CONCORDE CAPITAL

Ukrnafta

Missing the energy uptrend

January 22, 2008

Current price: USD 77.4
12M Target: USD 65.0

SELL

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Privat's recent announcement that it may sell its stake looks like another attempt to get the state's hand away from Ukrnafta's neck. Last year, the company missed our pessimistic expectations by a wide margin, making its stock price growth hardly justified. This year we expect Privat to win at least a small favor from the new government and get a higher gas price. However, that would still fall short of a complete recovery. Our valuation suggests a 16% downside; we reiterate our SELL recommendation.

Tickers

PFTS	UNAF
GDR (Frankfurt/Xetra)	UKAA

Market information

Market price, USD	77.4
MCap, USD mln	4,197.3
Chg 12M	16.5%
Hi/Lo 12M, USD	99.2/62.0
DRs per common share	1:6
No of shares, mln	54.23
Avg Mon Tr Vol YTD, USD mln	12.1
Free float	8.0%
Free float, USD mln	335.8

Prices as of Jan.18, 2007

Corporate Governance

Concorde Rating*	AA

** The rating is based on Concorde Capital's corporate governance survey. Q denotes quality corporate governance standards, AA - above average standards, A - average, BA - below average and P – poor.*

Shareholders

Naftogaz of Ukraine	50%+1
Privat Group	42%
Other	8%

Upcoming events

EGM*	Jan. 23, 2008

** Agenda includes an issue on distribution of 2006 earnings. Yet, we expect that shareholders will postpone it until 2008 AGM*

Heavy cavalry in use: Privat says it may consider sell-out

Last Friday, one of Privat's owners, Hennadiy Bogolyubov, said the group may consider selling its stake, probably to Russians, if it doesn't reach a compromise with the state. So far, the news looks like another argument in its negotiations for higher gas prices and lower production taxes. Combined with Privat's other levers, such as dividend payouts for 2006-07, it could be a successful move. A sell-out could also trigger value through higher managerial efficiency, yet we believe it is a matter of the more distant future.

Oil net-backs down 8% last year, no chance for lower royalty

As we expected, last year's increase in Ukrnafta's annual average realized oil price was more than eaten up by higher royalties: average net-back price decreased by 8% yoy, forcing the segment's net revenue down by an estimated 11%. With oil business accounting for more than 70% of 2007 EBITDA, ROIC slashed from previous year's 30% to 13% - below Ukrnafta's cost of capital. As royalties take 2.5% in the state budget, and given increasing social burden, we do not expect the rates to be lowered.

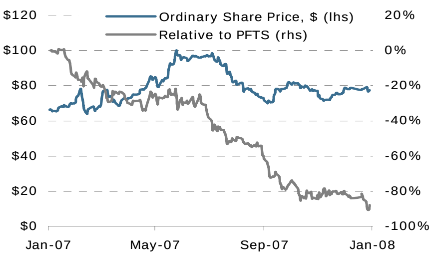
Gas segment: Disappointing 2007, the key to recovery

Ukrnafta's gas business brought the most disappointing result. Due to price caps and sales carried forward, the segment's net revenue slumped over 5x yoy, while gas EBITDA went into the red. With no relief on the production side and higher oil prices already factored in, gas segment performance is the key to value recovery. We expect gas business to contribute ~2/3 of total revenue surplus this year, and remain the most powerful top line driver.

Negatives yet to be priced in, we see 15% downside

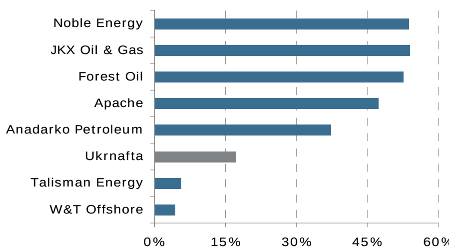
On galloping oil prices and the local market rally, Ukrnafta stock took off at a high clip in a beginning of last year, even though it had more reasons to fall than to appreciate. We believe, in the expectation of good news, last year's negatives will keep the stock trading somewhere around USD 65-70 per share, where UNAF seems to have strong support. The company may also pay up to 40% of 2006-07 earnings in dividends, yet cumulative 2Y DPS of USD 5.1 per share (6.5% yield) is still not enough to hold the stock at its current price.

Stock performance

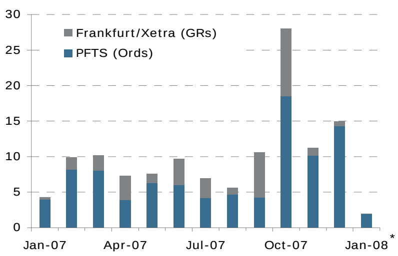


** for the period from Jan.1 to Jan.21, 08*
Source: Bloomberg, PFTS

Sector performance, 12M



Trading volume, USD mln



Key financials & ratios, USD mln

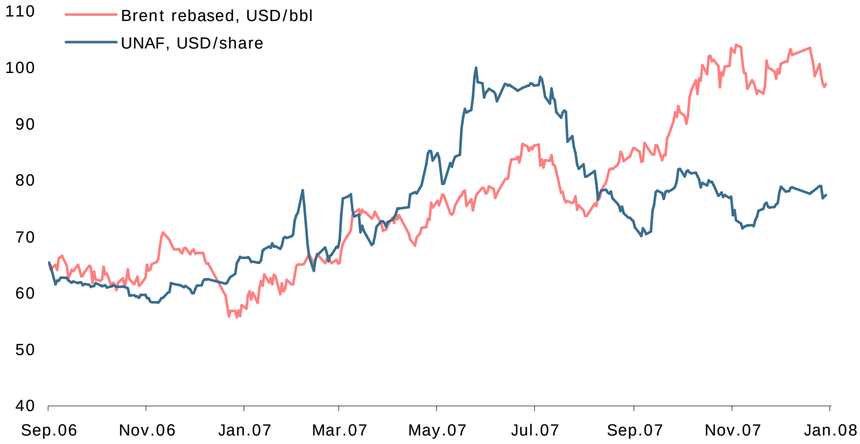
	Revenue	EBITDA	Net Income	EBITDA Mgn	Net Mgn	CPS	EPS	DPS	EV/EBITDA	P/CF	P/E
2006	1,659	748	478	45.1%	28.8%	10.60	8.81	3.52	5.77	7.3	8.79
2007E	1,097	454	208	41.4%	18.9%	5.31	3.83	1.53	9.59	14.6	20.22
2008E	1,385	623	321	44.9%	23.2%	8.48	5.92	2.37	7.18	9.1	13.07
2009E	1,572	742	395	47.2%	25.1%	10.08	7.28	5.46	5.92	7.7	10.62

Spot exchange rate: 5.05 UAH/USD
Source: Company data, Concorde Capital estimates

Negatives yet to be priced in

On galloping oil prices and the local market rally, Ukrnafta stock took off at a high clip in a beginning of last year, even though it had more reasons to fall than to appreciate. We believe, in the expectation of good news, last year's negatives will keep the stock trading somewhere around USD 65-70 per share, where UNAF seems to have strong support.

