

Ukraine 2011 Politics Preview

Biting the reform bullet

Government promises to wield consolidated power to tackle difficult reforms

Ukraine's parliament, the Verkhovna Rada, opened its eighth session today, which is due to last until summer. Pursuant to commitments made to the International Monetary Fund, the government has an ambitious agenda that includes making over the pension system (including raising the retirement age for women gradually to 55 by 2020) and stabilizing Naftogaz of Ukraine. We also expect the government to continue de-nationalizing key assets, particularly in the power generation sector and finalizing the sale of incumbent fixed-line telecom operator Ukrtelecom. For the first time in recent memory, Ukraine enters the year without a major nationwide election scheduled and with all the major government bodies (President, Cabinet of Ministers and the parliamentary coalition) on the same page.

Equity market outlook

We expect modest growth from the Ukrainian Exchange (UX) of 30-40% in 2011, after it posted 68% in 2009 and 90% in 2010. We believe banks and consumer goods as well as 2nd and 3rd tier stocks will outperform the market. We expect to see a number of local bond and Eurobonds placements, as well as some IPOs in the agriculture and consumer goods sectors.

Ukrainian politics in 2010 in review

Following his inauguration last February, Yanukovich moved quickly to install allies in key government posts, repair Ukraine's strained relationship with Russia and launch difficult but badly needed economic reforms. His support remains strongest in Eastern Ukraine where his party made a strong showing in October local elections, but nationwide popularity was eroding by yearend. Ukraine's image in the international community did not change much in terms of business climate as indicated by global development ratings, but suffered due to a perceived crackdown on the opposition and media (see Appendix 2).

Report date **1 Feb 2011**

Politically sensitive stocks

Centrenergo (CEEN UK)	Privatization
Dniproenergo (DNEN UK)	Privatization
Ukrnafta (UNAF UK)	Corp. conflict/LSE listing
Ukrtelecom (UTLM UK)	Privatization
Zakhidenergo (ZAEN UK)	Privatization

Note: We highlight these stocks as potentially the most sensitive to political factors in 2011

Key political issues for 2011

- Pension reform
- Oil & gas sector reform
- Electricity sector reform
- Labor code reform
- Cont. of tax reform
- Privatization

Political party tracker*

Party of Regions	29.0%	↔
Yulia Tymoshenko Bloc	13.5%	↓
Strong Ukraine	12.0%	↑
Front of Changes	5.4%	↓
Svoboda Party	3.6%	↑
Communist Party	3.1%	↓

Note: Arrows indicate comparison to popular support in October 2010 vs. October 2009

Source: Razumkov Center survey (September 30-October 4, 2010)

Key political issues for 2011

Pension reform

Ukraine, in its November 2010 memorandum and in ongoing talks with the IMF, committed to overhauling the pension system. Key tenants of what could be one of the most contentious pieces of legislation of the year include ensuring a balanced budget for the fund by increasing revenues through tax reform and improving payment of contributions, and raising the retirement age for women gradually over 10 years to 55 by 2020 (on par with males). The main law currently regulating the pension system dates back to 2001. Top government officials have said they expect to approve new legislation in March 2011.

Oil & gas sector reform

The government also pledged the IMF to balance the position of Naftogaz of Ukraine in 2011. It plans to achieve this via increasing gas prices for households and utilities by another 50% as of April 15, 2011 (following a 50% hike in August 2010), fully pass through higher gas prices to utility prices, and establish tighter control over operational costs. Ukrnafta is shaping up to be another big story – Prime Minister Mykola Azarov said in January he wants to change the management team (currently controlled by 42% shareholder Privat Group; the state owns 51%) and shareholders are due to vote on the creation of a vertically integrated structure by merging with refiner Ukratnafta at a March 22 EGM. Government officials have said the restructured entity could place up to a 20% stake on the London Stock Exchange.

Continuation of tax reform

Government officials claim that the new tax code passed last year will streamline legislation and help tackle tax evasion – the phase-in period began as of January 1, and the State Tax Administration and Finance Ministry have begun issuing supplemental guidance on new provisions. In addition, the government aims to clear VAT arrears in early-2011 and setup a new systematic and timely VAT refund process.

