



CONCORDE CAPITAL

Ukraine / Electricity

PES-Energougol

One more Oblenergo on the PFTS

March 12, 2008

Current price: USD 24.8
12M Target: USD 13.0

SELL

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Ticker

Bloomberg ENUG UZ

Market information

Market price, USD	24.8
MCap, USD mln	135.6
No of shares, mln	5.48
Free float	8.9%
Free float, USD mln	12.0

Shareholders

DTEK	91.12%
Other	8.88%

Key financials and ratios

	Sales, USD mln	EBITDA margin	Net margin
2007E	70.9	12.3%	6.5%
2008F	86.5	12.0%	7.5%
2009F	108.1	8.0%	4.2%

	EV/S	EV/EBITDA	P/E
2007E	2.0	16.2	29.3
2008E	1.6	13.3	20.9
2009E	1.3	15.6	30.1

- **Energougol was listed on the PFTS on February 29; its price has tripled over six trading days. The stock has been put on a one-month watch list for inclusion into SCM business group index (SCM_BGI)**
- **We believe the current market price does not account for the challenges Energougol faces in defending its bottom line against RAB-based tariffs expected to be introduced in 2009**
- **Risk to Energougol's profits is steep: DTEK is likely to accept the new RAB-based tariff policy for its distribution companies. The negative impact will be offset by its positive effect on DTEK's other distributor - flagship Servis-Invest**

INVESTMENT CASE

- Net margin of 6.5% was largest in the sector over 9M07; EBITDA margin of 12.3% was among within the top five
- High risk of declining profits after implementation of RAB-based tariff policy for electricity distribution companies (expected in 2009)
- Energougol is the second fiddle of the DTEK-related distribution companies: it decreased electricity supplies at 5% CAGR over 2005-2007 vs. +14% CAGR for Servis-Invest

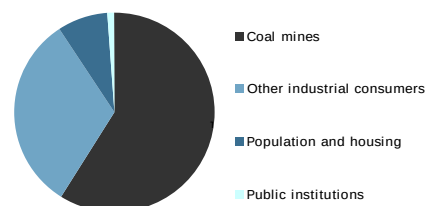
KEY FACTS ABOUT ENERGUGOL

- Operates in same regulatory environment as Oblenergos
- Acquired by SCM in 2004; now a structural unit of DTEK
- Transmits and supplies electricity in scattered areas in Donetsk region
- Main consumers are coal mines
- Total length of gridlines: 1.2 ths km (Oblenergo median is 36.3 ths km)
- Total transformer capacity: 0.4 GVA (Oblenergo median is 3.7 GVA)

Operating area (dark)

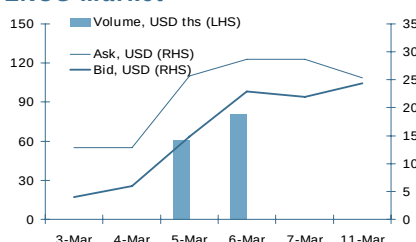


Consumer structure, 2006

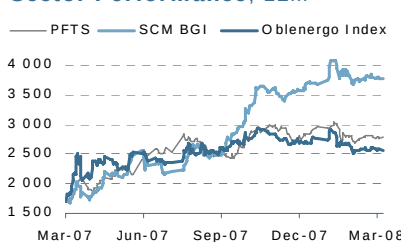


Source: Company data

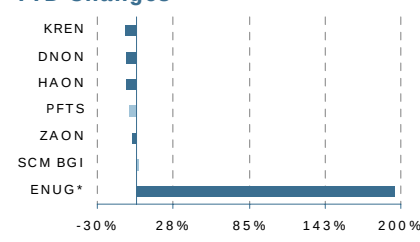
ENUG market



Sector Performance, 12M



YTD Changes



Source: PFTS, Bloomberg *ENUG performance is calculated from March 3, 2008 Note: Oblenergo index is MCap-weighted, FF adjusted, includes Dniroblenergo (DNON), Zaporizhyaoblenergo (ZAON), Kharkivoblenergo (HAON) and Krymenergo (KREN)

