

February 19, 2013

Local equity strategy

Opportunities for the 2013 AGM season

We expect the upcoming AGM season in Ukraine will draw the attention of active portfolio investors to the local market as it will open the door to multiple speculative opportunities. The straightforward one is dividends, while we note that most of dividend-yielding stocks will be less generous this season. Others are related to a specific item that is included in the agendas of an increasing number of AGMs – the approval of “significant deals”. This item creates three opportunities for minority shareholders: to sell illiquid stocks back to the issuer at market price, to use this chance to inflate the market price; and to use the speculative opportunity of arbitrage.

Dividend plays for 2013 are mostly traditional – iron ores (SGOK, CGOK and PGOK), a pipe producer (HRTR), as well as less liquid railway and power machinery stocks – DNVM, ZATR and KVBZ. On top of that, power utilities (GenCos) that are left in state hands could offer some noticeable dividends this year (CEEN, DOEN, HAON and ZAON).

Put option plays, a new class of opportunities that emerged in 2011 and were tested in 2012, are another chance for portfolio investors.

We reintroduce to investors the notion of the TEPO (temporarily embedded put option) that is granted to a shareholder who votes against a “significant deals” item at a company’s AGM/EGM. By law, such a company is obliged to buy back the shares of those who voted against, at a price not lower than the market price on the day before the announcement of the shareholder meeting. Those who voted “against” receive the right (not obligation) to offer their shares to the issuer within 30 days after the vote. We identified at least 37 stocks that might be subject to this option in the 2013 AGM season. This option offers three opportunities for investors/traders:

- Get rid of illiquid stocks via selling them at near market prices directly to the issuer: 26 stocks, at least;
- Use an opportunity to influence the price at which the issuer will have to buy back such shares (for those for which an AGM has yet to be announced): so far, this opportunity is open for 23 stocks;
- Use an arbitrage opportunity in case the share price falls below the implied strike price of the option. Theoretically, this can be applied to 16 more-or-less liquid stocks.

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Announced AGMs*

Ticker	Date	Key agenda items
ZATR	22-Feb	dividends
SHCHZ	25-Feb	sign.deals
YASK	25-Feb	sign.deals
SFER	25-Feb	sign.deals
DOMZ	26-Feb	sign.deals
BKOK	4-Mar	sign.deals
DNEN	4-Mar	sign.deals
ZAEN	4-Mar	sign.deals
KIEN	5-Mar	sign.deals
DOEN	20-Mar	div., sign.deals
CEEN	21-Mar	div., sign.deals
HAON	27-Mar	dividends

* As of Feb 19

Source: company data, mass media

DIVIDEND PLAYS

Traditional dividend-yielding stocks

The companies that have a good history of paying generous dividends include:

- Metinvest's cash cows, Northern and Central Iron Ores (SGOK, CGOK) and Khartsyzk Pipe (HRTR). They generate large profits and the main shareholder usually distributes 90%+ of its income in dividends. While we note that all these companies are very likely to post a decline in their 2012 profits (and DPS as well), we still count on double-digit dividend yields from them;
- Ferrexpo's Poltavskiy Iron Ore (PGOK), which chose a simple dividend policy of UAH 0.5/share, based on the experience of recent years;
- Profitable machinery companies Dniprovagonmash (DNVM, paid UAH 18/share over the last two years) and Zaporizhtransformator (ZATR, regularly paying all its profit as dividends). While their dividends will offer a good return, based on their market price, gaining the yields is not a trivial task as these stocks are completely illiquid.
- Kryukiv Railcar (KVBZ), a bit more liquid machinery stock which currently has a very tough environment (the demand for its main product, freight railcars, has been artificially limited since late 2012). Nevertheless, we expect the company will post some yoy increase in profit in 2012 and pay noticeable dividends, likely for the last time.

New dividend stocks – state-controlled utilities

The holding company for state-controlled electric utilities, the NAK ECU, pursues a standard 30% dividend pay-out policy for its affiliates. We see five affiliates which might pay dividends this year: Centerenergo (CEEN), Donbasenergo (DOEN), Kharkivoblenergo (HAON), Zaporizhiaoblenergo (ZAON) and Cherkasyoblenergo (CHON).