Ukrnafta stock price vs. Brent

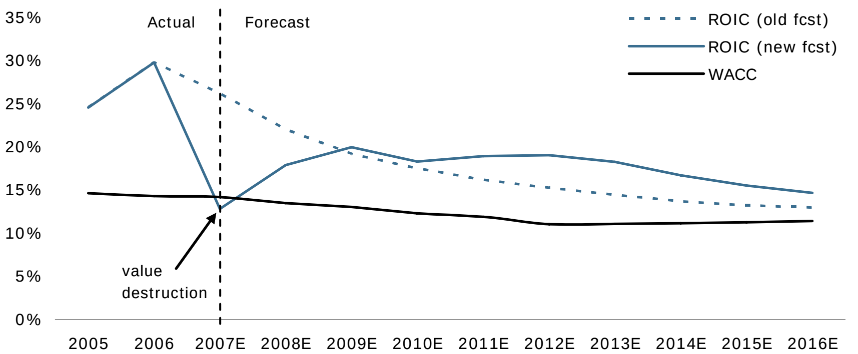


Source: Bloomberg, PFTS

In the second half of 2007, the market began realizing that Ukrnafta is missing on soaring oil prices, and the stock detached from Brent trend.

On the fundamentals side, underperformance in 2007 pushed the company's ROIC down to 12.9%, twice below our forecast and below its cost of capital:

ROIC vs. WACC



Source: Concorde Capital estimates

Investment case:

- average oil net-back prices down, despite growth of oil prices globally
- realized gas price decreased 40% yoy, capped below cost; ~60% of 2007 gas sales were carried forward
- potential for production growth is limited
- retail expansion stopped, revival unlikely
- prospects for vertical integration remain foggy

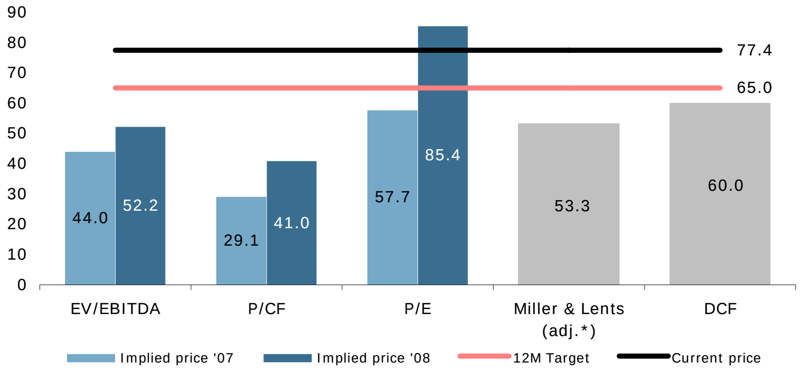
\+ oil price forecast upgraded
\+ low leverage, no restrictions to new projects from the financing side
\+ in long term, Privat's sell out could bring in new management and higher efficiency

Valuation

Our valuation includes (1) a peer comparison on profitability and cash flow multiples, (2) valuation based on data from the recent reserves report, and (3) DCF analysis. We set our 12-month target price at USD 65 per share, slightly above what DCF valuation suggests, to account for higher earnings-based valuations. Although there is a chance that Ukrnafta could pay out up to 40% of 2006-2007 earnings in dividends, USD 5.1 per share (6.5% yield) is still not enough to justify holding the stock at its current price.

We do not believe that in the near future Ukrnafta will experience tougher times than it has already had and the historical support at USD 65 per share is unlikely to be broken.

Valuation summary chart



** Estimated based on an evaluation of reserves and future operating income by Miller & Lents as of June 30, 2007, adjusted for CapEx and Net Debt*

Source: Thomson Financial, Bloomberg, Concorde Capital estimates

Relative valuation

With virtually its whole EBITDA generated by its upstream business, Ukrnafta is and will remain essentially an exploration and production company. Our retuned peer group includes only E&P companies with similar production profiles (share of oil and gas in hydrocarbons extracted). As before, we do not separate our peers geographically, as we believe that environmentally Ukrnafta stands as far from its CIS peers as it is from peers in the U.S. We also avoid relatively young companies, by limiting our sample at USD 2 bln MCap from below.

The stock is currently trading at a 46% premium on EV/EBITDA '08 and an even higher premium on Price/Cash Flow, which we provide as a consistency check.

At first sight, the stock appears underpriced on P/E, but a more careful look indicates the discount is justified. Although Ukrnafta does have a lower interest expense (and higher net margin) compared to generally higher leveraged peers, in contrast it lacks an exploration upside, and its long-term growth potential is rather limited. Also, the increasing cost of debt, brought on by the subprime crisis, could not be fully factored into peer valuations.

Peer comparison summary

		MCap, USD mln	EBITDA Mgn		Net Mgn		EV/EBITDA		P/CF		P/E	
			2007E	2008E	2007E	2008E	2007E	2008E	2007E	2008E	2007E	2008E
Ukrnafta	**Ukraine**	**4,197**	**41.4%**	**44.9%**	**18.9%**	**23.2%**	**9.59**	**7.18**	**14.59**	**9.13**	**20.22**	**13.07**
Apache	United States	33,225	73.9%	73.5%	26.0%	27.5%	5.28	4.72	5.76	5.11	13.32	11.28
Anadarko Petroleum	United States	28,704	62.0%	64.4%	14.5%	14.8%	5.93	5.60	6.94	5.27	17.46	17.12
Talisman Energy	Canada	19,153	58.2%	61.3%	15.1%	14.0%	4.79	4.07	4.26	3.72	14.67	14.26
Noble Energy	United States	13,039	73.9%	75.5%	28.5%	26.0%	6.49	5.87	6.37	5.91	14.94	15.34
Forest Oil	United States	4,296	75.1%	76.4%	19.5%	19.8%	7.24	5.24	5.20	4.56	19.70	14.60
W&T Offshore	United States	2,172	70.5%	73.6%	13.6%	14.2%	4.01	3.45	3.26	2.93	15.23	13.82
Mean			68.9%	70.8%	19.5%	19.4%	5.62	4.83	5.30	4.58	15.89	14.40
Median			73.9%	73.5%	17.3%	17.3%	5.61	4.98	5.48	4.83	15.08	14.43
Prem/Disc to mean							70.6%	48.7%	175.3%	99.3%	27.3%	-9.2%
Prem/Disc to median							71.1%	44.1%	166.3%	89.0%	34.1%	-9.4%
Implied price @ mean, USD							44.2	**50.4**	28.1	**38.8**	60.8	**85.3**
Implied price @ median, USD							44.0	**52.2**	29.1	**41.0**	57.7	**85.4**

Source: Company data, Thomson Financial, Bloomberg, Concorde Capital estimates

Notably, valuation against the only comparable Ukraine-based E&P company, JKX Oil & Gas, provides more consistent results, ranging from USD 65.5 implied price per share on P/E ’08, to USD 70.8 on EV/EBITDA ‘08. We do not include JKX into the peer group, due its different production profile, but the comparison to JKX suggests that the peers' P/E of 14.2x could indeed be too high for Ukrnafta.

