Ukraine / Electricity

Update

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Kievenergo

Warm Winter, Hot Prospects

Bloomberg	KIEN UZ
Reuters	KIEN.PFT
'DRs :	absent

Market data

Market price, USD	2.32
52 Wk H/L, USD	2.32 / 1.02
Shares, mln	**108.36**
MCap, USD mln	**251.5**
Free float, shares	9.00%
FF MCap, USD mln	22.6

12M target

Price, USD	4.00
12M MCap, USD mln	433.4
Upside	72%

Ownership

State (NC ECU)	50.0%
Kiev city (Kievenergoholding)	12.7%
Khmelnitskiy Group	26.0%
Other	11.3%

January 24, 2007

CONTENT

INVESTMENT CASE

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Generation Capacity:	
Electric	1.2 GW
Heat	10 GW
Power lines	10,900 km
Transformer cap.	5.72 GVA
Heat pipelines	1,810 km

Even after 44% ytd gains, KIEN trades at a 14% discount to less liquid and non-integrated Oblenergos. The market still overestimates its lease-at-risk factor. We see many political and technical reasons that make the termination of Kievenergo's lease rather unrealistic. With the altered business model and dramatic increases in heating tariffs, we expect significant growth in both the top and bottom lines in 2007. We upgrade our 12M target to USD 4.0 (72% upside) and re-iterate our BUY recommendation.

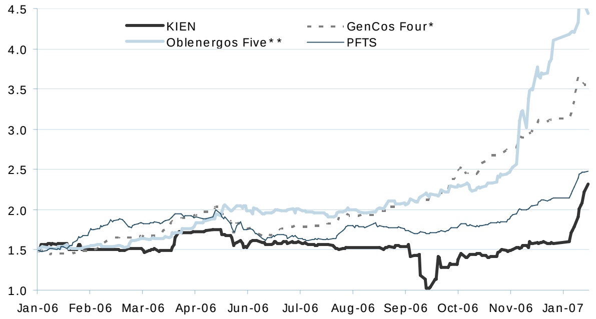
Two Years of Strong Sales Advances. A change in the company's business model and a double in tariffs for electricity production caused 74% growth in 2006E sales without a noticeable increase in real output. We forecast a 57% increase in 2007 revenues due to growth of Kievenergo's tariffs for electricity and heat production.

History of Low Profitability To Be Broken in 2007. The cross subsidization of Kievenergo's heat segment losses (which exceeded USD 80 mln in 2006) by electricity profits is expected to become a thing of the past as a result of a recent 2.4 times increase in heating tariffs for the company (the first increase since 2000) and new legislation for housing services. We forecast Kievenergo's profit margin to exceed 5% in 2007, noticeable progress compared to net margins of 0.2%-0.4% over the last five years.

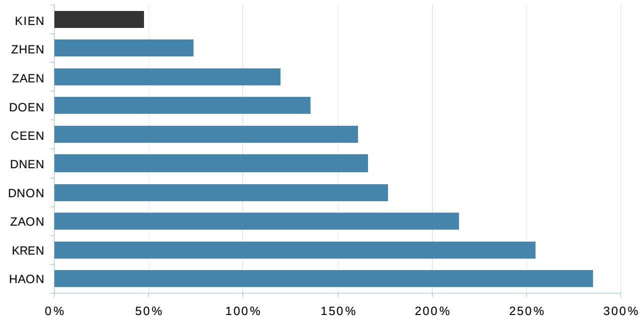
The Lease Agreement Is Very Likely To Be Renewed. Kiev's new mayor questioned the advisability of Kievenergo's lease of the city's power plants last August, which resulted in poor stock performance in late 2006. A tender to lease the assets, scheduled for May-June 2007, will clear up the situation. We see that Kievenergo has strong support from regulators and its main shareholders to continue the lease.

	Net Revenue		EBITDA		Net Income		EV/S	EV/EBITDA	P/E
	USD mln	yoy gr.	USD mln	margin	USD mln	margin			
2006E	655	74%	25.7	3.9%	0.8	0.1%	0.55	14.0	315.1
2007E	1,025	57%	103.7	10.1%	57.6	5.6%	0.34	3.3	4.4
2008E	1,104	8%	118.8	10.8%	66.3	6.0%	0.31	2.8	3.8

KIEN vs Indices



Most Liquid Energy Stocks: 52 Week



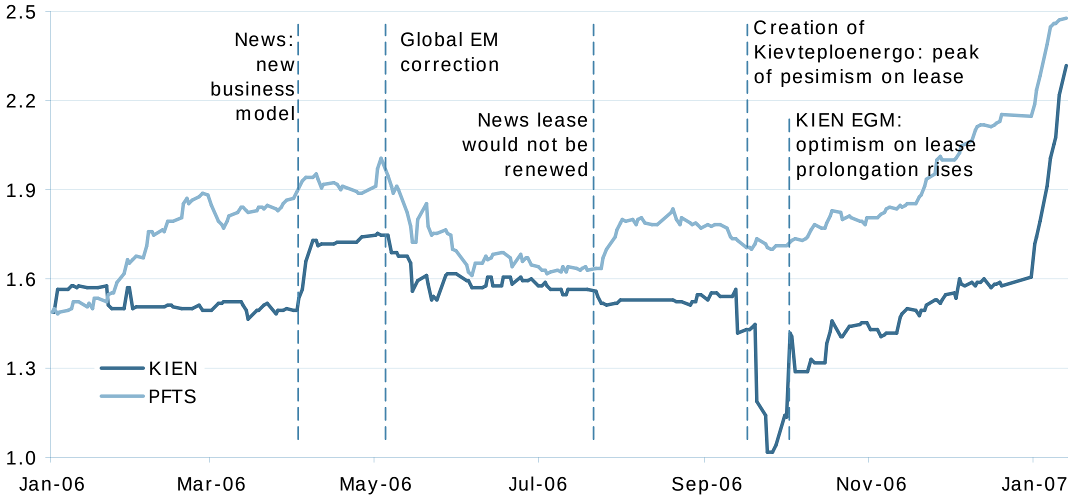
Source: PFTS, RTS, Bloomberg, company data, Concorde Capital estimates
** MCap-weighted index of traded generation companies*
*** MCap-weighted index of most liquid distribution companies (DNON, HAON, KREN, ZAON, ZHEN)*

NEW CITY MAYOR SPOILED STOCK PERFORMANCE

The market for Kievenergo was driven by news in 2006 and turned out to be quite volatile. Unlike other energy stocks in Ukraine, Kievenergo underperformed the market in 2006, mainly due to uncertainty related to its lease of city assets.

