Ukraine / Oil & Gas

Ukrnafta

Caught Up

HOLD

15 May 2006	**USD 66.8**
12M Target	**USD 62.6**

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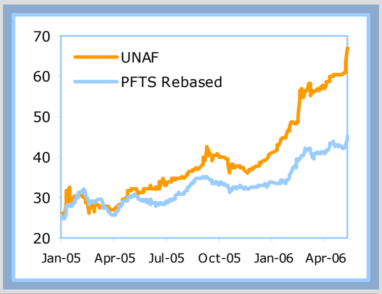
UNAF Mid-Market, USD



Market Information	
Bloomberg	UNAF UZ
Franfurt/Xetra	UKAA GR

No of Shares, mln	**54.2**
Reg S GDR to Ord.	1:6

Market price, USD	**66.8**
52Wk H/L, USD	66.8/30.9
MCap, USD mln	**3 624.1**
Free Float, %	**8%**
FF MCap, USD mln	289.9

Stock Ownership	
State	50%+1
Privat Group	42%
Minorities	8%

Ratios 2005	
EBITDA Margin	54%
EBIT Margin	45%
Net Margin	34%
Net Debt/Equity	7%

We believe that the stock's upside potential has been exhausted by the recent rapid adjustment induced by strong oil prices and the favorable stock market. Lagging downstream expansion, an unprecedented royalties hike and enforcement of auction sales will limit the company's value growth in the near term. We also do not expect vertical integration to materialize until the formation of the new government. Our recommendation is HOLD.

Downstream Weaker Than Expected, But Still Key To Growth. Development of Ukrnafta's downstream segment in 2005 lagged behind management plans and our forecast. Nevertheless, we believe retail sales will be the major driver for the company's growth in the long term, as opportunities in the upstream segment look rather limited.

Upstream Suffering From Royalty Hikes; Tolling To Stop. In 2005 a 53% yoy growth of Ukrnafta's crude oil price was completely offset by a 84% royalties hike in August 2005. The increase was not phased out this year, which corresponds to the worst-case scenario in our report from April 2005. In fact, royalties were increased further in January this year by another 60%. This second hike alone would result in about USD 142 mln lower EBITDA in 2006. Furthermore, due to changes to legislation, in 2006 it will be practically impossible for Ukrnafta continue tolling practices and thus, the company will have to sell all its oil via auctions. We believe Privat will respond by under-pricing oil at auctions to support its refineries.

Privat Creates A "Quasi"-VIOC. While the government and the President have failed to back up their intentions to create a vertically integrated oil holding (VIOC), Privat group has been consolidating oil assets. In early 2006 the group strengthened its positions in oil transshipment and finally closed a deal with Kontinium group on the Galychyna refinery. Now Privat has its fingers in all stages of the oil business: extraction, refining and marketing. However, we believe that formal integration of Privat's oil assets with Ukrnafta will not happen until the group agrees on the issue with new government, which is yet to be formed.

Power For Money: Privat Votes For Huge Dividends. At its EGM on May 11, 2006, the company's shareholders decided to allocate almost 100% of Ukrnafta's 2005 net income in dividends. Although these dividends are likely to limit the company's growth in the short-term, we believe this was the price Privat had pay to enhance its control over the company. The newly elected head of Ukrnafta's Supervisory Board, Karetko, seems to be more loyal to the group than his predecessor Ivchenko.

KEY FINANCIAL DATA, USD mln

	Net Revenue	EBITDA	Net Income	DPS, USD
2004	736.0	459.0	253.1	4.67
2005	1 087.9	585.9	364.9	6.73
2006F	1 622.5	635.1	343.2	2.53
2007F	2 074.5	669.1	355.8	4.92

Spot Exchange Rate 5.05

KEY RATIOS

	P/S	EV/EBITDA	P/E	Div Yield*
2004	4.92	8.06	14.32	7.0%
2005	3.33	6.31	9.93	10.1%
2006F	2.23	6.33	10.56	3.8%
2007F	1.75	6.16	10.19	7.4%

** calculated at average exchange rate for the reported year*

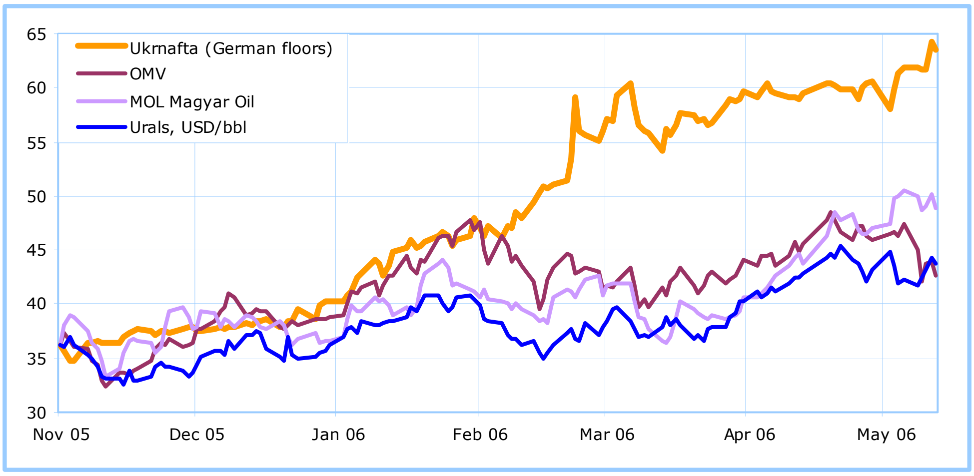
UNAF Stock: Adjusted

In 2005 the market was bullish about Ukrnafta's stock: its mid-market price on the PFTS increased by 64% yoy, from USD 25 per share in January 2005 to USD 41 in December 2005. Over January - Apr 2006 it gained 46% YTD and soared to USD 60.

Ukrnafta's stock has far outpaced its peers' growth rates, as well as oil price growth. It looks like market forces have eliminated the gap between Ukrnafta's market and fair value.

We believe the adjustment was accelerated by optimistic expectations about the Ukrainian economy and the lack of superior alternatives to the stock - Ukrnafta promised stronger liquidity and lower risks to equity investors. Taking into account the gas crisis in the early 2006, Ukrnafta looked like an adequate alternative to chemicals and steel for investors' portfolios. Increasing global oil prices only warmed up investors' attitudes to the company.

Ukrnafta vs Peers And Urals, USD / share (rebased)



Source: Bloomberg, Concorde Capital estimates

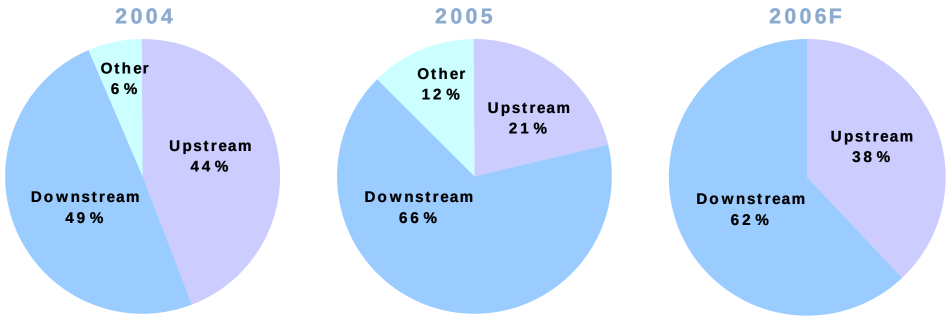
Recently, the price jumped by another 10.2% in two days (May 10-11), to USD 67 per share, in reaction to the company's highest ever dividend payout (about USD 370 mln, at current exchange rate) approved at Ukrnafta's EGM on May 11, 2006. Shareholders will receive DPS of USD 6.8 and a dividend yield of 10.2%. The ex-dividend date has been set for June 15, 2006, with the payout period from June 15 to December 15, 2006.

However, we believe this increase will be short-lived.

Structural Change To Continue

We estimate that in 2005 the structure of Ukrnafta's revenue radically changed: downstream sales almost doubled and accounted for 2/3 of the company's net revenue (~1/2 in 2004). The share of the upstream segment was cut in half, from 44% to 21%. Although this change was in part due to increased tolling last year (from 37% of extracted oil in 2004 to 56% in 2005), this tendency will continue in line with Ukrnafta's expansion of its filling station network.

Ukrnafta's Net Revenue Breakdown *



** the drop in upstream sales in 2005 was distorted by the large share of oil processed under tolling schemes (estimated). If it were not for tolling, the share of upstream in revenue would not have dropped so profoundly*

Source: Company data, Concorde Capital estimates

The table below demonstrates that gross sales in the upstream segment gradually gave up their positions, while the share of the downstream segment is growing. Since the structural change of Ukrnafta's net revenue in 2005 and 2006 is affected by increases of royalty payments (which are deducted from gross sales), the dynamics of gross sales by segment represents structural change to Ukrnafta's P&L more accurately.

Gross Revenue Breakdown

	Gross Revenue, USD mln			
	2004	**2005***	**2006F**	**2007F**
Upstream				
(extracted hydrocarbon sales)	467	571	1308	1373
Share in Gross Revenue	48%	35%	50%	43%
including:				
Oil and condensate	406	446	1090	1132
Natural and oil gas	61	125	218	241
Downstream				
(oil and gas products sales)	455	896	1312	1844
Share in Gross Revenue	46%	55%	50%	57%
including:				
Oil products	321	735	1134	1649
Gas products	134	161	178	195
Other**				
(non-recurring revenues mostly, estimated)	56	162	0.0	0.0
Share in Gross Revenue	6%	10%	0.0%	0.0%
Total	**978**	**1628**	**2620**	**3217**

** the structure of gross sales for 2005 does not perfectly reflect overall dynamics due to a large share of oil processed under tolling agreements*
*** 'Other sales' consist mostly of non-recurring items. For 2004, we identified and excluded those, but we do not have enough information to adjust 'other' sales for 2005.*

Source: Company data, Concorde Capital estimates

Downstream Lags Behind The Plan

In 2005 Ukrnafta's oil and gas products sales fell short of our forecast by about 50%. A less than expected number of filling stations and lower sales per station affected revenue the most. Although production of liquefied gas and stable gasoline outperformed both the management plans and our forecast, the contribution to gross sales growth was minor because of their small share in gross revenue.

Despite slower growth of retail sales than we expected, we believe that Ukrnafta's expansion into the downstream segment is strategically justified. Given that growth opportunities in the upstream are rather limited, it is the most feasible direction for the company's business development.

Retail Development To Remain Slow

2005: Plan Not Met

In 2005 Ukrnafta failed to meet its target of 800 filling stations by the end of the year. It has acquired only 141 stations, which is significantly below the its plan of 505. By the end of 2005, the company owned 436 filling stations, of which only 391 were operating.

Lower than expected expansion dynamics caused by the conflict which flared up in the middle of 2005 between the company's second-largest shareholder, Privat Group, and the state authorities. Privat was accused of selling its filling stations to Ukrnafta at above fair price, and Ukrnafta had to delay the development of its retail network until investigations were finished.

