Ukrlandfarming and Avangardco

A history of inefficient investments

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Executive summary

Ukrlandfarming and its subsidiary **Avangardco** were **efficient machines for wasting the money** of its creditors and minority shareholders. This can be concluded by looking into the history of the holdings:

- By "investing" almost USD 1.7 bln over the last four years, ULF did not grow in size and did not become more efficient.
- By "investing" almost USD 1.2 bln over the last eight years, Avangardco did not grow in size, became less competitive and cost-efficient.

As a result of such investments, the net debt of ULF increased by USD 1 bln since 2010 to almost USD 1.6 bln as of end-2016, while its EBITDA halved compared to 2010.

It is easy to **blame geopolitical and market conditions** for such a result, but ULF **peers suggest that the results could have been totally different**, had the company spent its money a bit more efficiently.

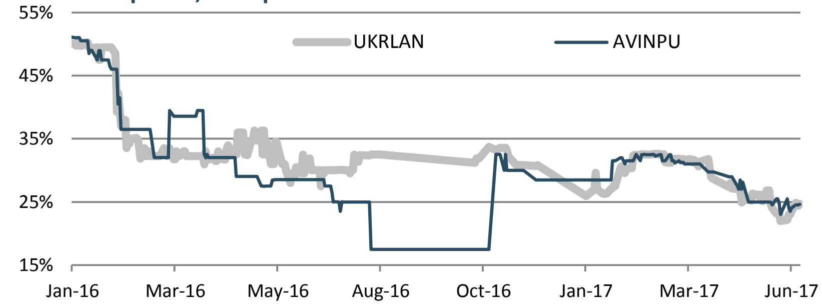
In our view, the **key source of troubles** for the holdings was **too easy access to debt and capital markets**, coupled with **poor corporate governance** and/or lack of control of capital:

- The "appetite for investments" of the holdings of Oleg Bakhmatyuk seem to be fuelled by available borrowed money and share capital contributions in 2009-2013, as well as the existence of two related banks which seem to be used as additional wallets for the holdings.
- Closure of debt markets since 2014, as well as the loss of the banks in 2014-2015 stopped the flow of crazy money to the holdings, thus significantly limiting their financial liquidity.

But neither in the fat years nor in the lean years did the holdings try to limit their investment appetites. In the fat years they spent everything generated internally and borrowed, while in the lean years they continued to spend everything generated internally. There was no place for minority shareholders or lenders in the holding's money distribution plans in any period.

ULF's lack of openness does not allow us to understand the processes going on inside the holding, as well as the scope of its operations and its operating efficiency over the last years. Avangardco's publication of some operating numbers raised even more questions as numbers were sometimes inconsistent with other market data. All this does not add trust to the holdings and their reporting.

Eurobond prices, % of par



ULF's poor results suggest that either the holding was poorly managed or it was spending money purposely in the wrong way (with or without the involvement of its shareholder Oleg Bakhmatyuk). All the possible reasons imply **the holding needs a significant strategy revision, possibly with the replacement of key decision-makers,** to become solvent and trustworthy. In the process of revision, a painful debt restructuring is unavoidable. But creditors should understand what they will receive in exchange.

For the creditors that are stuck in ULF and Avangardco, there is still room to recover their debts' value, but it will heavily depend on Bakhmatyuk's willingness to cooperate.

We continue to believe the following steps are necessary to somehow recover the value of ULF debt:

- Conducting an external audit (due diligence) to understand the true stance of the holding and its assets;
- Developing a new strategy with clear limits for maintenance CapEx and the expansion of working capital, which was among the key cash drainers;
- Regular publication of financial reports openly on ULF website. Higher frequencies (e.g. quarterly financials, monthly operating performance) would be preferable;
- Introducing a supervisory board (or any other board with clear power to approve the holding's annual budgets and distribution of cash generated) with the participation of creditors;
- Simplifying the legal structure of the holding to avoid any risks of assets stripping.

Our view on ULF and Avangardco Eurobonds remain negative, but we do not rule out changing it providing any progress on the items above is made.

