DTEK Energy Eurobonds

Price risk is growing

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The 40% advance in DTEK Energy's Eurobonds prices since early May was most likely fueled by the market's absorption of new coal pricing rules in Ukraine to DTEK's benefit. With that rally, DTEKUA Eurobonds have almost reached our target of 60% of par. We believe further price growth potential is limited. Moreover, the probability of DTEK intensifying its whining in the press after its problems is growing as the holding has apparently entered intense negotiations on long-term debt restructuring. Coupled with some external non-encouraging factors, all this increases the price risk of DTEKUA Eurobonds in the near future. So we're downgrading our outlook on DTEKUA Eurobonds from bullish to neutral and keeping our estimate of bond fair value unchanged.

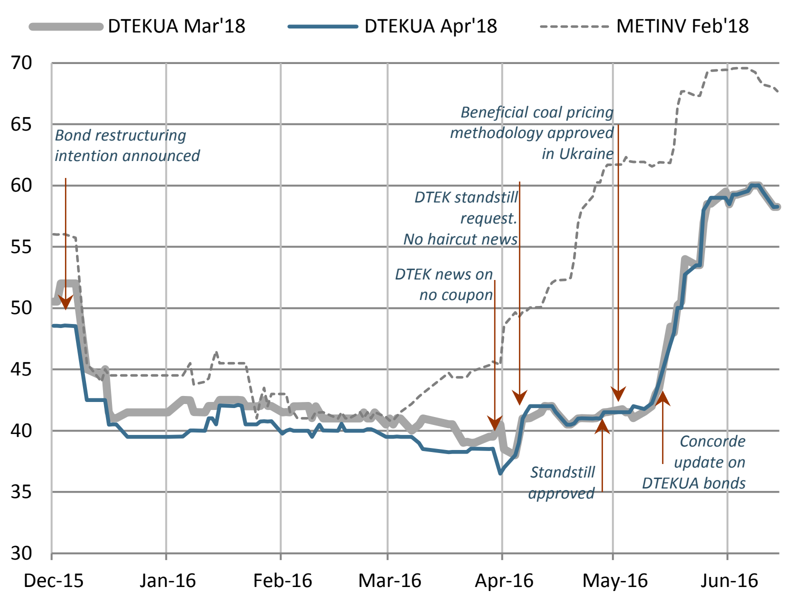
The risks that have emerged since our May 12 update on DTEK, which may result in short-term volatility in DTEK bonds and complicate the holding's debt restructuring process, are as follows:

- A plunge in coal mining at DTEK's Russian assets, which DTEK is trying to sell in exchange for debt reduction of up to USD 436 mln. The deal's potential price at the mines' output level of 2.0 mmt in 2015 looks suspiciously high, while a 24% yoy decline in mining in 1Q16 (based on our estimates) adds the risk that the deal price for DTEK will be smaller. If this risk materializes, DTEK's debt subject to long-term restructuring will be more than we initially expected.
- An inability to ship coal from the occupied regions of Ukraine (where DTEK mined 26% of its coal in 4M16) since early June. If this situation continues, it will harm DTEK's 2016 mining results and P&L .

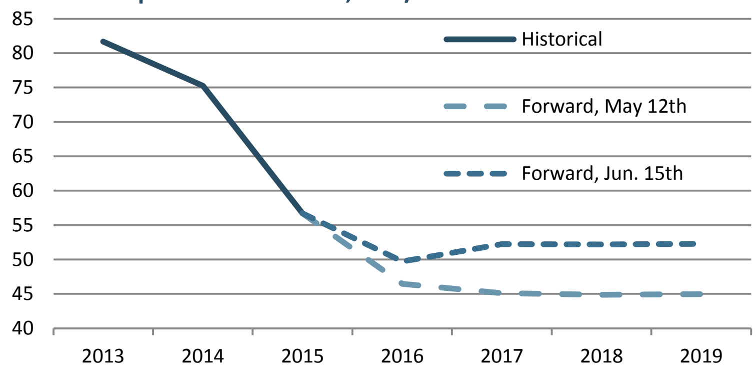
Among other risks is the slow increase in the price of electricity produced at DTEK's thermal power plants in May and early June. The prices are below the level assumed by new coal and power pricing methodology, approved in March-April 2016, though broadly in line with our forecasts for average price in 2016.