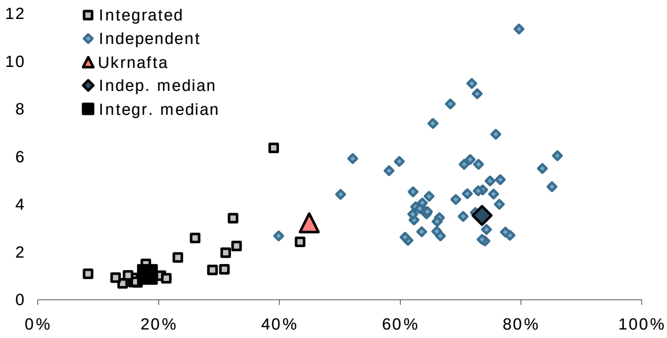
Ukrnafta vs. JKX Oil & Gas

		MCap, USD mln	EBITDA Mgn		Net Mgn		EV/EBITDA		P/CF		P/E	
							2007E	2008E	2007E	2008E	2007E	2008E
Ukrnafta	**Ukraine**	**4,197**	**41.4%**	**44.9%**	**18.9%**	**23.2%**	**9.59**	**7.18**	**14.59**	**9.13**	**20.22**	**13.07**
JKX Oil & Gas	UK/Ukraine*	1,174	75.8%	76.6%	51.7%	52.3%	8.18	6.59	9.78	7.89	13.12	11.02
Prem/Disc							17.3%	8.9%	49.2%	15.7%	54.1%	18.6%
Implied price, USD							65.6	**70.6**	51.9	**66.9**	50.2	**65.3**

** Registered in UK, key assets are located in Ukraine*
Source: Company data, Thomson Financial, Bloomberg, Concorde Capital estimates

EV/S is still hardly applicable. We still avoid valuing Ukrnafta on revenue multiples. It is hardly comparable with integrated companies due to the absence of a midstream component, or with pure E&P businesses due to presence of retail operations (see below).

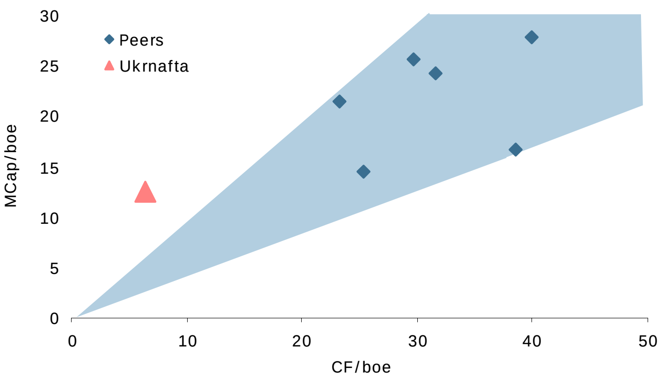
EV/S vs. EBITDA margin (2008E)



Source: Thomson Financial, Bloomberg, Concorde Capital estimates

Production and reserves multiples over-estimative. We warn against applying production and reserves multiples to Ukrnafta: its ~30% discount to peers is fully justified by ~5x lower cash flow per barrel of oil equivalent (boe) produced annually. Cash remains king: in our sample, EV/boe follow CF/boe and EBITDA/boe ratios. For the same reason, comparison on EV/Reserves is also misleading.

MCap/boe vs. CF/boe



Source: Thomson Financial, Bloomberg, company data, OilVoice, oilbarrel.com

New reserves evaluation points to a 32% downside. In their recent reserves evaluation report, Miller and Lents Ltd., an international oil and gas consultancy, provided an estimate of the NPV of Ukrnafta's free cash flow. Discounted at a 10% annual rate, it amounts to USD 5.9 bln. After making necessary adjustments, we arrived at a fair equity value of USD 2.9 bln, or USD 53.3 per share. This is pretty close to the results of our relative valuation and DCF modeling. The adjustments included:

- Higher discount factor of 14%, better capturing Ukrnafta's cost of capital.
- Larger CapEx, as the amount used by Miller & Lents covers only one-year of the company's CapEx needs.
- Net Debt. Technically, Miller & Lents's net future value is the cumulative cash flow to the firm, or enterprise value. Therefore, we subtract net debt.

Summary of reserves evaluation by Miller and Lents (June 2007)

	Net reserves		Net future value	
	Oil and gas liquids, mmbbl	Gas, bcf	Undiscounted, USD mln	Discounted at 10% p.a., USD mln
Proved developed	300.2	1,589.6	11,588.4	5,337.9
Producing	277.8	1,447.6	10,819.6	4,903.2
Non-producing	22.4	142.0	768.8	434.7
Proved Undeveloped	52.3	285.8	2,071.2	754.2
Additional future capital	-	-	(320.2)	(211.3)
Total proved reserves	**352.5**	**1,875.3**	**13,339.4**	**5,880.8**
Probable	31.1	665.7	2,880.2	919.3
Total Proved and Probable	**383.6**	**2,541.0**	**16,219.6**	**6,800.1**
Possible	13.2	184.4	843.1	246.1
Total reserves	**396.8**	**2,725.4**	**17,062.7**	**7,046.2**

Source: Miller and Lents report as of June 30, 2007

DCF valuation

The most material positive change to our model was an oil price forecast upgrade. However, its effect was almost completely eaten up by a combination of negative factors, such as a proportional increase in future effective royalties, downgraded production forecasts, and lower-than-expected gas volume sales and prices. Given a projected decrease in extraction volumes, our assumption of perpetuity growth rate of 2% aims at capturing the possibility of recovery in production rates in the distant future.