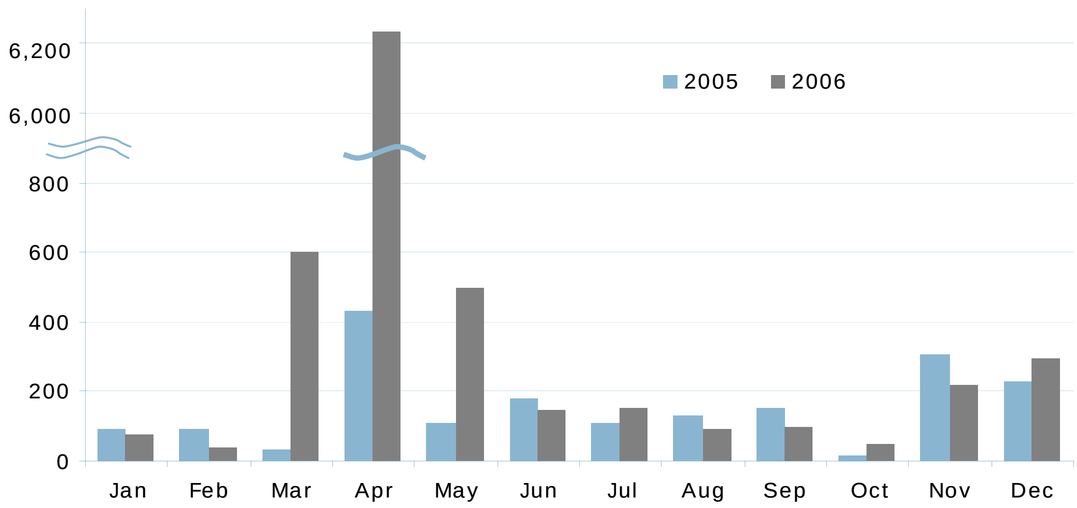
Kievenergo's change to its business model in late 2005 and their entrance on the capacity tender market in March 2006 stoked interest in the stock: the trading volume in April 2006 exceeded the total volume for all of 2005 by 3.3 times. However, the boom was brought to a halt as a result of the actions of Kiev's new officials in August 2006. Kiev mayor Leonid Chernovertskiy announced that the city might discontinue its lease with Kievenergo to use its power plants and subsequently created the municipal company Kievteploenergo to assume control of Kiev's power plants. On the news, the stock dropped, though on low volumes. Optimism that the lease might be continued returned following the company's EGM on (October 10). Over November 2006 to January 2007, KIEN followed the same upside trend as most of the other energy stocks, and almost caught up to the performance of the PFTS index yoy.

KIEN Stock Price Reaction to News in 2006, USD



Source: PFTS, Concorde Capital calculations

Trading Volume (ths of shares)



Source: PFTS, Concorde Capital calculations

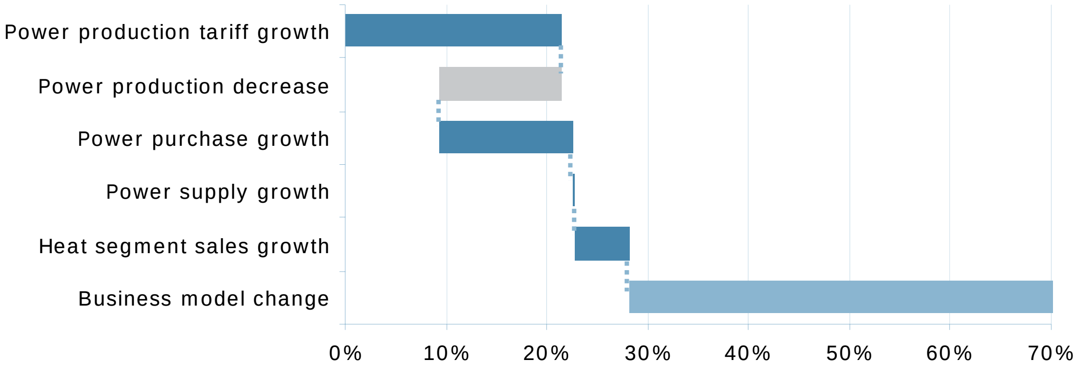
MIXED 2006 RESULTS

Results of 3Q06 led us to revise our sales growth estimates upward to 70% yoy for 2006 (or 74% growth nominated in USD), while Kievenergo's bottom line for 2006 is most likely to be much lower than we forecasted because of increased gas prices for heat production that generated almost USD 90 mln in losses for Kievenergo's heat segment (an increase of 5.5 times yoy). The almost tripling of heat production tariffs for Kievenergo in December 2006 will allow the company to cover all the costs of heating segment in 2007, a move that promises to lead to both sales and profit growth.

70% Sales Growth in 2006

As we forecasted, Kievenergo's sales grew significantly in 2006. Although we do not have FY2006 financials yet, we can estimate the company's revenue based on 3Q06 financials and our business model. We estimate 70% sales growth in 2006, which combines an increase in power production tariffs after entering the capacity tender market (the average tariff grew by 85% yoy), an increase in supplying electricity and heat, a 30% reduction in power production, and a change in the company's business model. Kievenergo currently accounts for power production and power supply businesses separately. Note that under the old business model (when electricity produced by Kievenergo's power plants was supplied directly to its consumers), sales only grew 28% yoy.

KIEN 2006 Sales Growth Components



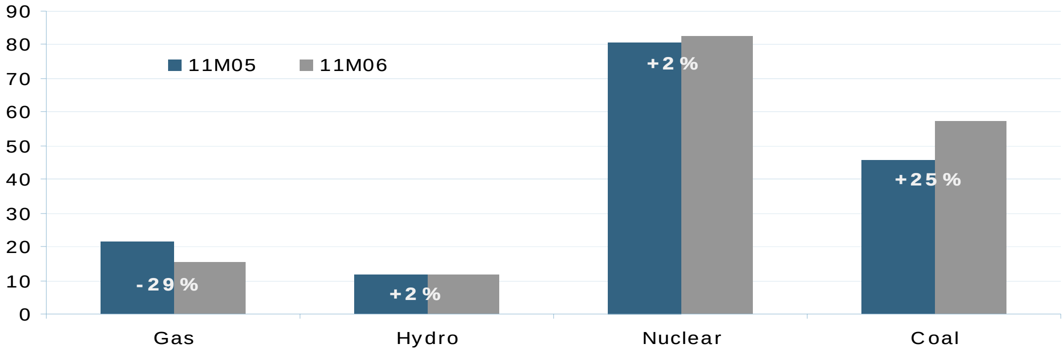
Source: Company data, EnergoBiznes, Concorde Capital estimates

Electricity Output Optimization

The company reduced electricity generation by 30% yoy in 2006, to its own benefit. The key reasons for the decrease were:

1. An increase in gas tariffs in January 2006 forced state regulators to start gas economization programs and since Kievenergo's power plants are gas-fueled (in fact Kievenergo is the largest gas consumer in Ukraine), limited gas use forced the company to reduce electricity output.