As a positive development, the global prices of steam coal are growing now, including spot and forward prices. This may enable DTEK to count on better coal pricing in the mid-term (as compared to what we earlier expected), provided that the link between the prices of local coal to Rotterdam prices will be sustained in the future.

Bond prices, % of par



Steam coal price in Rotterdam, USD/t



Source: Bloomberg

Ukraine operations in line with our forecast

Based on data provided by Ukraine Energy Ministry for 4M16:

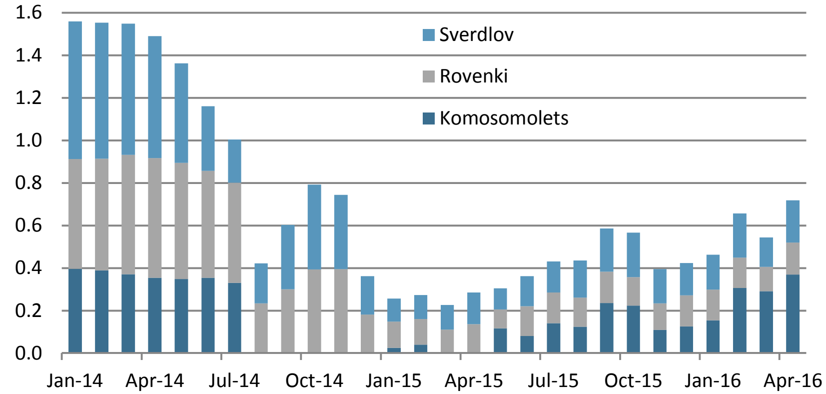
Coal production at DTEK's mines increased 10% yoy, mainly due to 2.3x growth of mining of anthracite and lean coal at the occupied territories of Donbas (the industrial belt of Ukraine's easternmost Donetsk and Luhansk regions). Importantly, DTEK's Komsomolets Donbasa mine, located in occupied part of Donetsk region, managed to mine 0.37 mmt of lean coal in April 2016, a level reached only before the occupation. This is broadly in line with our expectations for DTEK's flat yoy mining in Ukraine in 2016. We note that recent interruptions in coal supply from occupied Donbas (see more details on the next slide) adds some risks to our forecast.

DTEK's power plants located outside occupied Donbas reduced their power generation by 13% yoy. Yet among those, anthracite-burning thermal power plants showed spectacular growth (see table on right). This is in line with our vision that power generation at DTEK's TPPs will decrease 5-6% yoy in 2016.

DTEK Energy's operations in Ukraine

	4M16	4M15	yoy
Coal mining, mmt	**9.30**	**8.46**	**10%**
Anthracite & lean coal (occupied zone)	2.38	1.04	129%
Hard coal	6.92	7.42	-7%
Power generation (ex-occupied), TWh	**12.42**	**14.20**	**-13%**
From anthracite & lean coal	3.20	1.86	73%
From other fuel	9.22	12.34	-25%
By Zuyivska TPP (occupied zone)	n.a.	0.89	n.a.

