

The Donbas that Ukraine will never lose

Strategy note

Summary

In his attempt to destabilize Ukraine, Russian President Putin has reached some success in the country's two easternmost oblasts, collectively called Donbas. The good news is that the geography of the turmoil is much smaller than "Novorossiia" or "Southeastern Ukraine," which are Putin's invented labels to refer groundlessly to the wide region that he alleges to support joining Russia. More good news is the separatists are not that popular in Donbas: there were twice more supporters of staying in Ukraine than separatist-minded residents of Donbas in early May, and we believe this ratio increased over the last month. During that time, Rinat Akhmetov, the region's biggest capitalist who employs about 165K workers there, has gone from being an active supporter of "the voice of Donbas" to the main opponent of "the terrorists".

Donbas as a separate country is not sustainable (its total fiscal gap is bigger than Greece's). Joining the Russian Federation would demand heavy financing from federal budget. In particular, separation would mean a collapse of Donbas's state coal sector, which employs 150K people. On top of that, the electricity sector will not be competitive in Russia, nor would be the related private coal sector. Donbas would be a much bigger headache for Russia than Crimea is now.

The economy of the Luhansk Oblast, part of Donbas, is indeed dependent on Russian demand for its goods, but this dependence is smaller than even Ukraine's other regions that oppose joining Russia. The Donetsk Oblast's economy is not dependent on Russia, so its integration into the Russian economy will offer little economic benefit to both entities, as does the integration of Crimea.

We do believe Putin has no intention to annex Donbas, which would bring him a lot of headaches both from the West and from the inside the Donbas. At the same time, he has clear benefits from the destabilized Donbas:

- We see the main positive external factor for Putin from turmoil in Donbas is his improved ability to glue Crimea. The Crimean people are quite happy that they have "no war as in Donbas", and international pressure has dramatically shifted towards Donbas and away from Crimea.
- Another goal achieved by Putin is decreasing business activity in the heart of Donbas, which is hurting the Ukrainian economy and is being used by the Kremlin as a proof (for domestic use) that the new Kyiv government is failing.

Ideally, Putin indicated he would like to create an independent entity out of as many of the eight Russian-oriented oblasts of southeast Ukraine as possible and integrate them into the Eurasian Economic Union. However, the Donbas war has shown that this task will be difficult, if not impossible.

The destabilization in Donbas is harming the economy since it accounts for nearly 16% of Ukraine's GDP and 23% of industrial output. Moreover, many mining and processing companies in Ukraine's other industrial regions are involved in the production cycle in Donbas. We believe the election of a new Ukrainian president, launching efforts to grant more regional power, boosting active military operations in Donbas, as well as the growing impatience of local residents with the terrorists will enable the government to stabilize the situation in the next two months. At the same time, we believe that much will depend on Russia's willingness to facilitate the stabilization. Unfortunately, we see no prospects there.

That being said, we see that it would be premature to declare that the worst for Donbas is over. In the worst case, we see long-lasting unrest in the southeastern part of Donbas, which is heavily industrialized and is very close to the Russian border. This might damage Ukraine's economy heavily and may have negative implications for many listed companies, like the subsidiaries of Metinvest, DTEK, Donbasenergo, Centrenergo and Motor Sich, as well as Stirol, Stakhanov Railcar, Luhanskteplovoz, Sadovaya Group, Coal Energy and Ukrzaliznytsia.

At the same time, the containment of the military conflict outside their areas of activity (in Donetsk and Luhansk Oblasts) makes Senrinus Energy, Agroton, Azovstal, Ilyich Steel, and the subsidiaries of Avangardco safer businesses. But that does not mean their assets or employees are secure from any terrorist attacks.

What Donbas is for Ukraine

The Donetsk and Luhansk Oblasts (commonly known as Donbas, named after coal basin that covers much of the territory of these regions) are:

- Rich in coal, shale gas and fertile land
- Highly urbanized and industrialized with well-developed coal, steel and machinery sectors

In Ukraine, Donbas is responsible for:

- 7.7% of agricultural output (2012)
- 8.8% of area
- 14.5% of population
- 15.7% of GDP (2012)
- 23.3% of total industrial output (2012)
- 26.6% of total goods exports and 27.8% of exports to Russia (2012)
- 36.4% of electricity made from fossil fuels (2013)
- 44.0% of all pollutant emissions (2012)
- 52.8% of rolled steel output and zero iron ore output (2013)
- 66.7% of steam coal production (2013)
- 99.4% of coking coal production (2013)

