Vladimir Nesterenko
vn@concorde.com.ua
+380 44 207 5037
www.concorde.com.ua
Bloomberg: CONR<GO>

Analyst's Notebook

Ukraine / Chemicals
August 10, 2006

Stirol Audit Report: Not So Scary

Eurobond Holders Unlikely to Claim Early Redemption

Stirol (STIR: HOLD) has released its audit report for 2005, more than 5 weeks after the deadline set in the provisions of its 2005 Eurobond issue. The report was much awaited by Eurobond holders. Last month, Fitch put the company's ratings on its watch list "negative", citing the delay in receiving Stirol's 2005 IFRS financials and concerns regarding the company's compliance with the terms and conditions of its bonds issue.

We have investigated the audit report (see attachment #1), and our conclusion is that the company did indeed break certain non-financial covenants, which enable the bond holders to claim repayment of the debt (see clause 14.2 of the loan agreement, attachment #2). However, we think the risk that noteholders would demand immediate redemption is minor.

Stirol's Eurobonds

Stirol issued USD 125 mln of Loan Participation Notes in July 2005 through its off-shore subsidiary UkrChem Capital B.V. The notes were issued against a loan for the same amount from Moscow Narodny Bank. The notes bear interest of 7.875% and mature in Aug. 2008. As of 1q06, virtually all of the proceeds from the notes were still on Stirol's books in the form of cash and cash equivalents. According to Stirol's newly released audit report, the company this year purchased securities for USD 115 mln, which it plans to sell in the near future.

Auditors' Concerns

The auditors have not indicated any breaches by Stirol of the *financial* covenants of the loan agreement. The auditors found that Stirol did not comply with restrictions and mandatory disclosure requirements on related-party transactions; restrictions on dividend payments; and mandatory disclosure of beneficial owners of the company.

Our View

Although Stirol indeed broke certain *non-financial* covenants, the effect on its credit standing looks too small for the company's lenders to demand debt repayment. We believe the possibility of a credit rating downgrade is insignificant. We have not noticed any negative reaction from the stock market so far to this issue, and we think the market's attitude is well-justified.

Related-Party Transactions and Selling Prices

The auditors contend that Stirol didn't disclose information on related-party transactions in sufficient detail. The auditors say they were "unable to determine whether any adjustments might be necessary to disclosures of related party relationships, transactions and balances".

In particular, this means the auditors, did not have enough information to determine whether the company complied with clause 13.7 of Stirol's loan agreement, which demands that transactions with affiliates must be made on an arms-length basis, and with clause 13.16, which demands that at least 80% of Stirol's nitrogen fertilizer sales be made at or above applicable market prices.

The auditors identified a number of transactions with related parties, such as:

- sales and purchases of goods,
- trading in the company's treasury stock,
- sale of equipment on credit to an affiliated company, resulting in the creation of a long-term receivable

We believe that **the only related-party transactions that could potentially materially affect Stirol's creditworthiness would be sales of goods to related parties at below market prices**. We estimate that about 95% of the company's fertilizer export sales in 2005 were made through affiliated companies. On average, sales to related parties were made at prices only slightly (5-8%) lower than market prices (FOB Yuzhny, according to Decyfer). Formally, that is a breach of two of the non-financial covenants of Stirol's Eurobond. However, **we believe those transactions did not significantly violate the "arms-length" principle or substantially affect Stirol's credit standing**. Moreover, given that the traders might have been involved in marketing Stirol's products, their margins might have been economically justified.

According to the covenants, an independent appraiser should confirm that all transactions in excess of USD 10 mln were made on an arms-length basis. According to the auditors, Stirol did not provide a written opinion of an independent appraiser for such transactions, thereby breaking one more covenant. However, since the only material transactions in 2005 were sales of goods, which we estimate were made at close to market prices, we don't believe the breach will result in a claim for early repayment.

Dividends

The auditors also claim that Stirol did not comply with a restriction on dividend payments. The Group (Stirol and its subsidiaries) paid dividends in 2005, which the auditors contend was a breach of clause 13.9 of the covenants. However, the clause 13.9 qualifies dividends as a "restricted payment" only if the amount of dividends plus other "restricted payments" would be in excess of 50% of the group's income, which was not the case.

Other Concerns

The auditors also had other concerns, including alleged non-compliance with the terms and conditions of Stirol's liabilities under a USD 10 mln loan agreement with BSBTD, the Black Sea Bank for Trade and Development (USD 4.3 mln was still outstanding as of Dec 31, 2005). Namely, the agreement prohibits acquisition of subsidiaries "with the cumulative effect exceeding USD 500 ths". In 2005 Stirol acquired 75% of TEC Stirol LLC (a heat co-generation unit) for about USD 990 ths.

This breach could result in the lender demanding early repayment of the debt. Notably, the security for the loan includes an 86% stake in Stirol's subsidiary, Stirol Pack, which is consolidated with the parent and added USD 13.7 mln to the Group's 2005 net revenue and about USD 0.5 mln to its profits. Yet, we think Stirol can easily repay its debt to BSBTD, and we do not believe Stirol's pledge of the subsidiary is aimed at its disposal.

In addition, under the agreement with BSBTD, Stirol cannot pledge any of its assets. Stirol has pledged fixed assets worth a total of USD 3.4 mln as security for a loan facility from another bank.

The auditors also claimed that the company has not disclosed its "ultimate controlling party", which is required by IAS 24 "Related Party Disclosures".

To sum up, we do not think that the concerns expressed by the auditors will trigger a rating downgrade or a claim by bond holders for early redemption.

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For more details, please refer to two attachments:
#1: Stirol's 2005 IFRS Auditors Report
#2: Stirol's Loan Participation Notes Prospectus

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