Financial analysis

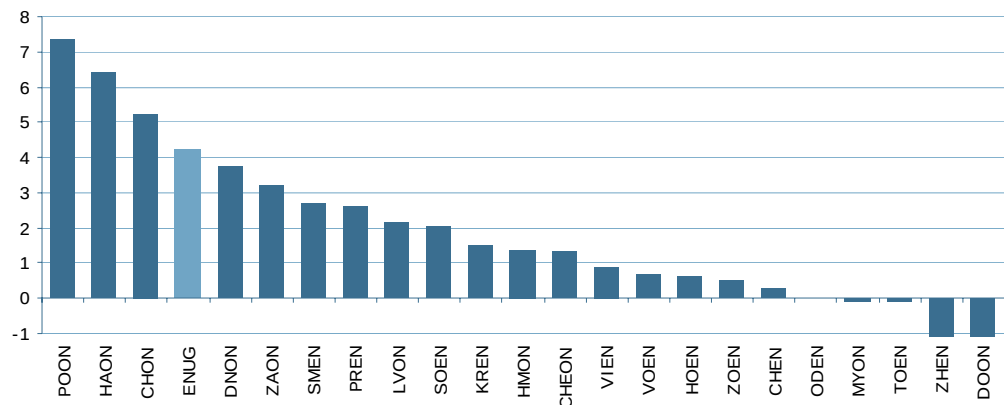
Of the most profitable Oblenergos right now, Energougol carries the highest risk of gradually decreasing its margins after the introduction of the new tariff policy expected in 2009.

Current tariff policy is beneficial for Energougol

The main determinants of Energougol's profit are distribution and supply tariffs. Presently, the National Electricity Regulatory Commission approves rates designed to allow Oblenergos sufficient cash generation to cover operating expenses and investment programs, and increase working capital. Each item to be covered by the tariff is subject to the NERC's review; therefore the ultimate size of the tariff depends on the skills and lobbying power of each distribution company's management.

Under the current scheme, Energougol reports the highest net margin of any Oblenergos and its net income in absolute terms is among the largest.

Net income of Oblenergos, 9M07, USD mln



Source: Company data, Concorde Capital estimates

P&L summary, USD mln

	2005	2006	2007E	2008E
Sales	44.6	64.3	70.9	86.5
Gross profit	4.0	5.2	7.5	9.9
Gross margin	9.0%	8.1%	10.6%	11.4%
Other oper. Income/losses	(0.4)	1.5	2.5	2.0
SG&A	(0.9)	(1.0)	(1.3)	(1.5)
EBITDA	2.8	5.7	8.7	10.4
EBITDA margin	6.2%	8.8%	12.3%	12.0%
D&A	(0.5)	(0.6)	(2.1)	(2.3)
EBIT	2.3	5.1	6.6	8.7
Net income	1.7	2.9	4.6	6.5
Net margin	3.7%	4.6%	6.5%	7.5%

Source: Company data, NERC, Concorde Capital estimates

According to our estimates, the company's costs related to distribution and supply of electricity grew 16% yoy in 2007, while related revenues rose 29%, yielding an increased gross margin. Higher *other operating incomes* resulted in growth in all margins in 2007. The company's estimated FY07 net margin is the expected to be the highest of any Oblenergos.

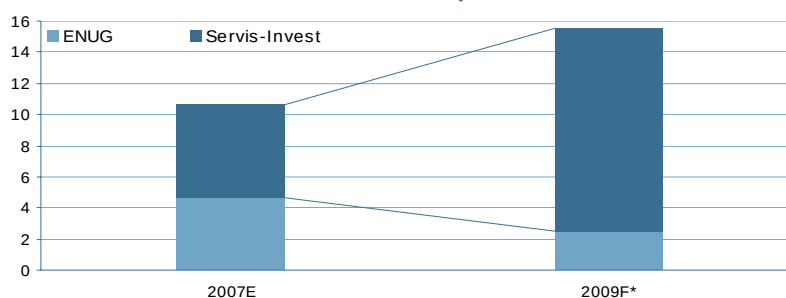
We have no doubt that Energougol's profit will grow in 2008: the NERC already approved a generous 30% hike in the company's distribution tariff for 2008 and allowed for an 80% yoy increase of its investment program. While current tariffs will allow the company to remain among the most profitable Oblenergos this year, we believe the situation will change in 2009.

RAB tariff policy: profits to gradual decrease starting in 2009?

While implementation of the RAB tariff policy (expected in 2009) is set to raise the profits of most Oblenergos, Energougol is an exception: its regulated income calculated as 11% return on RAB is USD 2.5 mln (45% lower than FY07E). Our conversations with NERC representatives lead us believe that Energougol's profits will not decline sharply under the new policy. In the most optimistic scenario, we expect stable profits, which combined with the anticipated increase in wholesale electricity tariffs, means falling margins.

Transition to RAB-based policy will be beneficial for DTEK holding, which controls one more distribution company, Servis-Invest. According to our estimates, the total regulated (RAB-based) profit of DTEK's distribution business will grow.