The key problem of these companies is that management usually considers dividends as additional tax on their profits and therefore tends to do their best to not report hefty profits for the full year. For instance, Donbasenergo showed a UAH 31 mln profit for FY12 after UAH 305 mln profit for 9M12. Zaporizhiaoblenergo yet to report their full-year profit and its 9M12 income suggest spectacular dividend yields. But there is a clear risk that it will use the same approach as Donbasenergo to kill their full-year financial result.

Estimated dividend yields for 2013 season

	DPS 2012, UAH	DPS 2013E, UAH	est. yiled
DNVM	18.0	18.0	28%
SGOK	2.67	2.00	24%
CGOK	2.14	1.05	16%
ZATR	0.41	0.43	15%
HRTR	0.28	0.08	9%
PGOK	0.50	0.50	4%

	DPS 2012, UAH	DPS 2013E, UAH	est. yiled
KVBZ	1.20	1.31	5.6%
CEEN	0.03	0.18*	3.2%
ZAON	0.04	0.04	3.0%
HAON	0.03	0.03*	2.6%
DOEN	-	0.39*	1.8%
CHON	0.04	0.01	1.0%

* Estimates based on already reported net income for 2012

Source: Company data, Concorde Capital research

New DTEK-related oblenergos: possible dividend play candidates

Theoretically, the new acquisitions of DTEK – Dniprooblenergo (DNON), and Krymenergo (KREN) as well as the mine Komsomolets Donbasa (SHKD) – could start paying dividends. Given that we have no dividend history from these companies, we do not count them as an opportunity this season.

Ukrnafta (**UNAF**) is another company with a good dividend history. However, we do not include it into our AGM list due to low certainty that shareholder meeting happens this year (it failed to hold a meeting last year). Another stock market heavyweight, Motor Sich (**MSICH**) is paying tiny dividends.

“SIGNIFICANT DEAL” PLAYS

TEPO possibilities - introduction

We are reintroducing the notion of the TEPO (temporarily embedded put option). A TEPO is granted to a shareholder who votes against a “significant deals” item at a company’s shareholder meeting.

TEPO summary

How to buy TEPOs:

- *Make sure the AGM of a company contains the “significant deal” clause. The TEPO opportunity is applied only to the stocks of companies whose AGM contains this item (or share capital increase item).*
- *Sign up for the AGM and vote “against” the significant deal item. Note that the AGM record day is the fourth business day before the AGM.*

How to use TEPOs

- *By law, you have a right (not obligation) to offer your shares to the issuer within 30 days after voting “against”. After that, your TEPO expires. That’s why it is temporary.*
- *By law, the issuer has an obligation to buy back the offered shares within 30 days after it receives the offer.*

Strike price of TEPOs

- *By law, the price at which the issuer can buy back its shares – from those who voted against significant deals – cannot be lower than (i.e. is close to) the market price prior to the day of AGM announcement. For reference, the latest available stock exchange’s price before the AGM announcement can be used.*

What is a “significant deal” and why shareholders vote for them

- *In our context, a significant deal is a contract worth more than 25% of a company’s total assets as of the last reporting year. By law, such deals should be approved by shareholder meetings.*
- *The big contracts are typical for all SCM-related stocks, as the holding company is actively using intercompany deals to optimize cash flows within the holdings. The deals are common for members of holdings that are involved in large borrowings. The practice is also common for the machinery sector, which is focused on a small group of suppliers or customers, and it is inherent for power generation companies which sign large coal supply contracts.*

So far, we identified 37 stocks which might be subject to a TEPO opportunity in the 2013 AGM season (for the list, refer to the summary on page 7). Below we list trading opportunities that are created by TEPO, while noting that not all of them can be applicable to each of the 37 stocks.

Opportunity 1: get rid of illiquid stocks or those without prospects

The most straightforward opportunity provided by TEPO is the possibility to sell your shares to the issuer. This is clearly a good exit chance for holders of those stocks that have little prospects on the market, either due to their poor liquidity or worsening fundamentals.