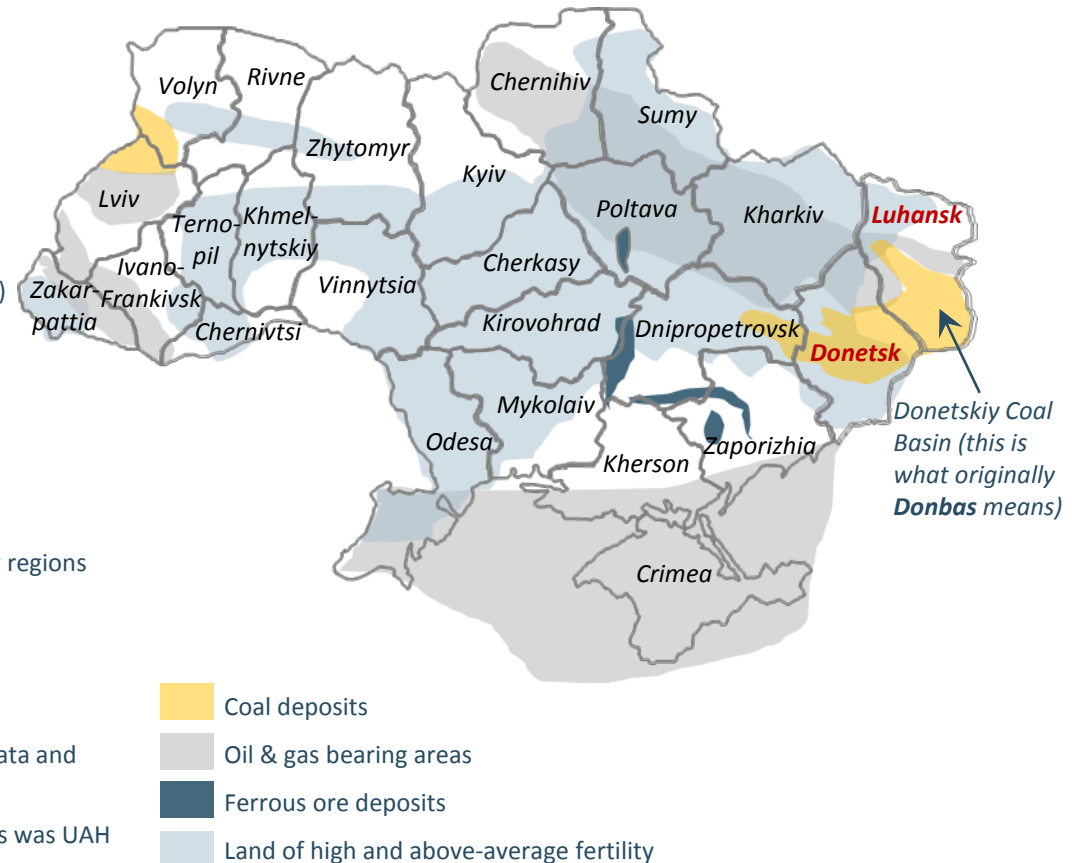
Donbas enterprises are:

- Monopoly suppliers of coking coal and lean coal to Ukraine's other regions
- Net importers of electricity from Ukraine's other regions
- Pure importers of iron ore from Ukraine's other regions
- Pure importers of gas from Ukraine's other regions and Russia
- Generators of UAH 3.1 bln in net losses in 2012

Donbas is a burden to Ukraine's economy and state (based on 2013 data and estimates):

- Total net subsidies to Donbas from Ukraine's budget and industries was UAH 38.6 bln (16.9% of the region's GDP), including, among others:
- UAH 17.3 bln in net subsidies from the pension fund
- UAH 12.0 bln in direct state subsidies for the coal industry
- UAH 10.0 bln in estimated implicit subsidies for electricity and natural gas

Location of Ukraine's core natural resources



Who will buy Donbas?

As a standalone economy, Donbas would be the world's:

- 6th biggest importer of iron ore (2.4% of global imports)
- 8th biggest producer of coking coal (2.5% of global)
- 13th biggest producer of steel (1.1% of global)
- 18th biggest exporter of goods to the Russian Federation (1.6% of total)

- Its area is 53.2 mln sq. km., larger than Slovakia or the Netherlands
- Its population is 6.56 mln, more than Slovakia or Finland
- Its 2012 GDP was USD 21.7 bln, 35x less than the Netherlands, 11x less than Finland and 4x less than Slovakia.
- It's an export-focused economy: the ratio of exports to GDP is 64%

If you buy this country, you should be aware that:

- Its workforce is 2.98 mln, out of which:
 - 0.15 mln (5%) are workers of state loss-producing coal mines (which generated USD 1.7 bln in losses in 2013). You have to either support these people with sector subsidies or employ them somewhere else.
 - 0.17 mln (6%) are employed by Akhmetov, the richest individual in the region, whom you will have to deal with.
- You will have to pay USD 4.8 bln annually to support the country's budget and economy:
 - Its budget had a USD 3.5 bln deficit in 2013, or 12.4% of its GDP (as much as Greece's 12.7%)
 - Its business is also used to receiving additional subsidies, which amounted to USD 1.3 bln (4.4% of its GDP) in 2013.
- Electricity supplied by its power plants to the wholesale market is about 20% more expensive than wholesale prices in the EU, 30% more expensive than in Ukraine and almost twice as expensive as in Russia.

To compare, the Crimean economy that is currently controlled by Russia:

- Generated USD 6.9 bln GDP in 2013
- Had a USD 0.9 bln budget deficit, or 12.3% of its GDP in 2013

We do not see any economic benefits for Russia from the annexation of Donbas. For Ukraine, it's an important resource base and integral part of its production cycles. This is why destabilization, not annexation, is more important for Russia here.



Donbas doesn't really "feed Ukraine"

One of the myths trumpeted by the separatists is that the region "feeds all of Ukraine," which is "sponging off Donbas." So they claim its welfare will improve if it stops subsidizing Ukraine's other regions.

Yet national statistics reveal that Donbas is an even higher burden for Ukraine's economy and budget than Crimea is.

- Despite generating more than 15% of the nation's GDP, this region accounts for just 3% of net VAT paid into the state budget (VAT is the core contributor to tax revenue) due to its high emphasis on exports.
- The region accounts for 18% of pension fund expenses, which is more than its contribution to the country's GDP.
- The region's coal sector received UAH 12 bln in subsidies in 2013, or 3% of Ukraine's state budget expenses.
- Its expensive coal-fired power plants are subsidized by other Ukrainian power producers, like hydro and nuclear.
- Its state coal mines also benefit from discounted electricity, while its heating enterprises benefit from subsidized natural gas

As a standalone economy, Donbas will have to direct nearly 17% of its aggregate GDP to cover the deficit of its state budget and other perks that its enterprises have grown accustomed to receiving from Ukraine.