Privatization

The State Property Fund expects to finalize the privatization of Ukrtelecom in 1Q11 to the only suitor to bid on it at a December 2010 auction, ending 12-years of talk of selling it off. The SPF is in the process of completing an independent valuation of the

fixed-line telecom operator. The government has removed remaining obstacles to auctioning off power generation companies and the Odesa Portside plant in 2011. An auction is expected to be announced for either Zakhidenergo or Dniproenergo in 1Q11, with the other hitting the block later this year. State-owned stakes in several Oblenergos could also be privatized this year.

Electricity sector liberalization

In our view, long-awaited sector reform (liquidation of the one-pool model and move to bilateral contracts with a balancing market) is a possibility in 2H11 following the privatization of both Zakhidenergo and Dniproenergo, in order to spur further interest from strategic investors in other state-owned assets. With electricity prices high, the government should be motivated to effect the reforms necessary to create a more efficient generating and pricing structure.

Labor code reform

Vice Prime Minister Sergiy Tigipko said Ukraine's labor code would likely receive a makeover in 1H11. Major changes are as yet unclear. Ukraine's current code was enacted when the country was still part of the Soviet Union and is slanted heavily in favor of worker rights and protections. Labor laws in Ukraine are notoriously unenforced with recourse in the event of violations typically relegated to courts rather than a government-controlled oversight body.

Land reform

Last January Ukraine's parliament overrode a presidential veto to extend the moratorium on the sale of agricultural land until 2012. However, according to provisions of that law, the sale of agricultural land is possible after parliament adopts bills on establishing a land cadastre and land market. The moratorium on land sales has been in effect since 2002. There are indications that some officials in the Yanukovych government favor land reform in the near term.

Sector barometer

We expect modest growth from the Ukrainian Exchange (UX) of 30-40% in 2011, after it posted 68% in 2009 and 90% in 2010.

Sector	2011 performance	Political sensitivity	Our view
Agriculture	market perform	low	Neutral to positive outlook regardless of the political situation. Depends on global commodity prices. Potential catalyst: cancellation of the moratorium on agricultural land sale is not likely before 2012, though several officials have recently talked this up. Less liquid stocks in the sector are expected to outperform in 2011, while liquid names have already eaten up most of their upside.
Banks	outperform	low	Banking stocks will be relatively uninfluenced by political events in 2011, with potential deposit insurance reform and a decision on Nadra Bank's future having limited impact. We believe banks will outperform this year, especially given their lag in performance to date following the crisis. Key drivers are budget policy (the extent to which privatization and external borrowing finance the deficit), the rate of the overall economic recovery and exchange rate stability.
Consumer, retail	outperform	low	We expect the recovery in domestic demand to accelerate due to growth in disposable income and a renewal in bank lending. We expect some IPOs in the sector and think we will see marginal improvement in fundamentals and deleveraging in 2011. We think these sectors (especially illiquid stocks) could outperform the market.
Machinery	market perform	low	Most listed stocks are dependent on external demand, mainly from Russia, with whom relations have significantly improved under Yanukovich. Railway machinery and Motor Sich will continue to be solid picks, but perform in line with the market. Our top sector pick is Bogdan Motors due to an expected pickup in domestic sales and renewal in consumer lending for auto purchases by Ukrainian banks.
Metals & Mining	underperform	neutral	Outlook depends on global steel and iron ore markets, less on domestic politics, though the current coalition is favorable for SCM/Metinvest-owned companies. We expect domestic steel & iron ore output to grow 10-15% and 8-12%, respectively in 2011. Prices should increase 25-30% (for steel) and 15-20% (for iron ore) as well. We prefer iron ore due to strong financials and high margins, and then liquid names in steel.
Oil & Gas, Chemicals	underperform	medium	The main plays of this year in the sector are both sensitive to political factors – the possible merger of Ukrnafta and Ukrtatnafta (and resolution of the struggle for control between the government and Privat group) and the acquisition of Regal Petroleum (Geo Alliance and Smart Group are bidding). We also note the government's traditionally high attention to the sector.
Real estate	outperform	neutral	The sector remains quite risky and stocks relatively illiquid. However, we expect a recovery here due to anticipated growth in disposable income and a renewal in bank lending.
Utilities	outperform	high	As we predicted, the privatization of the state's stakes in power generators has been accelerated under Yanukovich. We expect the first GenCo, either Zakhidenergo or Dniproenergo, to hit the auction block in 1Q11 with the other in a subsequent quarter. The privatization of the state's Oblenergo stakes, begun in 2009, should be back on as well in 2011. We view long-awaited catalyst electricity market liberalization as possible in 2H11. GenCos are set to be outperformers again in 2011, while Oblenergos will remain largely illiquid.