While this option is applicable to all TEPO stocks, below we present a list of 26 stocks for which we strongly recommend this opportunity.

Stocks for which using TEPO is the best way out

Ticker	Est. exit price, UAH	AGM date, 2013	Ticker	Est. exit price, UAH	AGM date, 2013
BKOK	0.20	4-Mar	DRMV	0.80*	TBA
DOMZ	0.13	26-Feb	DRMZ	1.79*	TBA
DNEN	201	4-Mar	HMBZ	0.50*	TBA
KIEN	5.0	5-Mar	MGZC	0.50*	TBA
SHCHZ	0.63	25-Feb	ZACO	1.62*	TBA
SFER	0.01	25-Feb	ZFER	0.45*	TBA
YASK	0.67	25-Feb	ZPST	2.64*	TBA
ZAEN	90.35	4-Mar	DGRM	TBA	TBA
AZGM	7.0*	TBA	DNON	TBA	TBA
AZOT	25.0*	TBA	KVBZ	TBA	TBA
DMPZ	0.028*	TBA	MMKI	TBA	TBA
DNSS	1000*	TBA	NVTR	TBA	TBA
DOON	9.0*	TBA	STIR	TBA	TBA

* Exit price is easily identifiable as stocks traded very rarely - once per month to once per year. The price potentially can be changed - see the next opportunity

Source: Company data, UX, Concorde Capital research

Opportunity 2: regulate the TEPO strike price

This opportunity stems from a regulatory clause that defines the buyback price, which should not be lower than (read – is close to) the market price before the AGM/EGM announcement. This means that those having the clear intention to offer their shares to the issuer can play bullish with such shares for some period before the AGM announcement is expected. This is especially applicable for relatively illiquid stocks, where little efforts are required to inflate share price.

A clear risk here is that we cannot know for certain the date of an AGM announcement, but at least we can understand the date range – AGMs should take place by end-April, by legislation, and they should be announced no later than 30 days in advance. The final deadline for announcements, therefore, is March 29.

We recommend using this opportunity for the stocks listed in the section above, as well for some other relatively illiquid stocks (those for which AGMs have not been announced yet) where keeping a higher price will not be costly. We included 23 stocks in this short list.

Stocks for which the TEPO strike price can still be raised (valid as of Feb 19, 2013)

	2012 AGM	ADT, UAH ths			2012 AGM	ADT, UAH ths	
	announcement date	Mar-12	Jan-13		announcement date	Mar-12	Jan-13
SGOK*	19-Mar	289.0	38.8	DNON*	22-May	36.4	0.2
KVBZ	6-Mar	77.1	12.7	DNSS	19-Mar	0.6	0.2
SHKD*	1-Mar	5.3	10.0	DOON*	23-Feb	0.0	0.2
ZFER	7-Mar	0.0	9.1	HMBZ	14-Mar	4.6	0.0
STIR	16-Mar	87.6	6.7	MGZC	29-Feb	1.5	0.0
HRTR*	1-Mar	58.1	5.0	DRMZ	7-Mar	0.9	0.0
CGOK*	15-Mar	83.0	4.3	AZGM	15-Mar	0.3	0.0
NVTR	2-Mar	5.6	1.5	AZOT	22-Mar	0.0	0.0
ZPST*	-	5.8	1.2	DMPZ	20-Mar	0.0	0.0
KREN*	23-May	1.6	1.2	DRMV	24-Feb	0.0	0.0
ZACO*	26-Oct	0.0	0.9	DGRM	7-Mar	0.0	0.0
MMKI*	7-Mar	1.8	0.3				

* Metinvest and DTEK affiliates – the degree of certainty about “significant deals” inclusions in their AGM agendas is the highest
 Source: Company data, UX, Concorde Capital research

