Electricity Sector

Privatization Plans Look Promising

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Analyst Notebook

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

A new draft decree has been sent the Cabinet of Ministers that, if passed, would put electricity companies back on the privatization block and attract much-needed private capital to rejuvenate their assets. The government's expected approval will finally set out a clear strategy for privatizations and, in our opinion, increase market valuations.

Privatization procedure by draft

	State ownership	Most likely procedure
DOEN	**85.77%**	Additional share issues, with selected subscriber for state's shares
CEEN	**78.29%**	
DNEN	**76.04%**	
ZOEN	75.00%	
DNON	75.00%	
VIEN	75.00%	
VOEN	75.00%	
ZAEN	**70.11%**	Tender with investment obligations; full stake for sale
HMON	70.01%	
KREN	70.00%	
MYON	70.00%	
CHEN	70.00%	
DOON	65.06%	
HAON	65.00%	
ZAON	60.25%	
TOEN	50.00%	
CHON	46.00%	
LVON	26.98%	Share placement on stock exchanges; full stake for sale
PREN	25.02%	
ODEN	25.01%	
SOEN	25% + 1	
CHEON	25% + 1	
POON	25% + 1	

Note: Bold fonts represent power generation companies; Others are power distribution companies

Key items of the current draft of the "Conception on Decreasing the State's Presence in the Energy Sector":

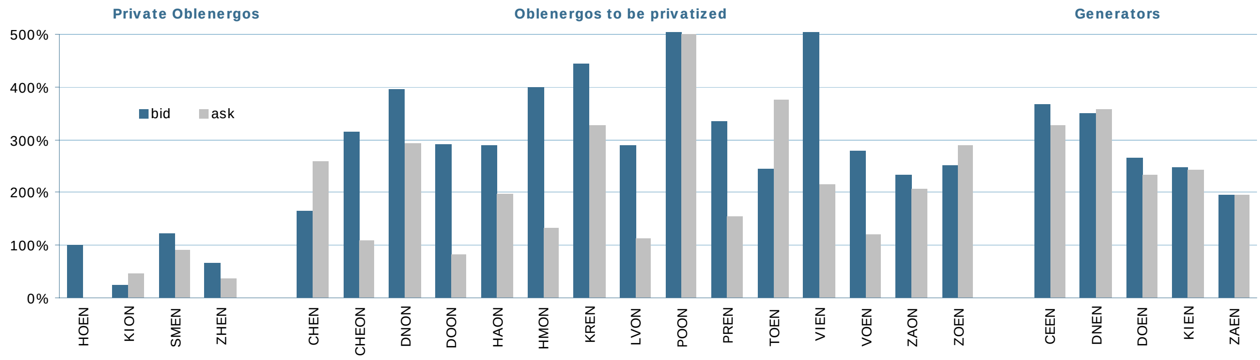
- full privatization of those companies where the state has a stake below 75%, with 50% of money raised from privatization directed to a special fund for upgrading energy assets
- privatization via additional share issues for those companies where the state has more than 75% will allow privatized companies to directly use proceeds from their privatization
- alternative ways to decrease the state's presence, joint ventures, asset leasing and concessions, are most likely to be practical for those companies whose privatization is prohibited (mainly CHPPs)

High probability of approval by the Cabinet. Taking into account the energy sector's urgent needs for additional capital and that the conditions listed in the draft look attractive for potential investors, the individual companies and to the state, we believe the Conception will be approved. The State Property Fund (SPF), which does not support the idea of decreasing state control in the energy sector, is very likely not to oppose the bill, because its passage would mean the SPF could sell 25%-27% of six Oblenergos in 2007 as it planned.

The primary beneficiaries will be those companies where the state has >75% ownership, as the proceeds from their privatization will go directly into the companies. The other companies can only dream of a share of the income from their privatization, if they prove their needs. In this respect, Zakhidenergo, where the state owns 70%, looks like it is in the least beneficial position compared to other thermal power generators.

Clear plans - A market booster. The absence of a clear strategy on further energy privatizations has been one of the reasons for discounted valuations compared to Russian peers. We believe a clarified privatization plan will lead to a decrease in the discount of Ukrainian GenCos and Oblenergos to Russian companies by EV/Capacity and EV/Electricity multiples.