Ukrainian Electricity Production by Fuel, TWh

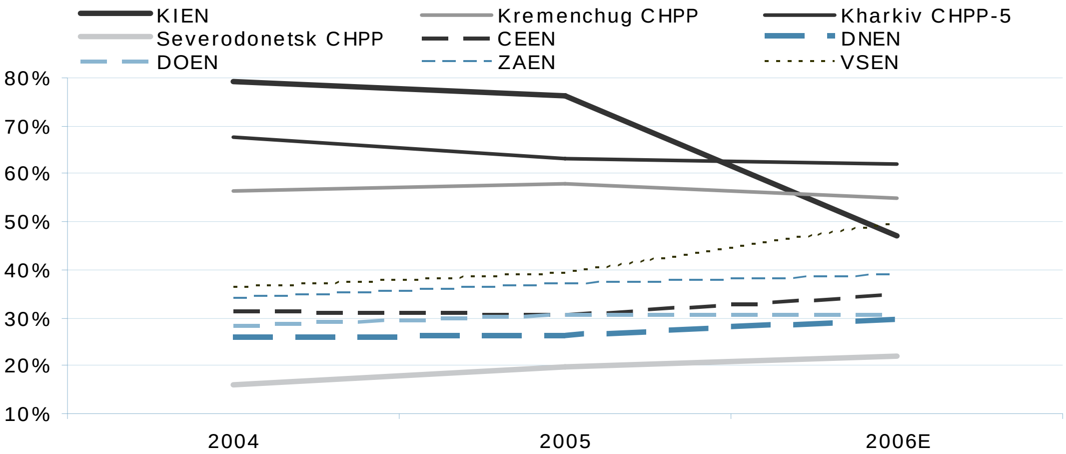


Source: EnergoBiznes, Concorde Capital estimates

2. As usual, Kievenergo suffered from gas cuts by suppliers due to its outstanding debt to them. As we wrote before, an unstable gas supply is an old problem for Kievenergo, and with gas prices rising, suppliers were more responsive to delayed payments, which led to more frequent gas cuts in 2006. The significant increase in the company's heat tariffs will allow it to stabilize payments for gas supplies and avoid cuts in the future.

3. Kievenergo started selling electricity on the capacity tender market in March 2006. The conditions of this market require it keep some of its generation capacity in a reserve or "waiting mode": Kievenergo's load capacity converged with other participants on the capacity tender market in 2006. This was beneficial for Kievenergo, since according to the market rules, the company receives compensation for this reserve capacity, which amounts to USD 3.2 – USD 9.5 per MW per day. In addition, decreased electricity production was beneficial in terms of energy savings: fuel efficiency grew from 47.8% in 2005 to 51.1% in 2006.

Installed Capacity Utilization Of Ukraine's Largest Power Companies



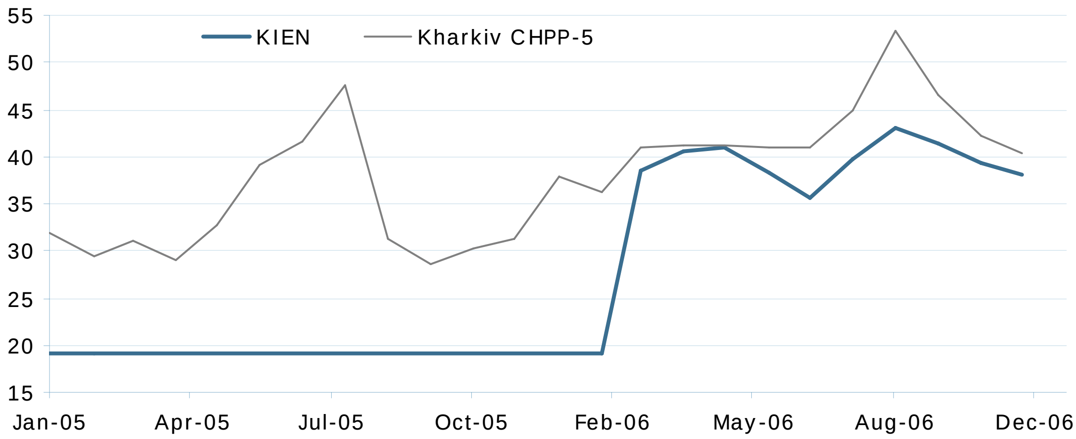
Source: Energobiznes, Concorde Capital calculations
Note: Kremenchug and Severodonetsk CHPPs do not participate in capacity tenders

We forecast Kievenergo will increase its load in 2007 up to the same level as Kharkiv CHPP-5 (i.e. up to 60%).

Electricity Production Tariffs Compensated for Declined Output

As we predicted in our April 2006 report, Kievenergo's entrance on the capacity tender market caused an increase in its average production tariff to the same level as tariffs at Kharkiv CHPP#5. Kievenergo's production tariff grew 85% yoy in 2006 to 35.0 USD per MWh (a bit larger than our forecast of USD 34.6 per MWh). Tariff growth led to increased sales from electricity production, despite a reduction in real output.

Average Production Tariff, USD / MWh



Source: NERC

An increase in Kievenergo's electricity production tariffs will be reflected in further growth of electricity sales, which will be especially noticeable in 1Q07.

Business Model Change Brought About Reported Sales Growth

As we explained in our previous reports, Kievenergo previously produced electricity for its customers, but now sells the power it produces to the wholesale market and then buys back the power it needs to supply its customers. This change in its business model means Kievenergo accounts electricity produced and supplied to its customers two times. This led to an additional automatic increase in both sales and costs by USD 160 mln (estimated) in 2006 compared to estimates under the old business model, but at the same time did not affect electricity profits (refer to our April 4, 2006 report on Kievenergo for more details).

Heat Segment Has Eaten Profits… For the Last Time

Kievenergo had no time to enjoy growth in electricity segment profitability since March 2006: all the profits generated by electricity were eaten away by heat production losses because of the significant increase in heat production costs caused by gas prices hikes in mid-2006 (refer to the next section for more details). Revised heat tariffs effective in 2007 mean heat production will at least avoid becoming a loss-making business in the future.

A significant increase in Kievenergo's heat production tariff since December 2006 will lead to about 130% yoy growth in heat segment sales in 2007, which will be the largest booster for both KIEN consolidated profits and revenues.

HEAT SEGMENT: RADICAL IMPROVEMENTS AHEAD

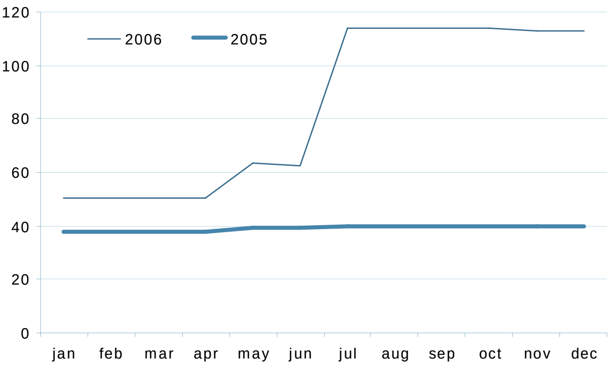
Tariffs for heat and hot water supply had not changed in Kiev since 2000, any potential increases were met with resistance of every "oppositional" political force, which hoped to gain from the populist strategy of "opposing tariff hikes". This was the main reason why Kiev authorities did not touch tariffs. By 2006, Kievenergo had cross-subsidized heating losses by electricity profits. The situation changed in late 2006 when the Kiev City Council voted to more than triple heating tariffs in the city, to the primary benefit of Kievenergo.