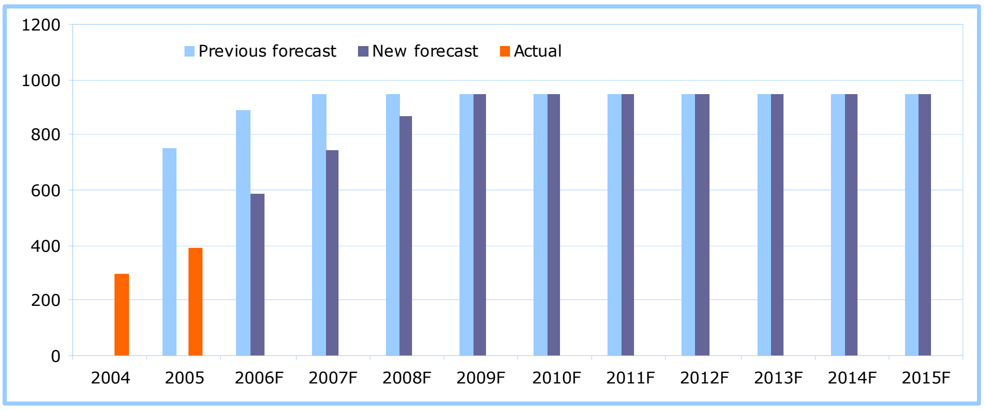
Number Of Outlets To Grow Slower Than Expected

This year the management revised its station acquisition target drastically: now they plan to have only 588 stations operating by the end of the year, in contrast to the 947 planned a year ago.

Compared to 2005, in 2006 Ukrnafta accelerated its retail development: during 1Q the company acquired 50 filling stations (92 were put into operation), thereby increasing the total number to 486 (483 operating). In contrast, for all of 2005 the company only managed to put 96 outlets into operation. This rapid pace makes Ukrnafta's year-end target of 588 realistic.

We have revised our forecast of downstream network expansion: instead of sticking to the management's ambitious target of 947 stations by the end of 2007, we now assume that Ukrnafta's retail network will grow slower and reaches the target (947) two years later, in 2009.

Number Of Stations In Operation By The End Of 2006 *



** note that the number of stations in operation may differ from the number of stations owned*

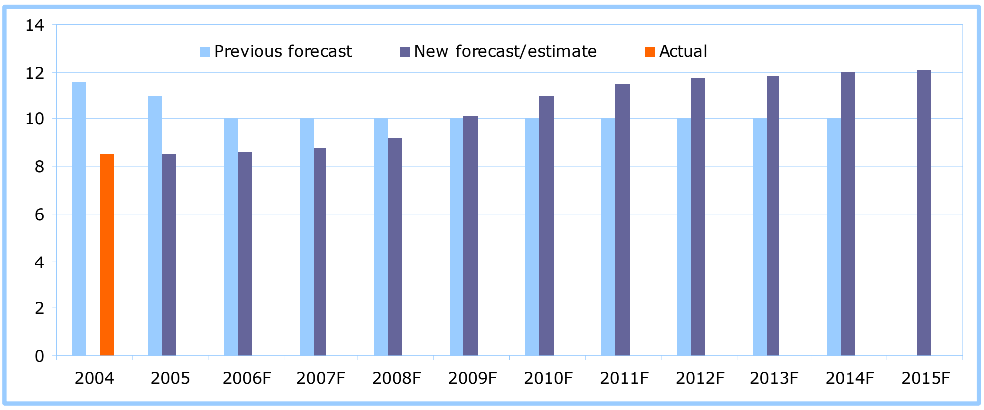
Source: Company data, Concorde Capital estimates

Per-Station Sales Forecast Downgraded
Based on the light oil product revenues disclosed in Ukrnafta's annual reports for 2004 and 2005, we estimate that oil products sales per station were about 8.5 cm a day, on average. This figure is substantially lower than our previous assumption of 11 cm/day (as was declared by the company's management).

With nothing to suggest that per station sales will quickly surge to the promised 11 cm/day, we have reconsidered our forecasts. Specifically, now we assume daily sales per station of 8.6 cm to be in 2006, gradually increasing to 12.1 cm by 2015.

We also do not think it would be too optimistic to assume that sales per station will grow at 3.5% 10-year CAGR. For comparison, Galnaftogaz already sells more than 10 cm a day through its branded stations. We believe that the major factors driving Ukrnafta's sales per station will be increasing domestic demand and the higher operating efficiency of its retail business.

Average Daily Oil Products Sales Per Station, cm *



** similar to our previous reports, we assume the following breakdown of Ukrnafta's light oil products sales in physical volumes: 65% - gasoline (35% - high-octane, 30% - low-octane), 35% - diesel fuel. The same assumption is embedded in our calculation of Ukrnafta's average retail oil prices.*

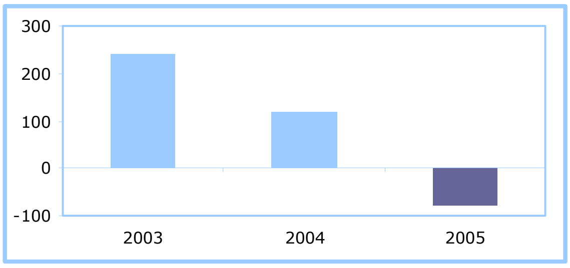
Source: Company data, Concorde Capital estimates

The Ukrainian Oil Market Favors Retail

The liberalization of the domestic oil market last year brought free-market pricing and resulted in retail prices catching-up to fair levels. Combined with globally increasing oil prices, this fueled a 37% yoy increase on average in local prices for gasoline and diesel.

After the cancellation of import duties for oil products and the reduction of tax burden on imported products in May 2005, Belorussian (Mozyr Refinery) and Lithuanian (Mozeikiu Refinery) gasoline rushed onto the market. Gasoline imports more than doubled, thus restricting the pricing power of domestic refineries through competition.

Net Gasoline Exports 2003-2005, mln Liters



Source: Energobiznes

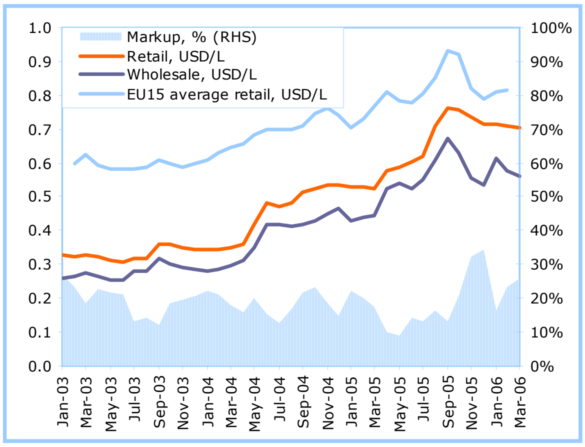
The government has also declared that it is going to avoid the price capping practices that it employed in the past.

We expect these measures to bring higher competition to the Ukrainian oil product market and will result in the higher sustainability of retail margins.

Retail Prices Rigidity - A Natural Hedge To Margins Squeeze
Retail market players benefit not only from growing prices, but also from the rigidity of retail markups. Historically, retail prices have generally followed wholesale price changes, but their behavior differed during ups and downs. When wholesale prices increased, retail adjusted quite quickly, however retail often did not follow decreases in wholesale. As a result, markups remained relatively stable during the periods of increasing bulk prices. Such rigidity serves as a natural hedge against more volatile wholesale prices.

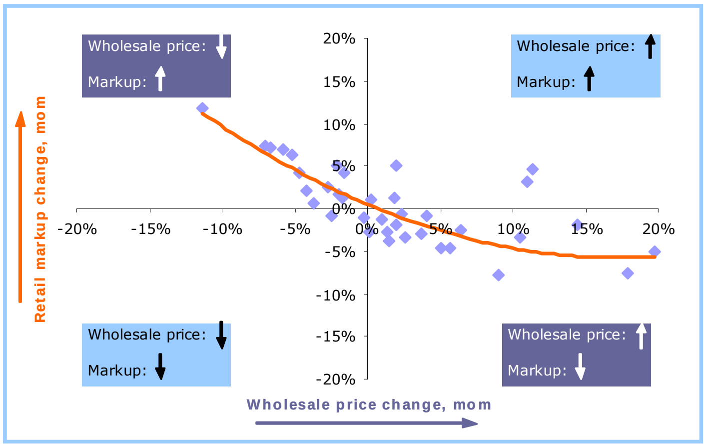
The scatter diagram below demonstrates this idea. As it shows, retail markup is more sensitive to decreases in wholesale prices than to its increases.

Average End-User Prices: Wholesale vs Retail



Source: UPECO, Concorde Capital estimates

Retail Markup Rigidity

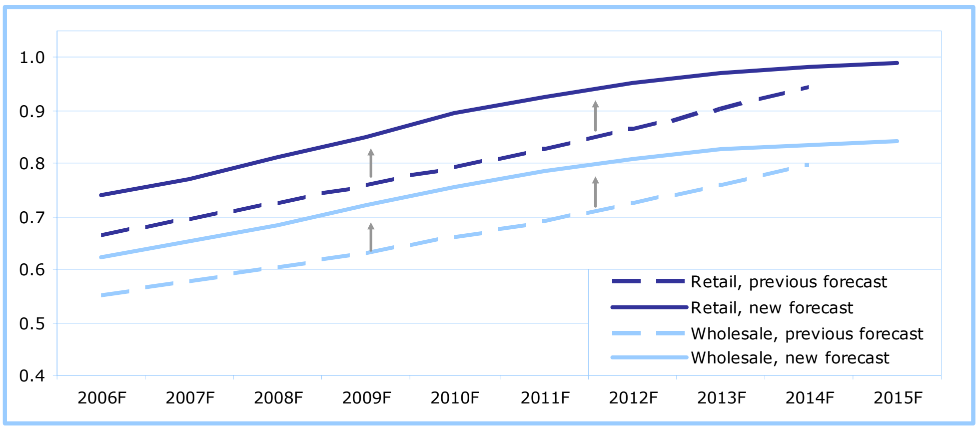


Source: UPECO, Concorde Capital estimates

Oil Product Price Forecast Upgraded
There is no clear consensus regarding the long-term world oil price forecast, however we believe the price will gradually appreciate over the next 10 years. As a result, we predict a slight upward trend for Ukrnafta oil products prices, as Ukrainian prices catch-up to European levels and due to the gradual increase of world oil prices. We have revised our model assumptions upward in order to reflect higher oil prices over the forecast period.

We believe domestic retail prices will grow 15% yoy on average in 2006 and 5% yearly for the next four years. In the long term, we anticipate domestic prices gradually moving towards European prices, which in turn will follow world oil trends. However, our forecast average retail price for Ukrnafta products in 2015 of USD 1.0/L is likely to still be lower than EU levels.

Oil Product Yearly Average Price Forecast, USD/Liter



Source: Concorde Capital estimates

Gas Products Outperforming

Gas product output left the management plans in the dust. In 2005 liquefied production came to 171 ths mt, up 7.4% yoy, 7p.p. more than we projected. Production of stable gasoline increased by 6.9% - 5.3 p.p. above our forecast. Taking into account the increasing demand for liquefied gas, we expect the company to at the very least maintain its current gas product output in the future.

Gamaliyivka GPP Project Unlikely To Raise Ukrnafta's Value

Despite Ukrnafta's goal to start in the second half of 2005, construction of a 2-bln cm gas processing plant have not gotten off the ground. After holding a tender for the plant's construction in January 2005 Ukrnafta chose a well-known Canadian engineering firm, PROPAKSystems, as the project's main contractor. However, the deal failed to get the approval for Ukrnafta's supervisory board. Recently the company announced another tender, which is to be held in June 2006. The project has been somewhat modified: now Ukrnafta is going to produce not only liquefied gas products and dry gas, but also high-octane gasoline.

Construction of the plant would enable Ukrnafta to get around selling wet gas to Naftogaz Ukrainy at below-market prices by allowing it to process its wet gas into higher value added products. According to our estimations, the plant, once constructed, will only start generating positive free cash flow in 2010. The incremental contribution to Ukrnafta's cash flow would be about 5-7% of its current yearly EBITDA. In the best case this would result in the appreciation of the company's value by 7%.