Forecast revision summary

		Updated			Previous			Change		
		2007E	2008E	2009E	2007E	2008E	2009E	2007E	2008E	2009E
Financials										
Gross revenue	USD mln	2,723	3,246	3,568	3,548	4,159	4,989	-23%	-22%	-28%
Royalty	USD mln	689	781	782	717	720	724	-4%	8%	8%
Net revenue	USD mln	1,097	1,385	1,572	2,053	2,538	3,184	-47%	-45%	-51%
Gross profit	USD mln	624	817	947	768	845	924	-19%	-3%	2%
Gross margin	%	56.9%	59.0%	60.3%	37.4%	33.3%	29.0%	20p.p.	26p.p.	31p.p.
SG&A and other	USD mln	(148)	(168)	(176)	(146)	(183)	(232)	1%	-8%	-24%
EBITDA	USD mln	454	623	742	622	663	692	-27%	-6%	7%
EBITDA margin	%	41.4%	44.9%	47.2%	30.3%	26.1%	21.7%	11p.p.	19p.p.	26p.p.
Depreciation	USD mln	(141)	(160)	(182)	(152)	(175)	(196)	-7%	-9%	-7%
EBIT	USD mln	313	462	560	470	488	496	-33%	-5%	13%
EBIT margin	%	28.5%	33.4%	35.6%	22.9%	19.2%	15.6%	6p.p.	14p.p.	20p.p.
Net income	USD mln	208	321	395	344	350	349	-40%	-8%	13%
Net margin	%	18.9%	23.2%	25.1%	16.8%	13.8%	10.9%	2p.p.	9p.p.	14p.p.
Net Debt	USD mln	158	270	195	266	392	480	-41%	-31%	-59%
CapEx	USD mln	(323)	(280)	(334)	(455)	(433)	(407)	-29%	-35%	-18%
Production										
Oil & condensate	mmbbl	23.4	23.1	22.9	23.9	23.9	23.9	-2%	-3%	-4%
Gas	bcm	3,238	3,189	3,110	3,435.3	3,435.3	3,435.3	-6%	-7%	-9%
Gas liquids	mmbbl	452.7	452.7	452.7	415.2	415.2	415.2	9%	9%	9%
Marketing										
Oil & condensate	mmbbl	21.6	21.4	21.2	20.9	20.9	20.9	3%	2%	1%
Gas	bcm	930.0	2,354.2	2,610.3	2,061.2	2,061.2	2,061.2	-55%	14%	27%
Gas liquids	ths mt	432.5	421.2	421.2	389.2	389.2	389.2	11%	8%	8%
Oil products	ths mt	821.3	824.9	824.9	1,391.4	1,767.1	2,282.4	-41%	-53%	-64%
# of fuel stations		565	565	565	748	868	947	-24%	-35%	-40%
Prices, ex. VAT										
Oil price - Brent	USD/bbl	72.8	80.2	80.2	65.3	65.3	65.3	11%	23%	23%
Oil price – Urals	USD/bbl	69.7	76.8	76.8	61.1	61.1	61.1	14%	26%	26%
Oil price – Ukrnafta	USD/bbl	58.7	67.6	68.4	55.9	56.2	56.5	5%	20%	21%
Gas price – Ukraine border	USD/tcm	130.0	179.5	230.0	130.0	180.0	230.0	0%	0%	0%
Gas price – Ukrnafta	USD/tcm	52.6	97.6	138.0	118.9	142.0	156.2	-56%	-31%	-12%

Source: Company data, Bloomberg, Concorde Capital estimates

DCF output

Valuation as of January
UAH mln

	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
EBITDA	2,293	3,113	3,710	3,830	4,200	4,523	4,661	4,602	4,558	4,549
EBIT	1,580	2,312	2,799	2,808	3,059	3,260	3,275	3,096	2,933	2,801
Tax Rate	25%	25%	25%	25%	25%	25%	25%	25%	25%	25%
Taxed EBIT	1,185	1,734	2,099	2,106	2,295	2,445	2,457	2,322	2,200	2,101
Plus D&A	713	801	911	1,023	1,141	1,263	1,385	1,506	1,625	1,748
Less CapEx	-1,632	-1,401	-1,669	-1,685	-1,764	-1,809	-1,818	-1,795	-1,778	-1,820
Less change in OWC	-305	-107	-153	35	-38	-32	-15	9	11	0
FCFF	-	-	1,188	1,478	1,633	1,867	2,009	2,042	2,058	2,029
WACC	14.2%	13.5%	13.1%	12.3%	11.9%	11.1%	11.1%	11.2%	11.3%	11.4%

Sum of discounted CFs	8,566	WACC To Perpetuity	11.5%
PV of Terminal Value	9,046	Terminal Value	21,781
Firm Value	17,612	Perpetuity Growth Rate	2.0%
Portion due to TV	*51.4%*	Implied Exit EBITDA Multiple	4.8x
Less Net Debt	-1,337		
Equity Value	16,275		
Implied 12M share price, UAH	**300.1**		
Implied 12M share price*, USD	**60.0**		

** 2008 UAH/USD rate forecast: 5.00*

Sensitivity of Ukrnafta 12M DCF implied price, USD per share

10-Year Discount Rates	Perpetuity Growth Rate				
	2.0%	*2.5%*	*3.0%*	*3.5%*	*4.0%*
WACC-1.0%	48.8	56.3	63.7	71.2	78.7
WACC-0.5%	47.4	54.6	61.9	69.1	76.3
WACC+0.0%	46.1	53.1	**60.0**	67.0	74.0
WACC+0.5%	44.8	51.5	58.3	65.0	71.7
WACC+1.0%	43.6	50.1	56.6	63.1	69.5

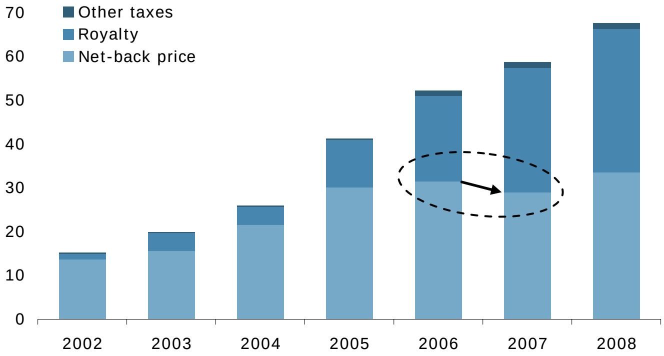
WACC to perpetuity	Perpetuity Growth Rate				
	1.0%	*1.5%*	*2.0%*	*2.5%*	*3.0%*
10.5%	59.7	61.7	63.9	66.4	69.3
11.0%	58.0	59.8	61.9	64.1	66.7
11.5%	56.6	58.2	**60.0**	62.1	64.3
12.0%	55.2	56.7	58.4	60.2	62.2
12.5%	54.0	55.4	56.9	58.5	60.4

Source: Concorde Capital estimates

Oil price up, net-backs down

Notwithstanding a 12.4% increase in Ukrnafta's annual average realized oil price, on par with the 11.3% Brent buildup, the effect was more than eaten up by higher royalties. As we expected, the company's net-back oil price decreased in 2007 by 7.7% on a 28.3% hike in the effective royalty rate.

Ukrnafta oil net-backs stumbled in 2007, USD/bbl



Source: Company data, Concorde Capital estimates

No chance for lower taxes, another increase is still a risk. We keep our view that there is no chance of downward royalty revision. Royalties are an important source of state budget income (~2.5% of the 2008 budget plan) and we see no alternative funding that could compensate for a reduction in royalty receipts. The draft budget law also assumes no change in royalty rates in 2008. Pressure from social spending pursued by the new government will be high in 2008 and will not ease in 2009 because of the presidential campaign.

Despite already high production taxes that make Ukrnafta's net-backs comparable to those of Russian E&P firms, the new government proposed another rise, right after its appointment last month. Ukrnafta's CFO disclosed that the idea was to increase the upper level of the base royalty from UAH 1090/mt (USD 29.4/bbl) to UAH 2000/mt (USD 54/bbl). We estimate that net-back prices would decrease respectively by ~45%, to USD 16/bbl. Ukrnafta was successful in a short fight to maintain royalty rates, but risk of another increase, possibly pushed by a state budget deficit, remains.