Support of Donbas economy by Ukraine in 2013, UAH bln

	Dontesk	Luhansk	Donbas	Crimea
Net pension fund subsidy	10.5	6.8	17.3	4.9
Net VAT paid (est.)	-0.1	-3.9	-4.0	-2.2
Other taxes, duties paid to central budget (est.)	-20.5	-5.5	-26.0	-5.9
Defense, Law & Admin expenses redistributed (est.)	7.9	4.1	12.0	4.3
Net subsidy to local budgets	11.9	5.2	17.1	5.7
Subsidy to support coal industry	8.0	4.0	12.0	0.0
Total net budget subsidy	17.7	10.6	28.4	6.8
% of regional GDP	10.4%	18.3%	12.4%	12.3%
Other subsidies:				
Naftogaz subsidy to heat enterprises (est.)	2.1	1.1	3.2	0.0
Electric subsidy – GenCos (est.)	4.0	0.9	5.0	0.0
Electric subsidy – coal mines (est.)	1.1	1.1	2.1	0.0
Total net subsidies from Ukraine	24.9	13.7	38.6	6.8
% of regional GDP	14.6%	23.6%	16.9%	12.3%

Donbas and Russia: not so deeply integrated as alleged

A widespread belief is that Donbas is so closely economically integrated with Russia that it will be devastated economically if Ukraine spoils its business links with its eastern neighbor. Our analysis suggests that this is only true for the Luhansk Oblast, but it's not true for the Donetsk Oblast or Donbas as a whole.

The Luhansk Oblast is among the leaders based on the ratio of Russian exports to regional GDP (the statistics show the dependence of the region's labor on Russia), but not the leader. Notably, almost 25% of its exports to Russia comes from just two enterprises, whose performance is independent of the warming or cooling of ties with Russia:

- Luhanskteplovoz produces locomotives for Russian Railway. Owned by Russian TMH, this company's demand has no relation to politics.
- Stakhanov Railcar is a freight car producer. However political relations with Russia turn out, this company has no future on the Russian market anymore due to protectionism. The company decreased its output almost 3x in 2013, compared to 2011.

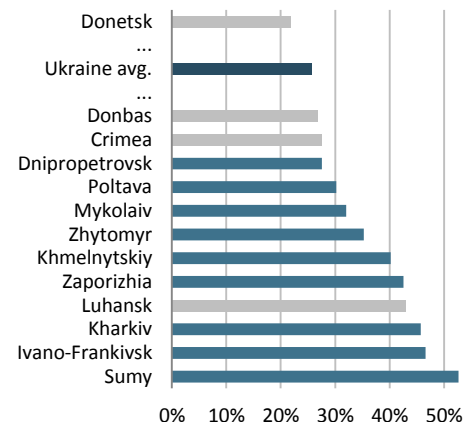
It is true that Donbas will lose more from Ukraine's shift towards the EU at the expense of good relations with Russia. Its exports to the CIS (the region that is politically controlled by Russia) is smaller than exports to the EU and U.S. But again, the difference between CIS and EU exports is smaller than for some other regions of Ukraine, which aren't considering separation at all.

Though, the contribution of Donbas's net exports to Russia to its GDP is zero. Also important is that contribution of net exports to Russia to Luhansk GDP is negative.

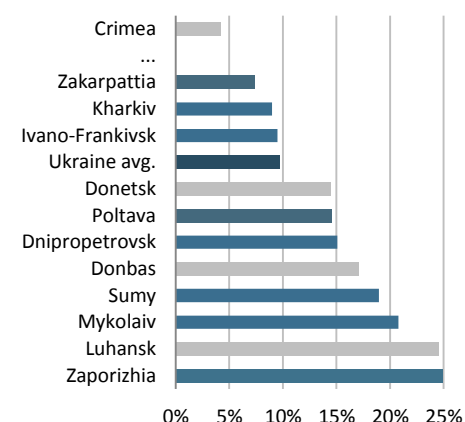
Notably, the dependence of the Donetsk Oblast economy on exports to Russia (14.5% to GDP) is on par with other industrialized regions of Ukraine, and its divergence from the nation's aggregate statistics (9.7% to GDP) can be explained by its very close location to Russia. Note also that Crimea has much smaller dependence on Russia, compared to other regions of Ukraine.

So it would be much easier for Russia to absorb the Zaporizhia, Luhansk or Sumy Oblasts compared to Donetsk or Crimea.

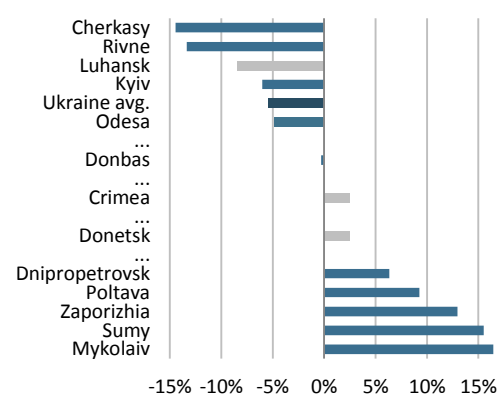
Exports to Russia as % of total exports, 2012



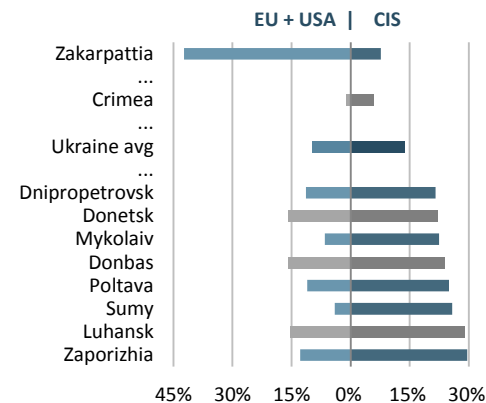
Exports to Russia as % of GDP, 2012



Net exports to Russia as % of GDP, 2012



Exports by destination as % of GDP, 2012



Coal & power industry of Donbas: heavily subsidized, not so self-sufficient

Donbas is the monopoly producer of lean coal, which is used as a primary fuel for power stations in Ukraine's other regions.