However, the future of the project is still too foggy to incorporate it into Ukrnafta's valuation. We will update our valuation once we have enough evidence that suggest the project is going to materialize.

Upstream Without A Paddle

Except for higher than expected oil and gas extraction, there was no good news from Ukrnafta's upstream wing.

In contrast to what we expected, the 84% royalties hike in 2005 was not phased out this year, but was followed by another increase of 60%. This second hike alone would result in ~USD 142 mln lower EBITDA in 2006 than Ukrnafta could earn if the royalty remained intact this year. Furthermore, starting this year royalties are pegged to the auction price, which will motivate Privat to under-price Ukrnafta's oil on auctions.

Enforcement of the auction sale requirement would push Ukrnafta to substitute transfer pricing practices for the tolling schemes it employed before. We expect this to lead to Ukrnafta's oil price growth lagging behind global trends.

Shock From Lingering Royalty Increases

Royalties hikes in August 2005 and in January 2006 put the pinch on Ukrnafta. These higher royalties are going to eat a considerable piece of Ukrnafta's net revenue and hurt its valuation.

In August 2005 oil royalties surged from USD8.0/bbl to USD14.7/bbl, by 84%, implying a proportional year-on-year increase in royalty payments, as new royalties had to be applied to the extracted volumes over the whole 2005. That is, for the periods prior to August 2005 royalty payments had to be restated.

We believed this was a temporary measure to support state budget revenues, which would have gone negative in 2006. However, the reality of the situation turned out to be even worse than our worst-case scenario (see our report from April 2005). Instead of decreasing in 2006, the royalty burden increased by another 60%, to USD23.6/bbl. The motivation behind the second increase was the same as the first - financing of the state budget deficit.

Now Differentiated
The 2006 state budget law assumes differentiated oil and condensate royalties: for deposits deeper than 5 km - USD8.8/bbl, 4-5 km – USD 14.8/bbl, <4 km – USD 23.6/bbl. We estimate that more than 90% of Ukrnafta's deposits are not deeper than 4 km, so the company will have to pay the maximum royalty for most of the oil it extracts.

Royalty Revisions*

	Before 2002	Jan-02	May-03	Dec-04	Mar-05	Aug-05	Jan-06
Oil, USD / bbl	0.4	1.3	4.1	7.7	8.0	14.7	8.8-23.6
Condensate, USD / bbl	0.0	0.0	2.7	2.7	8.0	6.7-8.0	8.8-23.6
Natural gas, USD / ths cm	5.4	5.4	5.7	5.8	6.0	6.0	3.0-6.0

** royalties for 2005-2006 are stated in range and depend on deposit depth. Starting Jan-06, royalties for oil and condensate depend also on their auction prices.*

Source: state budget laws 2002-2006, company data, Ukrainian News

For the state, a 50%+1 owner of Ukrnafta, the incremental royalty receipts will override the decrease in dividends and taxes, making the net effect positive.

Estimated 1-Year Effect Of Royalty Increases: The State Wins, Minorities Lose

2006F, USD mln	Gain (+) / Loss (-) for…			
The effect of…	Ukrnafta	the state*	Privat	other minorities
royalty receipts	-	+142	-	-
change in PBT	-142			
change in Taxes**	+35	-35		
change in Net Income	-107			
change in Dividends***		-21	-18	-3
Total	**-107**	**+86**	**-18**	**-3**

** the effect from changing royalties for Ukrnafta only, however Ukrnafta is not the only extractor, so the state's gain would be in fact larger*
*** for Ukrnafta "+" indicates reduction of taxes payable, which also means lower proceeds for the state budget*
**** assuming 40% payout ratio (announced on AGM in May 2006)*
Source: Concorde Capital estimates

Royalties Now Pegged To Oil Prices

Starting from 2006, royalties are not fixed: the law pegs them to the latest oil auction price, which implies that increasing oil prices will result in higher royalty payments.

The new formula for the calculations of royalties is:

$$\text{Royalty}_{t1} = \text{Royalty}_{base} \times (\text{Latest auction price}_{t1} \,/\, \text{Reference price}_{t0})$$

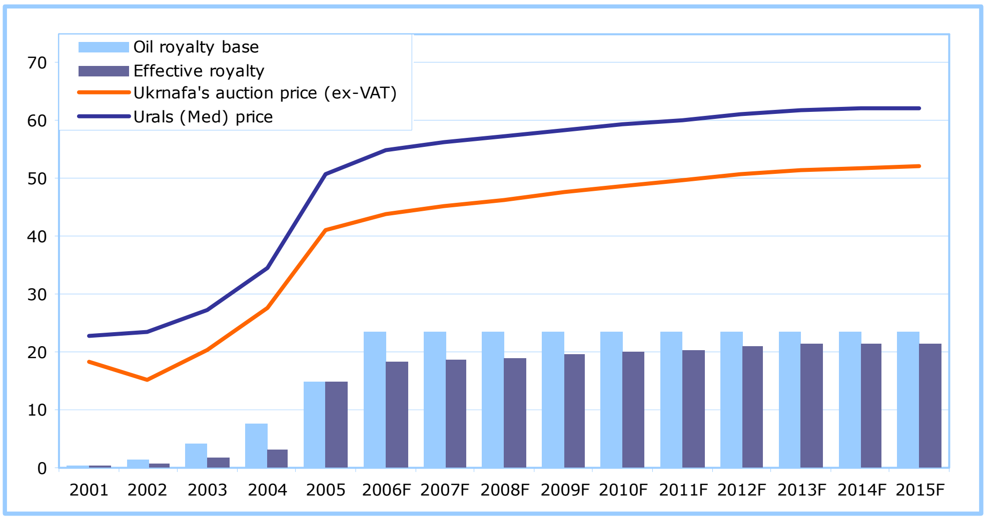
where t1 – current period, t0 – October 2006. The base period is fixed by the law, as is the reference price, which is the price of oil sold at the Oct-2005 auction (USD57.3/bbl, excl.VAT) as defined by the law.

For example, in January 2006 the average auction price was USD38.4/bbl. Thus, the royalty Ukrnafta had to pay until the next auction was:

$\text{Royalty}_{Jan\text{-}06}$ = 23.6 x (38.4 / 57.3) = USD15.8 per bbl of oil/condensate extracted.

In our forecasts we assume that this new formula for royalty calculation will remain in force from now on. We also expect that starting in 2006 Ukrnafta will sell all its oil at auctions and believe its selling price will gradually increase to ~USD55/bbl. This means that Ukrnafta will in fact pay less than the base royalty during the entire forecast period.

Base And Effective Royalty, USD / bbl



Source: state budget laws 2002-2006, company data, Bloomberg, Concorde Capital estimates, The above example reveals an interesting finding: by selling its oil at lower prices, Ukrnafta potentially could economize on its royalty payments. The net economic effect may not be obvious at the moment, as lower sales prices imply not only lower royalties but also affect gross sales. In the following section we define the conditions under which Ukrnafta could save on its royalty payments.

How To Economize On Royalties

We find that under new royalty calculation mechanism, Ukrnafta could benefit from restricting auction prices if and only if it sells more than 59% of its oil and condensate at auctions (see the derivation below). In this case, a one-dollar decrease in the auction price would raise net revenues, despite lower gross sales. Otherwise, it would be irrational to restrict auction prices in order to reduce royalties, as this would lead to lower net revenue.

A bit of math: the effect of bypassing auctions

A simple exercise demonstrates how Ukrnafta can economize on royalties, if it manages to sell some portion of oil out of auctions. Assuming zero excise taxes for simplicity, net sales from one barrel of oil can be calculated as follows:

$NS = p_a \times S_a + p_{na} \times (1-S_a) - R \times (p_a/p_0)$,

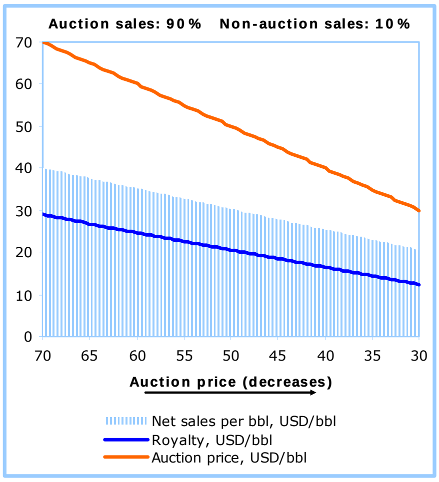
where NS – net sales per bbl, p_a – last auction price, p_{na} – non-auction price (assumed fixed), p_0 – reference price (as of October 2005), S_a – share of oil sold at auctions, R – royalty base.

Taking R=USD23.6/bbl and p_0=USD57.3/bbl (excl. VAT), we get:

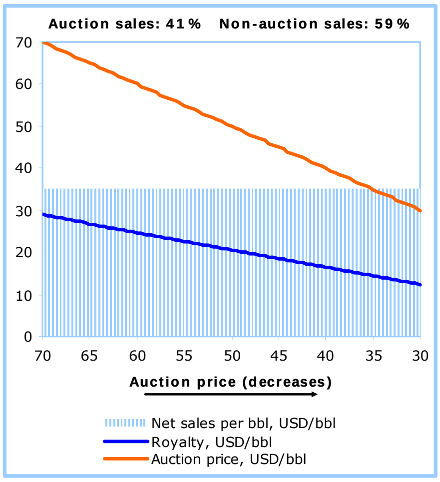
$\partial NS/\partial p_a = S_a - 0.41$; $S_a < 0.41$ => $\partial NS/\partial p_a < 0$.

So, if more than ~59% of extracted oil is sold at auctions, the reduction of the auction price by USD1 will result in the reduction of royalties by USD0.41, but net sales per bbl will ***increase*** (see the illustration below, Case 3).

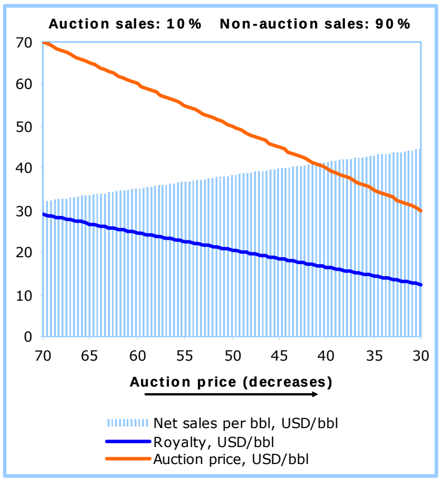
Case 1: Auction price **down**
Net Sales **down**



Case 2: Auction price **down**
Net Sales **stable**



Case 3: Auction price **down**
Net Sales **up**



Source: Concorde Capital calculations

In the above analysis, the critical assumption is the ability to bypass auctions. In the section "Ukrnafta's Response" we will show that on the contrary, if Ukrnafta sells all its oil via auctions, there will be no efficient way for the company to economize on royalties.

Auctions Enforced. Tolling Ceased?

Despite the legal requirement that all extracted hydrocarbons be sold at auctions, which was introduced five years ago and has remained in the state budget laws ever since, Ukrnafta has managed to employ a tolling scheme with Naftokhimik and last year was no exception. How was Ukrnafta able to pull this off given the legal restrictions? It seems that we have solved the "tolling puzzle." Specifically, we now have better understanding of why Ukrnafta tolled before and why this process will be impractical in the future.

Why Was Tolling Possible Last Year?

There are basically two documents regulating the sale of oil products: the law "On the introduction of auctions for oil, condensate, liquefied gas and coal," and the state budget law (revised yearly). Until recently the state budget laws included a requirement that all extracted hydrocarbons be sold via auctions. However, the wording of the document left it open to manipulation.