Source: Bloomberg, company data, Concorde Capital research

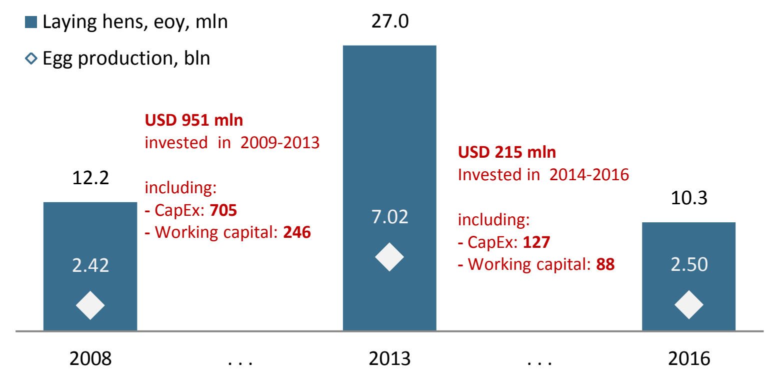
Avangardco: Eight years, USD 1.2 bln “investments” in vane

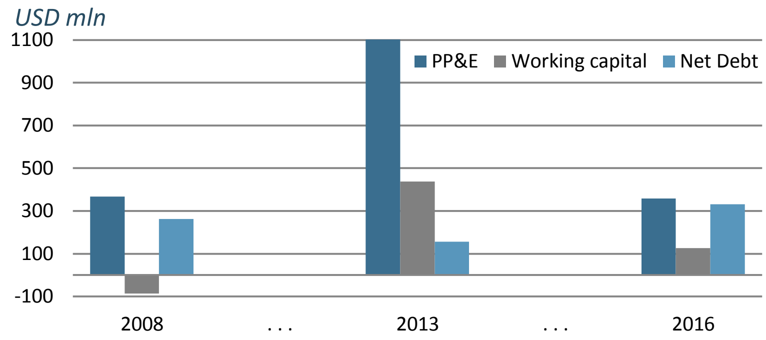
Since Avangardco's IPO in 2010, the company made significant progress in increasing its asset base and production, and it more than doubled in size by the year 2013. To facilitate such growth, the company invested USD 950 mln into working capital and CapEx in 2009-2013. It has built two new modern egg farms.

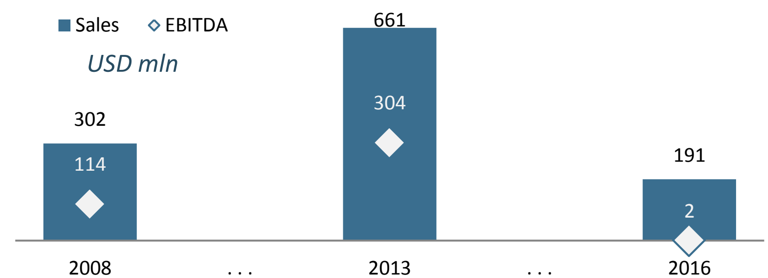
But all this did not help the company to occupy any sustainable share on Ukraine’s egg market – during the crisis that started in 2014, the company significantly decreased both its laying hen flock and egg production. At the same time, the company’s spending remained high – in 2014-2016, it “invested” USD 215 mln into “capacity maintenance” and “working capital.”

As a result, having spent over USD 1.1 bln in 2009-2016, the company has now returned to its size of the year 2008 (in terms of laying hen number and egg production). But now its net debt is USD 69 mln (26%) higher than in 2008, and its ability to generate EBITDA is much weaker than in 2008.

