Ukraine / Fixed Income / Oil & Gas

Naftogaz of Ukraine

Corporate Eurobond Alert

December 7, 2006

Vladimir Nesterenko
vn@concorde.com.ua

Oleksandr Klymchuk
ok@concorde.com.ua

+380 44 207 5030

Ticker	NAFTO
ISIN	XS0202078688
Moody's	Ba2 / Under Review
Fitch	B+ / Stable
Amt of issue	USD 500 mln
Coupon	8.125%
Maturity date	Sept. 30, 2009

NAFTO Market Implied Ratings

	Rating	Gap*
Bond-Implied	Caa3	-7
CDS-Implied	Caa1	-5

**Versus Moody's Senior Unsecured or Equivalent*
Source: Moody's

Naftogaz will have to clear its USD 0.5 bln tax debt as per the 2007 state budget, voted on yesterday by parliament. The funds will be returned to it in the form of 'compensation' for selling gas to heating utilities at a loss. If the president signs the law, Naftogaz will have to subsidize heating utilities, resulting in the deterioration of its cash flow and debt service capabilities.

Lower than Expected Price Realizations in 2007

The mere fact that the government proposed subsidizing gas prices for municipal heating enterprises (MHE) indicates those prices are likely to remain at the same level next year as in 2006, while the price of imported gas will grow by 37%. This will mean lower price realizations, revenues and cash flows than if prices for MHEs increase in line with those for other Naftogaz consumers.

Not Really 'Compensation'

The word 'compensation' is misleading because for Naftogaz's cash flow, the net effect of paying overdue taxes and getting compensated will be virtually zero. In essence, the effect is similar to writing-off overdue debt.

Working Capital Deficit Might Increase

Naftogaz's liquidity might get even worse next year if the company faces a lag between when it pays tax arrears and when it receives compensation from the state budget. If these payments are cleared against each other without any movement of cash, then will be no such risk.

Ratings Downgrade Possible

The risk of lower than expected cash flow and weaker debt service capability in 2007 might trigger a credit ratings downgrade. We don't rule out that Moody's, which is currently reviewing the ratings, might be take it down more than one notch.

Budget Law Still Requires the President's Signature

There is a chance that the president, who must sign the law before it can go into effect, will veto the budget in its current form.

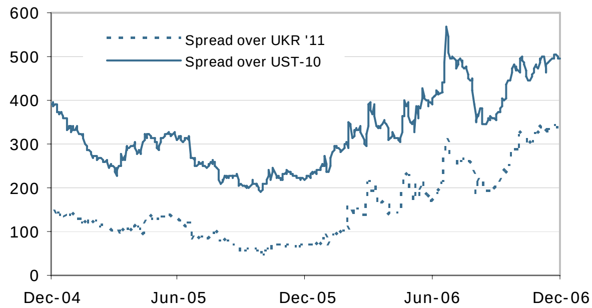
Discounts for MHEs Might Improve Collection Rates

If the subsidies lead MHEs to improve their payment discipline (as of November, Naftogaz received only 64% of payments, compared with 82% as of November 2005), Naftogaz working capital gap will avoid suffering from gas payment arrears.

NAFTO Historical Yield

Source: Bloomberg

NAFTO Spreads



Source: Bloomberg

Alarming Signals

Our back-of-the-envelope estimates suggest that next year, even if Naftogaz recovers from selling gas at loss in the early 2006, its debt service capability is likely to remain weak if the government initiative to fix gas prices for MHEs is implemented.

Despite an increase in domestic gas tariffs, next year's 37% hike in the price of imported gas, accompanied by possible losses on gas sales to MHEs is likely to result in a gross operating cash flow (GOCF) lower than in 2005. In turn, a greater need to finance working capital might lead to excessive gearing.

Although we do not expect Naftogaz to default on its debt, the ratios send alarming signals about the company's ability to service its debts. Our estimates also suggest that it will have to refinance its short-term borrowings.

We developed three scenarios for 2007, all of which presume that the 2007 budget law is signed by the president, Naftogaz sells gas to MHEs at a loss and receives compensation from the state budget equal to the amount of repaid taxes. The difference between the three scenarios is limited to the extent of Naftogaz's cash flow recovery due to local tariff increases in 2006-2007, the amount of its short-term debt and respective interest expenses.