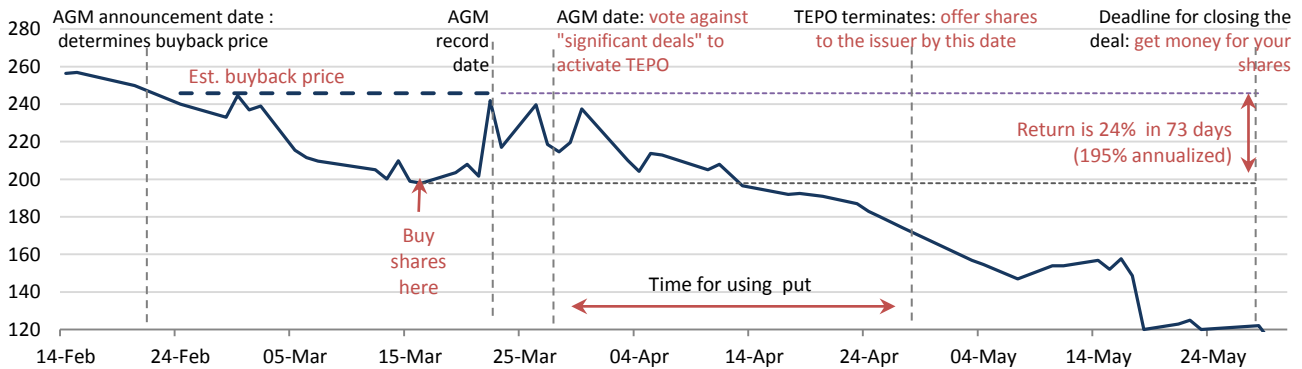
The key risk here is that before an AGM is announced, its agenda is not known and there is no 100% guarantee that a “significant deals” item will be there. What we do know is the companies in the list (or their closely related companies) did have the item in last year’s AGM (and some already have it this year) and their circumstances did not change from last year, meaning they still have (or plan) large contracts that should be approved by shareholders. Meanwhile, we have a higher degree of certainty about the companies controlled by DTEK and Metinvest.

Opportunity 3: play TEPO arbitrage

It might happen that a share price falls after a company’s AGM announcement. Given that a strike price under TEPO is fixed (as it is defined as the market price prior to the AGM announcement), such stock weakness allows for gaining arbitrage profit.

This real-life example of how arbitrage profit could have been earned last season is demonstrated below.

TEPO arbitrage: how it could have been done with Zakhidenergo (ZAEN) stock in 2012



Source: UX. Company data, Concorde Capital

Last season, there were many opportunities for arbitrage (refer to our March 21, 2012 note). This season, we expect fewer such opportunities as the market is more aware of this trick. Moreover, decreased liquidity on the local market clearly limits arbitrage opportunities to a narrow set of still liquid stocks (listed below).

Currently, we see an open opportunity to play arbitrage with Centerenergo and Donbasenergo, while the implied arbitrage profit is currently comparable to the theoretically offered dividend yield. Moreover, we see this opportunity as very risky for these two particular companies – we cannot recall a case in which state-controlled companies bought back their shares.

Stocks for which TEPO arbitrage can potentially emerge

	TEPO strike, UAH	Arbitrage profit	Est.dividend yield
AVDK	TBA	-	-
AZST	TBA	-	-
CEEN*	6.08	4.0%	3.2%
CGOK	TBA	-	16.1%
DNEN	201.05	0.0%	-
DOEN*	22.16	3.5%	1.8%
ENMZ	TBA	-	-
HRTR	TBA	-	10%

	TEPO strike, UAH	Arbitrage profit	Est.dividend yield
KREN	TBA	-	-
KVBZ	TBA	-	6%
MMKI	TBA	-	-
NVTR	TBA	-	-
SGOK	TBA	-	25%
SHKD	TBA	-	-
STIR	TBA	-	-
ZAEN	90.35	0.0%	-

* These companies are unlikely to buy back shares as they are state-controlled. Ukraine has no experience of share buybacks by state-controlled companies.
Source: Company data, UX, Concorde Capital research

