Andriy Gostik
+380 44 207 5037
ag@concorde.com.ua
www.concorde.com.ua
Bloomberg: CONR<GO>

Analyst's Notebook

Ukraine / Metallurgy
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Enakievo Iron & Steel Merger With Metalen In The Pipeline?

Launch Of Metinvest Holding Leads To SCM's Steel Business Restructuring

At the official presentation of Metinvest Holding on June 6, 2006, the holding's CEO Igor Syryi disclosed the list of companies that will form Metinvest. The companies are grouped into three divisions each representing separate links in a vertically integrated chain. There is a Coal & Mining division (coal miner Karsnodonvugillya and Avdiyivka Coke plant (**AVDK: BUY**)), an Iron Ore division (Pivnichny GOK and Tsentralny GOK) and a Steel division (Azovstal (**AZST: Suspended**), Enakievo Iron & Steel, Metalen, Khartzysk Tube (**HRTR: SELL**), Feriera Valsider rolling plant and a trader Leman Commodities).

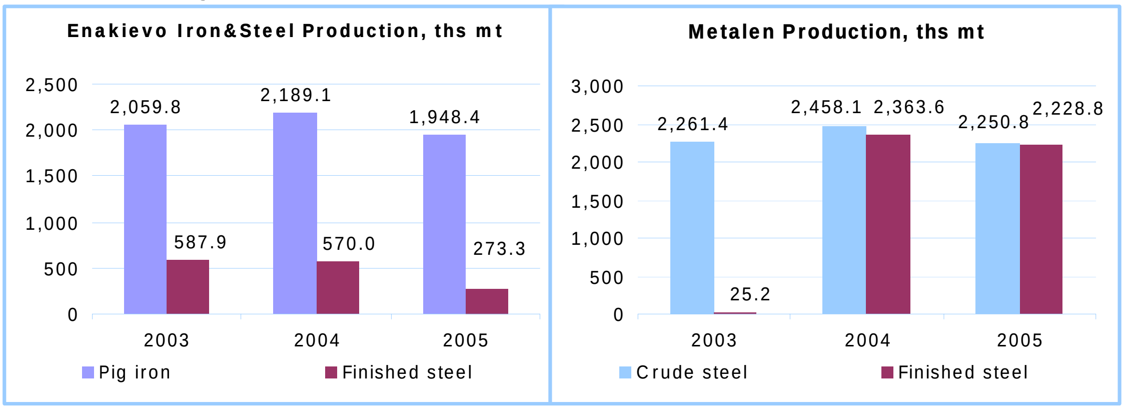
In order to streamline its complex structure into a single holding on the eve of metal & mining asset consolidation in 2006, System Capital Management (SCM) merged its key steel producer, Azovstal, with an adjacent coke maker Markokhim and later with the Trading House Azovstal. The re-organization of Enakievo Iron & Steel (ENMZ) and JV Metalen is still pending. These two separate legal entities share the same production facilities.

JV Metalen was created in October 1999, and based around Enakievo Iron & Steel's basic oxygen furnace (BOF) shop. The two companies supplement each other in a single production cycle, with Enakievo Iron & Steel focusing primarily on pig iron production (it operates three blast furnaces) and to a lesser extent on rolling finished steel products (the company also has two rolling shops), and JV Metalen making crude steel (it operates three oxygen converters) and semi-finished and finished steel products. Metinvest's CEO, Igor Syryi, has already stated that a decision on the creation of one legal entity on the base of Enakievo Iron & Steel and JV Metalen is to be adopted at upcoming shareholder meetings.

Merger Effect On ENMZ Financials

If SCM decides to join Metalen and Enakievo Iron & Steel, this step will be value adding for the latter as it will complete its production cycle. Enakievo Iron & Steel would be able to sell finished steel products, whereas now it concentrates on supplying pig iron to Metalen and the later then makes crude and finished steel and enjoys selling a higher priced product mix.