Key political events of 2010

Election & inauguration (January-February)

Viktor Yanukovich won the second round of the presidential election by a narrow margin of less than 3.5% against challenger Yulia Tymoshenko. He was inaugurated as Ukraine's fourth president on February 25.

Political consolidation (March-October)

After Yanukovich's inauguration, forces friendly to him quickly took control of the Verkhovna Rada (parliament) and Cabinet of Ministers (highest executive body), erasing memories of the chaotic infighting of the last five years. Constitutional Court decisions (notably an October ruling to throw out 2004 Constitutional amendments that limited presidential authority) have also favored Yanukovich. Allies have also been appointed to head up the National Bank, State Property Fund, Security Service and Prosecutor General. Local elections in October cemented Regions' footprint in Eastern and Central Ukraine in both regional councils and mayoral offices.

Rapprochement with Russia (April-present)







Yanukovich's administration has taken a more business-minded approach to its relations with Russia. The president signed landmark fleet-for-gas discount deal in April. Russian state-owned VTB Bank loaned Ukraine USD 2 bln in June. Last year Russian strategic investors acquired controlling interests in the Industrial Union of Donbas and Zaporizhstal.

Economic reform moves forward (July-December)

The government showed its readiness to implement difficult IMF commitments - it strengthened central bank independence, raised consumer gas tariffs by 50% as of August and passed a 2011 state budget with a planned deficit of UAH 38.8 bln (USD 4.9 bln) or 3% of GDP as projected by the government. The government responded to popular protests over an initial tax code passed by parliament in mid-November with a presidential veto and revision that was approved and signed into law on December 6. The new code will cut the corporate profit tax from 25% to 16% by 2014, shave the value-added tax from 20% to 17% by 2014 and increase the personal income tax maximum bracket to 17% (from flat 15% rate before). It also included a 10-year income tax vacation for the aerospace industry, including Motor Sich.

Appendices

Appendix 1: Political party tracker

↑/↓	Polling support* Oct 2010 (vs. Oct 2009)	Political party	Overview	Notes	Party leader
↔	29.0% (31.1%)	Party of Regions	Leader: Prime Minister Mykola Azarov. Electoral base: East and Southeast Ukraine. Ideology: Pro-Russian, Center-left. Currently controls Cabinet of Ministers and leads a majority in the Verkhovna Rada (parliament).	Took over control of key levers of power: in addition to parliamentary majority and the Cabinet, allies have been appointed to head up the central bank and State Property Fund. Experienced some backlash due to controversial tax code that restrained popularity last year.	
↓	13.5% (21.5%)	Yulia Tymoshenko Bloc	Leader: Former Prime Minister Yulia Tymoshenko. Electoral base: Western and Central Ukraine. Ideology: Pro-European, Center-right. Main opposition party.	Tymoshenko went from close second round presidential contender in February (lost by less than 3.5%) to marginalized by fall 2010. Political prosecution and criminal proceedings by the government against her and allies brought her back to forefront by end-2010.	
↑	12.0% (-)	Strong Ukraine	Leader: Vice Prime Minister Sergiy Tigipko. Electoral base: Central and Eastern Ukraine. Ideology: Centrist. Allied with Party of Regions.	Strong Ukraine established itself as a national party by early 2010 following Tigipko's presidential bid. Tigipko joined the Party of Regions led government in March. The party disappointed in October local elections, failing to win more than 10% in any region and any mayoral seats.	
↓	5.4% (7.8%)	Front of Changes	Leader: MP Arseniy Yatseniuk. Electoral base: Western and Central Ukraine. Ideology: Centrist. Opposition party.	Yatseniuk's popularity has been on the decline since mid-2009 after he launched a much-maligned marketing campaign when running for president.	
↓	3.1% (5.3%)	Communist Party	Leader: MP Petro Symonenko. Electoral base: Eastern Ukraine. Ideology: Pro-Russia, Communism. Parliamentary faction allied with Party of Regions.	The Communist Party's popularity has been in a secular downtrend, with recent polls indicated it was only supported by around 3% of Ukrainians. It still remains a dominant and influential force and will likely linger on the national scene.	
↑	3.6% (3.0%)	Svoboda Party	Leader: MP Oleh Tyahnybok. Electoral base: Western Ukraine. Ideology: Right, Nationalism. Opposition party.	Tyahnybok's radical nationalist party increased its standing significantly over 2010 as a reaction to perceived pro-Russian slant of the Yanukovich presidency. It had an impressive showing in Western Ukraine in the October local elections.	