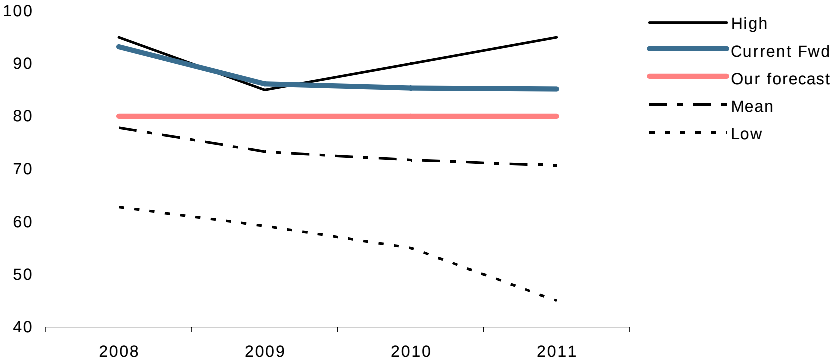
Reference: Royalty mechanics

The base oil royalty ranges from UAH 404 per mt of oil extracted (USD 10.9/bbl) for wells deeper than 5 km to UAH 1090/mt (USD 29.4/bbl) for shallower wells. The effective royalty is calculated as the base rate multiplied by the ratio of the highest of domestic auction prices and the average price of Russian supplies for the last month to the auction price in Oct. 2005 (UAH 1941/mt, or USD 52.4/bbl). This formula implies that every USD 1 increase in oil price translates into about USD 0.47 of Ukrnafta's realized price.

Gas royalties are UAH 50/tcm for gas for wells shallower than 5 km, and zero otherwise. The gas royalty is not linked to its price, and is also paid on the physical volume extracted.

Oil price forecast upgraded. Last year's average Brent price ended at around USD 6 higher than our forecast (USD 67/bbl). When it was made, it was one of the most bullish forecasts on the market, materially exceeding the USD 55-60 expected by global and Russian banks. We maintain our bullish view on future oil prices, which we believe to be effectively propped up by global producers' increased need for exploration and development CapEx, in addition to traditional factors.

Oil price forecasts by global banks*



** The sample excludes extremely aggressive forecast by Fortis. See Appendix 1 for a complete list.*
Source: Bloomberg, Concorde Capital

Ukrnafta's 2007 average realized oil price, USD 58.6/bbl, exceeded our forecast by 5%. For 2008 and on, we upgrade our forecasts according to revised Brent assumptions, by roughly 20% on average.

Gas business the key to recovery

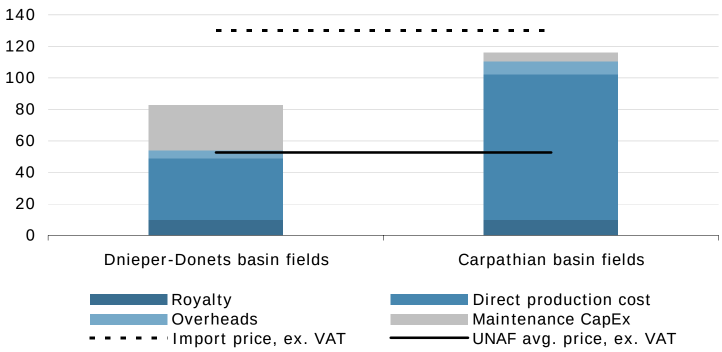
Ukrnafta's gas business brought the most disappointing results last year: the segment's net revenue slumped by over 5x yoy, from USD 467 mln to an estimated USD 86 mln. The two reasons were price caps and lower than expected sales in physical volume. In contrast to the hike in production taxes, gas business negatives were unexpected and directly affected Ukrnafta's value.

On the other hand, performance of the gas segment is the key to top line and EBITDA recovery in 2008; we estimate it will contribute ~2/3 of total revenue surplus. We forecast 2008 gas revenue at USD 972 mln, driven by both higher prices and sales in physical terms.

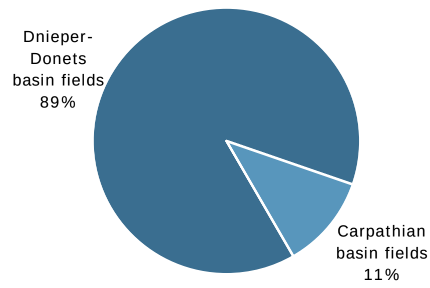
Gas segment 2007 result in the red. Notwithstanding 37% growth in the price of imported gas, Ukrnafta generated losses on gas sales. In 2007 the government obliged all state-owned producers and their partners to sell gas at the regulated price of USD 53/tcm ex-VAT (a 60% discount to the import price), to sole buyer, Naftogaz of Ukraine. As a result, the company's realized price decreased 40% yoy, 56% below our forecast and 5% below production cost.

Ukrnafta's management disclosed to us unimpressive data on the profitability of its gas business, which implies the average cash loss at ~USD 8/tcm, not considering maintenance (workover, etc.) CapEx.

Natural gas: OpEx and maintenance CapEx, USD/tcm



Gas production by origin, 2007

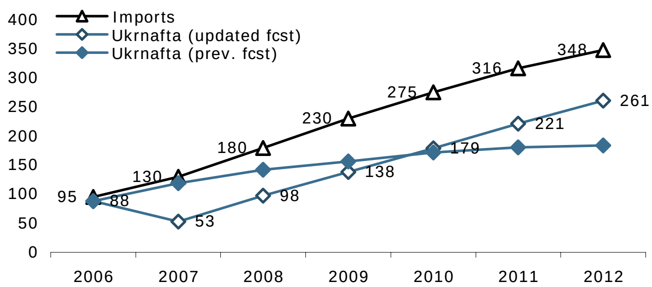


Source: Company data

Price catch-up postponed, yet inevitable. We believe the price cap is unlikely to be removed in 2008. The state's attitude toward treating Ukrnafta as a milk cow, regardless of the government's political color, does not offer enough reasons for assuming a rapid catch up in the company's gas price realizations. We believe that things can change only if the state's stake is privatized, which remains uncertain for at least the next three-five years.

Meanwhile, we account for Privat's considerable leverage in Ukrnafta, which is likely to help lift the cap itself. We assume the 2008 gas price at USD 98/tcm (+84% yoy), which still implies a 31% downgrade from our previous forecast (USD 142/tcm).

Gas price: Ukrnafta vs. imports, USD/tcm



Source: Concorde Capital estimates

We also think that next year the president will push the government to raise gas tariffs for the population, to avoid an even sharper increase during the presidential election campaign in 2009. A twofold jump in tariffs is currently being propagated by the presidential administration and industry insiders.

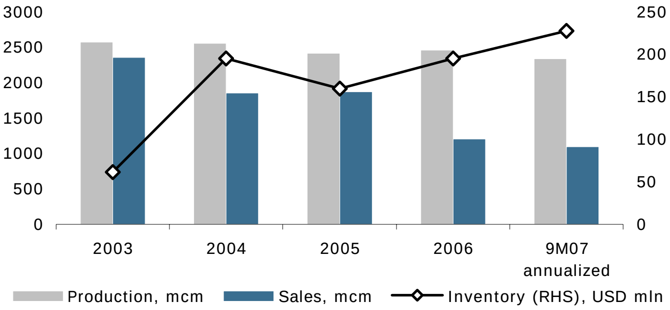
In the longer term, we believe that Ukraine's gas market will approach a European pattern, where public consumers pay a substantially higher price than the industry.

