Ukraine / Electricity

Dniproenergo

DTEK Takes the Reins

June 22, 2007

HOLD

Market price: USD 400 **12M Target: USD 432**

Alexander Paraschiy
+380 44 207 5030
ap@concorde.com.ua

The new plan to restructure Dniproenergo provides for increasing the company's share capital to the benefit of DTEK. We believe any short-term dilutive effect on the market price will be offset by the market's willingness to pay a premium for the arrival of a powerful strategic investor. The restructuring improves Dniproenergo's prospects to generate value for shareholders in the mid-term. We upgrade our target price to USD 432 per share. HOLD.

Market information

Bloomberg	DNEN UZ
No of Shares, mln	3.924
New shares to be issued, mln	2.043
MCap, USD mln	1,570
Free float	15%
FF MCap, USD mln	235

Stock ownership, current

NC ECU	76.0%
DTEK	8.3%
Other	15.7%

Ownership after restructuring, est

NC ECU	50.0%
DTEK	39.7%
Other	10.3%

Ratios, 2007E

EBITDA Margin	11.0%
Net Margin	2.8%
Net Debt/ Equity	0.34

We see the deal playing out like this: The Donbas Fuel and Energy Company (DTEK) will invest a total of about USD 388 mln to obtain the right to subscribe to 100% of the new shares; USD 188 mln will be directed at clearing Dniproenergo's outstanding debt; and the rest (USD 200 mln) will be directed for CapEx on Dniproenergo.

Dniproenergo benefits because it will:

- Solve its debt problem
- Complete its financial recovery process
- Obtain USD 200 mln in investments
- Increase its book value by about USD 400 mln, which will allow the company to attract debt for further CapEx financing
- Acquire a powerful strategic investor

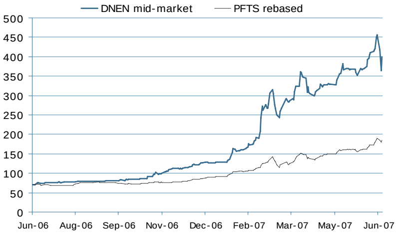
DTEK benefits because it will:

- Increase its presence in Dniproenergo by 31.4% for USD 388 mln, which is a 21.4% discount to the current market price

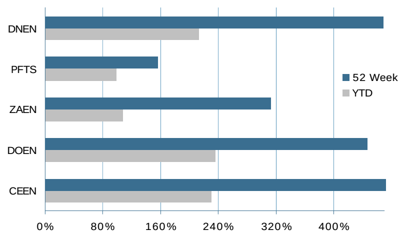
The effect for minority shareholders is:

- Risk of dilution in the short-term (maximum dilutive effect is 18%) should be offset in the short-term by the market, which might be ready to pay a premium if a strategic investor is behind the company
- In the mid-term, Dniproenergo will create value for shareholders that will offset any short-term dilutive effect

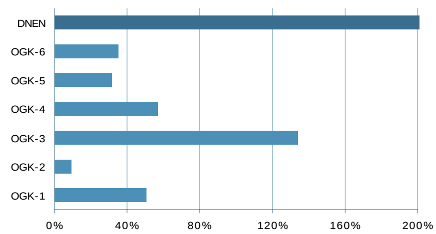
DNEN price, USD



Performance vs GenCos & PFTS



YTD Performance vs Russian OGKs



Source: PFTS, RTS, Concorde Capital calculations

Key Financials & Ratios

(in USD mln)	Sales	EBITDA	Net Income	EV/S	EV/EBITDA	P/E
2006	551.2	56.6	2.5	3.0	29.2	628
2007E	684.6	75.3	19.3	2.4	22.2	81
2008E	757.2	90.8	31.2	2.3	18.9	50

Spot exchange rate is 5.05

How it might be done

We believe Dniproenergo's additional share issue will be used as an instrument of the company's restructuring, as it was approved by the Dniproenergo's board of creditors this week. In the process of restructuring, all the additional shares will be accumulated by one investor, most likely, the Donbas Fuel and Energy Company (DTEK).