* According to Razumkov Center: 2010 survey conducted September 30-October 4. 2,007 participants. Margin of error: ±2.3%.

Source: Razumkov Center, political party websites, Concorde Capital research

Appendix 2: Ukraine global development ratings

↑/↓	Recent rating (vs. previous)	Rating name & sponsor	Excerpt from rating report	Rating components
↔	98/128 (97/127)	Best Countries for Business Index by Forbes	Ukrainian Government officials eliminated most tax and customs privileges in a March 2005 budget law, bringing more economic activity out of Ukraine's large shadow economy, but more improvements are needed, including fighting corruption, developing capital markets, and improving the legislative framework... Political turmoil in Ukraine as well as deteriorating external conditions are likely to hamper efforts for economic recovery.	Trade freedom, monetary freedom, property rights, innovation, technology, red tape, investor protection, corruption, personal freedom, tax burden, market performance. (www.forbes.com/bestbizcountries/)
↓	89/139 (82/133)	Global Competitiveness Index by World Economic Forum	The new government announced an ambitious reform agenda that, according to the GCI, should address as a priority the country's weak institutional framework (134th) and the highly inefficient markets for goods and services (129th), which stifles competition and prevents entrepreneurship from flourishing... Priority should also be given to fostering the development of the financial sector (119th), the major weaknesses of which exacerbated the effects of the crisis on Ukraine.	Institutions, infrastructure, macroeconomic stability, health & primary education, higher education & training, goods market efficiency, labor market efficiency, financial market sophistication, technological readiness, market size, business sophistication, innovation. (www.weforum.org/en/initiatives/gcp/index.htm)
↔	145/183 (142/183)	Doing Business Index by World Bank / International Finance Corporation	Ukraine eased business start-up by substantially reducing the minimum capital requirement. It cut 9 out of 31 procedures to obtain construction permits and it eased tax compliance by continuing the implementation of voluntary electronic filing for VAT returns.	Starting a business, dealing with construction permits, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, closing a business. (www.doingbusiness.org)
↓	164/179 (162/179)	Index of Economic Freedom by the Heritage Foundation	Structural constraints and political instability continue to undermine private-sector development. State intervention and the ongoing threat of expropriation limit dynamic economic activity. Ukraine's underdeveloped financial sector struggles to provide the necessary credit for private-sector development, while the regulatory environment remains opaque and burdensome.	Business freedom, trade freedom, fiscal freedom, government size, monetary freedom, investment freedom, financial freedom, property rights, freedom from corruption, labor freedom. (www.heritage.org)
↓	Partly Free (Free)	Freedom in the World Index by Freedom House	On a less positive note, events in Ukraine in 2010 caused it to fall from Free to Partly Free. Viktor Yanukovich, whose fraudulent electoral victory in 2004 had been overturned by the Orange Revolution, won the presidency on his second attempt in early 2010. He then oversaw a deterioration in press freedom, state efforts to curb student activism, intimidation of NGOs, local elections that were almost universally derided as neither free nor fair, and indications of increased executive influence over the judiciary.	Electoral process, political pluralism and participation, functioning of government, freedom of expression and belief, associational and organizational rights, rule of law, personal autonomy and individual rights. (www.freedomhouse.org)
↓	131/178 (89/175)	Press Freedom Index by Reporters without Borders	The Philippines, Ukraine, Greece and Kyrgyzstan all fell sharply in this year's index. In the Philippines this was due to the massacre of around 30 journalists by a local baron, in Ukraine to the slow and steady deterioration in press freedom since Viktor Yanukovich's election as president in February, in Greece to political unrest and physical attacks on several journalists, and in Kyrgyzstan to the ethnic hatred campaign that accompanied the political turmoil.	Physical attacks, imprisonment and direct threats; indirect threats, pressures and access to information; censorship and self-censorship; public media; economic, legal and administrative pressure; internet and new media; number of journalists murdered, detained, attacked or threatened and government role in this; country data. (www.rsf.org)