Electricity stock performance, 52 weeks



Source: PFTS
Note: Data range is truncated at 0% and 500%

How the state might decrease its presence

We now take a closer look at how – if approved - the "Conception on Decreasing the State's Presence in the Energy Sector" might be realized for each category of electricity company.

Companies:

	State's stake
LVON	26.98%
PREN	25.02%
ODEN	25.01%
SOEN	25% + 1 share
CHEON	25% + 1 share
POON	25% + 1 share

1. "Conflicting Oblenergos": Share placements

How? The state's remaining stakes in these companies are planned to be sold at stock exchanges, with the highest bidder selected as the winner.

Advantages / Disadvantages?

+ Corporate conflicts existing in the companies are very likely to be solved after full privatization, as those buying the stake will obtain additional advantages over their rivals
+ Stakes in these companies are expected to be sold with a large premium, as the two rival shareholders of each company seem ready to buy the stakes at any price (refer to our Oblenergo report as of December 2005)
- Money raised from privatizations are planned to be directed as follows: 50% to the state budget, and 50% to a special energy fund, and are highly unlikely to be directed back to the privatized companies

When? Scheduled for 2007

Who? Key candidates for buying the shares are well-known: VS Energy and KrAZ Group for Odesaoblenergo; Privat Group and Energy Standard Group for the rest companies.

Companies:

	State's stake
ZAEN	**70.1%**
HMON	70.0%
KREN	70.0%
MYON	70.0%
CHEN	70.0%
DOON	65.1%
HAON	65.0%
ZAON	60.3%
TOEN	50%+1 share
CHON	46.0%

Note: Bold fonts represents power generation company

2. Companies where the state has control

a) Privatization with investment obligations: State stakes of 46% - 75%

How? The companies are planned to be fully privatized through open tenders. Those putting forward the highest bid price, including investment obligations, will be declared the winner.

Advantages / Disadvantages?

+ The state will be able to control execution of investment obligations, a guarantee exists that new owners will upgrade the companies' assets
+ Sale of large blocks implies a premium for control
- Money raised from privatization are planned to be directed as follows: 50% to the state budget and 50% to the special energy fund, but not necessarily back into the privatized companies. Even if some funds are directed back to the companies, they would be subject to income tax (25% tax rate)

When? Not clear now, perhaps in 2008

Who? Candidates for buying the companies are transnational energy groups already present in CEE markets (CEZ, RAO UES, RAO Gazprom, EnBW ect), those present in Ukraine (AES, VS Energy) and local business groups (DTEK/SCM, Privat Group, Energy Standard Group).

Companies:

	State's stake
Dnister HAPP	**87.4%**
DOEN	**85.8%**
CEEN	**78.3%**
DNEN	**76.0%**
ZOEN	75.0%
DNON	75.0%
VIEN	75.0%
VOEN	75.0%

Note: Bold fonts represent power generation companies

b) Privatization through additional share issues: State stake of 75% or more

How? The state's 75% presence allows it to initiate additional share issues. Current shareholders will have a right to subscribe. According to this scenario, the state will not use its right, and a selected preferred party will use an opportunity to subscribe for the state's portion of the issue. Current legislation allows the AGM to select a party that will have preferential rights to subscribe for this portion. The party (an investor) can be selected via an (open) tender.

Advantages/Disadvantages?
+ Subscription to large blocks would imply a premium for control
+ Money raised from this type of privatization will be directed to the privatized companies without being subjected to income taxation
+ An opportunity (rather theoretical) for minority shareholders appears that they will be allowed to subscribe for more than their pre-issuance proportion
- Lack of previous experience with this type of privatization in Ukraine
- Risk of non-transparent selection of a preferential buyer for the state's portion of additional share issues

When? Not clear now, perhaps in 2008-2009

Who? Candidates are the same as for privatization with investment obligations.

c) Partnerships with private investors: An alternative way to decrease the state's presence

How? Might take several forms that are being considered: creation of joint-ventures with private investors, or just joint projects; lease (capital or operating) of the companies' assets.