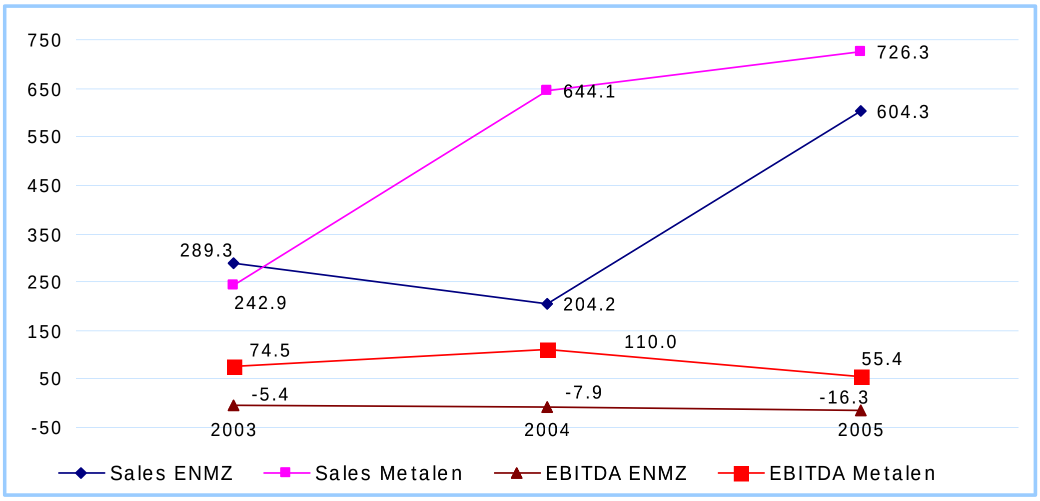
Production Dynamics



Source: Company data

Consolidation of the two assets on the base of Enakievo Iron & Steel would not result in consolidated sales equal to the sum of the sales of the two companies. Rather, the new company would have revenue slightly above that of Metalen which sells finished products, whereas revenue of the stand-alone Enakievo Iron & Steel mill would help reduce production costs for the newly united company, as Enakievo Iron & Steel's pig iron would be an intermediary product that would then be processed into crude steel and then rolled into finished steel products.

Reported Financials, USD mln



Source: Company data

The most important economic effect of the possible merger would be greater margins for Enakievo Iron & Steel thanks to positive margins of Metalen. Specifically, based on reported 2005 financials, we estimate that combined ENMZ and Metalen's sales and margins would be as follows:

USD mln

Sales	EBITDA	EBITDA mgn	Net income	Net mgn	Net debt	MCap
786.8	39.1	5.0%	27.1	3.4%	198.2	61.51

Source: Company data; Concorde Capital estimates

Real earnings and margins are probably higher than the estimated reported ones, as we believe ENMZ and Metalen have been practicing transfer pricing up until 2006.

Value Creation Or Just One More Abuse Of Minorities?

If SCM decides to conduct the merger the way it merged Azovstal with Markokhim and Trading House Azovstal, Enakievo Iron & Steel will have to increase its charter fund by 86% and swap the additionally issued shares for a 100% stake in Metalen. In this case, the par value of the shares issued will equal Metalen's charter fund. According to Ukrainian law, shareholders will not be able to subscribe for the newly issued shares if the merger is done through a share swap.

It is not clear whether the effect of value addition will outweigh the dilution effect should SCM merge Metalen with Enakievo Iron & Steel via a share issue as outlined above. Specifically, based on estimated 2005 multiples, the stock would be a BUY on EV/S and P/E metrics. Yet, the valuation does not prove meaningful if we use EV/EBITDA metric due to low combined reported margins and high net debt. We think that the BUY recommendation will only be justified after signs that related party transactions are being phased out and EBITDA margins show improvement.

	EV/S-05	**EV/EBITDA-05**	**P/E-05**
Post-merger ENMZ multiples	0.3	6.6	2.3
Int'l peer average*	1.2	4.9	7.2
Implied price	37.1	NM	10.0
Upside (downside)	525%	NM	69%

**Peer group consists of INI Steel, Bluescope Steel, Tangshan, Maanshan, IPSCO, CSN, Arcelor Brazil, SSAB*

In addition, there is a possibility that ENMZ will be joined to Metalen and not vise versa. Before the parameters of the hypothesized merger are known, it is hard to say what effect it will have on ENMZ's share price. Although SCM expressed its utmost commitment to transparency and adherence to western corporate governance standards which is necessary for the anticipated IPO of Metinvest Holding in the mid-term, we question how they will treat minority shareholders during the restructuring phase. We abstain from issuing any recommendation on ENMZ for the time being due to the high level of uncertainty surrounding it and will be watching the company closely.