Reference: Privat's leverage in Ukrnafta
With a majority on the Management Board, Privat group has the following ways to employ operating control in bargaining for a higher gas price:

- Ukrnafta accumulated a considerable volume of gas in storages, instead of selling it at a capped price, thus provoking a supply shortage to Naftogaz. The deficit in the country can only be covered by imports, a much more expensive source.
- Privat is able to block dividend payouts. Distribution of 2006 profits was already effectively postponed until Jan. 2008. At the EGM tomorrow Privat can vote for an around 40% payout ratio, but without consensus on the gas issue, Naftogaz won't see anything.
- Closer ties to the president. This year Igor Palytsya, Ukrnafta ex-chairman and Privat ally, joined the pro-presidential Our Ukraine party. Besides more support in general, this decreases the probability of the president signing the law on reducing the minimum quorum for shareholder meetings to 50%, which would have enabled Naftogaz to pass decisions without Privat's votes.
- In the most extreme case, the group could make the state more compliant with the idea of selling out to Russians, which was already spelled out recently by Bogolyubov, one of Privat owners.

Caps motivate storage, sales to recover in 2008-09. Recently the government allowed Naftogaz to purchase 3.5 bcm of gas not sold by Ukrnafta over 2006-07. Company CFO confirmed us that Ukrnafta deferred sales of 2.1 bcm of gas produced in 2006 and 1.4 bcm produced in 2007 (out of this, Ukrnafta's ownership for only 1.5 bcm can be evidenced by proper documentation). Thus, our guess that the company was pumping unusually large volumes into storages was correct (see our comment to the news of May 5, 2007). Ukrnafta's balance sheet reflects the situation pretty well: inventory accounts were growing in line with decreasing sales in physical terms.

Natural gas production and sales vs. inventory account



Source: Company data, Concorde Capital calculations

Capped gas prices made other producers also deferred gas sales this year. Some of them, e.g. Cardinal Resources and Regal Petroleum, could not wait long enough and had to divest.

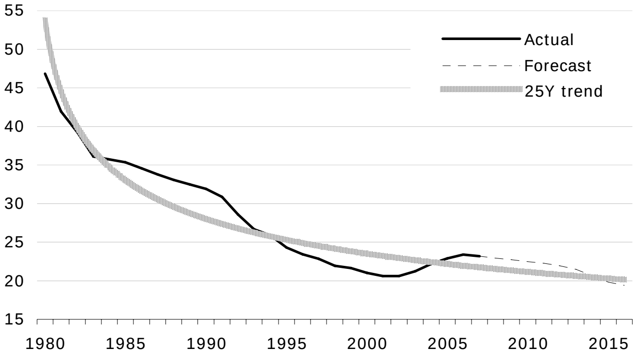
Although the price indicated by the government for purchasing unsold volumes just equals the current cap, we consider the news positive for the company. Even if stored gas is sold at a capped price, the company will be able to recover at least a portion of the value lost in 2006-07. Second, and perhaps more importantly, selling stored gas is likely to be conditional on the price. That is, we expect Ukrnafta to sell this gas only if the government lifts the cap. Otherwise, Naftogaz will have to cover the deficit with imports, a much more expensive source. The potential loss could exceed USD 150 mln (at Ukrnafta 2008 projected price of USD 98/tcm).

We estimate that in 2007 Ukrnafta sold about 0.93 bcm in total. We assume that in addition to natural sales of ~2.4 bcm/y, an additional volume of 1.5 cm will be sold over 2008-2009 from storage.

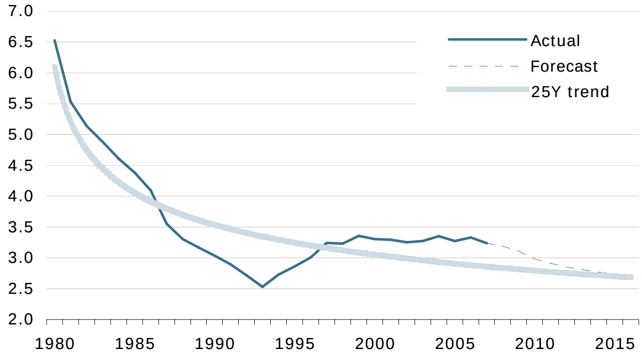
No relief on the production side

In 2007 Ukrnafta posted a 0.9% decrease in oil and condensate output, and a 2.8% fall in gas production. Based on 25Y trends, and a long-lived lack of expansion projects, we forecast Ukrnafta's hydrocarbon production to decrease at 2% CAGR over 2008-16, generally in line with management's guidance. Cumulative production over that period will amount to 358 mln boe, or around 52% of its P1 reserves. Consistency of our production forecast is indirectly supported by the 51% portion of terminal value in our DCF valuation.

Oil production, mln bbl



Gas production, bcm



Source: Company data, Concorde Capital estimates

Mythical VIC

We do not share the long-lived view that vertical integration is a value trigger for Ukrnafta. Our belief is that in at least the next 3-5 years Ukrnafta will remain a pure upstream business, with its rudimentary retail wing making an extremely minor contribution to operating income. Integration with a local refinery still looks possible in the long-term and depends on the political will to privatize Ukrnafta.

Ukrtatnafta issue. There are rumors that the recent conflict between the shareholders of one of the largest local refineries, Ukrtatnafta, was initiated by Privat group. The transfer of a 18% stake in the refinery from private Russia-related shareholders to Naftogaz of Ukraine in 2007 is currently being protested in the courts.

Ukrtatnafta seems to be the only realistic candidate for the missing mid-stream piece to Privat's oil business. The refinery is 43% owned by the state (not accounting for the disputable stake) and was specifically designed to refine locally produced crude; its capacity is sufficient to refine all of Ukrnafta's oil. Ukrnafta's potential synergy from integration with Naftokhimik (NAFP) and Galychyna (HANZ) refineries, controlled by Privat, are minor, if any, due to the low quality of their products and their critical need for a large-scale modernization, which may cost around USD 500 mln.

It is premature to make any conclusions, but there is a possibility that Privat is counting either on privatization of the state's stake in Ukrtatnafta, or on transferring the stake to Ukrnafta. Our view is that the first option can be realized only if the state loses the fight over the disputed 18%, while the second option seems conditional on the nationalization of Privat's stake in Ukrnafta, which seems less realistic.

Retail expansion stopped

Further expansion into downstream seems rather unlikely:

- Privat has little interest in selling its remaining retail assets to Ukrnafta, as it can gain more by capitalizing that business separately. The example of Galnaftogaz shows that the market value of a retail chain can exceed USD 2 mln per station – a price Ukrnafta's majority shareholder, the state, is unlikely to approve

- Local refineries, including Privat-related ones, are unable to supply enough products of reasonable quality. Competition from both independent and integrated retailers is dramatically increasing and quality gains more weight as a decisive factor of consumer choice

- We believe that the state is more likely to target ROIC rather than growth. We forecast that it will oppose any substantial investments in order to maximize dividends in the short-term

Response to hand controls: Sales on commission. Last year the government introduced regulation linking retail fuel prices to the price of oil according to a formula which also accounts for fuel station's operating costs and required return on capital. To avoid sanctions for a possible break of the 'recommended' price range set by authorities, Ukrnafta shifted toward selling oil products on commission. We estimate that in 2007 ~70% of oil products were sold on commission. This explains the dramatic difference between reported sales and our forecast. Margins were slightly affected as well, due to the fact that commission markup is a part of the top line.