Avangardco history



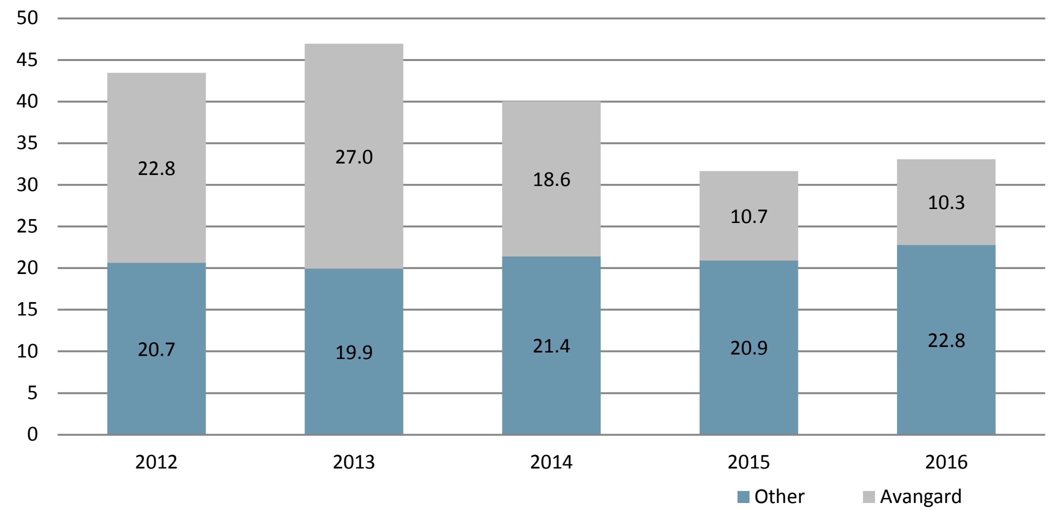




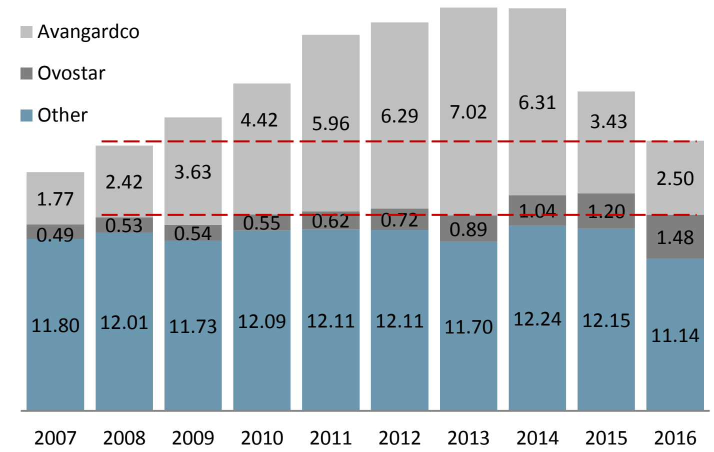
Source: Company data, Concorde Capital research

Avangardco: questions raised by Ukraine egg market stats

Industrial laying hen flock in Ukraine, mln

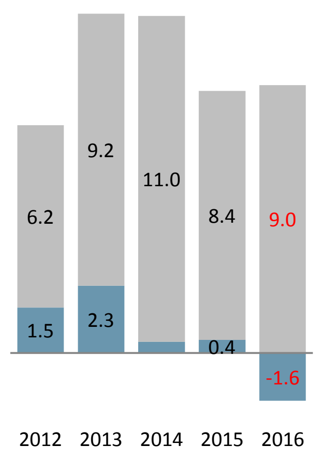


Egg production in Ukraine, bln units

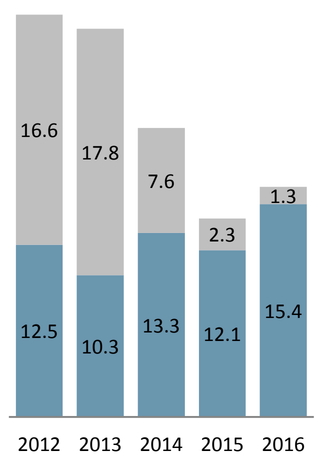


Distribution of laying hen flock by region:

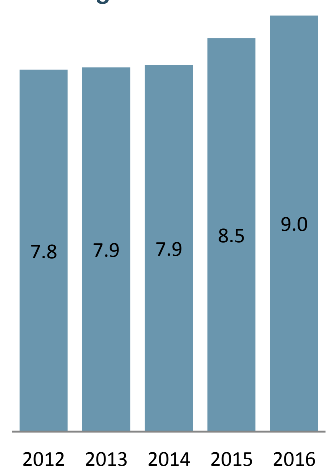
Khmelnytsk & Kherson



Other with Avangardco presence



Other regions



The Ukrainian egg market returned in 2016 to the levels seen in the year 2008, and so was Avangardco's share on the market.