Electricity Segment Covered Heat Losses

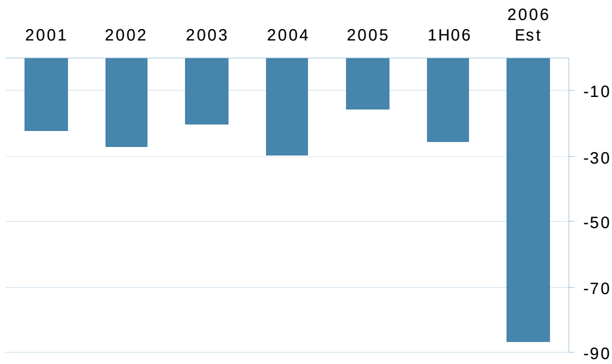
The below-cost heating tariffs always harmed Kievenergo, but the company had no power to change the situation. Kievenergo had patience for a long time because it had some margin of safety: its electricity business brought enough profits to cover heat segment losses (refer to our August 2005 report for more details). Another factor that allowed the company to weather the situation were preferential gas tariffs for its heating production facilities until early 2006, which gave the company a chance to manipulate gas tariffs by directing some cheap gas "purchased for heat production" for power production purposes.

The situation changed for worse since gas tariffs increased in 2Q06: gas tariffs for heating enterprises almost tripled. This made heat segment losses grow (according to our estimates) 5.5 times yoy in 2006.

Gas Tariffs for Heating Enterprises, USD / ths cm



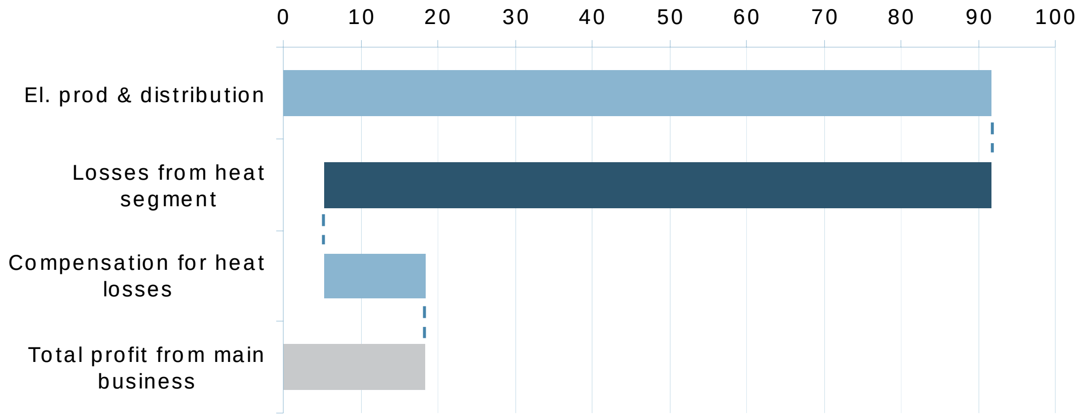
KIEN Losses from Heat Segment, USD mln



Source: Gaz Ukrainy, Kievenergo, Concorde Capital estimates

To Kievenergo's advantage, recent changes in the method of selling electricity to the Wholesale Energy Market allowed it to earn enough from electricity in 2006 to offset heat segment losses. In addition, Kiev decided to partially compensate heating losses for Kiev city's heat producers, Kievenergo and Darnitsa CHPP: the city directed USD 15.11 mln from its budget for the compensation, and we estimate USD 13.3 mln was directed to Kievenergo.

KIEN Profits/Losses from Main Activities, USD mln, 2006E



Source: Company data, Concorde Capital estimates

Note that without its heating segment, Kievenergo is an extremely profitable company, since heat sector losses are likely to be put to an end this year, it looks like the company will become rather profitable. For a more detailed discussion, see page 11.

Salutary Decision by the Kiev City Council

Despite serious political pressure, in October 2006 the Kiev City Council approved a significant increase in housing tariffs (by 3.4 times) for Kiev, which made it possible to increase the heat production tariff by 2.7 times for Kievenergo's power plants and boilers.

Heat Production Tariff for KIEN, USD/GCal

	2004 - Nov. 2006	Since Dec. 1, 2006	Growth
For households and housing	10.78	31.46	192%
For budget organizations	12.82	31.46	145%
For business consumers	15.84	33.56	112%
Average for KIEN (Est)	11.74*	31.68**	170%

Source: Kiev City Council, Concorde Capital estimates
** For the year 2005*
*** For the year 2007*

The new tariffs for KIEN have been in effect since Dec. 1, 2006. According to our estimates, the increases will allow KIEN's heat segment be in the black in 2007, even with 80% yoy growth in gas tariffs and a 20% increase in employee-related costs.

Continuing political pressure on Chernovetskiy, forced him to launch an initiative to decease retail heating tariffs for Kiev households. To leave KIEN's production tariffs untouched, the mayor plans a corresponding increase in heat tariffs for business consumers.

Why the City Council Agreed To It

The city council's persistence on the issue of increasing tariffs led to a series of political declarations that stand to personally benefit Kiev's mayor and council representatives directly. The key grounds for this hypothesis is that both Kievenergoholding (created in April 2006) and Kievteploenergo (September 2006) have some links to Chernovetskiy and therefore might lead to them controlling Kievenergo or operating Kiev's power and heat production assets (discussed more later in this report).

However, the main reason to increase heat tariffs to the break-even level was an amendment to the law "On prices and pricing" approved by the Verkhovna Rada on Sept. 22, 2006. According to the law, starting in 2007, local administrations must compensate the difference between housing tariffs and the real ("economically justified") costs of housing services provision from their budget, which meant that without increases, Kiev would have had to pay about USD 240 mln in compensation for Kievenergo's heat segment losses in 2007. The decision by the Kiev City Council was to protect its budget from additional compensation payments.

THE MOST PROFITABLE UKRAINIAN UTILITY?

Significant Earnings Potential

Assuming no changes in the electricity segment and full compensation of any heat segment losses, Kievenergo is likely become the most profitable utility in Ukraine with a net margin approaching 6% (a radical improvement from the 0.2%-0.4% posted over the last five years). This improvement raises both our optimism about the stock's ability to appreciate and our concerns that something might go wrong: the profitability growth looks too fantastic.

Possible Flies in KIEN's Ointment

There are some concerns that the company's profits can be limited for a number of different reasons:

- A new lease agreement for Kiev's heating infrastructure, which is expected to be signed in mid-2007 might have some surprises like high rent payments;
- Regulators might invent a mechanism to limit the profitability of Kievenergo's power plants in calculating their purchase prices on the wholesale market;
- The more than tripling of housing tariffs (the main source of payment for heat production) for Kiev citizens might cause payments delays since the average Kiev household now has to pay about USD 50 per month for heating (compared to average official monthly salary of about USD 200 and pension of USD 90). Kiev is going to subsidize part of household heating payments from its budget and since the local budget is not the most diligent payer, this might increase receivables and bad debt of KIEN. Still, the city budget can avoid additional expenses through the mayor's initiative to cross-subsidize the poor strata by higher heat tariffs for businesses and industrial consumers;
- A change in legislation governing party affiliation in local councils, if passed, might lead Chernovetskiy losing control over the majority in the Kiev City Council. This can lead to a revision of the decree increasing heating tariffs. We do not believe Kievenergo's heat segment will be loss-making anymore (following from the law on "On Prices and Pricing" mentioned on page 10), but possible downward changes in Kiev's set tariffs (which it would need to compensate for any losses from the budget) can raise Kievenergo's receivables;
- A significant improvement in the company's profitability raises the risk of sub-optimal spending by the management, which can cause an increase in management costs or "other expenses."