AGM opportunities summary, as of Feb 19, 2013

	Ticker	Dividends	DPS, UAH / Yield	Significant deals approval	Possible arbitrage play	Price inflation possibility	AGM date	Est. strike price	
Pure Dividend plays	ZATR	yes	0.43 / 15%				22-Feb		
	HAON	yes	0.03 / 3%				27-Mar		
	PGOK	yes	0.50 / 4%				TBA		
	ZAON	yes	0.04 / 3%				TBA		
	CHON	yes	0.01 / 1%				TBA		
Dividend and TEPO plays	DNVM	yes	18.00 / 28%	yes			TBA		
	DOEN**	yes	0.39 / 2%	yes	yes		20-Mar	22.16	
	CEEN**	yes	0.19 / 3%	yes	yes		21-Mar	6.08	
	SGOK	yes	2.00 / 24%	yes	yes	yes	TBA	TBA	
	CGOK	yes	1.05 / 16%	yes	yes	yes	TBA	TBA	
	HRTR	yes	0.08 / 9%	yes	yes	yes	TBA	TBA	
KVBZ*	yes	1.31 / 6%	yes	yes	yes	TBA	TBA		
Pure TEPO plays	KREN			yes	yes	yes	TBA	TBA	Possible TEPO arbitrage plays
	MMKI*			yes	yes	yes	TBA	TBA	
	NVTR*			yes	yes	yes	TBA	TBA	
	SHKD			yes	yes	yes	TBA	TBA	
	STIR*			yes	yes	yes	TBA	TBA	
	AVDK			yes	yes		TBA	TBA	
	AZST			yes	yes		TBA	TBA	
	ENMZ			yes	yes		TBA	TBA	
	ZAEN*			yes	yes		4-Mar	90.35	
	DNEN*			yes	yes		4-Mar	201.05	
	SHCHZ*			yes			25-Feb	0.63	
	YASK*			yes			25-Feb	0.67	
	BKOK*			yes			4-Mar	0.20	
DOMZ*			yes			26-Feb	0.13		
SFER*			yes			25-Feb	0.01		
KIEN*			yes			13-Mar	5.00		
AZGM*			yes		yes	TBA	7.00		
AZOT*			yes		yes	TBA	25.00		
DMPZ*			yes		yes	TBA	0.03		
DNSS*			yes		yes	TBA	1000		
DOON*			yes		yes	TBA	9.00		
DRMV*			yes		yes	TBA	0.80		
DRMZ*			yes		yes	TBA	1.79		
HMBZ*			yes		yes	TBA	0.50		
MGZC*			yes		yes	TBA	0.50		
ZACO*			yes		yes	TBA	1.62		
ZFER*			yes		yes	TBA	0.45		
ZPST*			yes		yes	TBA	2.64		
DGRM*			yes		yes	TBA	TBA		
DNON*			yes		yes	TBA	TBA		

* Stocks that have poor market prospects (totally illiquid and/or fundamentally weak). We recommend using TEPO to exit them.

** These companies are unlikely to buy back shares as they are state-controlled. Ukraine has no experience of share buybacks by state-controlled companies

Source: Company data, UX, Concorde Capital research

Risks

A shareholder could find himself unable to “buy” a TEPO, i.e. vote against significant deals at an AGM. The first possible reason is a shareholder is unable to sign up for an AGM for objective reasons (due to insufficient/improper set of documents supplied during the signing in) or subjective reasons (a shareholder is not allowed into the AGM due to resistance from the company). In addition, a shareholder’s vote “against” could be miscounted for technical reasons.

The strike price is not always identifiable. By legislation, it should not be less than the market price prior to an AGM announcement, but there is no clear definition of the market price. For reference, we use the stock’s exchange rate on the Ukrainian Exchange, and usually it works well, though there is no clear guarantee that a company will accept this approach. This risk is important only when playing TEPO arbitrage.

It might take more time for a shareholder to execute its TEPO due to resistance from a company, which can be critical for those having clear time limits (e.g. those counting on high returns from TEPO arbitrage). Eventually, all the companies have to obey the law.

DTEK & Metinvest-related stocks are less risky, state-controlled are more risky. The best way to cope with risk is to use TEPOs (and especially TEPO arbitrage and price inflation techniques) only for those companies that easily agree to buy back shares – those having a buyback history and whose majority shareholders have clear incentive to support high standards of corporate governance. From this standpoint, we see that companies controlled by SCM (and particularly those controlled by DTEK and Metinvest) form the least risky class. The state-controlled companies like Centerenergo and Donbasenergo are most risky, as this class of companies has no buyback experience.

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