It is particularly strange to observe that a company with modern egg production facilities so easily lost its market share in just three years. **The explanation looks strange that a company which invested over USD 1 bln into its development "lost competition to old ladies breeding their hens in the backyard."** Notably, its smaller peer Ovostar increased its market share.

Looking at the regional distribution of laying hen flock in Ukraine, we are observing large fluctuations in the flock only in the regions where Avangardco is present. All this may suggest that Avangardco was manipulating with its laying hen numbers during the period of its "active growth."

Also, it's worth noting that Avangardco's claim that its two new modern facilities in Khmelnytsk & Kherson oblasts hold 9 mln laying hens does not correspond to regional data from the state statistical agency (UkrStat), which suggests **Bakhmatyuk's data on laying hens may be misleading.**

Source: UkrStat, company data, Concorde Capital research

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Avangardco vs. Ovostar

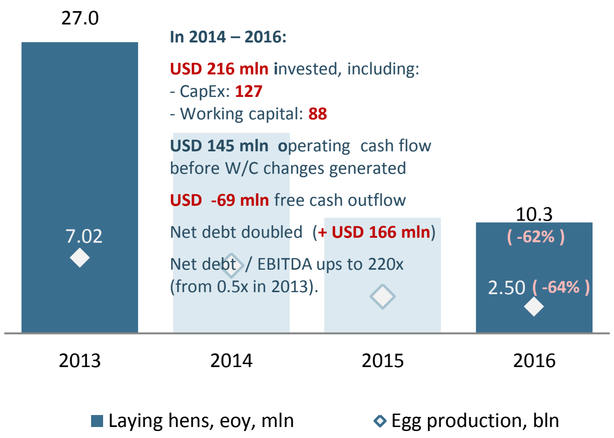
Avangardco can list dozens of reasons why its operational performance is so weak, which are summarized by the claim that it appeared in wrong place in wrong time. But looking at the performance of the Ukrainian egg market as a whole, as well as looking at the performance of the company's peer Ovostar we can conclude that the claims of Avangardco look ill-grounded.

Avangardco's operational and financial performance in 2013-2016 stands in contrast to Ovostar, which managed to grow in size by 1.7x for the period despite having invested much less in its development.

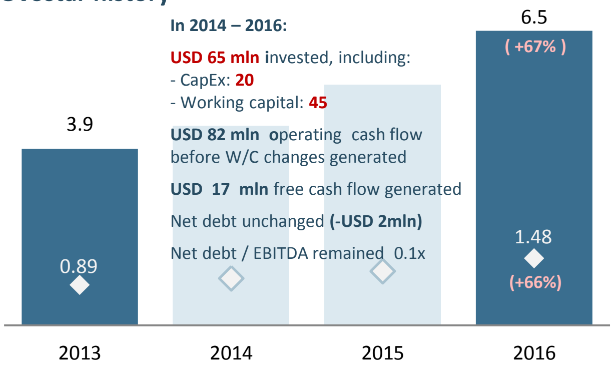
The key difference between Avangardco and Ovostar is that the latter was developing by investing only its own-generated cash flow, while Avangardco was using a lot of borrowed money (net debt increased by USD 166 mln in 2013-2016). Clearly, all this money was spent inefficiently.

The entire idea of Avangardco to build two brand new egg farms and concentrate its operations on just them looks questionable now. Despite Avangardco increasing the share of egg production at its two new modern egg facilities to 88% in 2016 (from 27% in 2012 and zero in 2008), its egg productivity did not improve. In particular, the company's egg production per average laying hen flock decreased 18% in 2016 compared to 2012 (and remained at the level of 2008). Also, costs per egg seem to have increased radically (in contrast to Ovostar) with greater concentration on the new farms.

