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Analyst's Notebook

Ukraine / Electricity
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Kievenergo EGM: Status Quo

Target Price: USD 1.74	(no change)
Recommendation: BUY	(no change)

The key results of KIEN's EGM were:

- the re-election of its supervisory board and the replacement of some members by people close to Chernovetsky (Kiev's Mayor) and Akhmetov;
- more power was given to the supervisory board, including the ability to change top management;
- the *status quo* was maintained in the company's top management; and
- all parties expressed optimism that KIEN will continue to lease Kiev's power plants.

Re-elections

As expected, KIEN's three main shareholders (the state with 50%, the city of Kiev with 12.7%, and a group led by Vasily Khmelniysky with 26.5%) managed to reach agreement on the future of the company and all three sides voted collectively on agenda items.

Even though **KIEN's CEO** Boris Yashchenko held onto his job, his report on the 1H06 financial results was not approved. It was "taken for consideration," which might mean the shareholders have not yet decided on Yashchenko's future. The key shareholders reserved the right to change the CEO at any time in the future through Tuesday's move to empower the supervisory board to change top management.

Supervisory Board: There were no changes in the proportion of members from each main shareholder group (two from Kiev, one from Khmelniysky's group and four from the state). However, Kiev's representatives were replaced by people close to the new mayor, and state representatives were also replaced by people close to Akhmetov's business group.

Audit Commission: Each of three main shareholders delegated one person to serve on the audit commission.

Grounds for Legal Disputes?

There were several questionable moves that might lead to questions about the legitimacy of the EGM:

- To prevent legal disputes, the usual procedure for electing the supervisory board is to vote on each candidate individually. However, at the EGM, the candidates were approved together as a group.
- During the selection of audit commission members, the delegate from the state was not named. Shareholders voted for the election of "someone from the NC ECU," without naming a specific person. Since Yushchenko disbanded the NC ECU Tuesday, the real outcome of the vote is far from certain.

These procedural issues could give people who are not satisfied with the EGM's decisions the right to invalidate them in court. If no lawsuits are filed in the near future, this means that all interested parties are in agreement on the company's future.

Financial Results

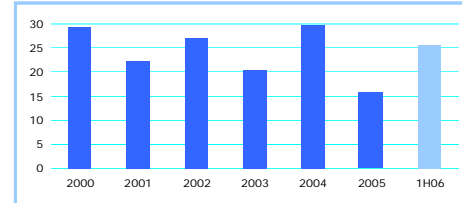
The company's weak bottom line for 1H06 was the result of a significant increase in the price of purchased gas for heat production without a corresponding change in heating tariffs. The company's heating losses almost tripled in 1H06.

Key Financials, USD mln

	1H05	1H06	yoy change
Sales	179.4	309.3	+72%
EBITDA	17.8	13.6	-23%
margin	9.9%	4.4%	
Net Income	5.5	0.3	-95%
margin	3.1%	0.1%	

Source: Company data, Concorde Capital calculations

Losses From Supplying Heat, USD mln



Source: Company data

If Kiev's City Council does not change heating tariffs in the near future, we expect KIEN's total losses from supplying heat to be about USD 80 mln for 2006. However, at the moment, an increase in heating tariffs is on the council's agenda, and we can expect some increase in late 2006.

Starting in 2007, according to a recently adopted law, the city is obliged to compensate from its own budget any difference between heating tariffs and the level justified by costs. We expect that the justified level will be equal to and not less than KIEN's real costs of supplying heat. Therefore, we expect KIEN to show at least a 6% net margin in early 2007.

Future of the Power Plants Lease: More Information, More Optimism

According to KIEN management and the city's representatives on the KIEN supervisory board, the recently created municipal company Kievteploenergo will become the owner of city's assets (heat networks and power plants which are now owned by Kiev). However, Kievteploenergo will not necessarily will be operator of the assets. KIEN will continue operating the assets until May 1, 2007 when the lease's future will be decided by a tender.

KIEN management and city representatives on KIEN's board are optimistic that KIEN will win the tender, because it is the only company with a qualified staff and experience operating Kiev's infrastructure.

How good are KIEN's chances of winning the tender?

Kiev's power plants are becoming very attractive assets since they started selling electricity at premium in 2006. Heating production costs are expected to be fully covered starting in 2007. We expect there will be many candidates hoping to win the tender, including some private companies with experience operating power plants and heating networks.

We are optimistic of KIEN's chances because it is unlikely Kiev will give preference to outsiders. Kiev and KIEN's other main shareholders have reached a consensus, and since Kiev has retained decision power within KIEN, the city has vested interests in KIEN continuing to operate its power plants.

As before, we estimate the chance of KIEN renewing its lease at more than 50%. We support our previous USD 1.74 price target and our BUY recommendation.

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