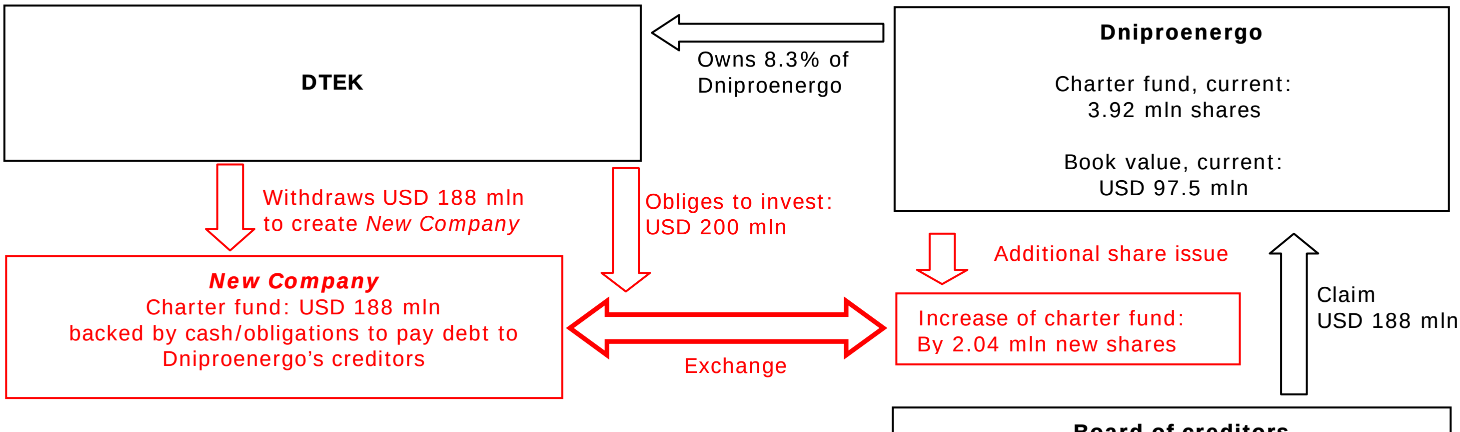
The most likely scenario for the structure of the deal is:

- DTEK creates a separate company with a charter fund equal to USD 188 mln (backed by cash or an obligation to pay off Dniproenergo's debts amounting to USD 188 mln).
- A 100% stake in the company is exchanged for all the shares of Dniproenergo's additional share issue.
- DTEK sings an agreement with the NC ECU to additionally invest about USD 200 mln in CapEx on Dniproenergo.

This structure would have the following outcomes:

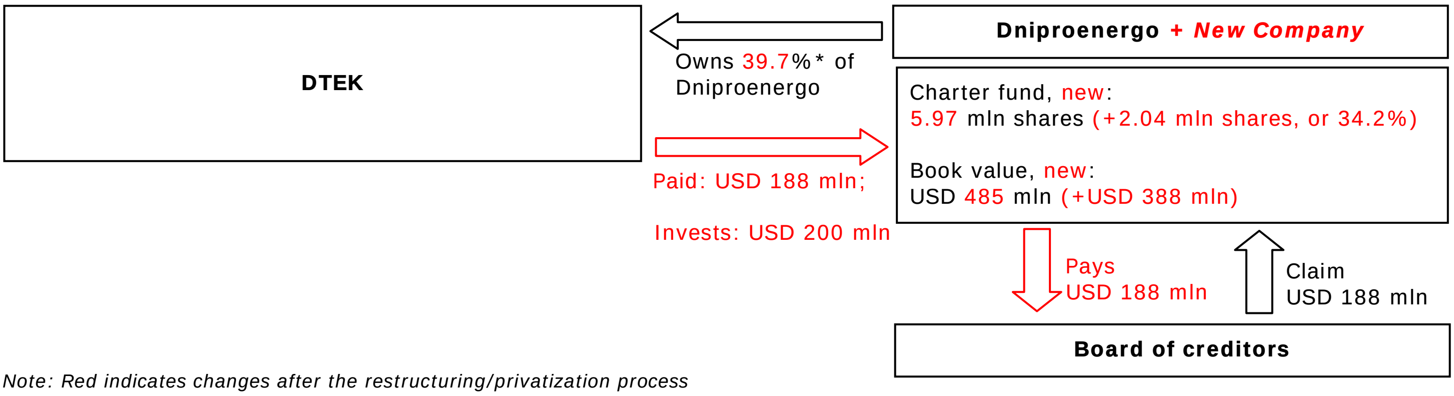
- The NC ECU will decrease its presence in Dniproenergo from 76.04% to a 50%+1 share.
- DTEK obtains all additional shares (34.2% of the charter fund after the additional share issue) and increases its presence in Dniproenergo from its current 8.3% to 39.7% after the issue (an effective increase by 31.4%).
- Debt to Dniproenergo's creditors amounting to USD 188 mln is cancelled. Technically, DTEK will either transfer cash to Dniproenergo and then the company will use it to pay off debt, or DTEK itself will pay Dniproenergo's debt to its creditors. The net effect of this operation on Dniproenergo's balance sheet is that USD 188 mln will be transferred from current liabilities to the company's share capital.
- Dniproenergo obtains about USD 200 mln for CapEx from DTEK. We believe that in the mid-term this operation will be reflected on the company's balance sheet as an increase in both shareholder equity and fixed assets.