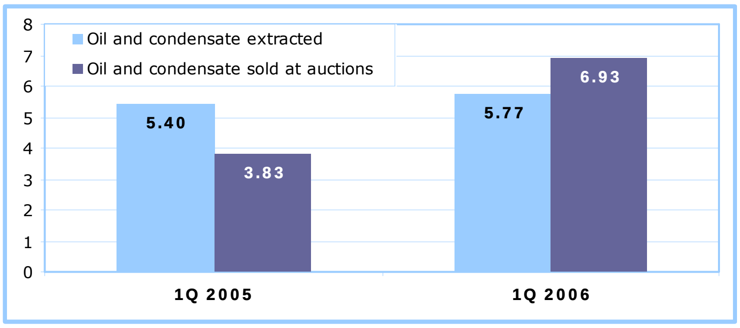
First, the word "sold" in the formulation "all extracted hydrocarbons must be sold via auctions" does not in fact imply that hydrocarbons must be *sold*. Second, the word "sold" has nothing to do with tolling, as the latter does not imply the transfer of property rights for the products. This same problem affects the law "On the introduction of auctions for oil, condensate, liquefied gas and coal." For this reason, we believe, Privat was able to avoid obligatory auctions and toll its products. There were also some other holes in the legislation which Privat used extensively to avoid auctions.

Changes To Legislation Banning Tolling & The Enforcement Of Auctions

In the 2006 state budget law there is a specific statement that says tolling and other transactions which do not imply the transfer of property rights are prohibited, while obligatory auction sales remain in force. That is why we believe Ukrnafta will find it extremely difficult to continue tolling this year and will sell all its oil at auctions.

Our logic is also confirmed by the physical volumes of Ukrnafta's oil sold at auctions this year: in 1Q06 the company sold almost double the amount of oil at auctions than in 1Q05 last year. The company even sold more oil than it extracted, the difference being due to the sale of oil stocks kept in Naftokhimik's storages.

Volumes Of Oil And Condensate Extracted vs Sold At Auctions, mln bbls



Source: Company data, Concorde Capital estimates

Ban On Tolling Hurts Ukrnafta's Value

The removal of tolling schemes implies quite serious material impact on Ukrnafta's valuation, due to the lower margins. However, it is still unclear what Privat's response to tougher regulation will be. Although the law does not allow Ukrnafta to toll its oil, Privat may decide not to adjust, but fight, as it has done in the past. If it wins and continues tolling, Ukrnafta's target could improve by 10-15%. Yet, for now we believe it is more reasonable to assume that Ukrnafta will stop using tolling schemes with refineries.

Unlike Ukrnafta, Privat's Traders Can Continue Tolling Ukrnafta's Oil

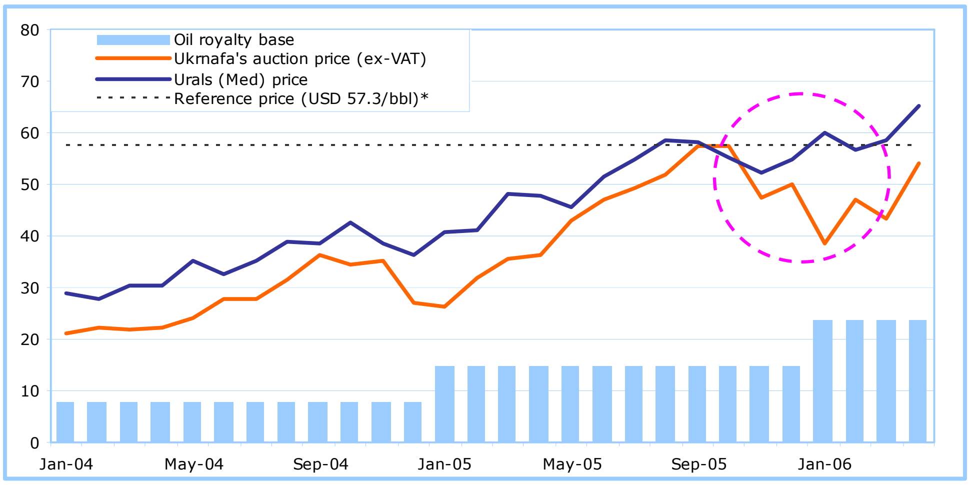
It is important to note that legal restrictions on tolling concern only oil extractors more than 50% owned by the state (like Ukrnafta) and have nothing to do with private companies. That is, the companies affiliated with Privat may continue tolling Ukrnafta's oil with refineries, provided Privat succeeds in channeling Ukrnafta's oil through affiliated traders.

However, tolling may be not the best option for the refineries. This year Galychyna and Naftokhimik are obliged to modernize their hydro-treating facilities, which implies higher CaPex and working capital needs. Thus to ensure sufficient cash flow, it would be better for the refineries to avoid tolling.

Ukrnafta's Response

In early 2006 Ukrnafta sold its crude at auctions at well below market price. Despite the growth of global oil prices, Ukrnafta's price decreased from an average of USD 51.6/bbl in 4Q05 to USD 42.9/bbl in 1Q06. At an auction held on December 29, 2005, the price was USD 50.1/bbl and just two weeks later the price dropped abnormally to USD 38.4/bbl (-23%).

Historical Royalties And Oil Prices, USD / bbl



** in force starting January 2006*
Source: State budget law

The chart: Ukrnafta's auction price rebounded in February, but then again dropped despite the increase in global prices. In March the government accused Ukrnafta of restricting its auction price, and at April's auction the price grew again. However, we believe that at least for this year, Ukrnafta's auction price will be hovering below the reference price. For details, see the discussion below.

After January's auction many oil market players, as well as the state authorities, argued that Ukrnafta intentionally sold its oil cheap to economize on royalties. For example, the Minister of Finance claimed that Ukrnafta was responsible for lower royalty receipts in the first quarter of this year.

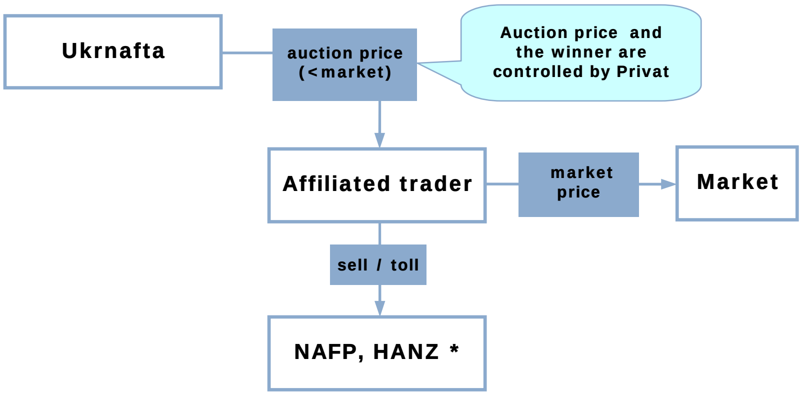
However, we believe that Ukrnafta's auction price dip in January had little to do with the royalties increase this year. In case of Ukrnafta, reducing royalties by under-pricing oil at auctions does not make any sense. Unless most of the oil is sold on the open market (which it would be difficult for UNAF to start doing this year), the company would have lost more than it gained.

We believe that Ukrnafta did this to subsidize Privat's refineries, not to economize on royalties.

Ukrnafta May Start Subsidizing Privat's Refineries
Ukrnafta will not be able to avoid auctions this year, and thus can't continue employing tolling schemes with Privat's refineries, which will need cheap oil from this year on.

We believe it was the need for cheap oil that led Privat to artificially downgrade Ukrnafta's auction selling price in January this year. If Ukrnafta sold its oil at a market prices at this the January's, the group's refinery, Naftokhimik Prykarpattya, would have suffered - its facilities are technologically outdated and its operating performance heavily depends on supplies of high-grade Ukrainian crude from Ukrnafta. In February - March 2006 Privat bought another refinery, Galychyna, so its need for cheap crude will increase.

Ukrnafta's Potential Oil Routes



** NAFP, HANZ – PFTS tickers for Naftokhimik Prykarpattya and Galychyna refinery, respectively*

In the future the company's yearly average auction price is likely to diverge from global oil prices - in our forecast, we assume the gap between Ukrnafta's selling price and Urals will increase in the near term.

Auctions Controlled By Privat
Privat has a great deal of experience in directing oil to affiliated traders at auctions. Moreover, the group can effectively control the auction price. Other bidders are pushed away by the unfavorable delivery conditions intentionally set by the seller.

Extraction Stronger Than Expected

Oil And Condensate Extraction Exceed Plans

In 2005 Ukrnafta's oil and condensate extraction growth rate was higher than expected – production grew by 3.2%, to 23.1 mln bbl, which is 0.4 mln bbl or 1.8% above our prior forecast. In 1Q06 Ukrnafta intensified its oil extraction even further: oil and condensate output grew 6.8% yoy, from 5.4 mln bbl in the first quarter last year to 5.8 mln bbl in 1Q06.

We revise our projections for 2006 up from 22.9 mln bbl to 23.5 mln bbl. High oil prices drove the company's reserves up. We do not expect the effect to reverse in the foreseeable future and upgrade our oil extraction forecast. In contrast to the slightly decreasing production volumes we assumed before, now we believe oil extraction will be virtually flat over the entire forecast period.

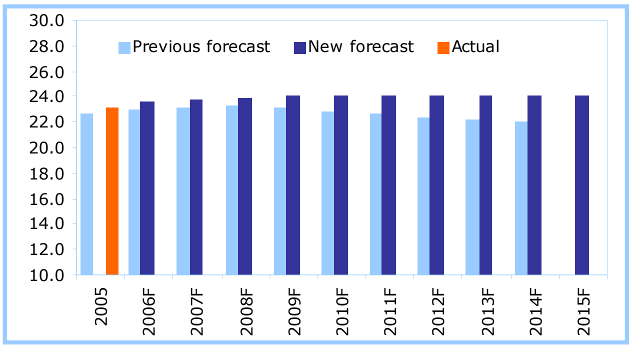
Gas Output Down

In 2005 gas extraction decreased by 2.3% yoy, and amounted to 20.4 mln boe, while we projected 1.5% growth. However, this slowdown does not spoil overall picture of upstream performance, as oil and condensate production is far more important for Ukranfta's income statement than gas output (see p.3). Noteworthy, in 1Q 2006 Ukrnafta increased its gas output by 10.2% yoy, from 4.8 mln boe in 1Q 2005 to 5.3 mln boe in the first quarter this year.

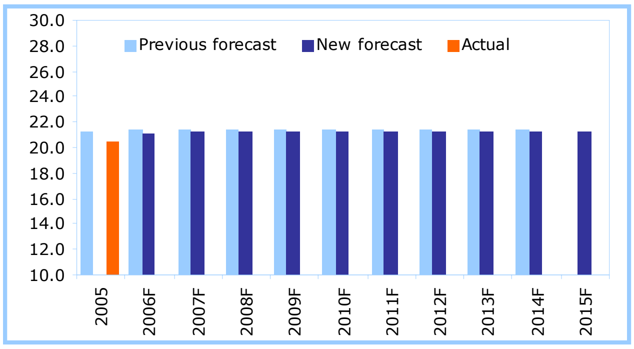
Despite strong 1Q results, we revise our gas output forecast downward. Taking into account the lower than expected gas production level last year and conservative management plan for 2006, we slightly abate our forecast for 2006, from 21.4 mln to 21.1. Gas production growth rates for the following years were left virtually unchanged.