We do not explicitly account for these possible complications/risks in our DCF model, and thus we set our target price somewhat below what the DCF valuation implies.

ASSET LEASE: UNCERTAINTY HOLDS

Kiev's new mayor, who was elected on March 2006, attempted to introduce new rules for the Kiev energy market, questioned Kievenergo's power plant lease and supported new energy structures, Kievenergoholding and Kievteploenergo. However, despite the uncertainty, we believe Kievenergo will renew its lease.

Disposition: Kievenergo, Kievenergoholding, Kievteploenergo

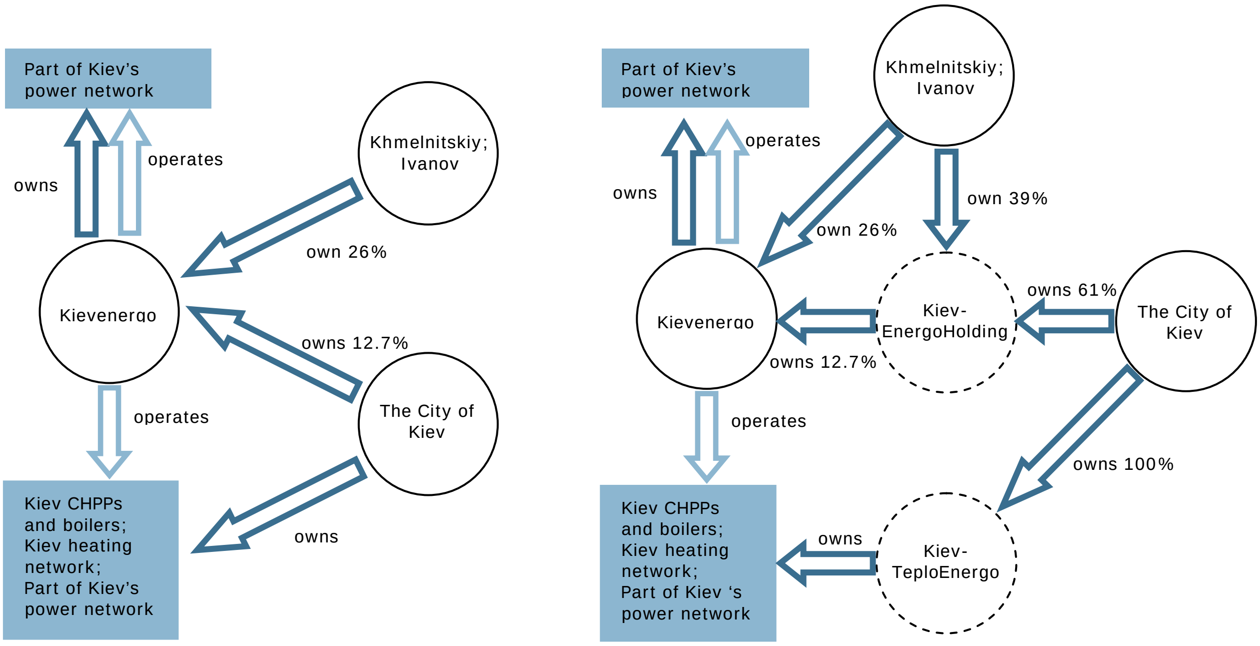
Since Chernovetskiy took office, the future of Kievenergo's lease became questionable. The creation of two energy structures in Kiev in 2006 (Kievenergoholding and Kievteploenergo) that are assumed to be candidates to lease Kiev's power plants aggravated market pessimism and caused KIEN's stock to depreciate in early October (refer also to our notes from Oct. 6 and Oct. 12, 2006). However, as we wrote before, their creation is unlikely to impact the probability of Kievenergo's lease being renewed. Instead, they complicate the ownership structure of Kiev's utilities and assets:

- Kievenergoholding was created in March 2006 "to improve the management of Kiev utilities" i.e. to control the city's stakes in Kievenergo, Kyivvodokanal (water and sewage company) and Kyivgaz (gas supply company). The company only increases indirect ownership of Kievenergo by private structures controlled by Vasiliy Khmelnistkiy and Andrey Ivanov who have a 39% interest in Kievenergoholding (refer to the chart below).

- Kievteploenergo is a municipal company that was initially created to own Kiev's heating infrastructure (power plants and heating networks), but this does not mean it will actually operate them. Misunderstanding this company's status with respect to municipal assets created some panic on the market in late September.

Relationships Around Kievenergo:

As of Mid-2006 **As of 2007 (Involving Kievenergoholding and Kievteploenergo)**



Source: State Securities Commission, Kievenergo, Concorde Capital

Potential Competitors to Kievenergo

It looks like two structures created in 2006 have a chance to lease Kiev's CHPPs instead of Kievenergo. Kievenergoholding is least likely to be interested in direct operation of Kiev's municipal assets since its private shareholders already have enough influence at Kievenergo. Kievteploenergo has more of a motive to operate the assets, but opposition is very strong.

Reasons the "Competitors" Were Created

Kievenergoholding was clearly created to increase the influence of private owners on Kievenergo. However, the reasons behind the creation of Kievteploenergo are more uncertain. Three possible reasons are:

1. The city decided to structure ownership rights over municipal utility assets by creating Kievteploenergo, which owns the assets on behalf of the city. Even though this is the official version, the timing is strange: it was created when the discussion about not renewing Kievenergo's lease was especially hot.
2. The private owners of Kievenergo and representatives of Kievenergoholding lobbied to create panic on the stock market and accumulate more shares of KIEN. Kievenergoholding's CEO did declare plans to buy out KIEN's free float. However, there is no direct support for this theory: after the announcement that Kievteploenergo would be created in October 2006, stock price dropped but volumes on the PFTS remained low (refer to the chart on page 4).
3. Kiev Mayor Chernovetskiy (who leads a majority in the city council) created the company as an alternative to Kievenergoholding. Since the Kiev City Council approved significant increases to heat tariffs in October, which will make Kiev's CHPPs especially profitable, this explanation appears highly probable.

If the last reason for creating Kievteploenergo is true, it is positive for KIEN because it means that there will be even more opposition to not renewing Kievenergo's lease to operate the CHPPs: in addition to the Fuel and Energy Ministry, the State Property Fund, the National Energy Company and the World Bank, Chernovetskiy would have another rival in KIEN's largest private shareholder Vasiliy Khmelnitskiy's business group.

Thus, it looks like the only person interested in not renewing Kievenergo's lease is Chernovetskiy, and he has powerful opponents in the government, energy regulators and Kievenergo's main owners.

Moreover, the configuration of the Kiev City Council might change soon, to the benefit of Chernovetskiy's opponents: if a law preventing deputies from changing parties is passed by Parliament and the President, Chernovetskiy will lose his majority and it will be much harder for him to fight against Kievenergo.

The Time for Truth Is Approaching

According to preliminary information, in May 2007 – only five months from now - the tender to lease Kiev's power plants and heating networks will take place and the lingering questions will be resolved.