DTEK Energy's coal mining in the occupied Donbas, mmt



Source: Energobiznes, Interfax-Ukraine, Concorde Capital research

DTEK needs a negative news flow during its negotiation period with creditors to improve its bargaining position. Among the most worrying news since mid-May, which adds some downside risk to our DTEK forecast, are:

Output declines at DTEK's Russian mines
DTEK's Russian mines are continuing to perform poorly based on its 1Q16 operating data and Ukrainian mining statistics. Mining has decreased 24% yoy to about 405 kt (1.6 mmt annualized), we estimate. This looks like negative news, given that DTEK is in negotiations to sell its Russian mines for a total value of about USD 436 mln (in the way of debt reduction by this amount). With the worsened performance (DTEK's CEO told journalists its Russian mines may end up boosting coal production to 2.6 mmt this year from 2.0 mmt last year), there is a risk that its Russian mines will be priced worse.

Interruptions in coal supplies from occupied Donbas
In the beginning of June, Ukraine's state railway operator stopped the transit of any goods from occupied Donbas. This has led to a 38% month-to-date decline in anthracite stockpiles at Ukrainian TPPs as of June 15. While coal supplies can be resumed any time soon, this case shows how large the risk is for the mines remaining on the occupied territory.

Among other risks, which do not look material in the mid-term, are:

Apparently low growth rates for electricity from DTEK's TPPs
Despite the introduction of a new approach to coal pricing on the Ukrainian market, which inflated wholesale electricity prices since May 2016, DTEK Energy's TPPs did not benefit much from this growth. After a 14% m/m jump in April, the average power price of DTEK's TPPs fell 8% m/m in May (and by about 4% m/m in first ten days of June), based on our calculations.

The key reason for such a decline, in our view, was the power sector regulator ruled to increase the selling price of nuclear power (+8% m/m in May, +0.9% m/m in the first days of June), which cannibalized the power rates of TPPs.

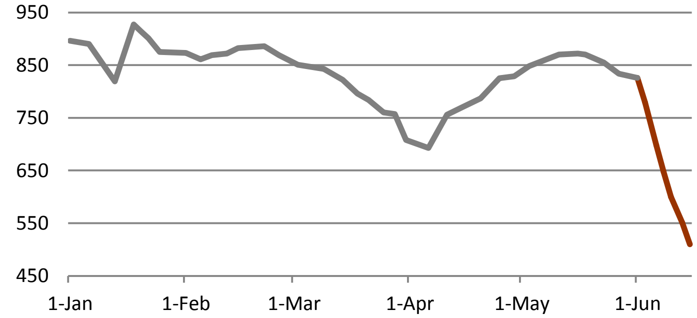
Such a decrease in TPP rates is still in line with our estimates that DTEK will have an average selling rate of UAH 1,100/MWh in 2016. It merely leaves less room for a positive surprise to our estimate.

Blocked accounts of Kyivenergo
Among other negative news, a local court blocked the accounts of Kyivenergo (DTEK's subsidiary) in early June. Kyivenergo said it has fully repaid its debt for natural gas supplies, while the account blocking was initiated due to Naftogaz's demand to pay penalties in the amount of UAH 1.5 bln (of which UAH 1.2 bln is now being questioned by Kyivenergo in a court). That's clearly a temporary issue that will be resolved soon, if DTEK wants to. Note that Kyivenergo is not alone in its problem – it reported that the accounts of 104 utility enterprises in Ukraine were arrested at the demand of state firm Naftogaz.

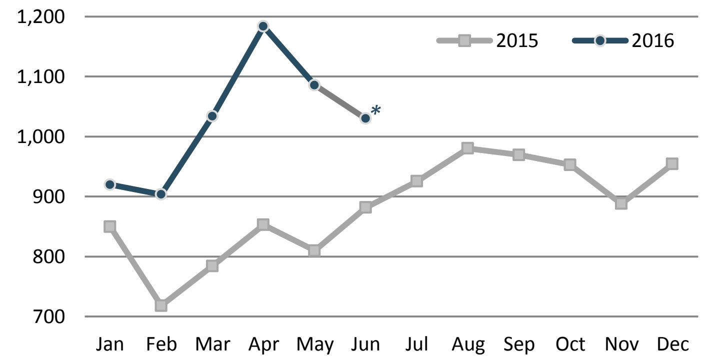
DTEK Energy's coal mining stats, kt

	1Q16	1Q15	yoy
Ukraine - anthracite	1,663	755	120%
Ukraine - hard coal	5,161	5,548	-7%
DTEK Energy, total	**7,229**	**6,832**	**6%**
Russia - anthracite	**405**	**529**	**-24%**