Ukrnafta Upstream Segment: Performance And Forecast

Oil and condensate extraction, mln bbl



Gas output, mln boe



Source: Company data, Concorde Capital estimates

Expansion Potential Still Limited…

Last year Ukrnafta announced its plans to launch an overseas oil extraction project in Nigeria. The plan was approved by the company's shareholders at an EGM held on December 2005. However, the project was put on hold due to a military conflict in Nigeria and it is rather uncertain when the work will start.

Local opportunities are also scarce. Recently Ukrnafta announced that it was going to compete for a license to develop Sahalinske oil deposit in Kharkov region. However, the current licensee, Poltavanaftogazgeologia (a subsidiary of the state-owned Nadra Ukrayiny) managed to extend its license until 2007. Until then, Ukrnafta will be able to continue working as sub-contractor for the current licensee. The auction to buy a license for extraction works will be held only in 2007. Yet, the chances of a state-owned company winning are higher than Ukrnafta's.

…But May Improve Due To Recent Appointments

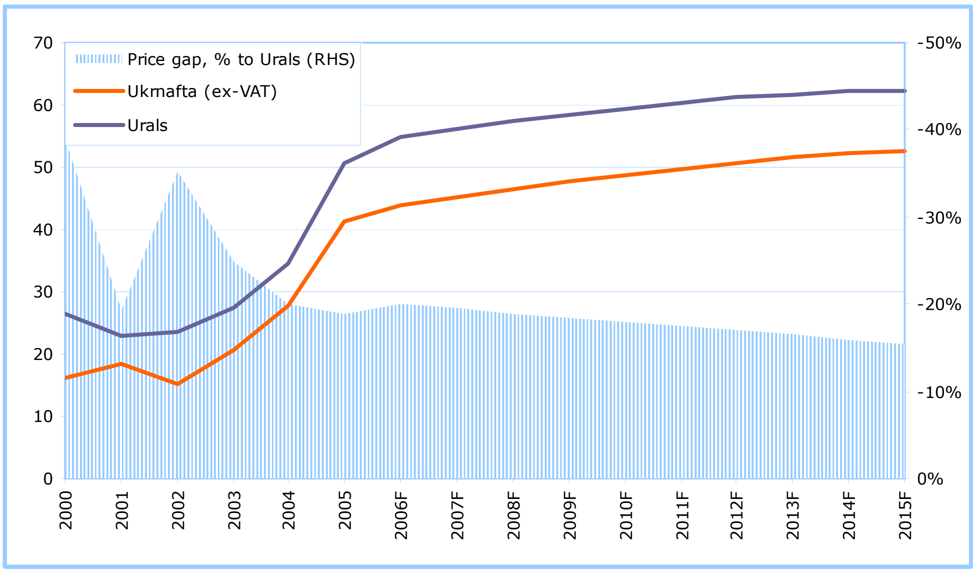
The election of Vladimir Karetko as the head of Ukrnafta's Supervisory Board, who is also the Head of The Board of Nadra Ukrayiny, may enhance Ukrnafta's chances of getting the license to develop Sahalinske. For details on Ukrnafta's Supervisory Board reshuffles, see the "Privat Creates A "Quasi"-VIOC" section.

High Prices To Prop Up Ukrnafta's Financials

In 2005 Ukrnafta capitalized on high oil and gas prices. Last year the average price of Brent grew by 57.4% yoy, while Urals gained as much as 47%. Ukrnafta's yearly average auction price generally followed global trend and grew by 53% yoy.

We expect the sale price of Ukrnafta's oil to increase at about 1.7% CAGR over the next 10 years, somewhat faster than Urals, basically due to two effects: increasing global prices and the narrowing gap between Ukrainian and Russian oil.

Ukrnafta's Crude Sales Price (ex-VAT) vs Urals Mediterranean (spot), USD / bbl



Source: Company data, Bloomberg, Concorde Capital estimates

Ukrnafta's Gas Price To Reach Market Levels

In 2005 Ukrnafta's average gas price doubled, to around USD 55/ths cm (ex-VAT). We forecast further rebound in Ukrnafta's natural gas prices, the major driver being increasing Russian gas prices. Although Naftogaz Ukrainy used to push Ukrnafta to sell natural gas at below market prices, we expect the company's price to gain about 60%, to ~USD 90/ths cm. Taking into account the results of recent gas auctions and the fact that year-average price of imported gas will at the lowest be USD 95/ths cm, the former price looks reasonable.

The belief that Ukrnafta can indeed resist Naftogaz, can be indirectly confirmed by the fact that in 2005 the company managed to sell a portion of its gas at auctions. Specifically, in August 2005 the company sold 253 mln cm (~8% of annual extraction) at auction for USD64/ths cm. In February this year, it sold 695 mln cm (~21% of expected annual extraction) at an auction for USD 106/ths cm, which is almost equal to the gas price cap established by the government (USD 107/ths cm) 11 days before the auction.

According to recent media reports, since gas prices began to climb in January 2006, Ukrnafta has been selling most of its gas to domestic industrial consumers, instead of Naftogaz at low prices. We will watch to see whether Ukrnafta can continue to do this and will upgrade our gas price forecast if it succeeds.

Privat Creates A "Quasi"-VIOC

Since intensively promoting the creation of a vertically integrated oil company (VIOC) based on Ukrnafta in mid-2005, the government has been very quiet. Several other modifications of the VIOC have been proposed by different authorities during that time, e.g. based on state-owned Naftogaz Ukrainy. However, the government seems to have no clear strategy regarding the issue.

Initially, Tymoshenko's government intended to create a VIOC in order to bring some market power under the state's control. The idea was that through an integrated oil holding the state could regulate oil product prices during crises.

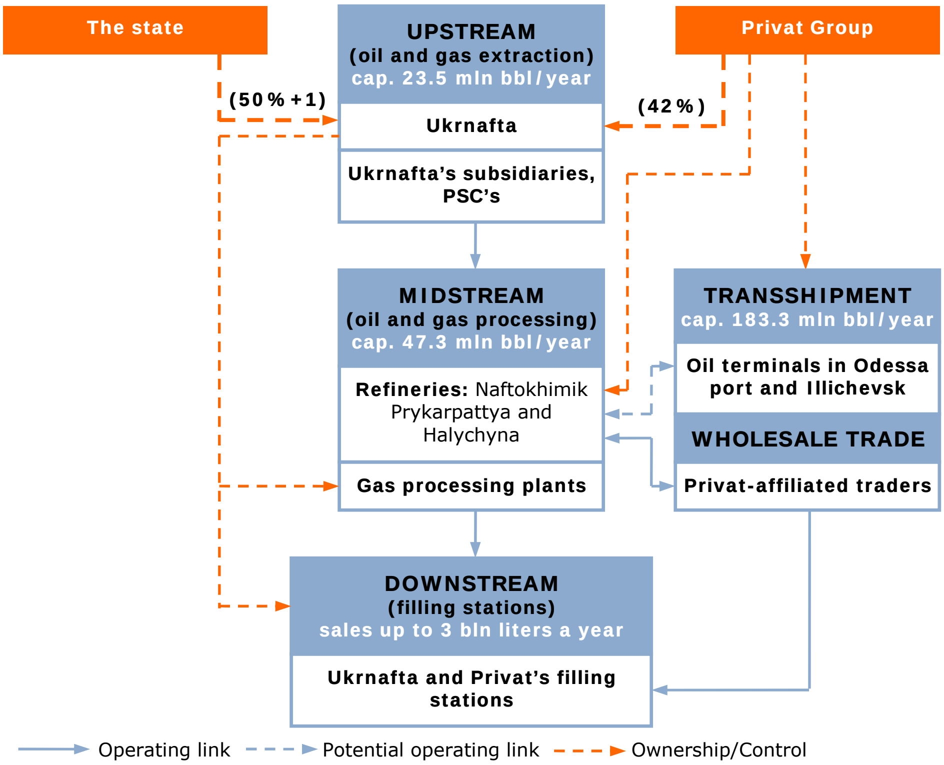
However, it looks like the state has lost its sense of urgency concerning the creation of a VIOC. As we have already mentioned, zero import duties established last year induced competition and fair pricing in the domestic oil products market. The government gave up questionable regulative levers in exchange for a more efficient market mechanism. It now looks as though Privat is more interested in the creation of a VIOC, while the government has stepped aside.

Privat: Doing Well On Its Own

While the government and President did not take any concrete steps towards the creation of VIOC, Privat has been consolidating oil assets. In early 2006 the group strengthened its positions in oil transshipment by adding an oil terminal in Illichevsk to its transshipment capacities in Odessa port and also closed a hard-fought deal with Kontinium group on Galychyna refinery.

As of now, Privat controls Ukrnafta, two refineries in the western region (Naftokhimik Prykarpattya and Galychyna), a major share in local wholesale trade and the largest oil transshipment capacities in Ukraine. In fact, it has already created a "quasi"-VIOC (we add "quasi" to reflect that it is not a formal holding yet).

Privat's Oil Empire: A Quasi-VIOC



Source: Ukrainian News, Interfax, Concorde Capital estimates

Although it looks like the current structure of this quasi-VIOC is unbalanced, the group has taken control of the most important components in the oil business.

The balance will be made up by affiliated traders. Firstly, because Ukrnafta alone can not meet the refineries' crude needs, so traders will be needed to assist in loading the refineries with imported crude. Second, the low processing depth of the two refineries means they can not sell all their products to Ukranfta's or Privat's stations. Through its traders, Privat can sell a portion of the refineries products on the market, and purchase the high-grade products it needs.

Further Penetration Into Refining

In early 2006 Privat bought Galychyna refinery, which surprised the market, as the group's initial plan was to sell its 32% stake. We believe that in fact Privat didn't want to bid, but did it once Yeremeev (the owner of Kontinium) accused Privat of selling its 32% stake for too high a price.

To load Galychyna, Privat will have to rebalance Ukrnafta's crude supplies: some portion is now going to be sold to the new refinery. Since Ukrnafta's oil won't suffice, Privat will have to supply Russian crude to its refineries. In this respect, the group may rely on its strategic partner and oil trader, Alfa-Nafta.

After the company's EGM on May 11, Igor Kolomoiskiy, the owner of Privat group, announced that he is considering selling its two refineries to Ukrnafta. Provided that the parties agree on the terms and the price is reasonable, this may improve Ukrnafta's value. In general, the announcement is in line with our expectations (see our ANB from January 6) and we retain the view that Privat will not sell any of its assets to Ukrnafta until it reaches agreement with the new government, after it is formed. We will be watching the situation closely and upgrade our valuation once any progress is made.

Privat Improves Operating Controls Over Ukrnafta

The changes to the Supervisory Board approved on the EGM considerably improved Privat's control over the company.

The state's two most powerful representatives in the Supervisory Board, Ivchenko (the Head) and Tretiakov (a member), were elected MPs and therefore resigned from the board. Until recently, Alexey Ivchenko was the Head Of The Board at the state-owned holding Naftogaz Ukrainy, Alexandr Tretiakov took the position of Deputy Minister Of Industrial Policy and the President's advisor.

The EGM also approved Vladimir Karetko and Alexandr Bolkisev to replace Ivchenko and Tretiakov. Karetko is currently the Head of The Board of the state oil exploration and development company Nadra Ukrayiny. He is rumored to be more loyal to Privat Group than Ivchenko, so we expect that the reshuffle will bring more control to the Group. Bolkisev is the Director General of Naftogaz's subsidiary, Gaz Ukrayiny and, following recent Ivchenko's dismissal, became acting head of Naftogaz's Board. There is no concrete information on his relationship with Privat, so we believe he is a goverment representative.