Restructuring process



Note: Red indicates the stages of Dniproenergo's restructuring

Changes in DTEK and Dniproenergo after restructuring:



Note: Red indicates changes after the restructuring/privatization process
** DTEK's new stake in DNEN is calculated as the sum of new shares bought (34.2%), plus the old stake (8.3%) that was effectively diluted in the process of restructuring to 5.4%*

The choice of a deal structure does not contradict current legislation and looks beneficial for DTEK.

What is the deal price?

For DTEK: Effectively, is comparable to the purchase of 31.41% of Dniproenergo's shares for USD 388 mln (effective MCap of USD 1,234 mln, or a discount of 21.4% to current MCap).

For the state: The deal is comparable to the privatization of 26.04% for USD 388 mln (effective MCap is USD 1,488 mln, or 5.2% discount to the market) that is automatically re-directed to the company.

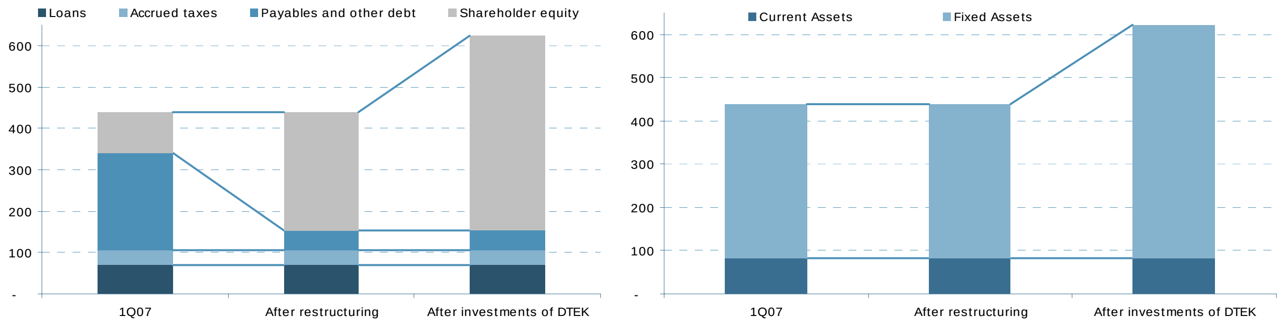
The alternative that might be considered by the state is a direct privatization of 26.04% of Dniproenergo. This way looks less beneficial for the company, as money raised from privatization would be directed to the state budget, and it would take political will to direct it back to the company. Moreover, if directed back, it would be subject to income taxation (25%). Thus, for Dniproenergo to receive USD 388 from the state via a direct privatization, the state would have to sell its 26.04% stake in the company for USD 517 mln. The alternative privatization MCap of USD 1,984 mln (26.4% premium to market) would have the same effect as the deal described above for the state (in terms of share decrease) and Dniproenergo (in terms of cash inflow).

Currently, the parameters of Dniproenergo restructuring are being considered by the Economic Court of Zaporizhya Region, and we believe they have a good chance of being approved.

Implications for Dniproenergo: Complete financial recovery + Intensive investment program

Assuming no other changes in Dniproenergo's balance sheet, the restructuring and investment process will have several implications for the company.

Changes in Dniproenergo's balance sheet, USD mln:



Source: Dniproenergo, Concorde Capital estimates

Dniproenergo stands to gain:

- Mid-term cash inflow of about USD 200 mln from DTEK for the company’s CapEX (USD 34 per kW of installed coal capacity), which is enough to modernize three 300-MW power units (16% of installed coal capacity)
- Complete write off of its debt and finish its financial recovery process
- Shareholder equity increase of about USD 388 mln, which together with the debt write-off, increases its options to raise new debt capital
- A new strategic investor with significant lobbying power and investment capacity

All in all, this is a remarkable opportunity for the company which had the lowest CapEx program among Ukrainian GenCos, and little chance of its improvement due to its high outstanding debt.

Implications for shareholders: Dilution risk in the short-term…

Taking into account a USD 388 mln increase in its MCap through restructuring, the total dilutive effect at the current market price will be up to -18%, which implies a short-term investment risk.