There are too many deterrents for Kievteploenergo and Kievenergoholding. The chances for some private companies are also small. We believe that Kievenergo, which has extensive experience in operating the assets, has the best chance to win the tender. Optimism is also fueled by the fact that Kievenergo has continued to invest in the construction of a third power unit at Kiev CHPP#6, "ignoring" the chance that the power plant can be operated by somebody else.

What If The Lease Is Not Prolonged?

Despite the fact that we believe Kievenergo's lease will be renewed, this section speculates on the consequences if the lease is terminated. The key results for Kievenergo are a decrease in long-term debt (as the new lessee/owner is likely to assume the World Bank loan), and transformation into pure power supply company.

1. Kievenergo will become an Oblenergo, i.e. it will buy electricity at the wholesale market and sell it to consumers in Kiev. The company would start focusing on upgrading its distribution segment and restructure, in order to liquidate the departments responsible for electricity and heat production, heat and hot water supply. As we show in the valuation section, even as an Oblenergo, an upside is implied to today's market price for KIEN.

2. Divorce process between Kievenergo and Kiev: the city or the direct owner of the CHPPs and heating networks will have to compensate Kievenergo for part of capital it invested in upgrading the assets it leased. The amount of compensation is hard to predict and would most likely be the result of long negotiations between all involved parties. In particular, it is hard to classify the sources of money directly invested by Kievenergo, as part of it was accumulated from capital collected as a result of the depreciation of the municipal assets it operated. From 1999 to 2005 Kievenergo spent USD 143 mln to upgrade its heating infrastructure, 87% of the money (USD 125.5 mln) was invested directly by the company or from the World Bank loan.

3. The new lessee/owner of Kiev's heating assets will have to create a new team to efficiently manage and coordinate the work of the assets, which is not an easy task. In addition, Kiev CHPPs not operated by KIEN might face problems in working on the capacity tender wholesale market. Since the National Energy Company (NC ECU) and the Ministry of Fuel and Energy are against Kievenergo losing its lease, they might make the new lessee's life harder.

This rough analysis supports optimism that Kievenergo's lease will be renewed since there are too many sticky complications for a possible successor.

VALUATION

Peer Comparison

We conducted a peer comparison of KIEN using three peer groups as benchmarks:

- EU peers: vertically integrated energy companies, which like KIEN are involved in electricity and heat production and supply. We believe the most comparable parameter for these companies is EBITDA. Electricity parameters and sales are not comparable because they do not capture differences in market conditions and power prices.
- Russian peers: vertically integrated (not restructured) energy companies. We believe that they are most comparable in terms of electricity output and profitability (EBITDA).
- Ukrainian peers: as usual, we used a sum-of-the-parts valuation that combines power generation and power distribution companies. We valued KIEN by peers' electricity data (generation and distribution segments separately). Note that KIEN's value can be higher than implied by this type of valuation as it does not account for KIEN's heat segment.

EU Peers

Peer Financials, USD mln

	Sales		EBITDA		Net income		MCap
	2006E	2007E	2006E	2007E	2006E	2007E	
CEZ	7,045	8,370	2,728	3,218	1,303	1,647	25,139
Vattenfall	18,169	18,679	5,304	5,553	n/a	n/a	13,150
EnBW	15,628	16,584	3,071	3,565	885	1,229	16,004
Endesa	25,649	26,872	8,992	7,088	3,236	2,122	51,375
EdF	73,762	76,965	18,865	20,296	5,552	5,924	127,497
KIEN	**655**	**1,025**	**26**	**105**	**1**	**58**	**251**

Source: Bloomberg, Company data, Concorde Capital estimates

Peer Multiples

	EV/S		**EV/EBITDA**		**P/E**	
	2006E	2007E	2006E	2007E	2006E	2007E
CEZ	3.7	3.1	9.6	8.0	19.3	15.3
Vattenfall	1.1	1.0	3.7	3.5	n/a	n/a
EnBW	1.1	1.0	5.6	4.5	18.1	13.0
Endesa	2.9	2.7	8.2	10.3	15.9	24.2
EdF	2.0	2.0	7.9	7.5	23.0	21.5
Mean	2.2	2.0	7.0	6.8	19.1	18.5
KIEN	0.5	0.3	14.0	3.3	314.4	4.4

Source: Bloomberg, Company data, Concorde Capital estimates

Implied KIEN Price, USD

	By Peers EV/S		**By Peers EV/EBITDA**		**By Peers P/E**	
	2006E	2007E	2006E	2007E	2006E	2007E
Implied upside	419%	659%	-72%	141%	-94%	324%
Implied price	12.0	17.6	0.7	5.6	0.1	9.8

Source: Bloomberg, Company data, Concorde Capital estimates

Russian Peers

Peer Data

	Sales, USD mln		EBITDA, USD mln		Power prod., TWh		Installed capacity
	2006E	2007E	2006E	2007E	2006E	2007E	GW
Bashkirenergo	1,116	1,161	138	182	25.6	26.9	5.1
Irkutskenergo	775	821	206	265	61.2	63.0	11.6
Novosibirskenergo	522	574	57	61	11.1	11.6	2.4
KIEN	655	1,025	26	105	5.0	5.7	1.2

Source: Bloomberg, Company data, Concorde Capital estimates

Peer Multiples

	EV/S		EV/EBITDA		EV/El. Prod USD/MWh		EV/Capacity USD/kW
	2006E	2007E	2006E	2007E	2006E	2007E	
Bashkirenergo	1.4	1.4	11.5	8.7	62.1	59.2	309
Irkutskenergo	4.7	4.4	17.6	13.8	59.2	57.9	314
Novosibirskenergo	1.3	1.2	12.4	11.6	63.6	60.9	294
Mean	2.5	2.3	13.8	11.4	61.6	59.3	306
KIEN	0.5	0.3	14.0	3.3	72.2	60.3	288

Source: Bloomberg, Company data, Concorde Capital estimates

Implied KIEN Price, USD

	EV/S		EV/EBITDA		EV/El. Prod		EV/Capacity
	2006E	2007E	2006E	2007E	2006E	2007E	
Implied upside	504%	819%	-2%	331%	-21%	-2%	9%
Umplied price	14.0	21.3	2.3	10.0	1.8	2.3	2.5

Source: Bloomberg, Company data, Concorde Capital estimates

Ukrainian Peers: Sum-of-the-Parts Valuation

We used the four traded GenCos as a benchmark for Kievenergo's generation segment and the five most liquid Oblenergos as a benchmark for the distribution segment.