Ukrnafta oil products sales in 2007, USD mln

	Forecast	Actual*
Gross sales	8,337	4,309
VAT and excise tax	(1,689)	(746)
Other deductions**	(0)	(2,429)
Net sales	**6,648**	**1,134**

** Estimated*
*** Includes value of sales on commission*
Source: Concorde Capital estimates

Appendix 1. Oil price forecasts

	As Of	2008	2009	2010	2011
Barclays	18.01.08	85.8	71.1	72.8	n/a
UBS Securities	17.01.08	86.0	79.0	75.0	78.0
Fortis	16.01.08	n/a	112.2	139.4	174.1
Standard Chartered Bank	15.01.08	74.0	n/a	n/a	n/a
Deutsche Bank	11.01.08	72.7	85.0	80.0	75.0
McKinnon & Clarke	10.01.08	80.0	85.0	90.0	95.0
JPMorgan Chase	09.01.08	76.0	69.0	n/a	n/a
ABN Amro	08.01.08	75.0	65.0	55.0	45.0
Banc of America Securities	07.01.08	69.0	69.0	69.0	69.0
Citigroup	20.12.07	80.0	75.0	75.0	n/a
Societe Generale	14.12.07	80.4	74.0	69.0	71.0
Merrill Lynch	12.12.07	82.0	70.0	n/a	n/a
Economist Intelligence Unit	03.12.07	78.0	72.0	66.0	69.0
Morgan Stanley	03.12.07	78.0	81.0	83.0	85.0
UniCredit	30.11.07	95.0	n/a	n/a	n/a
Raiffeisen	30.11.07	76.0	72.0	68.0	70.0
ING	26.11.07	74.0	68.0	62.0	57.0
Commerzbank	16.11.07	70.3	n/a	n/a	n/a
Lehman Brothers	09.11.07	84.0	78.0	n/a	n/a
BNP Paribas	05.11.07	87.0	n/a	n/a	n/a
Credit Suisse	02.10.07	68.0	n/a	n/a	n/a
National Australia Bank	27.09.07	62.8	59.2	n/a	n/a

Source: Bloomberg

Appendix 2. Glossary and conversion factors

bbl	barrel of oil
bcf	billion cubic feet
bcm	billion cubic meters of natural gas
boe	barrel of oil equivalent
Brent	European Dated Brent Forties Oseberg Spot Price, a reference oil price
cm	cubic meters of natural gas
mcm	million cubic meters of natural gas
mmbbl	million barrels of oil
mt	metric ton
net-back price	the price excluding production taxes (e.g. royalty), VAT, excise and other indirect taxes
tcm	thousand cubic meters of natural gas
P1 reserves	Proved Reserves as per SPE classification

Conversion factors:

1 cm of natural gas	= 35.3 cf
1 boe of natural gas	= 160.2 cm
1 mt of oil	= 7.3 bbl
1 mt of condensate	= 8.0 bbl

Financial Statements, IFRS

Income Statement Summary, USD mln

	2005	2006	2007E	2008E	2009E	2010E	2011E	2012E
Gross Revenue	**1,628**	**2,582**	**2,723**	**3,246**	**3,568**	**3,570**	**3,672**	**3,753**
Royalty	(242)	(476)	(689)	(781)	(782)	(781)	(780)	(775)
VAT	(271)	(427)	(449)	(536)	(589)	(589)	(606)	(619)
Other deductions	(27)	(20)	(488)	(544)	(626)	(634)	(641)	(647)
Net Revenues	**1,088**	**1,659**	**1,097**	**1,385**	**1,572**	**1,566**	**1,645**	**1,711**
Gross Profit	691	965	624	817	947	963	1,034	1,095
Gross margin	64%	58%	57%	59%	60%	61%	63%	64%
SG&A	(108)	(145)	(148)	(168)	(176)	(168)	(165)	(160)
Other Operating Income/Costs, net	3	(72)	(22)	(26)	(29)	(29)	(29)	(30)
EBITDA	**586**	**748**	**454**	**623**	**742**	**766**	**840**	**905**
EBITDA margin	53.9%	45.1%	41.4%	44.9%	47.2%	48.9%	51.1%	52.9%
Depreciation	(100)	(114)	(141)	(160)	(182)	(205)	(228)	(253)
EBIT	**486**	**634**	**313**	**462**	**560**	**562**	**612**	**652**
EBIT margin	44.7%	38.2%	28.5%	33.4%	35.6%	35.8%	37.2%	38.1%
Interest Expense	(11)	(17)	(20)	(26)	(28)	(25)	(26)	(24)
Financial income	24	30	6	6	6	6	5	5
Other income/(expense)	(13)	(17)	(23)	(14)	(11)	(8)	(5)	(2)
PBT	**486**	**630**	**277**	**428**	**527**	**534**	**587**	**631**
Tax	(121)	(152)	(69)	(107)	(132)	(134)	(147)	(158)
Net Income	**365**	**478**	**208**	**321**	**395**	**401**	**440**	**473**
Net Margin	34%	28.8%	18.9%	23.2%	25.1%	25.6%	26.8%	27.7%
Dividends declared	365	191	83	128	296	301	330	355

Balance Sheet Summary, USD mln

	2005	2006	2007E	2008F	2009F	2010F	2011F	2012F
Current Assets	**341**	**397**	**472**	**513**	**562**	**554**	**568**	**580**
Cash & Equivalents	15	75	41	51	58	58	61	63
Trade Receivables	39	18	120	152	172	172	180	188
Inventories	160	196	220	218	240	232	234	236
Other current assets	127	109	91	92	92	92	92	92
Fixed Assets	**1,255**	**1,463**	**1,650**	**1,800**	**1,961**	**2,093**	**2,222**	**2,334**
PP&E, net	1,056	1,215	1,333	1,466	1,618	1,750	1,875	1,984
Other Fixed Assets	199	249	317	334	343	343	347	350
Total Assets	**1,595**	**1,860**	**2,122**	**2,313**	**2,523**	**2,647**	**2,790**	**2,914**
Shareholders' Equity	**1,401**	**1,508**	**1,716**	**1,777**	**2,044**	**2,148**	**2,288**	**2,431**
Share Capital	3	3	3	3	3	3	3	3
Reserves and Other	1,398	1,506	1,713	1,774	2,041	2,145	2,285	2,428
Current Liabilities	**106**	**158**	**208**	**214**	**226**	**224**	**228**	**231**
ST Interest Bearing Debt	-	-	-	-	-	-	-	-
Trade Payables	43	29	45	39	43	41	42	42
Accrued Wages	6	8	10	12	14	14	15	15
Accrued Taxes	16	28	35	44	50	50	53	55
Other Current Liabilities	42	94	117	118	118	118	118	118
LT Liabilities	**88**	**194**	**199**	**322**	**254**	**275**	**274**	**252**
LT Interest Bearing Debt	88	193	198	322	253	274	274	252
Other LT	1	0	0	0	0	0	0	1
Total Liabilities & Equity	**1,595**	**1,860**	**2,122**	**2,313**	**2,523**	**2,647**	**2,790**	**2,914**

