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Analyst's Notebook

ZaporizhCoke (ZACO)
Recommendation: **BUY**

Ukraine / Metals
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Investment Appeal Regained as ZACO Retreats from Share Issue

With this notebook, we restore our BUY recommendation for ZaporizhCoke (ZACO) after a period of suspension since Aug. 29, 2006, and re-instate a 12-month target price of USD 2.47 per share. The basis for our improved view on the stock was ZACO's AGM yesterday, which brought two positive surprises – the renouncing of a dilutive share issue and the announcement of a large dividend payout.

ZaporizhCoke: No Dilution

At ZACO's AGM on Oct. 18, the company's controlling shareholder tandem of System Capital Management (SCM) and Zaporizhstal voted to remove a controversial item from the AGM's agenda: ZACO's merger with trading company ZARS via a dilutive share issue. This decision effectively prevented a more than 10-fold dilution of minority stakes, which was the risk that prompted us to suspend the stock's recommendation. While the official reason for this decision was an insufficient legal basis for the proposed merger, we infer that the real grounds were:

- Concerns from SCM about the negative publicity that immediately followed the release of the agenda for the AGM. SCM has recently started to position itself as a western-style corporation, and its metal & mining arm, Metinvest Holding, is likely to go public in the next two years. We believe that ZACO's merger with ZARS through a dilutive share issue would not justify the possible erosion in the value of its holding company, Metinvest, due to the negative PR on the eve of Metinvest's expected IPO.

- A recent court ruling on Oct. 10 in favor of minority shareholders in the case of Zaporizhstal's similar dilutive share issue might have signalled ZACO's majority shareholders that a merger with ZARS would involve a lot of costly litigation and delays.

Substantial Dividends: A Positive Sign

The AGM approved a dividend payment of USD 15.8 mln for 2005, an 85% payout from ZACO's 2005 net income. This amounted to a DPS of USD 0.132 and implied a dividend yield of 11% to the ask quote and 16% to the mid-market price, as of yesterday. The dividend payout period is from October 18 to Dec. 31, 2006.

While from 2005-2006 hefty dividends were paid out by Pivnichny and Centralny Iron Ore plants, which are 99%-controlled by SCM, large dividends by ZACO came as a positive surprise. Although it could be in the interest of ZACO's controlling shareholders to re-distribute cash generated by ZACO to its other assets, we do not rule out the possibility that the dividends were a sweetener designed to temper the worries of minority shareholders. If so, this is a signal of improving corporate governance at ZACO.

What to Expect

While it's probably too early to say that the risk of minority shareholder dilution or other unwelcome corporate actions at ZACO has been completely removed for the foreseeable future, we believe that the likelihood of such events has been reduced dramatically. We think it is in the best interest of its controlling shareholders to maximize the market value of their assets as they move toward IPOs. In our opinion, the companies associated with large corporations, such as SCM, Interpipe and IUD, are likely to be among the first to improve corporate governance while their holding corporations prepare to go public.

We restore our BUY recommendation for ZACO and re-iterate a 12-month target price of USD 2.47. The market reaction seems to corroborate our expectations: yesterday the closing ask quote rose 14.5% on the PFTS, while the bid quote surged 42.5%. Our target still implies a 86% upside to the latest ask quote.