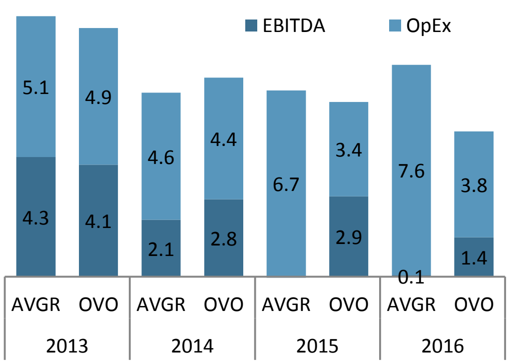
Avangardco history



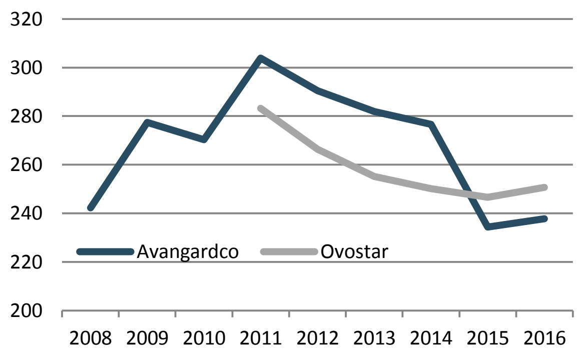
Ovostar history



Total revenue per egg produced, USc



Egg production per laying hen p.a.



Source: Bloomberg, company data, Concorde Capital research

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Ukrlandfarming*: Four years, USD 1.7 bln “investments” in vane

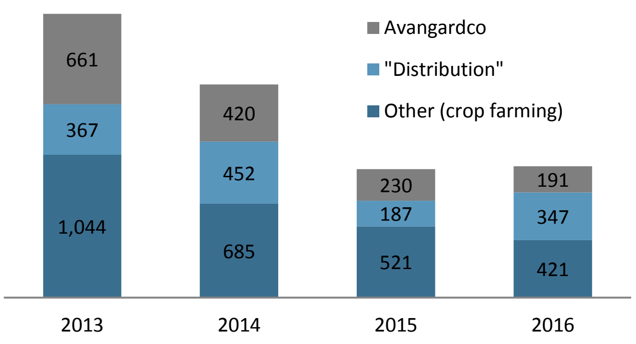
Between end-2012 and end-2016, ULF spent almost USD 1.7 bln for its “growth and development”, but grew little in size. The only parameter that grew significantly was the company’s net debt.

Since Ukrlandfarming’s USD 500 mln debt placement in 2013, the company raised its leased land bank in the same year from 532,000 ha to 654,000 ha, and managed to increase its cultivated land bank to a reported 611,000 ha in 2013. However, over the last three years, the company has been gradually reducing its land bank and the size of its farming operations. Based on our estimates, **in the year 2016 ULF was processing almost the same land bank as in the year 2012.**

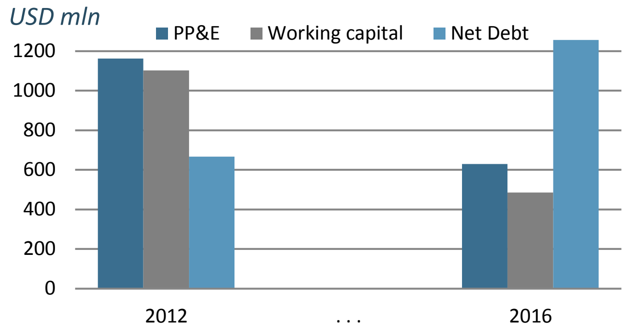
That means all the huge “investments” of 2013-2016 did not allow the company to either increase the scope of its operations, or improve its efficiency. The company’s EBITDA per hectare dropped from a suspiciously high number of USD 1060 in 2012 to a suspiciously low USD 243 in 2016 (see next slide).

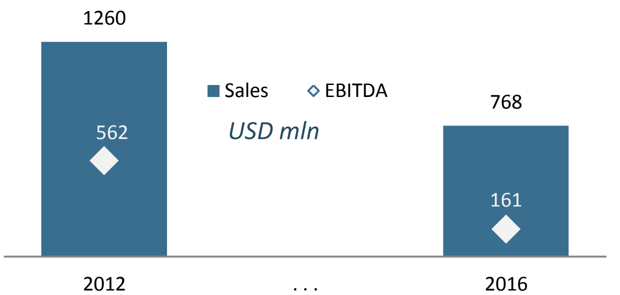
The only “segment” of ULF that remained stable over the last four years is “distribution” (sale of agricultural machinery, crop protectors, fertilizers, seeds etc.). The presence of such a segment, which contributed 45% of total ULF revenue in 2016 (net of Avangardco) is another element of uncertainty.