On the other hand, Donbas is not self-sufficient with gas coal, another coal type of coal used by some power stations. Ironically, power stations in Donbas use more gas coal, which is partially imported from the Dnipropetrovsk Oblast.

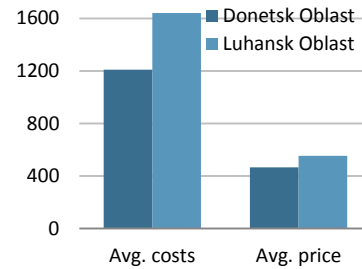
Donbas's coal industry is heavily subsidized by the state. All the state-controlled coal mines, which employ about 150,000 people in the region, are loss-making, as their average coal costs exceed their selling price by almost 3x.

- The total state subsidy to the coal industry of Donbas amounted to UAH 12.0 bln in 2013;
- On top of that, coal mines benefit from special prices for electricity, which allowed them to save additionally about UAH 2.0 bln in 2013, we estimate.
- Donbas's power generating units, which are mostly coal-burning, also benefit from an implicit subsidy that is granted at the cost of other power producers and power consumers. Electricity sourced from coal-burning thermal power plants is 30% more expensive than the average price on the wholesale market (which averages power from nuclear and hydro producers). By selling their power at above-average prices, Donbas-based power plants generated an additional UAH 5.0 bln in revenue in 2013, we estimate.

By losing Donbas, Ukraine would have to import lean coal, start exporting gas coal, would have cheaper electricity, would export more electricity, and would save about 3% of state budget costs by not supporting coal mines.

Integrating the Donbas coal and power sectors into the Russian economy would not make any economic sense.

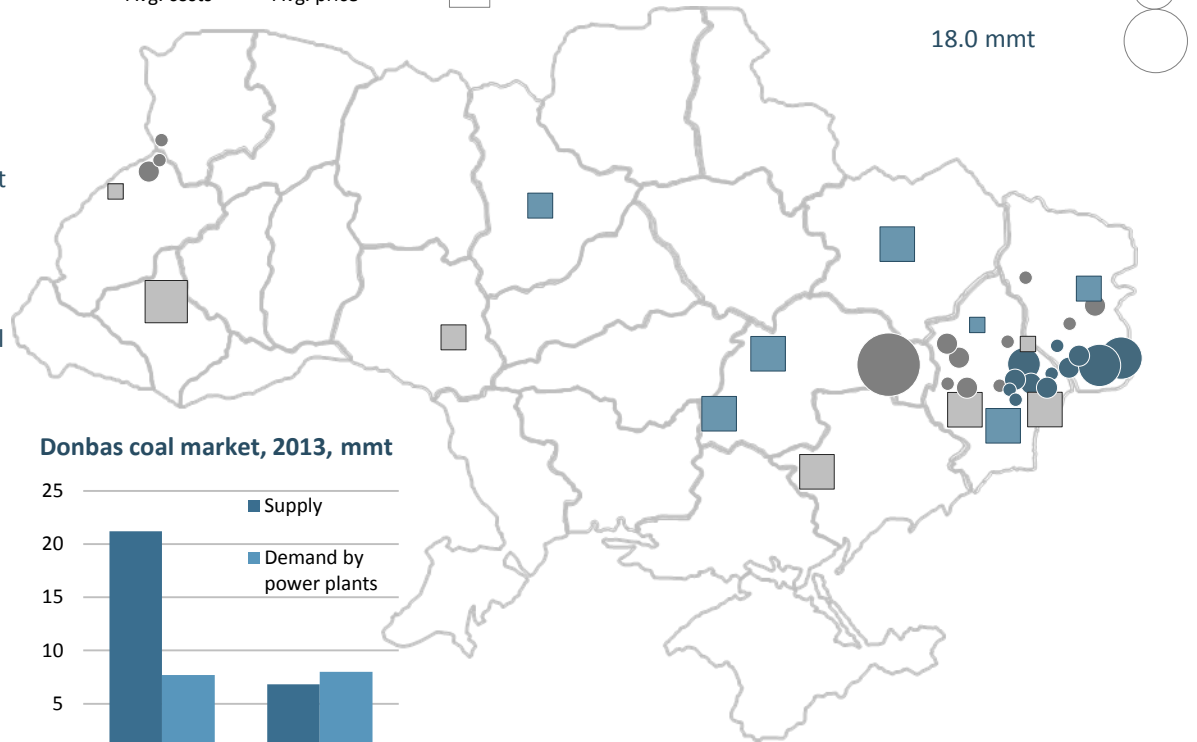
State mines KPI, 2013, UAH/t



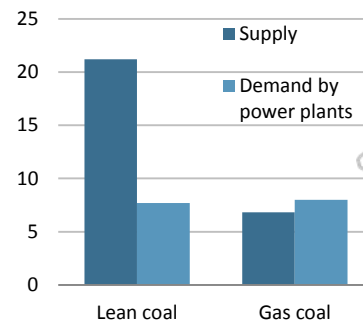
Key consumers of steam coal:



Key producers of steam coal:



Donbas coal market, 2013, mmt



Donbas steel industry: all its iron ore imported from Kryviy Rih

Another backbone industry of Donbas is metallurgy. The region is self-sufficient in coking coal and coke, but has no in-house sources of iron ore.