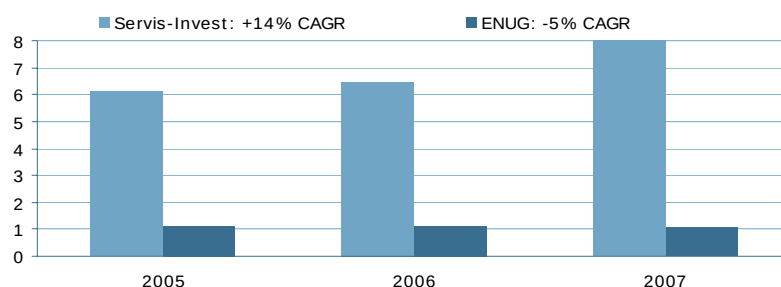
Net income of DTEK distribution companies, USD mln



* Assuming net income will be pre-determined as 11% return on RAB
Source: NERC, Company data, Concorde Capital estimates

Comparing the two DTEK-related electricity distribution companies, it is clear Servis-Invest is the flagship.

Electricity supplied by DTEK-related distribution companies, TWh

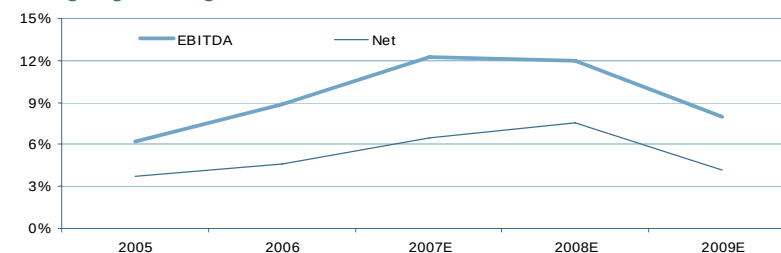


Source: DTEK, Energobiznes

We believe DTEK will accept the new rules of the game on the market to the benefit of Servis-Invest. Though there is a big chance that DTEK will lobby for saving high profits of Energougol for some period. In any case, there is a high risk that the Energougol's profits will fall beginning in 2009.

We forecast Energougol's 2009 net income will remain at their 2007 level, which will mean the company's net margin will fall from 7.5% in 2008 to 4.2%.

Energougol margins forecast



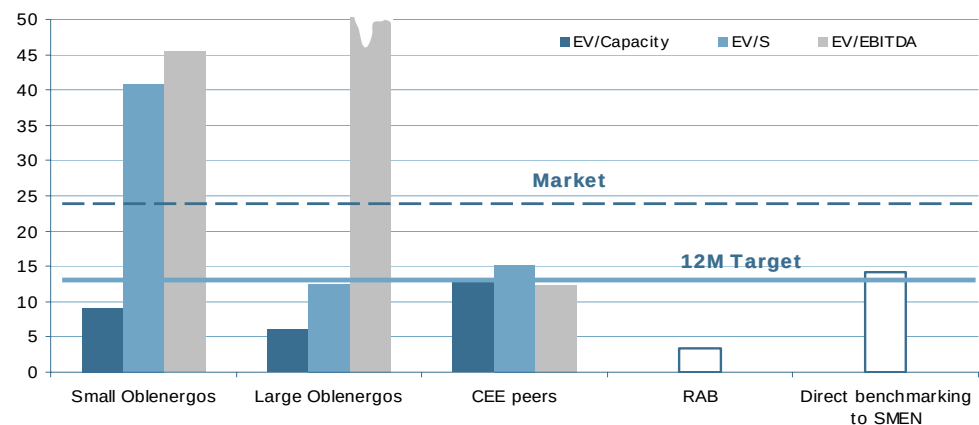
Source: Company data, NERC, Concorde Capital estimates

Valuation

Summary

EV/S multiples of seemingly straightforward peers, Oblenergos (though they can hardly be compared by size to Energougol), suggest an upside. However, we hold the strong belief that benchmarking to small Oblenergos overestimates Energougol's value. The key reason is that Energougol has a much lower asset base than any small Oblenergo, which implies a high risk that Energougol will have lower profitability after implementation of a RAB-based tariff policy. We believe the best benchmark for Energougol is the group of large Oblenergos, which will demonstrate comparable profitability under a RAB-based tariff policy.

