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Analyst's Notebook

Ukraine/Telecommunications
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UTEL's AGM: Where Is The Company Going?

Unfortunately, the company's AGM did not answer this question. The key issues of the meeting, privatization and the approval of its 2006 operating plan were not considered, as the Government (the main shareholder) has not decided on the privatization.

The Main Outcomes of the AGM:

Financial results for 2005 announced officially:

- Net revenue USD 1.3 bln (13% growth yoy, 5% higher than our estimates)
- EBITDA USD 370 mln (8% decline yoy, within 2% to our estimates)
- Net income USD 101 mln (30% decline yoy, 20% lower than our estimates)

The effect of mobile cannibalization on UTEL's EBITDA was in line with our forecasts. A significant deviation in net income from our expectations was due to "other expense" items which took a toll on the company's bottom line.

Changes in the supervisory board:

The size of the board increased by three people, two of them are representatives of the "power structures": the Deputy Minister of Internal Affairs and the Deputy Head of the State Security Service.

We believe the latter appointments are related to the restructuring of UTEL (necessary before privatization) as was earlier announced, by separating the special department providing confidential telecom services for state bodies.

Several odious figures were excluded from the board: Sergey Liovochkin (close to Ex-President Kuchma) and Alexander Tretiakov (former Yushchenko advisor, who was accused of corruption just before Yushchenko fired the Tymoshenko government). Now the Yushchenko representative on the board is Yuriy Ruban, a neutral political figure.

Clean-up is always good news.

UTEL's Future Still Holds Uncertainties

Because the government has not yet decided whether to privatize UTEL, the company's financial plan for 2006 has not been approved by the government. The financial plan is expected to be adopted at another shareholders' meeting to be held later this year (after the decision on UTEL future be made).

The Government is considering the tradeoff between its own short-term interests and the interests of its asset, Ukrtelecom, which are contradictory:

The government's interests (budget incomes and social protection) come at a cost for UTEL, by imposing high dividend payouts (84% last year), and by forcing the telecom monopoly to provide universal (social) services. These aims are income-distorting for Ukrtelecom, which in turn lowers its investment attractiveness, would

cause a decrease in the state's proceeds if UTEL is privatized. This explains why government is reluctant to approve UTEL's financial plan before it has decided on privatization.

UTEL From The Point Of View Of The State

If we treat UTEL solely as a cash cow for the government, two cases should be considered:

- **Privatization is announced:** the government's goal in this case is to **sell the company for as much as it can get**, in order to fill the budget. This means the company's investment attractiveness will be boosted further: new licenses (digital TV, Wi-Fi etc), solving the problem of universal service obligation (USO) burden, tariff liberalization, possibility of issuing debt secured by the state.
- **No privatization:** this decision implies different tactics, i.e. **imposing as much burden on UTEL as possible** (again, to fill the budget). This means keeping the burden of USO in place, or even imposing higher dividend payouts at the EGM. The result would be cash flow restrictions for UTEL, resulting in under-investments and a further loss of competitiveness in the telecommunication market, value distortion.

The second outcome does not look beneficial for UTEL shareholders or the state (in the mid-term). Still, it may happen for two reasons:

- in the short run, the government may prefer to have a bird in the hand (milking UTEL rather than spending money to increase UTEL's value for an uncertain return from privatization)
- the "distribution" of political forces may prevent UTEL's privatization. In particular, the Socialist Party of Ukraine is against UTEL's privatization. It is represented in current Government and State Property Fund, and it is likely to remain there in the future. They stood aside when Kryvorizhstal was privatized, but now they may be less agreeable.

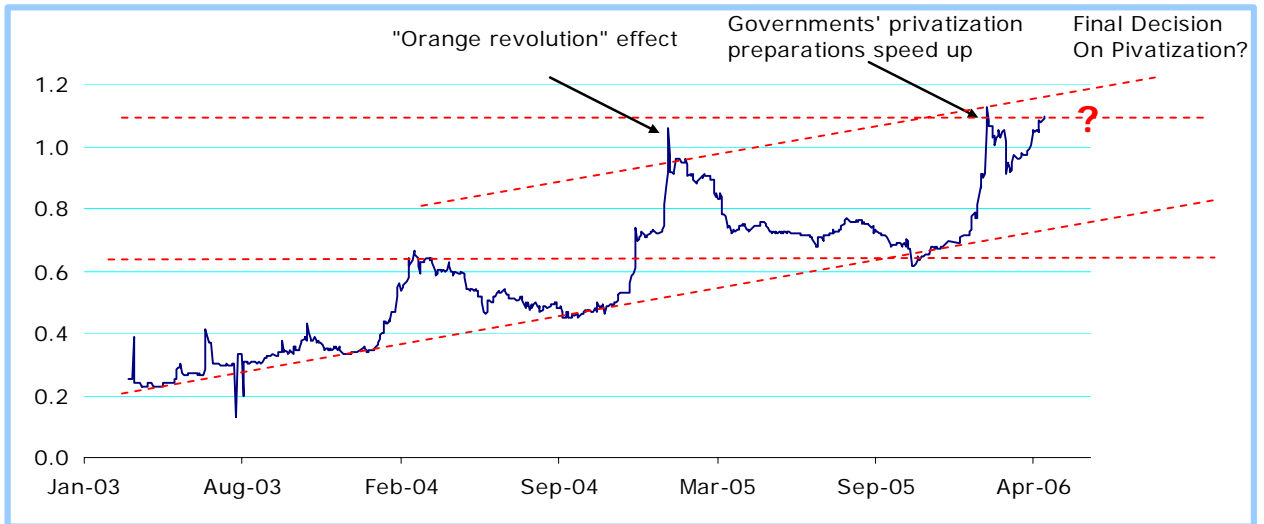
Still, the government understands that keeping UTEL in the state's hands and regulated tariffs will not benefit the company in the environment of increasing competition from mobile and other fixed operators.

What's Next?

We believe, for the government, economic efficiency will outweigh the needs of short term benefits and political limitations, and expect the state to approve the UTEL's privatization in the near future.

Technically speaking, the market has enough room to react heavily to negative news. On the other hand, it will take real good news to break strong resistance level at UAH 1.1 (USD 0.21). Historically, the stock price has reacted swiftly and sharply to positive events. The final decision on privatization may be the trigger that shifts the stock to a new level.

UTEL Mid Market, UAH*



Source: PFTS

* Current UAH/USD exchange rate is 5.05

We reiterate our **BUY** recommendation for UTEL.

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