The Structure Of Ukrnafta's Supervisory Board*

Before EGM	After EGM
Alexey Ivchenko, Head (state)	**Vladimir Karetko, Head (state)**
Alexandr Tretiakov (state)	**Alexandr Bolkisev (state)**
Igor Voronin (state)	Igor Voronin (state)
Vladislav Tarashevskiy (state)	Vladislav Tarashevskiy (state)
Dmitry Yeger (state)	Dmitry Yeger (state)
Igor Kolomoiskiy (Privat)	Igor Kolomoiskiy (Privat)
Gennadiy Bogolyubov (Privat)	Gennadiy Bogolyubov (Privat)
Mikhail Kiperman (Privat)	Mikhail Kiperman (Privat)
Timur Novikov (Privat)	Timur Novikov (Privat)
Gennadiy Korban (Privat)	Gennadiy Korban (Privat)
Dmitriy Parfenenko (SPFU)	Dmitriy Parfenenko (SPFU)

** the formal affiliation is mentioned in the parentheses, informal affiliation is indicated with color: blue –state, dark blue – Privat, blanc – other.*

Business Model

Key projections
For the purposes of forecasting local currency is used

	2005	2006E	2007F	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F	CAGR 5Y	CAGR 10Y
GDP growth	2.5%	3.0%	4.5%	7.0%	7.5%	7.0%	6.5%	6.0%	5.0%	4.0%	4.0%	5.8%	5.4%
Industrial production growth	3.1%	4.0%	6.0%	8.5%	9.0%	8.5%	8.0%	7.5%	6.5%	5.5%	5.5%	7.2%	6.9%
Output:													
Crude oil & condensate, mln bbls	**23.1**	**23.5**	**23.8**	**23.9**	**24.0**	**24.0**	**24.0**	**24.0**	**24.0**	**24.0**	**24.0**	**0.4%**	**0.2%**
growth, %	3.2%	1.9%	1.0%	0.5%	0.5%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%		
Natural and oil gas, mln boe	**20.4**	**21.1**	**21.3**	**21.3**	**21.3**	**21.3**	**21.3**	**21.3**	**21.3**	**21.3**	**21.3**	**0.2%**	**0.1%**
growth, %	-2.3%	3.3%	1.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%		
Liquefied gas, ths bbls	**1 365**	**1 378**	**1 391**	**1 395**	**1 398**	**1 398**	**1 398**	**1 398**	**1 398**	**1 398**	**1 398**	**0.3%**	**0.1%**
growth, %	7.4%	0.9%	1.0%	0.2%	0.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%		
Stable gasoline, ths bbls	**1 906**	**1 944**	**1 961**	**1 966**	**1 970**	**1 970**	**1 970**	**1 970**	**1 970**	**1 970**	**1 970**	**0.3%**	**0.1%**
growth, %	6.9%	2.0%	0.9%	0.2%	0.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%		
Prices (est, net):													
Crude oil, USD/bbl	41.18	44.00	45.24	46.43	47.66	48.67	49.70	50.75	51.57	51.82	52.08	2.5%	1.7%
Oil condensate, USD/bbl	42.48	45.39	46.67	47.90	49.16	50.20	51.26	52.35	53.19	53.45	53.72	2.5%	1.7%
Natural gas, USD/ths cm	55.40	89.51	97.98	102.88	108.02	113.42	119.09	125.05	128.80	130.09	131.39	5.9%	3.9%
Liquefied gas, USD/bbl	40.15	44.60	46.60	48.93	51.38	53.94	55.83	57.51	58.66	59.24	59.84	4.6%	3.0%
Stable gasoline, USD/bbl	48.17	53.51	55.91	58.70	61.64	64.72	66.98	68.99	70.37	71.08	71.79	4.6%	3.0%
Oil products, USD/Liter	0.53	0.62	0.64	0.68	0.71	0.74	0.77	0.79	0.81	0.82	0.83	4.6%	3.0%
Urals price (spot), USD/bbl	**50.77**	**55.00**	**56.20**	**57.33**	**58.47**	**59.35**	**60.24**	**61.14**	**61.75**	**62.37**	**62.37**	**1.8%**	**1.3%**
Gross sales, UAH mln:													
Oil & condensate, UAH mln	2 285	5 532	5 773	5 955	6 142	6 272	6 405	6 541	6 646	6 679	6 712	3.0%	2.0%
Natural & oil gas, UAH mln	638	1 106	1 228	1 290	1 354	1 422	1 493	1 568	1 615	1 631	1 647	6.2%	4.1%
Downstream gas products, UAH mln	823	905	997	1 049	1 104	1 159	1 200	1 236	1 261	1 273	1 286	5.8%	3.6%
Downstream oil products, UAH mln	3 766	5 754	8 409	11 214	14 548	17 215	18 708	19 655	20 249	20 656	21 071	26.6%	13.9%
Other, UAH mln	830	-	-	-	-	-	-	-	-	-	-		
Total gross sales, UAH mln	**8 343**	**13 296**	**16 407**	**19 508**	**23 148**	**26 068**	**27 806**	**28 999**	**29 770**	**30 239**	**30 716**	**15.9%**	**8.7%**
growth, %	60.4%	59.4%	23.4%	18.9%	18.7%	12.6%	6.7%	4.3%	2.7%	1.6%	1.6%		
VAT, excise and other deductions, UAH mln	1 525	2 880	3 554	4 226	5 014	5 647	6 023	6 282	6 449	6 550	6 654	15.9%	8.7%
Royalties, UAH mln	1 242	2 182	2 273	2 342	2 412	2 461	2 511	2 562	2 601	2 614	2 626	2.9%	1.9%
Net revenue, UAH mln	**5 575**	**8 234**	**10 580**	**12 940**	**15 722**	**17 961**	**19 272**	**20 156**	**20 720**	**21 075**	**21 436**	**18.5%**	**10.0%**
growth, %	42.4%	47.7%	28.5%	22.3%	21.5%	14.2%	7.3%	4.6%	2.8%	1.7%	1.7%		
Gross profit, UAH mln	**3 542**	**3 546**	**3 990**	**4 344**	**4 740**	**5 063**	**5 288**	**5 471**	**5 586**	**5 623**	**5 660**	**8.3%**	**4.8%**
Gross margin, %	63.5%	43.1%	37.7%	33.6%	30.2%	28.2%	27.4%	27.1%	27.0%	26.7%	26.4%		
EBITDA, UAH mln	**3 003**	**2 970**	**3 239**	**3 412**	**3 593**	**3 734**	**3 842**	**3 940**	**3 990**	**3 979**	**3 988**	**5.3%**	**3.0%**
EBITDA margin, %	53.9%	36.1%	30.6%	26.4%	22.9%	20.8%	19.9%	19.5%	19.3%	18.9%	18.6%		
EBIT, UAH mln	**2 489**	**2 318**	**2 464**	**2 521**	**2 594**	**2 637**	**2 669**	**2 693**	**2 671**	**2 587**	**2 524**	**2.9%**	**0.9%**
EBIT margin. %	44.7%	28.2%	23.3%	19.5%	16.5%	14.7%	13.9%	13.4%	12.9%	12.3%	11.8%		
Net Income, UAH mln	**1 870**	**1 742**	**1 815**	**1 806**	**1 814**	**1 811**	**1 823**	**1 847**	**1 845**	**1 802**	**1 779**	**0.9%**	**0.2%**
Net margin, %	33.5%	21.2%	17.2%	14.0%	11.5%	10.1%	9.5%	9.2%	8.9%	8.6%	8.3%		
Dividend Declared, UAH mln	1 870	697	1 361	1 355	1 360	1 359	1 367	1 385	1 384	1 352	1 334	14.4%	6.7%
Dividend Payout Ratio, %	100%	40%	75%	75%	75%	75%	75%	75%	75%	75%	75%		

Source: Concorde Capital estimates

Since our December 2005 report, we have modified the most critical assumptions in our model:

- Production growth rate constant starting 2010 (instead of decreasing) due to reserve replacement fueled by high oil prices
- Ukrnafta's oil prices slowly approach Urals; Urals gradually appreciate
- Gas prices adjust upward over 2005 - 2006 and then slowly approach imported gas prices
- Oil product prices rebound and gradually approach EU levels; EU prices grow in line with global oil
- No tolling (instead of 50% assumed before)
- Higher royalties, new formula remains unchanged until 2014
- Expansion CapEx vanishes by the end of the forecast period. Station acquisition costs down from USD 1.2 mln to USD 0.9 mln (estimated based on 2005 reported data)

Valuation

Discounted Cash Flow Model

Our DCF analysis incorporates certain changes worth mentioning. First, we now assume lower WACC, as perceived risks have substantially decreased since 2004 (see our Strategy Report of March 2006). Second, we apply a more conservative growth to perpetuity, 3% instead of the 4.5% assumed before.

Discounted Cash Flow Valuation

Valuation date **May 15, 2007**

We use local currency for our forecasts (UAH mln)

	2006F	2007F	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F
EBITDA	**2 970**	**3 239**	**3 412**	**3 593**	**3 734**	**3 842**	**3 940**	**3 990**	**3 979**	**3 988**
EBIT	2 318	2 464	2 521	2 594	2 637	2 669	2 693	2 671	2 587	2 524
Tax Rate	25%	25%	25%	25%	25%	25%	25%	25%	25%	25%
Taxed EBIT	1 739	1 848	1 891	1 946	1 978	2 002	2 019	2 003	1 940	1 893
Plus D&A	651	775	891	999	1 097	1 173	1 247	1 319	1 392	1 464
Less CapEx	(1 326)	(2 326)	(2 210)	(2 077)	(1 938)	(1 614)	(1 576)	(1 556)	(1 552)	(1 555)
Less change in OWC	133	114	79	60	38	70	105	91	94	82
FCFF	**-**	**412**	**651**	**928**	**1 174**	**1 631**	**1 795**	**1 857**	**1 875**	**1 884**
WACC	13.5%	12.6%	11.2%	10.3%	9.8%	9.9%	10.0%	10.1%	10.3%	10.5%
WACC To Perpetuity										10.5%
Terminal Value										25 875

Firm Value	**18 117**	PV of Terminal Value	10 992
Less Net Debt	(796)	**Portion due to TV**	**60.7%**
Equity Value	**17 320**	Perpetuity Growth Rate	3.0%
12-mo Fair Value per Share	**USD 62.63**	Implied Exit P/EBITDA Multiple	6.0x

Source: Concorde Capital estimates

Sensitivity of fair value per share, USD

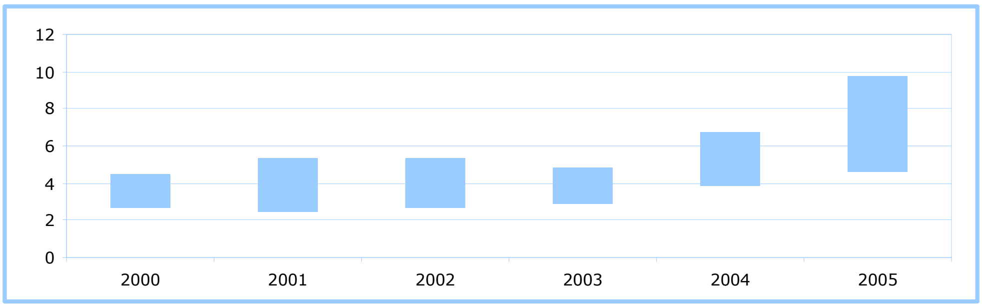
10-Year Discount Rates	Perpetuity Growth Rate				
	2.0%	**2.5%**	**3.0%**	**3.5%**	**4.0%**
WACC – 1.5%	63.84	66.49	69.49	72.91	76.87
WACC – 1.0%	61.68	64.22	67.11	70.40	74.20
WACC – 0.5%	59.60	62.05	64.82	67.99	71.64
WACC + 0.0%	57.61	59.96	**62.63**	65.67	69.19
WACC + 0.5%	55.70	57.96	60.52	63.45	66.83
WACC +1.0%	53.86	56.03	58.50	61.32	64.57
WACC + 1.5%	52.09	54.18	56.55	59.26	62.39

WACC to perpetuity	Perpetuity Growth Rate				
	2.0%	**2.5%**	**3.0%**	**3.5%**	**4.0%**
9.0%	64.72	68.17	72.19	76.95	82.66
9.5%	62.03	65.04	68.51	72.56	77.34
10.0%	59.68	62.33	65.35	68.85	72.92
10.5%	57.61	59.96	**62.63**	65.67	69.19
11.0%	55.78	57.88	60.25	62.93	65.99
11.5%	54.14	56.03	58.15	60.53	63.23
12.0%	52.67	54.39	56.29	58.42	60.81

Source: Concorde Capital estimates

The P/EBITDA multiples of 6.3x and 6.0x implied by our DCF valuation for the end of 2006 and 2007 respectively, as well as the exit EBITDA multiple, fit well into the range of historical and projected multiples for the company's peers.