However, DTEK might treat minorities right by buying out shares at a price that is close to the market.

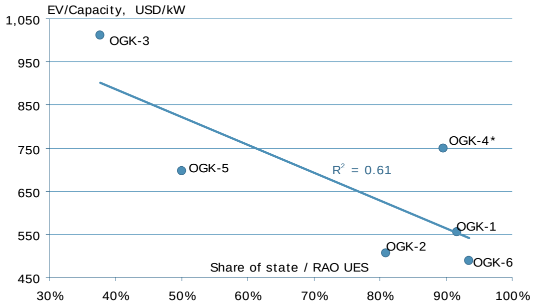
… but definitely positive in the long-term

With the company's value increasing through the restructuring, we believe that in the mid-term any possible negative effect of the additional share issue for minority shareholders will be offset.

Valuation revision

As the market now values generation companies mainly by discounting their growth prospects, we believe that due to the entrance of a strategic investor Dniproenergo deserves a premium valuation to other traded GenCos, which remain in state control. As the experience of Russian power generation companies suggest, the market is ready to value companies with a strategic investor at a premium to those where a state holding is the main shareholder.

Russian OGK market ratios



*OGK-4, seemingly an outlier of the trend, is valuated higher due to its planned privatization via an additional share issue scheduled for July 2007.

Source: RTS, Company data, Concorde Capital calculations

We believe this premium incorporates higher expectations of development for privatized companies' compared to those not yet privatized.

Calculation of premium: Experience of Russian OGKs
Among the four actively traded Russian thermal generation companies (OGKs), two companies have strategic investors (with stakes of 25% and 46.6%) and two are majority controlled by RAO UES holding, which is controlled by state.

Valuation differences for Russian OGKs

	MCap, USD mln	Capacity, MW	EV/Capacity, USD/kW	EV/S 2007E	EV/EBITDA 2007E
Controlled by RAO UES					
OGK-2	3,906	8,695	505	4.1	25.2
OGK-4	5,650	8,360	749	5.2	31.9
Mean			**627**	**4.6**	**28.5**
With strategic investor					
OGK-3	8,063	8,497	1,012	9.2	57.8
OGK-5	5,518	8,672	697	4.8	27.3
Mean			**854**	**7.0**	**42.6**
Mean premium to RAO UES-controlled			**36%**	**51%**	**49%**

Source: RTS, Company data, Concorde Capital calculations

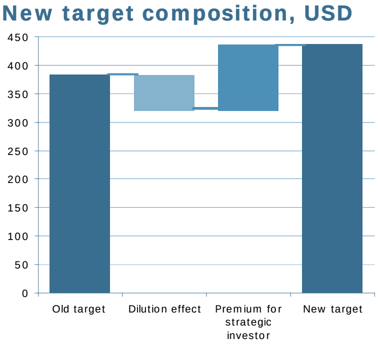
Using data from the Russian market, we set a premium to Dniproenergo for the entrance of a strategic investor at 35% compared to our last target. Note that this premium offsets the dilutive effect of the additional share issue.

New target calculation

Target price, old	**383**	**USD**
x Shares, old	3.924	*mln*
Target MCap, old	1,503	**USD mln**
+ Net debt	68	USD mln
Target EV. old	**1,571**	**USD mln**
+ Additional investments in the process of restructuring (Est)	388	USD mln
Post-restrucuring target EV	**1,958**	**USD mln**
+ Premium for strategic investor	35	%
New target EV	**2,644**	**USD mln**
- Net debt	68	USD mln
New target MCap	2,576	**USD mln**
/ Shares, new	5.967	*mln*
Target price, new	**432**	**USD**

Source: Concorde Capital estimates

New target composition, USD



Source: Concorde Capital estimates

The new target implies a 8% upside to market price. We change our recommendation on DNEN to HOLD.

Appendix: Case of Russian TGK-5

The recent experience of Russian Regional Generation Company #5 (TGK-5) is the best example of the efficient privatization of generation company via an additional share issue. We believe this recent case inspired Dniproenergo's decision to conduct an additional share issue.