Generation

	El. Production, TWh		MCap, USD mln	EV/El. Prod, USD/MWh	
	2006E	2007E		2006E	2007E
Centrenergo	14.0	15.3	580.0	50.1	55.6
Dniproenergo	14.4	15.6	599.8	45.7	44.2
Donbassenergo	7.9	8.4	229.3	40.1	41.2
Zakhidenergo	16.1	17.2	786.6	53.5	54.5
KIEN	5.0	5.7			
Mean				47.3	48.9
KIEN implied EV, USD mln				235.7	278.6

Source: Company data, PFTS, Concorde Capital forecasts

Distribution

	El. Supply, TWh		MCap, USD mln	EV/El. Supply, USD/MWh	
	2006E	2007E		2006E	2007E
Dniprooblenergo	27.0	27.9	640.3	23.5	22.7
Zaporizhoblenergo	10.2	10.4	391.0	38.3	37.6
Zhytomiroblenergo	1.9	2.0	115.1	62.8	59.2
Kharkivoblenergo	5.0	5.1	269.4	52.9	51.6
Krymenergo	4.1	4.4	128.0	31.1	29.4
KIEN	7.0	7.3			
Mean				41.7	40.1
KIEN implied EV, USD mln				292.1	292.7

Source: Company data, PFTS, Concorde Capital forecasts

Implied Value: Combining the Parts

To value KIEN by local peers, we add the implied EV of electricity generation and distribution segments. In this case, we ignored Kievenergo's heat segment, which accounts for about 50% the company's sales. An under-valuation of KIEN by ignoring its heat segment is offset by the resulting over-estimation of its value by selected peers since we believe Ukrainian energy assets are currently over-priced by the market.

We attributed Kievenergo's net debt only to its generation segment because it was incurred due to a World Bank loan to upgrade its power plants and heating networks. The company did not use loans for upgrades of its electricity distribution segment.

Thus, the implied MCap of Kievenergo's generation segment is the implied EV less total net debt; the implied distribution MCap is equal to its implied EV. This division in the MCap allows us to make guesses about KIEN's price if its lease on generation assets is discontinued in 2007. Note that even if we treat KIEN solely as a distribution company, there is an implied upside of 35% to its market price:

KIEN Implied Price

Probability of lease prolongation	0%	25%	50%	75%	100%
Implied MCap, USD mln	292.7	338.9	385.2	431.4	477.6
Implied price, USD	2.70	3.13	3.55	3.98	4.41
Implied upside	16%	35%	53%	72%	90%

Source: Company data, PFTS, Concorde Capital forecasts

We estimate the probability Kievenergo will continue its lease at 75%, which implies a 72% upside.

DCF Valuation

In our DCF model, we assume Kievenergo will begin to reap the full benefits in 2007 from growth in its electricity and heat production tariffs that took place over 2006.

Business Model

	2004	2005	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E
Electricity production, TWh	7.33	7.11	4.98	5.72	6.30	6.30	6.61	6.74	6.81	6.81
Production tariff, UAH/MWh	97	97	180	210	223	232	238	244	250	255
Electricity supply, TWh	7.66	7.33	7.70	8.05	8.37	8.70	9.01	9.28	9.51	9.75
Average purchase price, UAH/MWh	99	99	162	173	180	185	190	194	199	202
Avg. distribution/supply tariff, UAH/MWh	18	18	19	20	21	21	22	22	23	23
Heat production, TCal	15.62	15.31	15.54	15.00	15.45	15.60	15.76	15.92	16.08	16.24
Average heat tariff, UAH/GCal	58	59	65	160	160	160	162	165	167	170
Revenue breakdown, UAH mln										
Electricity production revenue	711	690	896	1202	1401	1458	1576	1648	1699	1733
Electricity purchase/supply revenue	98	314	1394	1551	1678	1796	1909	2008	2110	2197
Heat production revenue	817	907	1010	2400	2472	2497	2560	2624	2690	2758
Other revenue sources	21	10	7	25	25	25	25	25	25	25
Total sales	**1,647**	**1,920**	**3,306**	**5,178**	**5,577**	**5,775**	**6,070**	**6,305**	**6,524**	**6,713**
EBITDA margin	6%	7%	4%	10%	11%	10%	10%	10%	9%	9%

DCF Model
Valuation Date: Jan. 23, 2007

For the purposes of forecasting, local currency is used (UAH mln)

	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
EBITDA	**130**	**523**	**600**	**599**	**602**	**600**	**594**	**587**	**576**	**591**
EBIT	29	420	477	472	472	468	461	452	439	452
Tax Rate	25%	25%	25%	25%	25%	25%	25%	25%	25%	25%
Taxed EBIT	21	315	358	354	354	351	346	339	329	339
Plus D&A	101	104	123	127	129	131	133	135	137	139
Less CapEx	(240)	(230)	(170)	(150)	(140)	(140)	(140)	(139)	(139)	(139)
Less change in OWC	(8)	(56)	(58)	(49)	(60)	(62)	(13)	(13)	(11)	(11)
FCFF	**(125)**	**133**	**253**	**282**	**284**	**280**	**326**	**322**	**316**	**328**
WACC	11.3%	11.7%	11.2%	11.3%	11.0%	10.7%	10.4%	10.5%	10.5%	10.5%
Sum of discounted CF's		**1,482**	**1,521**							
WACC to perpetuity										12%
Perpetuity growth rate										2%
Terminal Value										**3,344**
Implied exit EBITDA Multiple										5.7 x
Discounted TV		**1,329**	**1,484**							
Firm value		**2,810**	**3,005**							
Portion due to TV		47%	49%							
Less Net Debt		(547)	(473)							
Equity Value		**2,263**	**2,532**							
Implied share price, USD		**4.14**	**4.63**							
Implied upside			**100%**							

Sensitivity Analysis

Implied Share Price, USD

WACC	Perpetuity Growth Rate				
	1.0%	***1.5%***	***2.0%***	***2.5%***	***3.0%***
-1.5%	4.80	4.94	5.10	5.27	5.47
-1.0%	4.65	4.78	4.94	5.10	5.29
-0.5%	4.50	4.63	4.78	4.94	5.12
+0.0%	4.36	4.49	**4.63**	4.78	4.96
+0.5%	4.22	4.34	4.48	4.63	4.80
+1.0%	4.09	4.21	4.34	4.49	4.65
+1.5%	3.96	4.08	4.20	4.35	4.50