Ukrlandfarming revenue by key segments, USD mln



Ukrlandfarming history





** All the numbers on the page are net of Avangardco*
Source: Company data, Concorde Capital research

Ukrlandfarming* vs. Industrial Milk Company

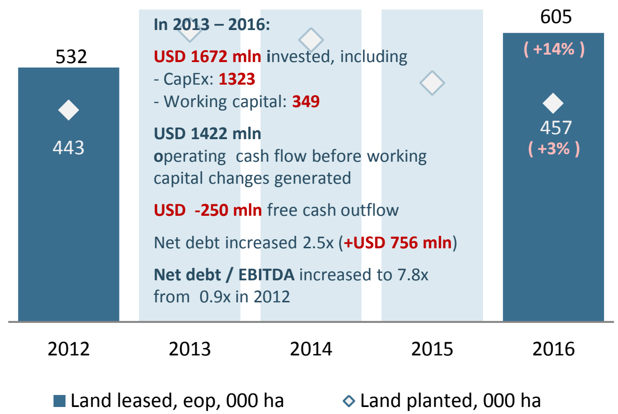
Weakened corn prices are considered a key problem for Ukrlandfarming over the last couple of years. We would have bought such explanation if we had not seen the operational and financial performance of another farmer focused on corn cultivation - Industrial Milk Company (IMC).

Again, the two companies differentiate in their way of financing their development. Unlike ULF, IMC was developing by counting on its own funds, having not increased its debt between 2012 and 2016. At the same time, IMC managed to increase its operational land bank by 46% for the period. In contrast, ULF spent about USD 0.8 bln of borrowed money and “invested” a total of USD 1.7 bln to expand its farming operations by just 3% for the period.

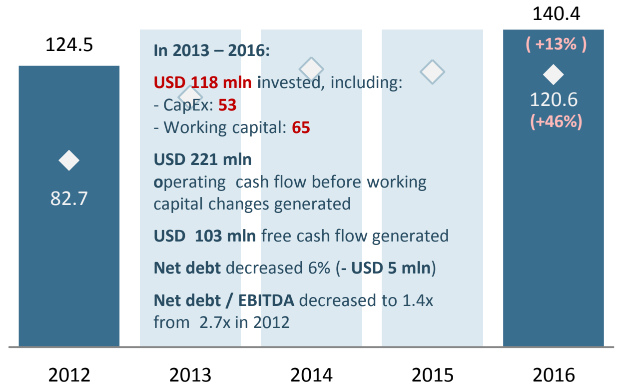
Investments by ULF seem to not bring any result – the profitability of its farming segment was decaying over the last four years to questionably low levels. In contrast, IMC’s profitability per hectare was gradually growing.

Higher debt and lower profitability made ULF’s financial leverage growing to a risky 7.8x (net debt to EBITDA) in 2016, making the company de facto insolvent.

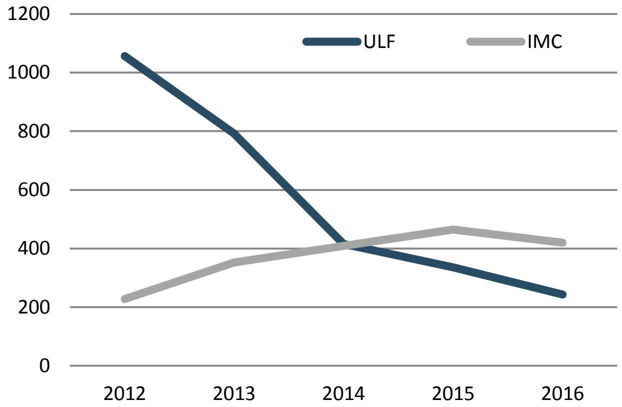
Ukrlandfarming history



Industrial Milk Company history



EBITDA per hectare of land leased, USD



** All the ULF numbers on the page are net of Avangardco*
Source: Company data, Concorde Capital research

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How large is Bakhmatyuk's debt?

