idle for the last three years. Coal fueled power unit #7 at Dniproenergo's Zaporizhzhya power plant has been in operation for the last two weeks. The official reason - to accumulate coal reserves at those power plants to prepare to winter season.

However, this event forces us to revise our conservative attitude about the gas-fueled power units that are operated by Dniproenergo and Centrenergo: we add 1600 MW (out of total 2400 MW) gas-fueled capacity to Dniproenergo and 1400 MW (out of total 3000 MW) gas fueled capacity to Centrenergo for valuation purposes. We do not add the total amount of gas-fueled capacities, since the rest have been mothballed and we do not believe they will be restarted in the mid-term.

Maintaining our HOLD recommendation

As we believe Dniproenergo's local peers are priced fairly, we value Dniproenergo by other GenCos.

Net debt adjustments

Because every GenCos has large overdue payables and receivables, and some of the companies have large amounts of restructured debt, we can only compare GenCos after applying equal treatment to their net debt. To adjust the net debt for the companies' overdue payables and receivables, we add the payables and restructured debt, less receivables. In addition, we apply a uniform approach to accounting for the GenCos' payables. Dniproenergo has declared most of amount Energorynok owes it as bad payables, which is reflected in accounting for 80% of total receivables as a bad debt provision at the end of 2005. Other GenCos account for only 1%-56% of their total payables as bad debt, which, we believe is too optimistic. Thus, we assume that for all GenCos, net payables at the end of 2005 are equal to 20% of total payables.

Assuming the USD 208 mln investment in Dniproenergo by DTEK is spent to repay debt, we believe Dniproenergo will have any more outstanding payables. we adjust Dniproenergo's reported net debt, decreasing it by the amount of discounted investments from DTEK over the next five years: USD 134 mln.

Net debt adjustment

	Net debt reported	Net debt adjusted
CEEN	95.7	359.7
DOEN	71.8	169.8
ZAEN	134.0	233.5
DNEN	58.3	-75.7

Source: Company data, Concorde Capital calculations

Valuation by local peers

	MCap USD mln	Net debt USD mln	Capacity MWh	EV/Capacity USD/kW
CEEN	1507	359.7	5950	314
DOEN	662	169.8	2710	307
ZAEN	1326	233.5	4600	339
Mean				320
DNEN	2226	-75.7	7360	292
Implied upside				**10%**

Source: Company data, PFTS, Concorde Capital calculations

We set a new 12M target price for Dniproenergo at USD 410 per share, which implies a 10% upside. We reiterate our HOLD recommendation.

Is the valuation justified?

Our valuation implies a USD 2,446 mln target MCap at the new number of shares, which is **USD 944 mln** more than our valuation before the announcement of the restructuring process. We believe this addition is justified.

DTEK invests **USD 342 mln** in cash or discounted investment obligations (refer to page GGG). Compounding for 12 months, we get USD 393 mln.

The rest of the difference, **USD 551 mln**, can be generated from additional cash flow to Dniproenergo as a result of the process of restructuring.

Assuming 15% WACC in perpetuity this value can be generated by additional annual cash inflow of **USD 83 mln**. We believe it is realistic.

Case study: Trying on Vostokenergo's shirt
If Dniproenergo had the same capacity load and the same EBITDA margin as Vostokenergo, its 2007 EBITDA would be USD 364 mln (**USD 260 mln more** to our 2007 forecasts for Dniproenergo).

Dniproenergo will benefit from synergies as part of DTEK's vertically integrated holding: DTEK's coal mines can supply coal to Dniproenergo power plants at lower prices than Dniproenergo currently pays to less efficient state-controlled mines. Lower fuel costs will be reflected in an increase in both price-competitiveness (i.e. higher capacity load) and profitability of power generation. For instance, the EBITDA margin of DTEK-affiliated Vostokenergo is 12.1% higher than for Dniproenergo, even though Vostokenergo's fuel efficiency is less.

While we do not believe Dniproenergo will match Vostokenergo's parameters in the short-term, we can expect a convergence in capacity load and margins in the long-term.

Margins of Ukrainian GenCos, 1H07

	Gross	EBITDA	Net
Centrenergo	17.8%	15.5%	5.7%
Dniproenergo	19.8%	16.1%	6.7%
Donbasenergo*	20.0%	12.9%	3.8%
Zakhidenergo	14.6%	9.0%	4.4%
Vostokenergo	34.0%	28.3%	19.8%**

** Margins of Donbasenergo are adjusted for additional payments to compensate an EBRD loan*
*** The net margin of Vostokenergo cannot be directly compared to other GenCos since the company does not have power plants on its balance sheet, thus has low depreciation costs*
Source: Company data

There are other positive changes that add value:

- The fact that the company's debt might be cleared significantly improves the financial stability of Dniproenergo, positioning it favorably compared to Centrenergo (with USD 266 mln overdue payables and restructured debt) and Donbasenergo (USD 116 mln). Dniproenergo will now be able to easily attract additional debt for future CapEx.

- The company will have a guaranteed source of cash for investment projects in the next five years. At the moment, the government's program to reconstruct energy objects, passed in 2004, has had little effect because GenCos have not been able to attract money for financing.

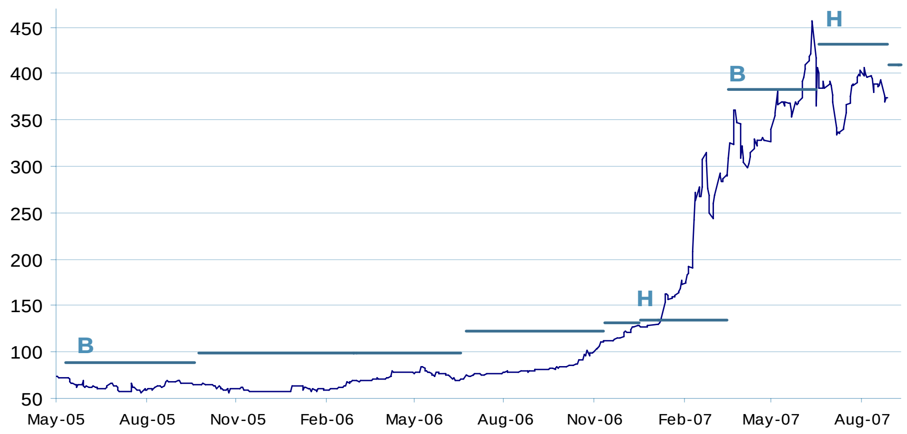
Analyst Certification

I, Alexander Paraschiy, 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.

Dniproenergo (DNEN)

Date	**Target price**, USD	**Market Price**, USD	**Rec'**	**Action**
13-May-05	88	75	BUY	Initiating
26-Sep-05	99	67	BUY	Maintain
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
22-Jun-07	432	400	HOLD	Downgrade
23-Jul-07	432	366	HOLD	Maintain
31-Aug-07	410	373	HOLD	Maintain

DNEN recommendation history



Concorde Capital Coverage Universe

Buy	45	*52%*
Hold	14	*16%*
Sell	21	*24%*
Under Review/Suspended	6	*7%*
Total	**84**	***100%***

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