Implied prices, USD



Source: Bloomberg, Company data, NERC, Concorde Capital estimates

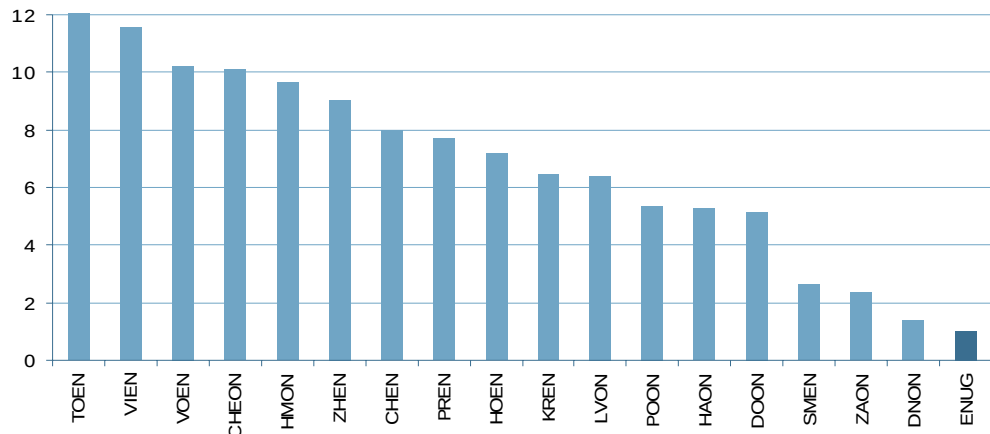
We set a 12M target at USD 13 (46% downside) and issue a SELL recommendation on ENUG.

Peer valuation

Ukrainian peers: Oblenergos

Even though Energougol looks comparable to small Oblenergos by volume of electricity supplied, revenue and profitability, we believe benchmarking to small Oblenergos (applying EV/S multiple) heavily overestimates the stock. The looming transition to RAB tariff policy will link Oblenergo profits to their asset base (or replacement value (RV) of their assets). In this regard, Energougol's RV/Sales ratio is comparable to large "industrial" Oblenergos and is much less than for small companies.

RV* / Sales

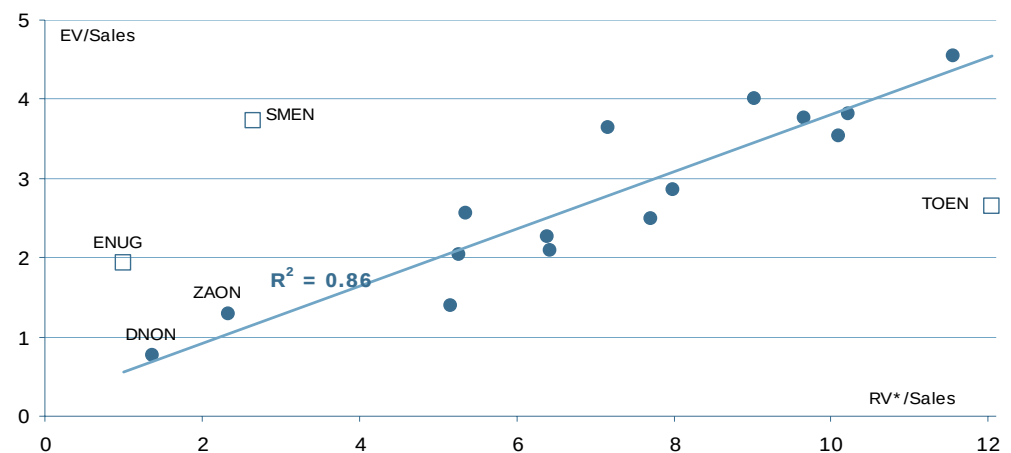


* RV - replacement value of assets: calculated based on NERC data, (refer to our Aug. 21, 2007 report on Oblenergos); RV for Energougol is assumed to be 2x smaller than for Sevastopoblenergo, refer to page 6 for more details

Source: Company data, NERC, Concorde Capital estimates

The graph below suggests the market has already priced in expectations introduction of the new tariff policy - it values most Oblenergos proportionally to the replacement value of their fixed assets. The diagram suggests Energougol is overpriced.

Oblenergos' EV / Sales vs. RV* / Sales



* RV - replacement value of fixed assets

Note: Squares represent outliers

Source: Company data, NERC, Concorde Capital estimates

Peer summary

	Sales USD mln	EBITDA margin	Net margin	Net debt* USD mln	MCap USD mln	Transformer Capacity GVA	Electricity Supplied TWh
Small Oblenergos							
SMEN	53.5	12.3%	5.8%	2.2	162.4	0.91	0.88
TOEN	53.3	8.3%	-0.1%	2.5	151.2	2.10	1.01
ZHEN	105.4	11.4%	0.0%	7.3	401.3	3.43	1.89
Large Oblenergos							
DNON	1,399.7	1.3%	0.4%	131.0	946.0	9.60	27.14
ZAON	569.0	1.5%	0.7%	55.7	678.0	9.60	10.47
ENUG	70.9	12.3%	6.5%	4.9	135.6	0.44	1.10