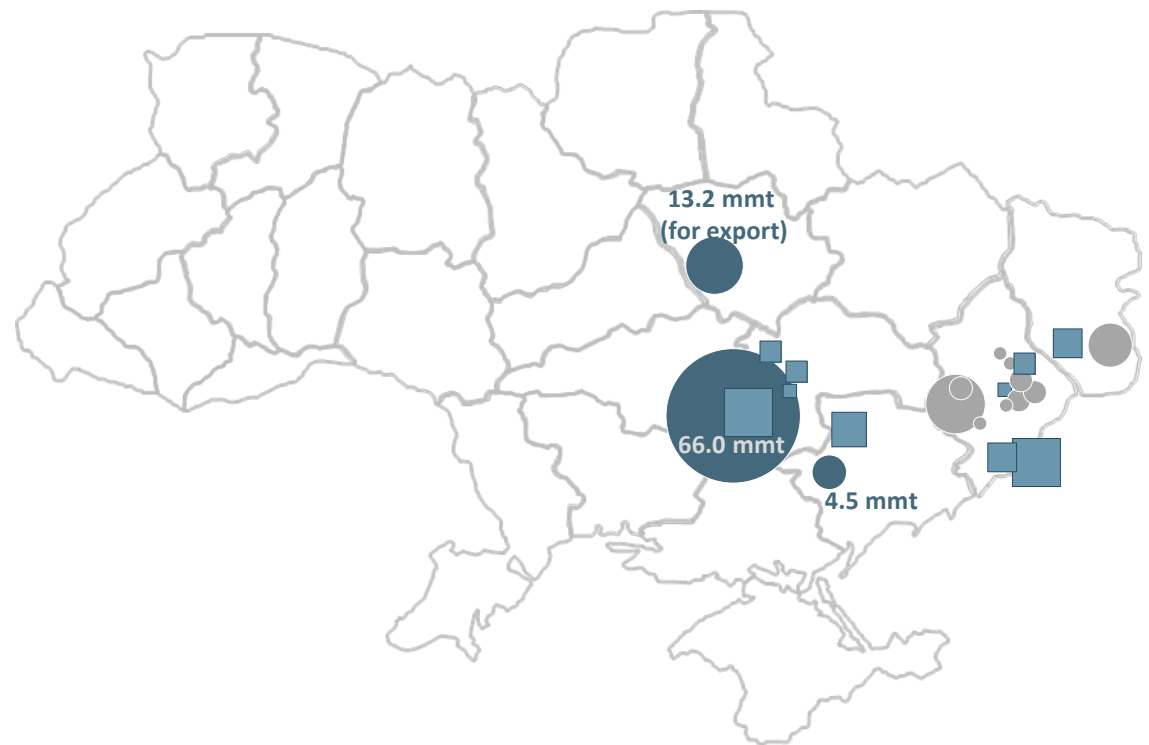
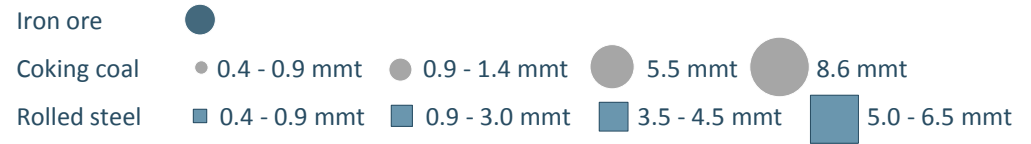
Most of the iron ore processed by Donbas plants is supplied from the Kryviy Rih basin located in the Dnipropetrovsk Oblast. An alternative is Russian iron ore.

The integration of the Donbas region in Ukraine's iron ore-coke-steel chain is very deep. The integration of Donbas into the Russian steel chain would not make any sense.

Unlike the coal sector, there are no preferential prices for coke or iron in Ukraine's steel sector, so a theoretical exit of Donbas from Ukraine would cause no major economic losses for any side.

But, if Donbas theoretically exits Ukraine, it will likely turn into a grey area which Western countries would not trade with. In 2013, 84% of Donbas-made steel was supplied to countries other than Russia or the CIS, and 67% went to EU countries and Turkey.

Key steel industry players:



Akhmetov is against the separation of Donbas

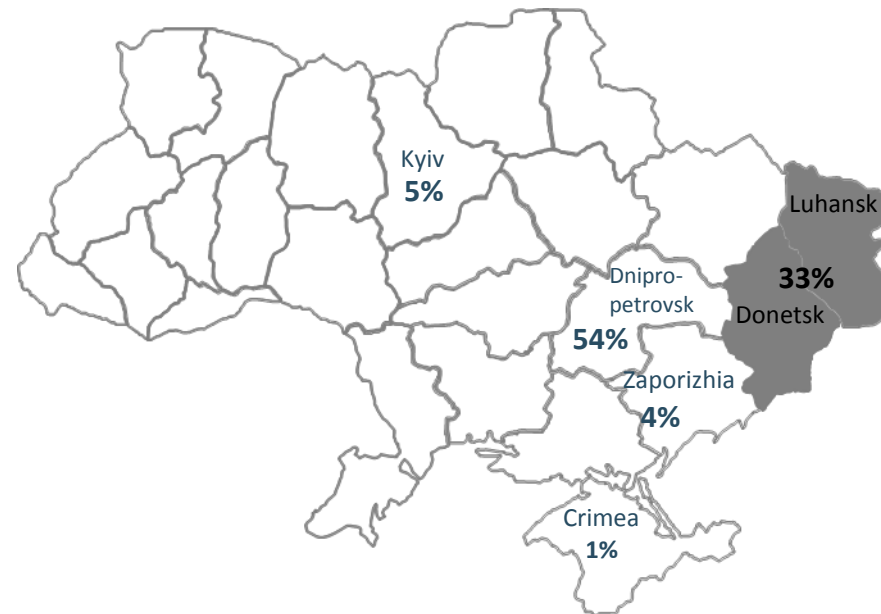
Rinat Akhmetov, who is widely known as the “king” of Donbas (he employs about 6% of the total workforce) stands to lose too much from the region’s separation.