Officially, the total debt of Ukrlandfarming is USD 1,668 mln as of end-2016.

But it looks like this is not the entire amount of debt that Oleg Bakhmatyuk and his companies are going to restructure.

The additional debt of Bakhmatyuk includes:

- Money owed by Bakhmatyuk's failed banks to Ukraine's National Bank and the Deposit Guarantee Fund (DGF). According to ULF's Jan. 2017 letter, such obligations amount to UAH 20.6 bln (about **USD 760 mln**, based on the end-2016 exchange rate). This includes UAH 10.9 bln (USD 400 mln) due to the NBU and UAH 9.7 bln (USD 360 mln) due to the DGF. In the best case, the latter could be fully repaid by the banks themselves.
- In the best case, the above amount might be decreased by a debt of ULF to Bakhmatyuk's failed banks. According to ULF, the failed banks' loans to related parties amounted to **UAH 4.8 bln** in December 2014 (USD 177 mln at the end-2016 exchange rate). However, this does not mean that this is debt consolidated by ULF. For instance, ULF's financials for 2014-2016 do not contain information about loans from related parties (as of end-2013, debt to related parties was reported at USD 125 mln).

Our analysis suggests that the total debt of Oleg Bakhmatyuk that he might be aiming to restructure ranges from USD 1.89 bln to USD 2.43 bln.

Assuming that ULF is the only money-generating asset of Bakhmatyuk, we expect he will be willing to put all his debt burden on the holding. As we estimated in our August 2016 report, total value of ULF assets is close to USD 0.8 bln, or 33% - 42% of total Bakhmatyuk's debt. Given that it is impossible for creditors to take over all the ULF assets, the value of Bakhmatyuk's existing debt of is lower than that estimate. The ultimate value for debt holders will depend on their negotiating power. Given that currently the Eurobonds of ULF and Avangardco are trading at 22%-25% of their par value, we see no growth potential in them.

Possible range of Bakhmatyuk's debt, USD mln

Reported debt of ULF & AVGR	**1,668**	(1)
- Incl. loans	806	
- Incl. Eurobonds	756	
- Other (local bonds)	106	
Debt of Bakhmatyuk banks to NBU	**399**	(2)
Debt of Bakhmatyuk banks to DGF	**359**	(3)
- Incl. est. related party debt to banks	177	(4)
Maximum apparent debt	**2,427**	(1) + (2) + (3)
Minimum possible debt	**1,891**	(1) + (2) - (4)

Source: Company data, Concorde Capital research

ULF and Avangardco bonds: restructuring terms imply value of 15-22% of par

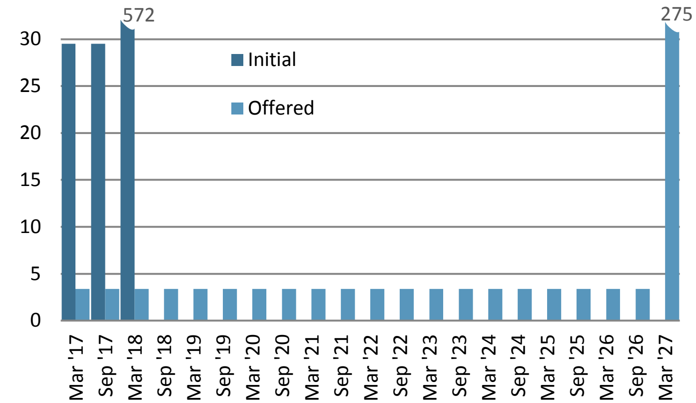
Based on recent Bloomberg report, ULF and Avangardco are trying to negotiate the following restructuring terms of their bonds:

- Face value cut by 50%;
- Postponement of maturity by nine years for UKRLAN and eight years for AVINPU;
- Decrease of coupon rate to 2.5% for UKRLAN (from 10.875%) and to 3.0% for AVINPU (from 10.0%).