* Net debt includes outstanding payables and receivables, refer to our Nov. 9, 2007 Oblenergo report
Source: Company data, NERC, Concorde Capital estimates

Peer multiples

	EV/S	EV/EBITDA	P/E	EV/Electr. USD/MWh	EV/Capacity USD/mVA
Small Oblenergos					
SMEN	3.1	25.0	52.4	187.3	180.8
TOEN	2.9	34.9	neg	152.9	73.2
ZHEN	3.9	34.1	n/m	215.9	119.1
Mean	3.3	31.3	52.4	185.4	124.4
Large Oblenergos					
DNON	0.8	60.0	168.6	39.7	97.0
ZAON	1.3	86.8	175.6	70.1	76.4
Mean	1.0	73.4	172.1	54.9	86.7
ENUG	2.0	16.2	29.3	127.8	319.3

Valuation by small*

Implied price	40.8	45.4	54.5	37.0	9.1
Implied upside	68%	97%	79%	50%	-63%
Valuation by large					
Implied price	12.4	115.6	145.3	10.3	6.1
Implied upside	-50%	367%	487%	-58%	-75%

* Valuation by small Oblenergos is for illustration purpose only
Source: PFTS, Company data, NERC, Concorde capital estimates

CEE peers

Peer summary

	Sales USD mln	EBITDA margin	Transformer capacity, GVA	MCap USD mln	EV USD mln
EMASZ	643.0	9.6%	3.65	421	504
ELMU	1193.5	14.0%	8.45	1,053	1,202
Prazska Energetika	760.2	20.4%	6.31	1,495	1,479
ENUG	70.9	12.3%	0.44	136	141

Source: Company data, Bloomberg, Concorde capital estimates

Peer multiples

	EV / S	EV / EBITDA	EV / Capacity, USD / mVA
EMASZ	0.8	8.1	138
ELMU	1.0	7.2	142
Prazska Energetika	1.9	9.5	235
Mean	1.2	8.3	172

ENUG

multiples	2.0	16.2	319
Implied price, USD	15.2	12.3	12.9
Implied upside	-38%	-50%	-48%

Source: Company data, Bloomberg, Concorde capital estimates

Valuation by asset base

Direct approach: RAB

The NERC is expected to introduce a new tariff methodology in 2009, which will calculate regulated profits of electricity distribution companies as a return on their regulatory asset base (RAB). We derive the RAB of Energougol as an estimate of the company's fair enterprise value. Similar to Oblenergos, we calculate RAB as the depreciated replacement value of the company's assets, plus part of needs for working capital and its investment program.

$$RAB = \text{Depreciated RV} + CIP + 1/12 * \text{Operating expenses} + 0.05 * \text{Investment program}$$

Unlike with Oblenergos, the NERC does not provide replacement value for Energougol, so we took the NERC's estimates of the replacement value for Sevastopblenergo (SMEN) to derive Energougol's value. We assume that Energougol's asset value is two times smaller: both companies are comparable by structure of power lines and transformer capacity, while Energougol's numbers are two times smaller.

Sevastopblenergo vs Energougol

	Sales	EBITDA	Trasnformer capacity, GVA	Network length, ths km	RV of assets, USD mln	EV, USD mln
SMEN	53.5	6.6	0.91	2.24	170.2	164.6
ENUG	69.8	8.1	0.44	1.20		
Ratio, SMEN / ENUG			2.1x	1.9x		

Source: NERC, Company data

We estimate the replacement value (RV) of ENUG's assets is USD 85.1 mln. We calculate depreciated RV as 25% of total RV, similarly to our approach for Oblenergos.

Our calculations yield USD 23.1 mln RAB for Energougol, which implies a fair value of USD 3.3 per share (implied downside is 87%).

Alternative approach: benchmarking to SMEN

At the moment, the market capitalization of Sevastopblenergo is larger than its RAB suggests. If the market is ready to value Energougol proportionally, Energougol's EV will be just two times smaller than Sevastopblenergo's, i.e. USD 82.3 mln. This corresponds to USD 14.1 per share (43% downside). Note that we believe Sevastopblenergo is overpriced.

Disclosures

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Buy	49	45%
Hold	28	26%
Sell	14	13%
Under Review	17	16%
Total	108	100%

Investment banking clients*

Buy	8	100%
Hold	0	0%
Sell	0	0%
Under Review	0	0%
Total	8	100%

** Concorde Capital provided investment banking services to the company within the past 12 months.*

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