His most valuable assets, iron ore deposits, are located in the Dnipropetrovsk region, and he would face the risk of losing them if the Donetsk and Luhansk Oblasts are annexed by Russia.

In March and April, after his close political ally was ousted in Kyiv, Akhmetov was passively supporting the pro-Russian forces in order to use the ensuing turmoil as leverage on the new government to assure enhanced regional authority to Donbas. But the recent escalation in violence, with near-stoppages of Donbas enterprises (due to the risk of terrorist attacks, logistical problems and danger for employees on the streets), has harmed not only Akhmetov’s business in Donbas, but also his related business in the Dnipropetrovsk Oblast. In fact, Akhmetov is the main loser from the region’s turmoil that he tried to manipulate for two months.

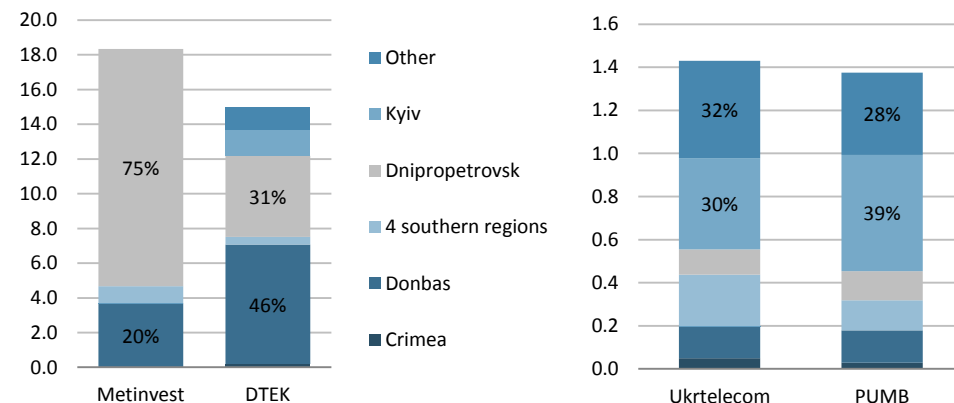
Maybe it’s true that Akhmetov lost his influence over other power brokers in his native Donetsk (as some experts allege) by changing his position in mid-May to staunchly oppose the terrorists. But he still remains a powerful figure in the region having maintained the loyalty of about 165,000 of his relatively well-paid Donbas employees, as well as their family members.

Regional distribution of businesses which brought dividends to Akhmetov in 2013



Note: We used DTEK and Metinvest as dividend payers (PUMB and Ukrtelecom did not pay dividends in 2013, all of Akhmetov’s other businesses are ignored here). Dividends distributed by regions in proportion to the regions’ contribution to EBITDA of the holdings. Akhmetov’s stake in Metinvest is assumed to be 71.25%, in DTEK – 100%

Regional distribution of 2013 EBITDA of Akhmetov’s core business units, UAH bln



Majority of Donbas residents prefer Ukraine, but this region differs indeed

Unlike the residents of Ukraine's other regions, Donbas residents indeed are more inclined to see their region independent or part of the Russian Federation, according to a poll conducted by the Kyiv International Institute of Sociology (KIIS) in early May. But even here, twice more prefer remaining part of Ukraine.

At the same time, Donbas is a unique region – those wanting to leave Ukraine, those wanting autonomy under a federal Ukraine, and those wanting a unitary Ukraine form nearly equal groups, unlike the residents of all other regions that certainly prefer a unitary Ukraine.

The large share of supporters of federal autonomy in Donbas stems from the following factors:

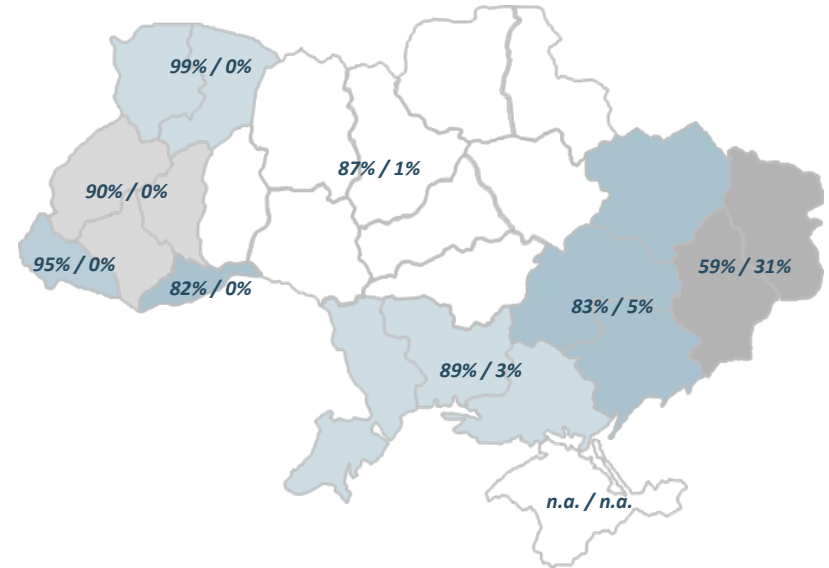
- Its people are unhappy with the flight of “their” president (Yanukovich). Since they are not able to elect their president (as they have been accustomed to), they want the ability to elect “their” governor, which they believe would be possible under *federal* status for Ukraine. They ought to learn that governors are *appointed* in the Russian Federation;
- Their fears are fueled by Russian mass media, which are preferred in Donbas. Media have fueled hysteria about “fascists” in Kyiv and committing “genocide” in Donbas. Ultimately, an autonomous Donbas (as Crimea was) would be easier prey for Putin;
- Ideas about shifting more governing authority to Donbas were actively supported by regional elites like Akhmetov. He even referred to the separatist movement, which have resorted to terrorist tactics, as “the voice of Donbas” that justifiably seeks more regional power. Note that neighboring regions, also dependent on Russian demand, do not support any separatism.