Advantages/Disadvantages?
+ Money from the partners can be directed into the companies' development, while the state can retain control over the companies or their assets
- No clear rules for cooperation: Questionable attractiveness for this type of investment
- Absence of previous projects like this in the energy sector of Ukraine
- Risks of shadow privatization at low prices

When? We do not believe these types of partnerships will take place.

Companies:

	State's stake
Ukrhydroenergo	100%
Dnipro-dzerzhynsk CHPP	100%
Mykolaiv CHPP	100%
Kherson CHPP	100%
Odesa CHPP	100%
Kharkiv CHHP#5	100%
Kyivenergo	50%

Assets owned by state:

Crimean generation systems
Severodonetsk CHPP
Lysychansk CHPP
Zuiv CHPP
Kharkiv CHPP#2

3. Companies whose assets cannot be privatized: Co-operation with private investors

How? As the privatization of heat and power plants is not allowed by legislation, several ways of co-operation without decreasing the state's control over the assets are being considered: joint projects with investors, operating leases, or concessions.

Advantages/Disadvantages?
+ Money from the partnerships/leases can be directed to developing the assets, while the state will retain its control over the assets
+ Past experience with these type of projects in Ukraine
- Risk of shadow privatizations
- Absence of legislation on concessions

When? Cooperation and lease agreements are currently at work now at several heat and power plants. With clear rules for cooperation (in 2007-2008 after the approval of the Conception), we believe the attractiveness of these assets for potential investors will increase.

Notes on the draft:

Egalitarian principle

The Conception draft, in our opinion, represents a good balance between state budget needs and energy companies' investment needs, as it foresees equal distribution of income from the privatization of 25%-65% stakes to the budget and energy fund for CapEx projects. Of course, it would be best for the energy companies if 100% of the money could be directed to the energy fund. Taking into account the state budget's "appetite" for privatization funds, we believe equal distribution is a compromise that will satisfy the government and the companies. Though, no doubt the proportion distributed between the energy fund and the state budget can be changed in the final version of the Conception.

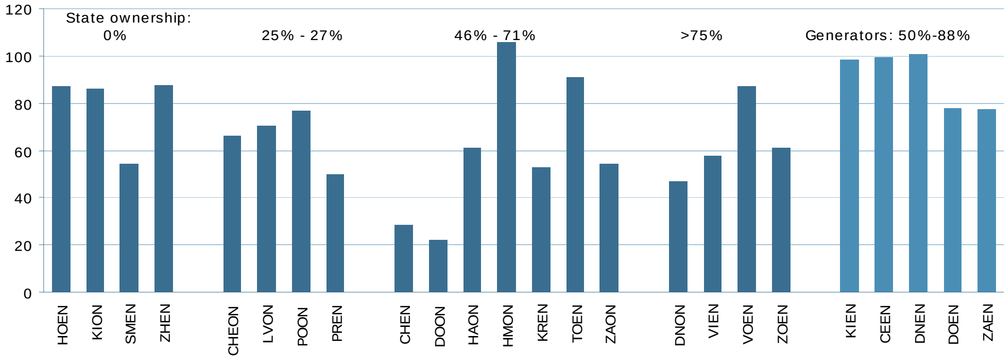
Companies with >75% state ownership have advantages

Compared to companies with a state presence of 50%-65%, those with 75% or more look better positioned from the point of view of financing. All the money raised from their privatization (via additional share issues) will be automatically directed back into the companies. The group of energy companies with less than 75% state ownership can only think of part of the state's take from their privatization, and only if they will prove they need this money. More, in case they obtain money, under current legislation they will be subject to income taxation.

From this prospective, thermal power generation companies Centrenergo, Dniproenergo and Donbasenergo are in better position than Zakhidenergo, where the state has only a 70.1% stake.

Multiples comparison

EV/Electricity* vs. State ownership



Source: PFTS, Energobiznes, Concorde Capital
**EV/Electricity supplied (USD/MWh) for distribution companies, Oblenergos (dark bars);*
EV/Electricity produced (USD/MWh) for generation companies (light bars)

EV/Electricity comparison by groups of Obelenergos

State ownership	Mean EV/El. (USD/MWh)	Discount to private
0%	78.9	-
25%-27%	66.0	-16%
46%-71%	59.3	-25%
>75%	63.4	-20%

Source: PFTS, Energobiznes, Concorde Capital

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

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 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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