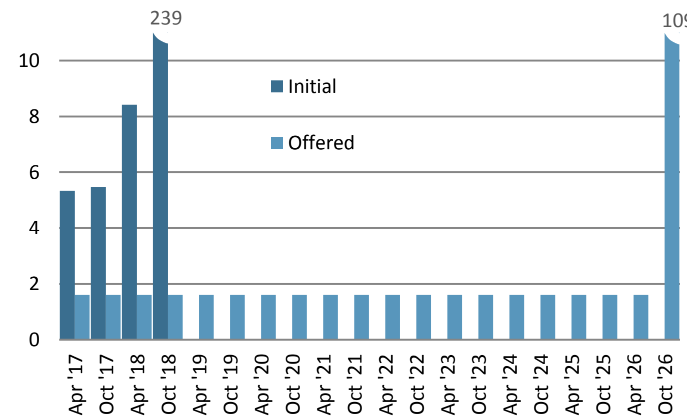
In our view, such restructuring conditions won't be acceptable for bondholders. We expect that in the process of negotiations such conditions will be changed to the benefit of bondholders. At the same time, we expect that ultimate cash flow to bondholders will be more or less in line with what Bakhmatyuk is trying to offer (i.e., we expect new restructuring of the bonds in the long-term).

The offered restructuring terms corresponds to net present value of future cash flows to bondholders of 15% of par for UKRLAN and 16% of par for AVINPU, assuming a 20% discount rate. At the discount rate of 15%, NPVs will be 20% of par and 22% of par, respectively. Such estimates do not allow us treating the bonds as attractive investments.

Payment schedule, ULF bond (UKRLAN), USD mln



Payment schedule, Avangardco bond (AVINPU), USD mln



Source: Bloomberg, Concorde Capital research

Financial summary, USD mln

Ukrlandfarming

	2013	2014	2015	2016
Net revenue	2,072	1,557	938	959
EBITDA	842	434	243	162
OCF before W/C	767	553	315	192
Working capital (W/C) investments	170	-372	-187	-113
Net CapEx	-1,201	-279	-131	-24
FCF before interest & tax	-264	-98	-3	55
PP&E, eoy	2,900	1,592	1,141	987
Working capital, eoy	1,350	803	561	611
Cash, eoy	297	195	62	81
Total debt, eoy	1,663	1,675	1,598	1,669
Net debt, eoy	1,365	1,480	1,537	1,588
Net debt / EBITDA	1.6	3.4	6.3	9.8
Net debt / OCF before W/C	1.8	2.7	4.9	8.3
Net debt / FCF	-	-	-	28.8

Avangardco

	2013	2014	2015	2016
Net revenue	661	420	230	191
EBITDA	304	130	-1	2
OCF before W/C	259	96	27	22
Working capital (W/C) investments	-65	-46	-21	-21
Net CapEx	-185	-77	-37	-12
FCF before interest & tax	10	-27	-31	-11
PP&E, eoy	1,104	580	405	358
Working capital, eoy	438	256	145	126
Cash, eoy	157	118	31	13
Total debt, eoy	323	344	339	344
Net debt, eoy	166	226	308	331
Net debt / EBITDA	0.5	1.7	-	220.7
Net debt / OCF before W/C	0.6	2.4	11.4	15.2
Net debt / FCF	16.8	-	-	-

Ukrlandfarming w/o Avangardco

	2013	2014	2015	2016
Net revenue	1,411	1,137	708	768
EBITDA	538	304	244	161
OCF before W/C	507	457	288	170
Working capital (W/C) investments	235	-326	-166	-92
Net CapEx	-1,016	-202	-93	-12
FCF before interest & tax	-274	-71	29	66
PP&E, eoy	1,796	1,012	736	629
Working capital, eoy	912	547	416	486
Cash, eoy	141	77	30	68
Total debt, eoy	1,340	1,331	1,259	1,325
Net debt, eoy	1,199	1,254	1,229	1,257
Net debt / EBITDA	2.2	4.1	5.0	7.8
Net debt / OCF before W/C	2.4	2.7	4.3	7.4
Net debt / FCF	-	-	42.9	19.0

Source: Company data, Concorde Capital research

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