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Analyst's Notebook

Ukraine / Electricity
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Kievenergo to Lose Power Plants?

We downgrade our KIEN valuation due to new uncertainty

New target: USD 1.74
Upside: 14%
Recommendation: HOLD

Unexpected Move of New Kiev Mayor

Kiev's mayor Leonid Chernovetsky informed the CEO of Kievenergo (**KIEN**) by letter that the City of Kiev would not renew the lease of its heating infrastructure to KIEN, which expires on September 27. The infrastructure includes heating networks, boilers, and two large combined heat and power plants (CHPPs), which are KIEN's main source of revenue. A working group dedicated to the analysis of Kiev's heating infrastructure was created on August 1.

KIEN is unique as it is the only company that is both a producer and supplier of electricity. It operates Ukraine's largest combined heat and power plants (Kiev CHPP-5 and Kiev CHPP-6), as well as electricity and heat distribution networks. KIEN owns only the electricity distribution network, but the rest are owned by the City of Kiev and leased by KIEN.

KIEN Stripped Down to an Ordinary Oblenergo?

Kiev's CHPPs have become attractive assets due to recent changes in energy market regulations. Since March 2006 KIEN has been getting paid extra for the role the CHPPs play in maintaining the balance of the national power grid (please see our report on KIEN of April 9, 2006). It looks like the new municipal authorities in Kiev are interested in gaining control of the CHPPs. They cannot gain control over KIEN, as the City only indirectly controls 12.7% of its shares, while 50% plus one share of KIEN belongs to the state-run National Energy Company.

The new mayor could lease the heating assets to another company, and if he pushed hard enough, he might well find support for such a decision in the Kiev city council. For example, KievEnergoholding, the company that owns the 12.7% stake in KIEN, could be a candidate to operating Kiev's power plants and heating networks. KievEnergoholding is owned 61% by the city council and 39% by a business group headed by MP Vasyl Khmenlytsky and city council member Andriy Ivanov. They and Chernovetsky initially clashed, but recently they struck a peace deal and several top city councilors allied to Chernovetsky, Khmenlytsky and Ivanov were appointed or re-appointed to KievEnergoholding's board.

Thus, there is a threat that KIEN could lose its generation business and become purely an electricity distribution company, like its peers in all other Ukrainian regions (Oblenergos). However, there are reasons why such a scenario is unlikely...

Upgrading Other's Assets

KIEN has significantly upgraded its leased assets over the years. For example, KIEN carried out a World Bank loan project to upgrade Kiev's heating infrastructure. KIEN has already spent more than \$160m of a World Bank money and about the same amount of its own capital. Kiev's contribution to the upgrade program was less than 10%. Thus, it would not be legally easy for the City to take the heating networks and CHPPs away from KIEN. KIEN would need to be compensated for its investments, and it's not clear how the new lessee could do that.

The World Bank Factor

There is a risk that the World Bank would suspend its program if KIEN loses its lease. The World Bank can pull strings with the president and the government when local officials cause problems for its projects. Thus, Chernovetsky would be ill-advised in the short term to discontinue KIEN's operating of Kiev's heating infrastructure.

What's Up With Kiev CHPP-6/3?

KIEN is currently constructing a third power unit at Kiev CHPP-6, using bank loans and its own funds. The project is 60% complete, according to KIEN management, and it is expected to be finished in 2008. If KIEN is restructured, the future of this project is also unclear. Ownership of this power unit is also questionable.

Winter Should Bring Cooler Heads

Only KIEN has enough specialists to operate and manage Kiev's power plants and heat pipelines. If the assets changed hands just before the winter season, it could cause problems with Kiev's heat supply. Autumn is not the best time to implement such a major restructuring.

Other Unknown Factors

Representatives of KIEN, the city administration and KievEnergoHolding have not commented on the future of Kiev's heating infrastructure. There is already a special commission including city council representatives which is supposed to be working on reform plans for Kiev's heating system.

Mayor Already Having Second Thoughts?

At a press conference today Chernovetsky seemed to be taking a step back. He said: "I'm working on this to understand whether (KIEN's lease) contract is economically beneficial for us (the City) or not." He said it seemed "not very fair" that the City got only 12.7% of KIEN in return for the CHPPs and heating network, but "that doesn't mean that I'll tear (the contract) up. This is all just a procedure."

All In All, KIEN Seems Well Protected

To sum up, we believe it is unlikely that KIEN will lose its power and heating businesses, but the risk cannot be ignored and it should be factored into KIEN's stock price.

Valuation Implications

In our recent report (April 9, 2006) we valued KIEN using two methods, which both implied similar values: DCF and sum-of-the-parts valuation using Ukrainian peers. We can use the second method to assess the impact of a possible separation of the generation segment. We assume that if KIEN's businesses are separated, all of KIEN's interest-bearing debts (most of them were incurred for the heating infrastructure upgrade) would also be separated from the company. We also decreased our forecast for KIEN 2006 electricity production from 8.5 TWh to 7.0 TWh, based on 1H06 results.

Generation Segment

	Stock Price USD	MCap USD mln	Net debt USD mln	El. prod. 2006E, TWh	EV/El. prod. USD/MWh
CEEN	0.8	295.5	95.7	13.3	29.5
DNEN	76.0	302.3	60.1	14.2	25.6
DOEN	5.3	142.8	78.0	7.8	28.2
ZAEN	27.5	357.5	53.2	15.5	26.5
Average					26.8

KIEN			69.1	7.0	
Implied Generation MCap, USD mln					118.2
<i>Source: company data, PFTS, Concorde Capital estimates</i>					

Distribution Segment

	Stock Price USD	EV USD mln	El. supply, 2006E, TWh	EV/El. supply USD/MWh
ZAON	0.99	177.6	10.22	17.4
DNON	45.54	272.9	26.37	10.3
HAON	0.34	86.4	4.98	17.3
Average				15.0

KIEN			6.68		
Implied Distribution MCap, USD mln					100.4
<i>Source: company data, PFTS, Concorde Capital estimates</i>					

The two charts below show KIEN's implied price depending on the probability of separation of its generation segment.

Valuation Summary



Source: Concorde Capital

We believe new risks can be captured in a 25% probability of KIEN losing control of its heating and power assets. We downgrade KIEN's 12m target price to USD 1.74 (14% upside to the current price) and downgrade our recommendation to HOLD. We expect during the next month the situation around KIEN will become clear enough for the risk to decrease.

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