Parameters of the issue:

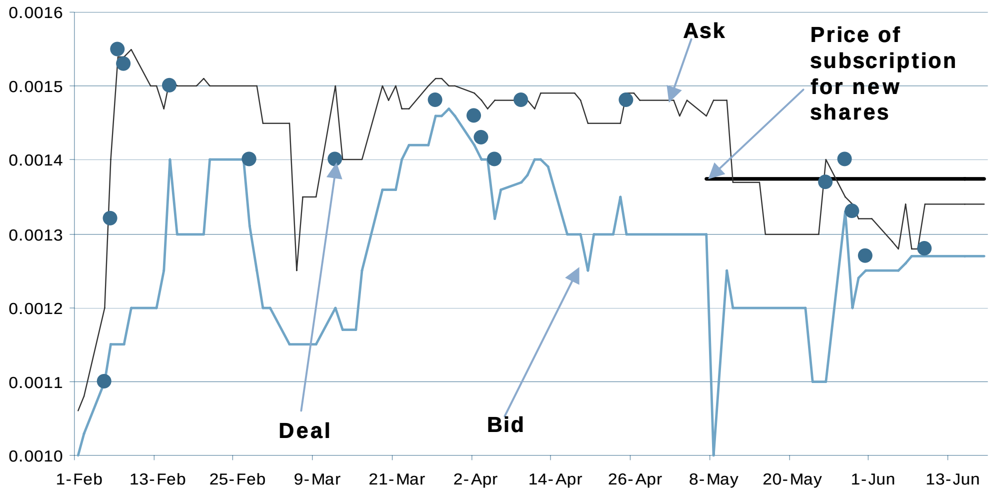
- Number of shares increased from 900.52 bln to 1,230.25 bln (+37%)
- Nominal value of each new share was RUR 0.01 (USD 0.00039)
- The board of directors approved the price of subscription to the additional share issue based on research from Morgan Stanley and Russian KIT-Finance. The purchase price for new shares was determined at RUR 0.0353 (USD 0.00137), or at a 253% premium to the nominal price (a 1% discount to the closing mid-market price on the day before the announcement)
- During the first stage of subscription, 20.99% of shareholders realized their preferential rights of subscription for new shares. Owners of 79.01% of shares (including RAO UES with its 64.83% stake) did not subscribe.
- The board of directors decided to allow the company Integrated Energy Systems (IES) to subscribe for the remaining 79.01% of the additional issue.

Results of the additional issue:
- RAO UES's stake in TGK-5 dropped from 64.8% to 47.5%.
- IES' stake increased from 27.4% to 41.2%.
- TGK-5 received USD 453 mln in cash from the additional share issue.

Impact on the market price: Slightly negative

As early as May 7, 2007, TGK-5's board of directors announced the price for subscription to the additional shares and market quotes for the company have corrected slightly. After May 7 stock quotes did not exceed the price announced by management. We believe this is because institutional investors were not ready to pay a higher price for TGK-5 shares than a strategic investor, which had the right to subscribe at the announced price.

TGK-5 Market price, USD



Source: RTS, Company data

Concorde Capital
3V Sportyvna Square
2nd entrance, 3rd floor
Kyiv 01023, UKRAINE

Tel: +380 44 207 5030
Fax: +380 44 206 8366
www.concorde.com.ua
office@concorde.com.ua

CEO
Igor Mazepa im@concorde.com.ua

Head of Equity Sales
Lucas Romriell lr@concorde.com.ua

Equity Sales
Marina Martirosyan mm@concorde.com.ua
Anastasiya Nazarenko an@concorde.com.ua
Duff Kovacs, CFA dk@concorde.com.ua

Director of Research
Konstantin Fisun, CFA kf@concorde.com.ua

RESEARCH COVERAGE BY SECTOR

Strategy
Konstantin Fisun kf@concorde.com.ua
Oleksandr Klymchuk ok@concorde.com.ua

Metals & Mining
Eugene Cherviachenko ec@concorde.com.ua

Utilities (Telecom, Energy)
Alexander Paraschiy ap@concorde.com.ua

Oil & Gas, Chemicals
Vladimir Nesterenko vn@concorde.com.ua

Consumer/Retail Group
Andriy Gostik, CFA ag@concorde.com.ua
Olha Pankiv op@concorde.com.ua
Alexander Romanov ar@concorde.com.ua
Anna Dudchenko ad@concorde.com.ua

Machinery
Olha Pankiv op@concorde.com.ua
Eugene Cherviachenko ec@concorde.com.ua
Inna Perepelytsya pi@concorde.com.ua

Financial Services, Macroeconomics
Alexander Viktorov av@concorde.com.ua

Fixed Income
Oleksandr Klymchuk ok@concorde.com.ua

Corporate Governance
Nick Piazza np@concorde.com.ua

News/Production
Nick Piazza np@concorde.com.ua
Polina Khomenko pk@concorde.com.ua

Editor
Brad Wells bw@concorde.com.ua

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