Historical P/EBITDA Multiples For Ukrnafta's Peers*



** include OMV, MOL, Tatneft, Husky Energy and PTT*
Source: Bloomberg, Thomson Financial, Concorde Capital calculations

Peer Comparison

Peer multiples suggest Ukrnafta's stock should be valued around USD 60-66, which fits the current market price and our DCF valuation well. We believe that EV/EBITDA and P/E multiples are the most reliable for valuation purposes, while higher EV/S is justified by Ukrnafta's higher margins and ROE, as well as by its stronger sales growth potential.

We added two companies to our peer group: Husky Energy (Canada) and PTT (Thailand). Both theses companies in addition to hydrocarbon exploration and production, are engaged in oil and gas product marketing. Like Ukrnafta, both have a filling station networks, however their refining capacities are not sufficient to cover their own needs and the companies have to buy refined products. We also have added Tatneft back to our peer group, as its financial projections are now available.

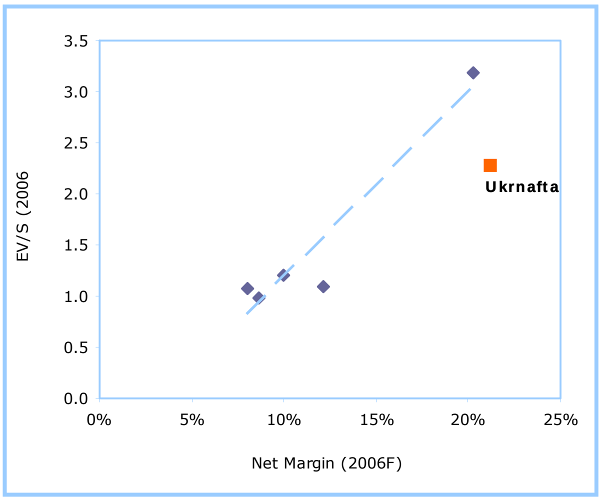
Comparative Valuation

	Market Cap*, USD	EV/S			EV/EBITDA			P/E		
		2005	**2006F**	**2007F**	2005	**2006F**	**2007F**	2005	**2006F**	**2007F**
Ukrnafta	3 624	3.4	**2.3**	**1.9**	6.3	**6.3**	**6.2**	9.9	**10.6**	**10.2**
OMV AG	19 700	1.1	1.1	1.1	5.8	6.0	4.5	13.3	13.0	9.8
MOL Magyar Olaj Gazipari	11 936	1.2	1.2	1.1	6.9	6.9	6.0	10.4	10.6	9.8
Tatneft	10 698	n/a	1.1	1.0	n/a	5.5	5.6	n/a	9.3	10.3
Husky Energy Inc	26 542	3.2	3.2	2.2	8.0	8.1	5.7	15.5	14.9	12.1
PTT Public Company Limited	18 555	1.0	1.0	0.9	6.5	6.4	6.2	9.5	9.0	8.6
Mean		1.6	**1.5**	**1.2**	6.8	**6.6**	**5.6**	12.2	**11.4**	**10.1**
Implied target		30.8	**43.5**	**41.7**	71.9	**69.6**	**60.4**	81.9	**71.9**	**66.5**
Upside/Downside		-54%	-35%	-38%	8%	4%	-10%	23%	8%	0%

	ROE	EBITDA Margin			Net Margin			Sales Growth	
	2005	2005	**2006F**	**2007F**	2005	**2006F**	**2007F**	**2006F**	**2007F**
Ukrnafta	35.4%	53.9%	**36.1%**	**30.6%**	33.5%	**21.2%**	**17.2%**	**49.1%**	**27.9%**
OMV AG	16.3%	18.4%	17.7%	23.3%	8.1%	8.1%	11.0%	2.6%	-3.6%
MOL Magyar Olaj Gazipari	23.3%	17.0%	17.4%	17.6%	10.0%	10.0%	10.7%	-1.8%	0.7%
Tatneft	n/a	n/a	20.0%	17.4%	n/a	12.2%	10.6%	n/a	3.3%
Husky Energy Inc	26.6%	40.0%	39.1%	38.0%	19.6%	20.2%	17.4%	0.1%	43.6%
PTT Public Company Limited	28.8%	15.1%	15.2%	14.2%	8.6%	8.6%	8.4%	5.4%	8.1%
Mean	23.8%	22.6%	**21.9%**	**22.1%**	11.6%	**11.8%**	**11.6%**	**1.6%**	**10.4%**

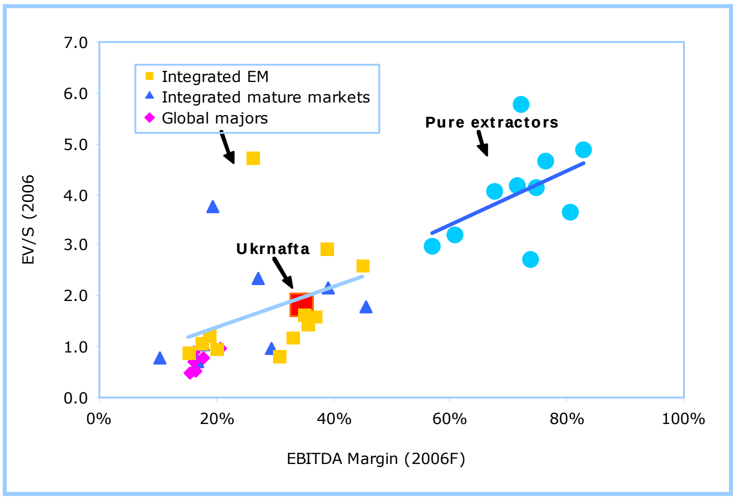
** calculated at PFTS closing price as of May 12, 2006*
Source: Thomson Financial, Concorde Capital estimates

EV/S Multiples vs Net Margins



Source: Thomson Financial, Concorde Capital estimates

EV/S And EBITDA Multiples For Different Peer Groups



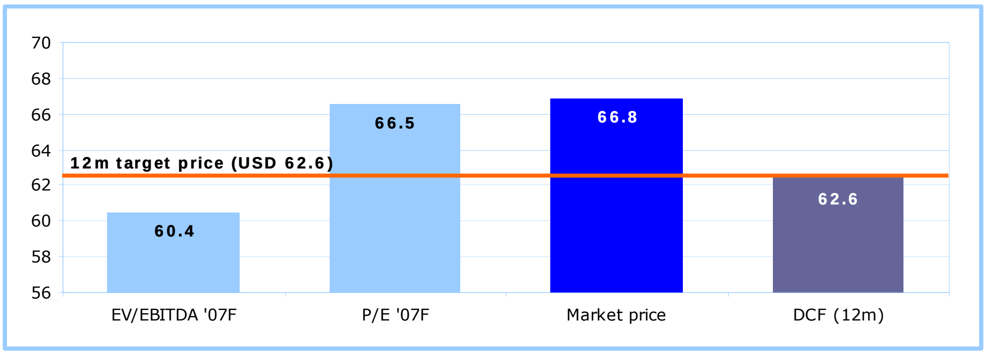
Source: Thomson Financial, Concorde Capital estimates

We avoid using EV/Output and EV/Reserve multiples, because Ukrnafta's business structure is changing: its downstream (retail) business is expanding rapidly, while its upstream potential remains limited. By 2012, we estimate that the share of Ukrnafta's retail sales in its total net revenue will exceed 80%. The scatter diagram presented below confirms our view that Ukrnafta should not be compared with companies that exclusively operate in the exploration and production segments – it is now more on par with other integrated companies.

Valuation Conclusions

The results of the two methods do not materially differ – the fair price implied by DCF is almost in the middle of the range suggested by peer multiples. We set our 12-month target at USD 62.6 per share.

Ukrnafta's Value-Meter, USD Per Share



Source: Concorde Capital estimates, PFTS

Financial Statements According To UAS

Income Statement Summary, USD mln

	2004	2005	2006F	2007F	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F
Net Revenues*	**736**	**1 088**	**1 623**	**2 074**	**2 537**	**3 083**	**3 522**	**3 779**	**3 952**	**4 063**	**4 132**	**4 203**
Change y-o-y	*N/M*	*48%*	*49%*	*28%*	*22%*	*21%*	*14%*	*7%*	*5%*	*3%*	*2%*	*2%*
Cost Of Sales*	(226)	(397)	(924)	(1 292)	(1 686)	(2 153)	(2 529)	(2 742)	(2 879)	(2 967)	(3 030)	(3 093)
Gross Profit*	510	691	699	782	852	929	993	1 037	1 073	1 095	1 103	1 110
Other Operating Income/Expenses, net	(5)	3	-	-	-	-	-	-	-	-	-	-
SG&A	(46)	(108)	(114)	(147)	(183)	(225)	(261)	(283)	(300)	(313)	(322)	(328)
EBITDA*	**459**	**586**	**585**	**635**	**669**	**704**	**732**	**753**	**772**	**782**	**780**	**782**
EBITDA margin, %	62.4%	53.9%	36.1%	30.6%	26.4%	22.9%	20.8%	19.9%	19.5%	19.3%	18.9%	18.6%
Depreciation	(92)	(100)	(128)	(152)	(175)	(196)	(215)	(230)	(244)	(259)	(273)	(287)
EBIT*	**367**	**486**	**457**	**483**	**494**	**509**	**517**	**523**	**528**	**524**	**507**	**495**
EBIT margin, %	49.9%	44.7%	28.2%	23.3%	19.5%	16.5%	14.7%	13.9%	13.4%	12.9%	12.3%	11.8%
Interest Expense	(6)	(11)	(10)	(19)	(33)	(45)	(54)	(57)	(55)	(52)	(47)	(40)
Financial Income	10	24	24	24	24	24	24	24	24	24	24	24
Other income/(expense)*	(12)	(13)	(13)	(13)	(13)	(13)	(13)	(13)	(13)	(13)	(13)	(13)
PBT	**360**	**486**	**458**	**474**	**472**	**474**	**474**	**477**	**483**	**482**	**471**	**465**
Tax	(107)	(121)	(114)	(119)	(118)	(119)	(118)	(119)	(121)	(121)	(118)	(116)
Effective tax rate	*30%*	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*
Net Income	**253**	**365**	**343**	**356**	**354**	**356**	**355**	**357**	**362**	**362**	**353**	**349**
Net Margin, %	*34.4%*	*33.5%*	*21.2%*	*17.2%*	*14.0%*	*11.5%*	*10.1%*	*9.5%*	*9.2%*	*8.9%*	*8.6%*	*8.3%*
Dividend Declared	**253**	**365**	**137**	**267**	**266**	**267**	**266**	**268**	**272**	**271**	**265**	**262**