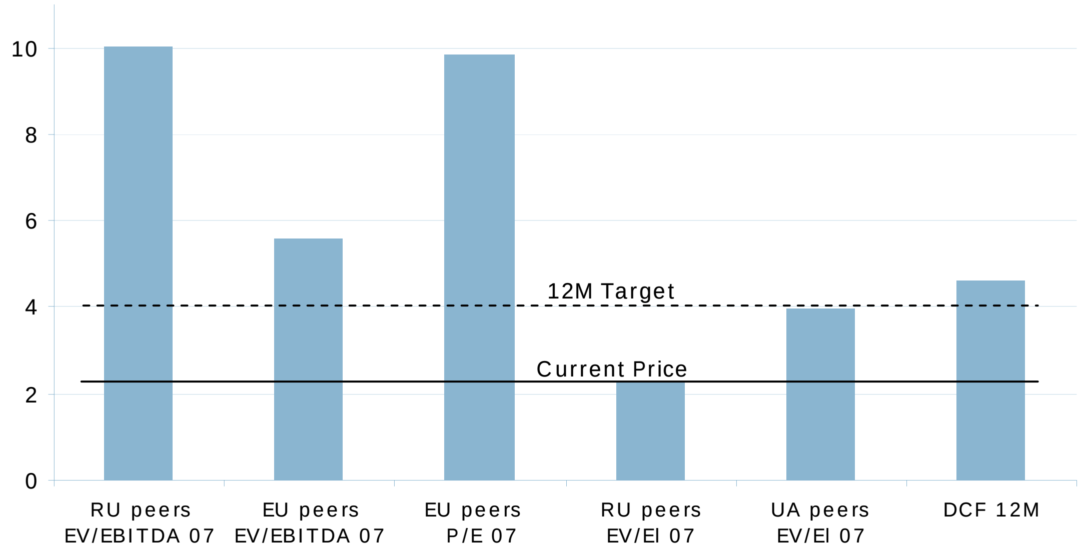
Implied Share Price, USD

WACC to perpetuity	Perpetuity Growth Rate				
	1.0%	***1.5%***	***2.0%***	***2.5%***	***3.0%***
10.5%	4.74	4.91	5.10	5.32	5.56
11.0%	4.60	4.75	4.93	5.12	5.34
11.5%	4.47	4.61	4.77	4.94	5.14
12.0%	4.36	4.49	**4.63**	4.78	4.96
12.5%	4.25	4.37	4.50	4.64	4.80
13.0%	4.16	4.26	4.38	4.51	4.66
13.5%	4.07	4.17	4.28	4.40	4.53

Valuation Summary

We set KIEN's 12M target close to the value implied by a local peer comparison and DCF valuation (remembering that the DCF implied value should be treated with a discount). Our 12M target price is USD 4.0 per share, which implies a 72% upside for the stock.

Implied 12M Prices for KIEN, USD



Source: PFTS, Bloomberg, Company data, Concorde Capital

Financial Summary

According to Ukrainian Accounting Standards

Income Statement Summary, USD mln

	2004	2005	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Net Revenues	**310**	**376.5**	**655**	**1,025**	**1,104**	**1,144**	**1,202**	**1,248**	**1,292**	**1,329**	**1,359**	**1,388**
Gross Profit	82	65	74	199	220	224	229	233	235	238	239	245
EBITDA	**19.2**	**27.7**	**25.7**	**103.7**	**118.8**	**118.7**	**119.1**	**118.7**	**117.7**	**116.2**	**114.0**	**117.0**
EBITDA margin, %	*6.2%*	*7.4%*	*3.9%*	*10.1%*	*10.8%*	*10.4%*	*9.9%*	*9.5%*	*9.1%*	*8.7%*	*8.4%*	*8.4%*
Depreciation	(16)	(21)	(20)	(21)	(24)	(25)	(26)	(26)	(26)	(27)	(27)	(27)
EBIT	**3**	**7**	**6**	**83**	**94**	**93**	**94**	**93**	**91**	**90**	**87**	**90**
EBIT margin, %	0.9%	1.8%	0.9%	8.1%	8.5%	8.2%	7.8%	7.4%	7.1%	6.7%	6.4%	6.5%
Interest Expense	(2)	(3.4)	(5)	(7)	(7)	(6)	(5)	(5)	(5)	(5)	(5)	(5)
PBT	**2**	**9**	**1**	**77**	**88**	**88**	**89**	**88**	**87**	**86**	**83**	**85**
Income tax	(0)	(7)	(0)	(19)	(22)	(22)	(22)	(22)	(22)	(21)	(21)	(21)
Net Income	**1**	**2**	**1**	**58**	**66**	**66**	**67**	**66**	**65**	**64**	**62**	**64**
Net Margin, %	*0.4%*	*0.5%*	*0.1%*	*5.6%*	*6.0%*	*5.8%*	*5.6%*	*5.3%*	*5.1%*	*4.8%*	*4.6%*	*4.6%*

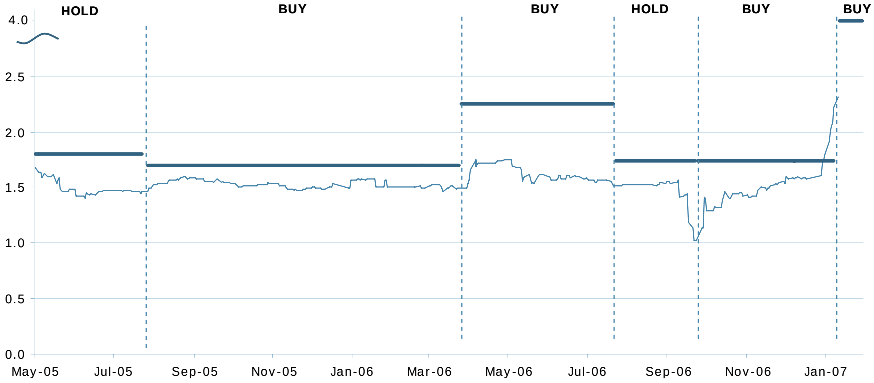
Balance Sheet Summary, USD mln

	2004	2005	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Current Assets	**111**	**136**	**154**	**211**	**223**	**228**	**238**	**247**	**256**	**264**	**271**	**279**
Cash & Equivalents	4	7	10	17	18	18	19	20	20	21	22	22
Trade Receivables	42	37	45	75	79	82	86	89	92	95	98	100
Inventories & other	65	91	100	120	126	128	133	139	143	148	152	156
Fixed Assets	**335**	**371**	**396**	**431**	**438**	**443**	**445**	**449**	**452**	**454**	**456**	**458**
PP&E, net	233	270	273	281	372	385	389	390	392	393	393	393
Other Fixed Assets	102	101	124	151	66	57	57	58	60	62	63	65
Total Assets	**447**	**507**	**551**	**643**	**661**	**671**	**683**	**696**	**708**	**718**	**728**	**736**
Shareholders' Equity	**133**	**160.0**	**159**	**228.3**	**263**	**303**	**339**	**367**	**387**	**403**	**416**	**428**
Share Capital	5	5	5	5	5	5	5	5	5	5	5	5
Reserves and Other	128	155	153	223	257	298	334	361	381	398	410	422
Current Liabilities	**130**	**125**	**151**	**190**	**187**	**179**	**176**	**172**	**176**	**180**	**185**	**191**
ST Interest Bearing Debt	8	11	25	25	24	20	19	19	18	17	18	20
Trade Payables	76	83	84	108	106	100	95	89	92	95	98	100
Other Current Liabilities	47	28	42	57	58	58	61	63	66	68	69	71
LT Liabilities	**183**	**222**	**241**	**225**	**211**	**189**	**169**	**158**	**145**	**135**	**127**	**117**
LT Interest Bearing Debt	27	65	94	86	80	65	63	61	56	53	54	60
Other LT	37	40	40	40	40	40	30	28	26	26	22	12
Total Liabilities & Equity	**447**	**507**	**551**	**643**	**661**	**671**	**683**	**696**	**708**	**718**	**728**	**736**

Analyst Certification

I, Alexander Paraschiy, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

Stock Price and Target History, USD



Date	Closing price	Target price
23-Jan-07	2.32	4.00
12-Oct-06	1.41	1.74
6-Oct-06	1.04	1.74
4-Aug-06	1.51	1.74
7-Apr-06	1.50	2.25
15-Sep-05	1.50	1.70
15-Aug-05	1.40	1.70
13-May-05	1.62	1.80

Concorde Capital Rating Universe

Buy	35	48%
Hold	19	26%
Sell	11	15%
Under Review/Suspended	8	11%
Total	73	100%

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