The presence of supporters of “federalism” (which most residents fail to distinguish from “separatism” or “unitary country with some decentralization”), as well as the presence of Russian fighters, has fueled the current warfare. Note that the cited poll data is a month old. We believe the separatists, which became increasingly violent since that time, have lost much of their support.

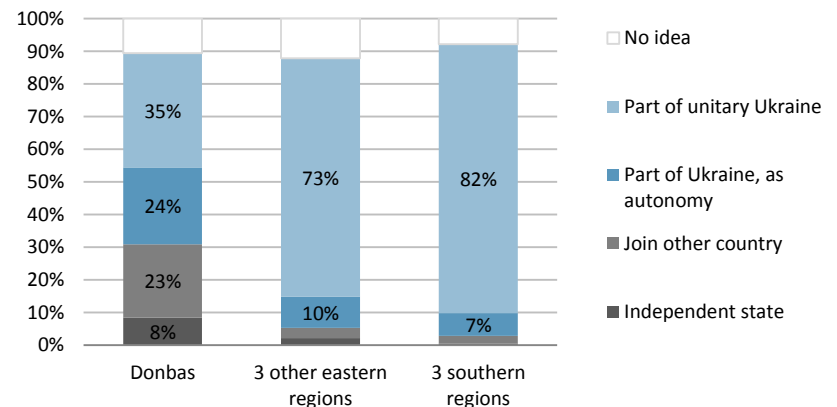
The Kyiv government is considering decentralizing authority to Ukraine's regions, which will be a key step in deescalating the Donbas crisis. At the same time, we believe that it will be much harder to tame the Luhansk Oblast, which is more dependent on Russia and more distressed than the Donetsk Oblast.

A very important revelation of the KIIS poll that Ukrainians don't share Putin's vision of a “Novorossiya” or “Southeastern Ukraine” that the Russian establishment has promoted as a region that yearns to ally with Russia. Putin strangely continues to use these terms when referring to the fighting, which is limited to the Donbas region alone.

Those seeing their region as a part of Ukraine / Those wanting independence or joining other country



Status of their region that the respondents prefer



Armed conflicts in Donbas currently raging

The good news is that armed fighting has been contained to only part of the Donetsk and Luhansk Oblasts. But that's largely not the result of the anti-terrorist operation's (ATO) efficiency or any other attempts by Kyiv to stabilize the situation. For instance, the northern part of the Luhansk Oblast, which is mostly rural area, is of low interest to the separatists. At the same time, the territory that is partially or fully occupied by the separatists forms the backbone of the Donbas economy.

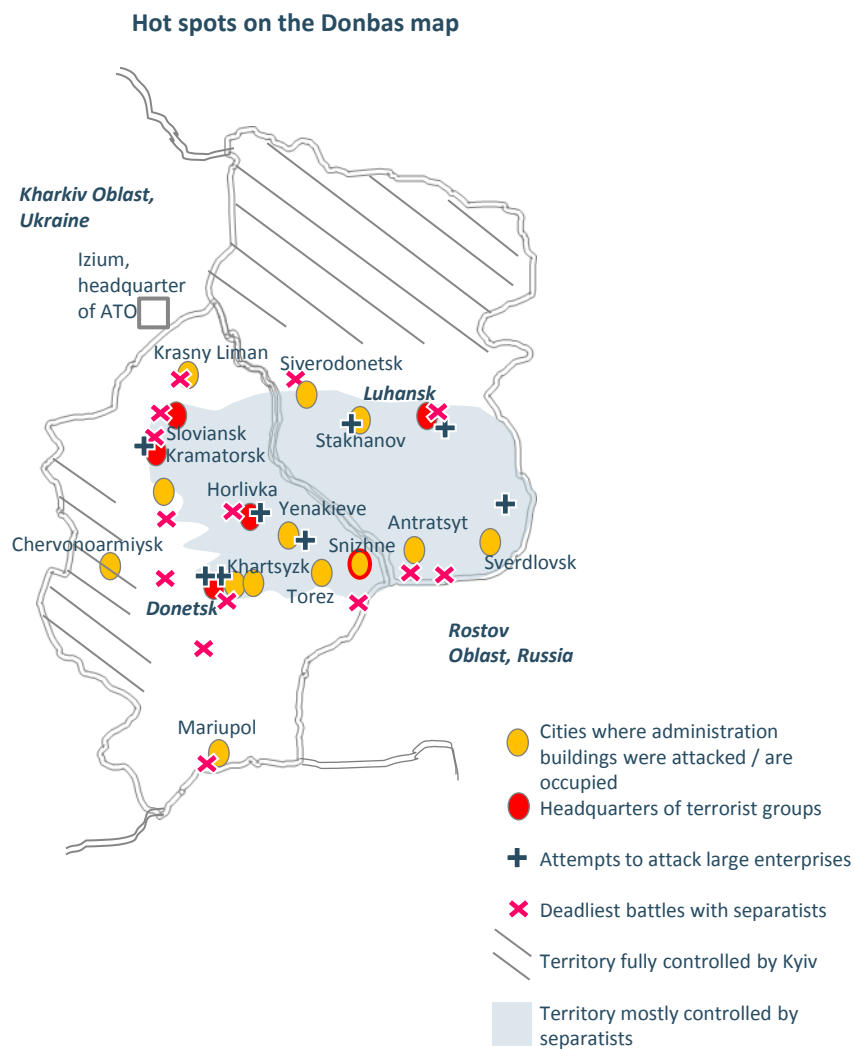
Most of the coal mines of Donbas, and all the mines that produce lean coal for thermal power plants, are in the territory controlled by the separatists.