Balance Sheet Summary, USD mln

	2004	2005	2006F	2007F	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F
Current Assets	**422**	**341**	**545**	**728**	**882**	**1 075**	**1 230**	**1 313**	**1 358**	**1 380**	**1 381**	**1 389**
Cash & Equivalents	24	15	24	31	38	46	53	57	59	61	62	63
Trade Receivables	137	39	161	207	254	308	352	378	395	406	413	420
Inventories	196	160	230	323	388	474	544	576	587	588	576	569
Other current assets	65	127	129	166	203	247	282	302	316	325	331	336
Non-Current Assets	**1 123**	**1 255**	**1 482**	**1 800**	**2 072**	**2 300**	**2 478**	**2 573**	**2 642**	**2 692**	**2 725**	**2 745**
PP&E, net	849	1 056	1 274	1 578	1 837	2 048	2 213	2 300	2 364	2 411	2 442	2 460
Other Non-Current Assets	274	199	208	222	236	252	265	273	278	281	283	286
Total Assets	**1 545**	**1 595**	**2 027**	**2 527**	**2 955**	**3 375**	**3 709**	**3 885**	**4 000**	**4 072**	**4 107**	**4 134**
Shareholders' Equity**	**981**	**1 030**	**1 225**	**1 314**	**1 403**	**1 491**	**1 580**	**1 670**	**1 760**	**1 851**	**1 939**	**2 026**
Share Capital	3	3	3	3	3	3	3	3	3	3	3	3
Reserves and Other**	979	1 028	1 222	1 311	1 400	1 489	1 578	1 667	1 758	1 848	1 936	2 024
Current Liabilities*	**462**	**477**	**704**	**905**	**1 071**	**1 269**	**1 428**	**1 522**	**1 586**	**1 624**	**1 644**	**1 666**
ST Interest Bearing Debt	-	-	8	10	13	15	18	19	20	20	21	21
Trade Payables	111	43	276	258	337	431	506	548	576	593	606	619
Accrued Wages	4	6	10	12	15	18	21	23	24	24	25	25
Accrued Taxes	22	16	48	62	76	92	106	113	119	122	124	126
Other Current Liabilities**	324	412	362	561	630	712	778	818	848	864	868	875
LT Liabilities	**102**	**88**	**98**	**309**	**482**	**614**	**700**	**694**	**654**	**597**	**524**	**442**
LT Interest Bearing Debt	101	88	97	307	480	612	698	692	652	595	522	439
Other LT	1	1	1	1	1	2	2	2	2	2	2	2
Total Liabilities & Equity	**1 545**	**1 595**	**2 027**	**2 527**	**2 955**	**3 375**	**3 709**	**3 885**	**4 000**	**4 072**	**4 107**	**4 134**

Exchange Rates, UAH/USD

	2004	2005	2006F	2007F	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F
Average	5.32	5.12	5.08	5.10	5.10	5.10	5.10	5.10	5.10	5.10	5.10	5.10
Year-end	5.31	5.05	5.10	5.10	5.10	5.10	5.10	5.10	5.10	5.10	5.10	5.10

* These lines for 2003 and 2004 were adjusted to exclude non-recurring items from sales and associated with them expenses from COGS, with net effect included in Other Income / (Expense) and reported above the line
** These lines for 2004-2005 were adjusted to record dividends declared

Financial Statements According To UAS

Cash Flow Statement Summary, USD mln

	2004	2005	2006F	2007F	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F
Net Income	253	365	343	356	354	356	355	357	362	362	353	349
Depreciation	92	100	128	152	175	196	215	230	244	259	273	287
Non-operating and non-cash items	15	(13)	134	(130)	1	(1)	0	(2)	(4)	0	6	3
Less Changes in working capital	(187)	80	26	22	16	12	7	14	20	18	18	16
Operating Cash Flow	**172**	**532**	**632**	**400**	**546**	**562**	**578**	**599**	**624**	**639**	**651**	**655**
Capital Expenditures, net	(261)	(259)	(261)	(456)	(433)	(407)	(380)	(316)	(309)	(305)	(304)	(305)
Other Investments, net	(2)	9	(11)	(14)	(14)	(16)	(13)	(8)	(5)	(3)	(2)	(2)
Investing Cash Flow	**(263)**	**(250)**	**(272)**	**(470)**	**(447)**	**(424)**	**(393)**	**(324)**	**(314)**	**(308)**	**(306)**	**(307)**
Net Borrowings/(repayments)	101	(18)	18	213	175	135	88	(5)	(39)	(57)	(72)	(82)
Dividends Paid	-	(279)	(369)	(137)	(267)	(266)	(267)	(266)	(268)	(272)	(271)	(265)
Other	10	5	0	0	0	0	0	0	0	0	0	0
Financing Cash Flow	**110**	**(292)**	**(350)**	**77**	**(92)**	**(130)**	**(178)**	**(271)**	**(307)**	**(329)**	**(344)**	**(347)**
Beginning Cash Balance	N/A	25	15	24	31	38	46	53	57	59	61	62
Ending Cash Balance	24	15	24	31	38	46	53	57	59	61	62	63
Net Cash Inflows/Outflows	**20**	**(10)**	**9**	**7**	**7**	**8**	**7**	**4**	**3**	**2**	**1**	**1**

Ratio Analysis and Per Share Data

	2004	2005	2006F	2007F	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F
Liquidity Ratios												
Current Ratio	0.91	0.71	0.77	0.80	0.82	0.85	0.86	0.86	0.86	0.85	0.84	0.83
Receivables Collection DOH (est.)	68	30	23	32	33	33	34	35	36	36	36	36
Inventories Processing DOH (est.)	315	166	77	78	77	73	73	75	74	72	70	68
Payment Period (est.)	179	72	63	75	64	65	68	70	71	72	72	72
Cash Conversion Cycle	204	124	37	35	46	41	40	40	38	36	34	31
Operating Efficiency Ratios												
Total Asset Turnover	0.48	0.69	0.90	0.91	0.93	0.97	0.99	1.00	1.00	1.01	1.01	1.02
Fixed Asset Turnover	0.66	0.92	1.19	1.26	1.31	1.41	1.47	1.50	1.52	1.52	1.53	1.54
Operating Profitability Ratios												
Operating Profit Margin	50%	45%	28%	23%	19%	17%	15%	14%	13%	13%	12%	12%
Net Margin	34%	34%	21%	17%	14%	12%	10%	9%	9%	9%	9%	8%
ROE	26%	36%	30%	28%	26%	25%	23%	22%	21%	20%	19%	18%
Financial Risk Ratios												
Debt-to-Equity Ratio	0.10	0.09	0.09	0.24	0.35	0.42	0.45	0.43	0.38	0.33	0.28	0.23
Total Debt-to-Assets Ratio	0.36	0.35	0.40	0.48	0.53	0.56	0.57	0.57	0.56	0.55	0.53	0.51
Interest Coverage	63.3	46.3	47.3	25.3	15.2	11.3	9.6	9.1	9.5	10.1	10.9	12.3
Du Pont Analysis												
Net Margin	34.4%	33.5%	21.2%	17.2%	14.0%	11.5%	10.1%	9.5%	9.2%	8.9%	8.6%	8.3%
Total Asset Turnover												
Fin Leverage Multiplier	1.57	1.56	1.61	1.79	2.02	2.19	2.31	2.34	2.30	2.24	2.16	2.08
ROE = NM x TAT x FLM	25.8%	36.3%	30.4%	28.0%	26.1%	24.6%	23.1%	22.0%	21.1%	20.0%	18.7%	17.6%
Per Share Data, USD												
EPS	4.667	6.730	6.329	6.561	6.531	6.557	6.550	6.591	6.678	6.672	6.517	6.431
DPS	4.667	6.730	2.532	4.921	4.898	4.918	4.912	4.943	5.009	5.004	4.888	4.823
BPS	18.091	18.999	22.591	24.232	25.864	27.504	29.141	30.789	32.458	34.126	35.756	37.363

Exchange Rates, UAH/USD

	2004	2005	2006F	2007F	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F
Average	5.32	5.12	5.08	5.10	5.10	5.10	5.10	5.10	5.10	5.10	5.10	5.10
Year-end	5.31	5.05	5.10	5.10	5.10	5.10	5.10	5.10	5.10	5.10	5.10	5.10

Analyst Certification

I, Vladimir Nesterenko, hereby certify that the views expressed in this research report accurately reflect our 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.

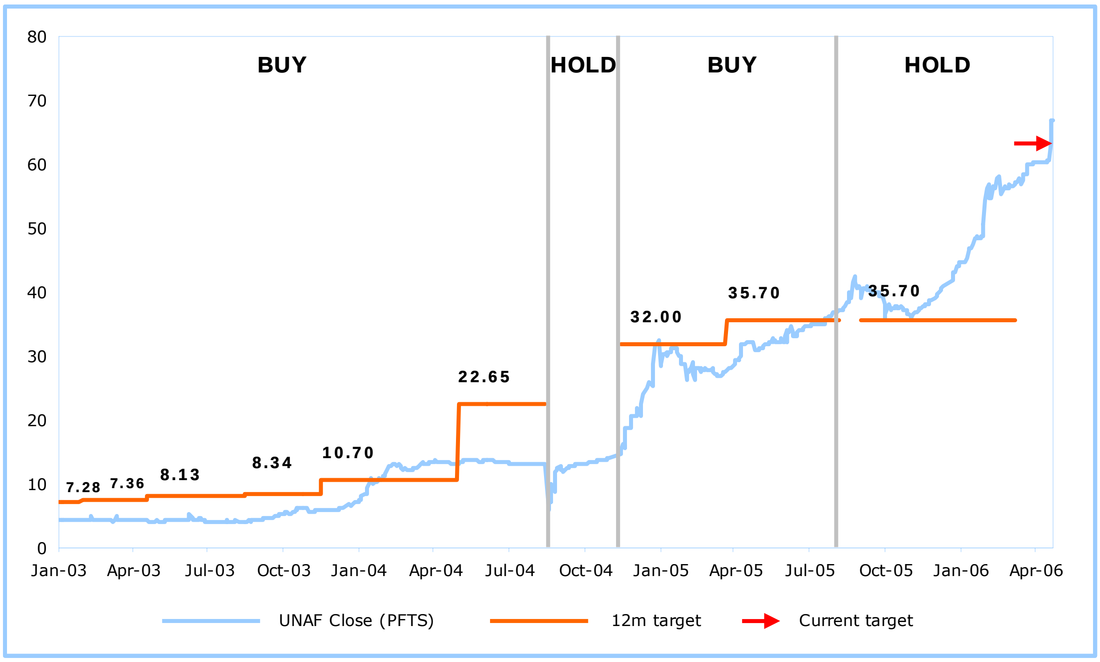
Date	Target price, USD	Closing price, USD
20-Jan-03*	7.28	4.43
17-Feb-03	7.36	4.32
07-May-03	8.13	4.23
03-Sep-03	8.34	4.05
05-Dec-03	10.70	5.87
19-May-04	22.65	13.23
06-Sep-04	Pending	5.93
03-Dec-04	32.00	15.17
11-Apr-05	35.70	27.75
26-Aug-05	Pending	37.00
22-Sep-05	35.70	39.20
15-May-06**	62.60	66.83***

** This stock was covered by analysts currently engaged with Concorde Capital prior to legal inception of the company in Oct 2004, recommendations are supported by research*

*** From January 2003 to December 2005 the company was covered by Andriy Gostik, who now focuses on another sector. In January 2006, Vladimir Nesterenko took over coverage.*

**** Closing price as of May 12, 2006*

Stock Price And Target History, USD



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