Stockpiles of anthracite at Ukrainian TPPs, kt



Average price of electricity supplied by DTEK TPPs, UAH/MWh



** In June 1- June 10.   Source: Company data, Energobiznes, Ukrenergo, NERC, Concorde Capital research*

DTEK Energy key operating data

	2013	2014	2015	2016F
ROM coal mining, mmt	**41.4**	**37.1**	**28.7**	**28.5**
- Ukraine, hard coal	22.2	21.9	22.0	20.5
- Ukraine, anthracite	17.8	12.6	4.7	6.3
- Russia, anthracite	1.4	2.6	2.0	1.7
Est. marketable coal output, mmt	**29.4**	**26.4**	**20.4**	**20.2**
- Ukraine, hard coal	15.8	15.6	15.6	14.5
- Ukraine, anthracite	12.6	8.9	3.3	4.5
- Russia, anthracite	1.0	1.8	1.4	1.2
Coal sold to third parties, mmt	**8.3**	**5.5**	**4.2**	**3.6**
Coal bought from third parties, mmt	**7.9**	**7.7**	**1.4**	**1.2**
Use of coal by DTEK TPPs, mmt	**25.6**	**23.4**	**19.3**	**18.2**
^ Hard coal	17.7	15.9	15.9	13.8
^ Anthracite	8.0	7.5	3.4	4.4
* Own coal	20.8	18.5	17.9	17.2
* Third party coal	4.8	4.9	1.4	1.0
Power generation, TWh	**58.2**	**52.2**	**41.0**	**38.9**
- From hard coal	37.6	33.1	31.4	27.5
- From anthracite	16.9	15.7	6.7	8.7
- From natural gas	3.8	3.3	3.0	2.7
Supply of generated power, TWh	**53.3**	**47.8**	**37.7**	**35.7**
^ From hard coal	34.4	30.0	28.8	25.3
^ From anthracite	15.4	14.3	6.1	8.0
*** From all types of coal**	**49.8**	**44.3**	**35.0**	**33.3**
^ From natural gas	3.3	2.9	2.7	2.5
^ From wind	0.3	0.7	-	-
* Supply to WEM	53.3	47.8	36.4	33.9
* Supply to the occupied Donbas	-	-	1.2	1.8
Supply of generated heat, TWh	**18.7**	**15.5**	**14.4**	**13.5**
- From coal	1.3	1.2	1.0	0.9
- From natural gas	17.4	14.3	13.4	12.6
Power distribution, TWh	**56.9**	**53.8**	**45.1**	**42.0**
Dniproblenergo	22.6	23.0	21.7	20.8
Power grid	11.3	9.5	8.2	7.4
Donetskoblenergo & PES Energougol	9.6	8.1	6.7	5.1
Kyivenergo	8.9	8.9	8.5	8.7
Krymenergo	4.5	4.3	-	-

Source: Company data, Concorde Capital research

Debt valuation update

Debt restructuring – modeling on Metinvest's case

On May 25, steel producer Metinvest, which has the same shareholder as DTEK (but is ahead of DTEK in its debt operation), announced its key long-term restructuring parameters that were agreed upon with key bondholders, including:

- repayment of Eurobonds in 2021 (possible early repayment in a cash sweep),
- two coupon periods (grace period until end-2018 and period of increased coupons for 2019-2021).

In our view, DTEK's ultimate restructuring parameters will be comparable to what is being agreed upon with Metinvest's key debt holders. Below, we attempt to model what DTEK may offer, taking into account Metinvest's case.