Appendix 3: Ukrainian political system

Ukraine is a semi-presidential republic. It declared independence from the Soviet Union on August 24, 1991. The government has three branches: executive, legislative and judicial. Ukraine has 24 oblasts (regions), one autonomous republic and two cities with special status (see map right). Ukraine's capital is Kyiv. Ukraine's current constitution was adopted June 28, 1996.



Verkhovna Rada of Ukraine. Ukraine's Verkhovna Rada (Supreme Council in Ukrainian) is a unicameral parliament with 450 seats. It has the power to amend the Constitution of Ukraine, adopt laws, approve the state budget, ratify and denounce international treaties, declare war and peace, and appoint officials and judges. The Verkhovna Rada can override a presidential veto with a two-thirds majority. Seats in the Verkhovna Rada are distributed on a proportional basis among political parties in a nationwide vote (to parties whose vote total exceeds a 3% barrier).

President of Ukraine. Ukraine's president is the head of state. The Ukrainian president is elected by popular vote for a five-year term. The current president, Viktor Yanukovich, was inaugurated on February 25, 2010. The Ukrainian president has the power to:

- Guarantee independence, territorial integrity, national security, the Constitution of Ukraine and basic human rights and freedoms
- Disband the Verkhovna Rada in line with Constitutional procedures
- Nominate several key government positions to the Verkhovna Rada for approval: the Prime Minister, the Minister of Foreign Affairs, the Minister of Defense, the Prosecutor General, Head of the Security Service of Ukraine (SBU), and Head of the National Bank of Ukraine
- Sign into effect or veto laws passed by the Verkhovna Rada

Cabinet of Ministers of Ukraine. Ukraine's Cabinet of Ministers is the highest body of executive power. Ukraine has 12 ministries and there are 17 positions in the Cabinet (including the Prime Minister and Vice Prime Ministers). The Cabinet of Ministers term is for the duration of the parliamentary convocation or coalition. The Prime Minister is the head of the executive and presides over the Cabinet of Ministers. The

Prime Minister is appointed by the Verkhovna Rada, following submission of the candidate by the President of Ukraine. Nominations to the Cabinet, made by the Prime Minister or President depending on the position, are affirmed by the Verkhovna Rada. The Prime Minister nominates the heads of government agencies including the State Property Fund and the Antimonopoly Committee to the Verkhovna Rada for approval. The current prime minister, Mykola Azarov, was confirmed on March 11, 2010.

Constitutional Court of Ukraine. Ukraine's Constitutional Court is charged with interpreting the Constitution of Ukraine and decides whether laws and legal acts are unconstitutional. The court is composed of 18 judges, appointed in equal shares by the president, Verkhovna Rada and the Congress of Judges. Judges are currently appointed for a single nine-year term.

Court system in Ukraine. The judicial system in Ukraine has four levels of courts of general jurisdiction: local courts, appeals courts, high courts and the Supreme Court. High courts include the High Administrative Court of Ukraine, which rules on administrative cases, and the High Economic Court of Ukraine, which rules on economic and commercial cases. The highest level is the Supreme Court of Ukraine. Supreme Court appointments are made by parliament and have no term limits.

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