Cash Flow Statement Summary, USD mln

	2005	2006	2007E	2008F	2009F	2010F	2011F	2012F
Net Income	365	478	208	321	395	401	440	473
D&A	100	114	141	160	182	205	228	253
Non-operating and non-cash items	(13)	(19)	(1)	(0)	(0)	(0)	(0)	(0)
Changes in working capital	80	2	(60)	(21)	(31)	7	(8)	(6)
Operating Cash Flow	**532**	**575**	**288**	**460**	**547**	**612**	**661**	**720**
Capital Expenditures, net	(259)	(283)	(323)	(280)	(334)	(337)	(353)	(362)
Other Investments, net	9	18	(4)	(14)	(9)	0	(4)	(3)
Investing Cash Flow	**(250)**	**(265)**	**(327)**	**(294)**	**(343)**	**(337)**	**(357)**	**(365)**
Net Borrowings/(repayments)	(13)	105	5	121	(68)	21	(0)	(22)
Dividends Paid	(279)	(357)	-	(277)	(128)	(296)	(301)	(330)
Equity Financing & Other	0	1	(0)	0	0	(0)	0	0
Financing Cash Flow	**(292)**	**(250)**	**5**	**(155)**	**(197)**	**(276)**	**(301)**	**(352)**
Beginning Cash Balance	N/A	15	75	41	51	58	58	61
Ending Cash Balance	15	75	41	51	58	58	61	63
Exchange Rate Impact	-	(0)	-	-	-	-	-	-
Net Cash Inflows/Outflows	**(10)**	**60**	**(34)**	**10**	**7**	**(0)**	**3**	**2**

UAH/USD Exchange Rates

	2005	2006	2007E	2008F	2009F	2010F	2011F	2012F
Average	5.12	5.05	5.05	5.00	5.00	5.00	5.00	5.00
Year-end	5.05	5.05	5.05	5.00	5.00	5.00	5.00	5.00

Source: Company data, Concorde Capital estimates

Disclosures

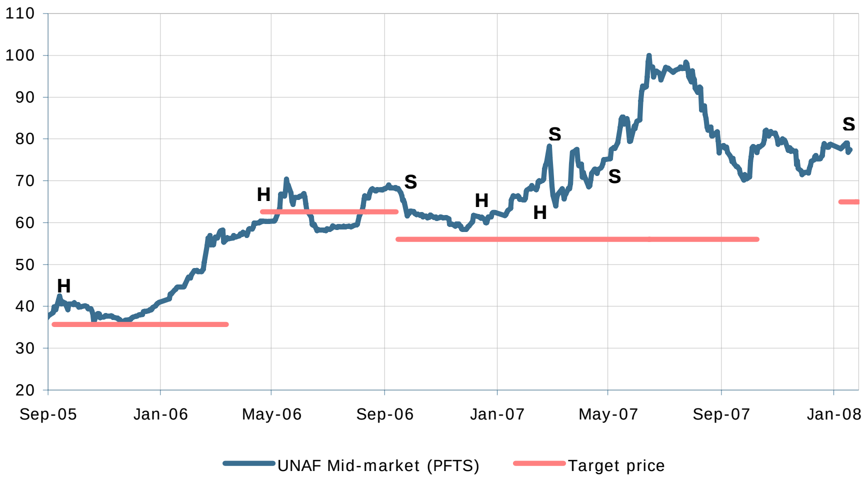
Analyst certification

I, Vladimir Nesterenko, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

Date	**Target price**, USD	**Market price**, USD	Rec	Action
20 Jan 03(1)	7.28	4.43	BUY	Initiate
17 Feb 03	7.36	4.32	BUY	Maintain
07 May 03	8.13	4.23	BUY	Maintain
03 Sep 03	8.34	4.05	BUY	Maintain
05 Dec 03	10.70	5.87	BUY	Maintain
19 May 04	22.65	13.23	BUY	Maintain
06 Sep 04	Pending	5.93	HOLD	Downgrade
03 Dec 04	32.00	15.17	BUY	Upgrade
11 Apr 05	35.70	27.75	BUY	Maintain
26 Aug 05	Pending	37.00	N/A	*Suspend*
22 Sep 05	35.70	39.20	HOLD	Downgrade
28 Mar 06(2)	Pending	57.28	N/A	*Review*
15 May 06	62.60	66.83	HOLD	Maintain
21 Sep 06	56.00	65.45	SELL	Downgrade
28 Dec 06	56.00	62.41	HOLD	Upgrade
07 Mar 07	56.00	62.48	HOLD	Maintain
29 Mar 07	56.00	74.75	SELL	Downgrade
30 May 07	56.00	83.09	SELL	Maintain
29 Oct 07	Pending	81.46	N/A	*Review*
22 Jan 08	65.00	(3)77.40	SELL	Maintain

(1) This stock was covered by analysts currently engaged with Concorde Capital prior to the legal inception of the company in October 2004, recommendations are supported by research.
(2) Until December 2005 the company was covered by Andriy Gostik, who now focuses on another sector. In January 2006, Vladimir Nesterenko took over coverage.
(3) PFTS closing price as of January 18, 2007

Recommendation history, USD per share



Investment Ratings

The time horizon for target prices in Concorde Capital's research is 12 months unless otherwise stated. Concorde Capital employs three basic investment ratings: Buy, Hold and Sell. Typically, Buy recommendation is associated with an upside of 15% or more from the current market price; Sell is prompted by downside from the current market price (upside <0%); Hold recommendation is generally for limited upside within 15%. Though investment ratings are generally induced by the magnitude of upside, they are not derived on this basis alone. In certain cases, an analyst may have reasons to establish a recommendation where the associated range given above does not correspond. Temporary discrepancies between an investment rating and its upside at a specific point in time due to price movement and/or volatility will be permitted; Concorde Capital may revise an investment rating at its discretion. A recommendation and/or target price might be placed Under Review when impelled by corporate events, changes in finances or operations. Investors should base decisions to Buy, Hold or Sell a stock on the complete information regarding the analyst's views in the research report and on their individual investment objectives and circumstances.

Concorde Capital ratings distribution

Buy	38	31%
Hold	29	23%
Sell	13	10%
Under Review	19	15%
Suspended / Not Rated	25	20%
Total	124	100%

Investment banking clients*

Buy	7	78%
Hold	1	11%
Sell	0	0%
Under Review	1	11%
Suspended / Not Rated	0	0%
Total	9	100%

**Within the last twelve month period, Concorde Capital has obtained compensation from these companies.*

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