The key difference in DTEK's potential deal that is apparent now is in the **ultimate maturity** of its restructured bond (DTEK says it will be late 2023, or **+2Y vs. Metinvest**). That allows us to assume that the **grace period for DTEK's** bonds will also be longer **(+1Y vs. Metinvest**).

We found out that Metinvest's **agreed payment conditions** during the grace period (till end-2018) **are nearly identical** as during the standstill. Very likely, DTEK will try to follow this pattern.

After the grace period, Metinvest is offering an increased coupon by **1.56pp** (as compared to the current level) – we assume **DTEK will offer the same premium**.

METINVEST

Three Eurobonds of USD 1,176 mln total par value, 9.31% average coupon rate

Approved standstill parameters - till late September (Nov.) 2016:

Coupon:

- **30%** of accrued is paid in cash;
- **70%** paid though cash sweep or capitalized (bearing interest);

Principal: may be paid through cash sweep.

Pre-announced (preliminary agreed upon) restructuring parameters:

1. Grace period (till end-2018):

In this period, payment parameters are almost identical to what Metinvest offered during the standstill, namely:

Coupon:

- **30%** of average current coupon rate (or 2.79%) paid in cash;
- **~70%** of average coupon rate (or 6.58%) paid though cash sweep or capitalized;
- **1.50%** - paid though cash sweep, otherwise not capitalized (that's the only difference vs. the standstill).

Principal: may be paid through cash sweep.

2. Second period (2019-2021):

Coupon: 10.88% - paid in cash (**1.56pp** higher than average current coupon rate).

Principal: payable in end-2021, may be paid through cash sweep.

DTEK

Two Eurobonds of USD 910 mln total par value, 8.31% average coupon rate

Approved standstill parameters - till late October 2016:

Coupon:

- **10%** of accrued is paid in cash;
- **90%** paid though cash sweep or capitalized (but not bearing interest);

Principal: may be paid through cash sweep.

Possible restructuring parameters:

1. Grace period (likely to be till end-2019):

Similar to Metinvest, we assume DTEK will offer payment parameters identical to what was offered during the standstill, namely:

Coupon:

- **10%** of average current coupon rate (or 0.83%) paid in cash;
- **90%** of average coupon rate (or 7.48%) paid through cash sweep or capitalized (but not bearing interest);
- Some extra amount may be paid through cash sweep.

Principal: may be paid through cash sweep.

2. Second period (may start in 2020, to end in 2023 as announced):

Coupon: 9.88% - paid in cash (**1.56pp** higher than average current coupon rate).

Principal: payable in end-2023, may be paid through cash sweep.

Valuation summary

“Metinvest’s case” offers a DTEK bond price of 63.2 cent per dollar

By assuming DTEK’s restructuring parameters that were modeled on the previous slide, and taking into account the worst possible payment arrangement (no cash sweep payments are made at any time), we derive the following payment schedule:

- During the standstill (June-October 2016), DTEK will pay monthly 10% of its accrued coupon (as agreed). The rest will be capitalized (with no interest accrued on this) and repaid at the end of the standstill.
- During the grace period (till end-2019), DTEK will again pay quarterly 10% of its accrued coupon. The rest will be capitalized (with no interest accrued) and repaid in late 2023.
- During 2020-2023, DTEK will pay quarterly 9.88% in coupons. All the outstanding bonds will be repaid in late 2023.

Such a schedule suggests an NPV of DTEK Eurobonds of 63.2% of par value (assuming a 15% discount rate).

This is consistent with the “fair range” of 55-66 cents per dollar derived earlier

In our May 12 update on DTEK, we modeled three possible scenarios of debt repayment that yield a fair value of DTEKUA bonds in the range of 54.5% to 65.9% of par, with 60.2% of par in the base case. The new approach described above yields about the same value.

Conservatively, we are keeping our fair price estimate of DTEKUA bonds at 60% of par.

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