At the moment, it is hard to predict how long the war in Donbas will continue. Much will depend on the success of the government's ATO and Russia's willingness to stop the escalation. Progress with both factors is barely visible:

- Progress with the ATO is only visible in the northern city of Krasny Liman in the Donetsk Oblast, while some westernmost cities of the Oblast are reportedly freed. At the same time, little progress has been observed in the most embattled cities of Sloviansk and Kramatorsk, even though these cities are farther from the Russian border.
- Terrorists are also active in the big cities of Donetsk, Luhansk and Horlivka.
- Pro-Russian terrorists are pumping their resources into the city of Snizhne, which is very close to the Russian border, according to recent information from military journalists.

If the ATO continues in the current way, and no progress with the Kremlin is made on de-escalation, it will be increasingly hard for the Ukrainian forces to move to the east, closer to the Russian border. Thus far, we haven't seen any progress there.

Core industrial centers like Donetsk, Luhansk, Horlivka, Alchevsk, and Yenakiieve have fallen out of Kyiv's control. That's particularly worrying as military operations in such big cities do not look possible without severe damage and human loss. Defeating the terrorists would require tight coordination between the local population and ATO forces, which does not look possible to organize, at this point.



Implications for listed securities

Containing the armed conflicts has benefited those companies that have their assets outside the hot spots of Donbas:

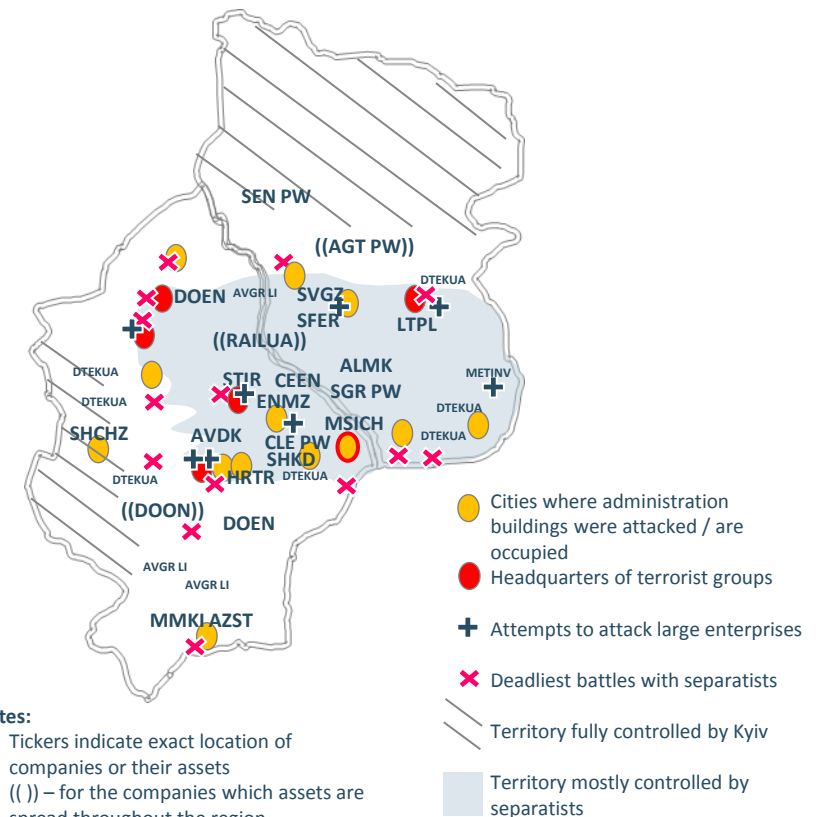
- Serinus Energy (SEN PW);
- Dobropillivuhillia and Belozerskaya mines, Kurakhove TPP of DTEK (DTEKUA)
- Pokrovske Mine (SHCHZ UK);
- Agroton (AGT PW), with most of its land plots located in the northern part of the Luhansk Oblast;
- Avangardco (AVGR LI), with two out of three of its Donbas-based factories located outside the war zone;
- To some extent, the Mariupol-based companies Azovstal (AZST UK) and Ilyich Steel (MMKI UK), controlled by Metinvest, are under less risk.

But that does not guarantee immunity from guerilla attacks on the companies' assets or employees.

The following companies have assets located directly in the Donbas war zone:

- Snizhne Machinery of Motor Sich (MSICH UK), which produces blades for aircraft engines
- Yenakieve Steel (ENMZ UK), Avdiivka Coke (AVDK UK), Khartsyzsk Pipe (HRTR UK) and Krasnodonvuhillia of Metinvest (METINV)
- Komsomolets Donbasa Mine (SHKD UK), Donetskoblenergo (DOON UK), Luhansk TPP, Zuiv TPP, Sverdlovanratsyt and Rovenkyanratsyt of DTEK (DTEKUA)
- Sloviansk TPP, one of the two owned by Donbasenergo (DOEN UK)
- Uglegorsk TPP, one of three owned by Centrenergo (CEEN UK)
- Ukrzaliznytsia's (RAILUA) Donetsk Railway, which generates most of its freight traffic in the war zone
- Horlivka-based Stinol (STIR UK)
- Stakhanov Railcar (SVGZ UK)
- Stakhanov Ferroalloy (SFER UK)
- Mines of Sadovaya Group (SGR PW) and Coal Energy (CLE PW)
- Alchevsk Steel (ALMK UK) and Luhanskteplovoy (LTPL UK), although their Russian ownership makes them unlikely targets for pro-Russian terrorists.

Hot spots on the Donbas map vs. location of the assets of listed companies



Notes:

- Tickers indicate exact location of companies or their assets
- (()) – for the companies which assets are spread throughout the region
- Larger font is for assets that contribute much into the company's business (sales, or EBITDA contribution is more than 10%)

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