Naftogaz debt service projections, UAH bln

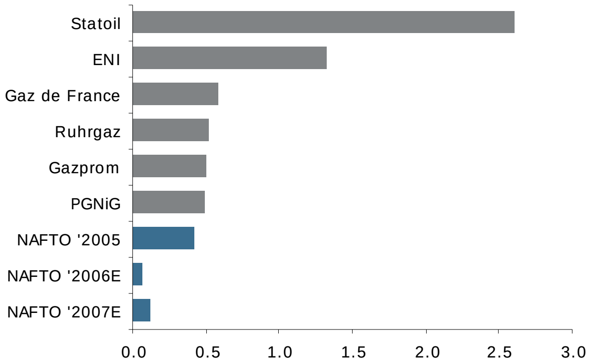
	2004	2005	2006E	2007E		
				Optimistic scenario	Mid-case scenario	Pessimistic scenario
Gross operating cash flow (GOCF)[1]	4.9	4.2	0.9	2.4	1.7	1.1
Interest expense	0.2	0.6	0.8	0.9	1.0	1.0
LT debt	4.1	8.7	9.4	9.4	9.4	9.4
Current portion of LT debt	0.4	0.9	0.0	0.0	0.0	0.0
ST debt	0.7	0.5	1.7	3.7	4.3	5.0
Total debt	4.8	9.2	11.1	13.1	13.8	14.4
Interest Coverage[2]	29.77	7.53	1.12	2.52	1.77	1.08
GOCF/Total debt	1.03	0.45	0.08	0.18	0.13	0.08
Debt Service Ratio[3]	8.58	2.96	1.12	2.52	1.77	1.08
Debt Service Ratio (incl. ST debt)[4]	3.91	2.22	0.36	0.51	0.33	0.19
Total Debt Coverage[5]	1.00	0.43	0.07	0.17	0.12	0.07

[1] GOCF = operating cash flow + income tax + interest
[2] Interest Coverage = GOCF/(interest)
[3] Debt Service Ratio = GOCF/(interest + current portion of LT debt)
[4] Debt Service Ratio (incl. ST debt) = GOCF/(interest + current portion of LT debt + ST debt)
[5] Total Debt Coverage = GOCF/(interest + total debt)

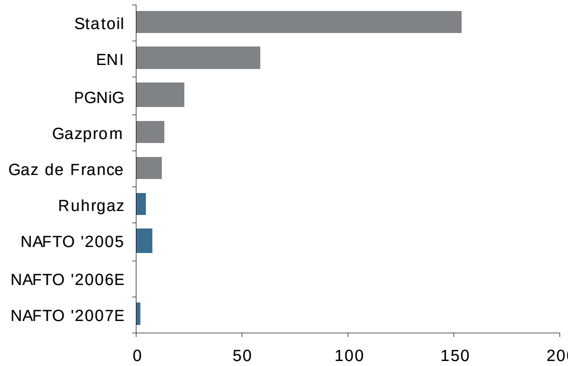
Source: Company data, Concorde Capital estimates*
** We used IFRS financials for 2004-2005, which can be provided on request*

NAFTO vs. Gas Majors*:

Total Debt Coverage



Interest Coverage



** For the purpose of calculating ratios for the companies other than Naftogaz, GOCF was approximated by EBIT. Thus, the ratios are likely to be underestimated, as depreciation and other non-cash items were not added back and hence reduce the numerator.*

Source: Company data, Concorde Capital estimates

Concorde Capital
3V Sportyvna Square
2nd entrance, 3rd floor
Kyiv 01023, UKRAINE

Tel: +380 44 207 5030
Fax: +380 44 206 8366
www.concorde.com.ua
office@concorde.com.ua

CEO
Igor Mazepa — im@concorde.com.ua

Equity Sales
Marina Martirosyan — mm@concorde.com.ua
Lucas Romriell — lr@concorde.com.ua
Anastasiya Nazarenko — an@concorde.com.ua

Director of Research
Konstantin Fisun, CFA — kf@concorde.com.ua

Chief Strategist
Tom Warner — tw@concorde.com.ua

Utilities (Telecom, Energy)
Alexander Paraschiy — ap@concorde.com.ua

Metals & Mining
Andriy Gostik — ag@concorde.com.ua
Eugene Cherviachenko — ec@concorde.com.ua

Machine Building, Construction, Consumer Goods
Olha Pankiv — op@concorde.com.ua

Financial Services & Macroeconomics
Alexander Viktorov — av@concorde.com.ua

Oil & Gas, Chemicals
Vladimir Nesterenko — vn@concorde.com.ua

Fixed Income
Oleksandr Klymchuk — ok@concorde.com.ua

News/Production
Nick Piazza — np@concorde.com.ua
Polina Khomenko — pk@concorde.com.ua

Editor
Brad Wells — bw@concorde.com.ua