



Andriy Gostik
ag@concorde.com.ua
+380 44 207 5037
www.concorde.com.ua
Bloomberg: CONR<GO>

ZaporizhCoke (ZACO)
Recommendation: **Suspended**



Analyst's Notebook

Ukraine / Metals
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On the trail of the mysterious ZARS

This notebook supplements our earlier notebook of August 29 and alert of August 30 about ZaporizhCoke's (ZACO) planned dilutive share issue and merger with the dark horse company ZARS, which is scheduled to be voted on at ZACO's AGM on October 18. Here we present more detailed information that we have found about ZARS, which provides a few clues as to the nature and purpose of the merger.

ZACO's Owners Co-Founded ZARS

ZARS is a metal trader located in Zaporizhyya, which appears to have been co-founded by the same three business groups that own ZaporizhCoke: System Capital Management, which owns 35.7% of ZACO; ARS (another Donetsk-based business group, which often cooperates with SCM), which owns 15.3% of ZACO; and the owners of Zaporizhstal (**ZPST: Susp**), who own 41% of ZACO.

ZARS's owners when it was founded in 2002 included:

- Ukrainian limited company Luks, owned by Dongorbank, which is owned by SCM;
- Ukrainian limited company Luks-Service, probably also controlled by SCM;
- The Donetsk Shakhtar Football Club, owned by SCM;

- Valery Dudinov, who has worked as a manager at ARS;

- Ukrainian limited company Tsentrostal, one of the trading companies with which Zaporizhstal is seeking to merge through a similar dilutive share issue;
- Swiss-registered AiroI Beteiligungen AG, which owned 14.9% of Zaporizhstal as of July 24;
- Cyprus-registered Denssec Ltd, which owned 7.9% of Zaporizhstal as of January;
- Metallurg Zaporizhyya Football Club, likely to be controlled by Zaporizhstal's owners.

In 1H06, ZARS's main activity was the export of rail cars and cisterns produced by Azovzahal'mash (controlled by SCM), while in 2005 ZARS was mainly exporting pipes produced by Luhansk Pipe (owned by Zaporizhstal) and rail cars and cisterns from Azovzahal'mash.

This information suggests, in our view, that ZARS's ownership structure has traditionally been similar to that of ZaporizhCoke.

But ZACO Could Have Been Sold

If the planned merger of ZACO and ZARS announced this week is carried out, the owners of ZARS will own just over 90% of ZACO's shares after the merger. Thus, assuming ZACO's main shareholders own stakes in ZARS in roughly equal proportions to their stakes in ZACO, the main effect of the merger would be to increase the stakes of ZACO's three main shareholder groups while shrinking the shares of minority shareholders by 10 times.

However, it is possible that ZARS's ownership has changed, or that an agreement has been made that at some point before the merger is completed ZARS's ownership would be changed. Thus, any of the three possible scenarios suggested in our notebook of August 29 – we hypothesized that ZARS might be a vehicle for either SCM, Zaporizhstal's owners, or some third group to acquire control of ZACO – could be true.

Looking at IPOs, Disregarding Existing Minority Shareholders

One legitimate purpose of the proposed merger could be to streamline SCM's and Zaporizhstal's business operations. Both groups are actively seeking western financial capital and considering IPOs within the next few years, and the appearance of companies like ZARS in their business structures is an obstacle.

But even while they work on plans for IPOs, some Ukrainian business groups continue to view their companies' existing minority shareholders as a nuisance. For a business group that wants to consolidate a group of companies, having minority shareholders in each individual company can make matters complicated.

The scale of the proposed share issue by ZACO suggests that the dilution could be deliberate. Normally, in order to minimize taxes, share swaps are arranged so that the par value of the shares being swapped are equal. In this case, ZACO plans to swap UAH 11 mln worth of newly issued ZACO shares for 100% of ZARS's shares. But as of June 2006, ZARS's charter fund was only UAH 16,500. In order for the share swap between ZACO and ZARS to be nominally equal, ZARS's charter fund would have to be increased some 667 times.

If so, the dilutive share issue would be very similar to the one planned at Zaporizhstal, which is attempting to swap newly issued shares for the shares of five trading companies. Reportedly, those trading companies' charter funds were increased just prior to the merger announcement.

On the other hand, our trading desk reported today that regional traders associated with Zaporizhstal were bidding for large volumes in ZACO at its current low price. This may mean that ZACO's owners intentionally confused the market in order to buy the shares on the cheap and may not go through with the share issue after they have done so, a technique Nyzhnyodniprovsky Pipe's owners employed in 2004.

ZARS Financials: Substantial But Shrinking

ZARS has substantial sales and healthy margins. However, both sales and margins show a declining tendency.

	2004	2005	1Q06	1H06
Sales	506.6	449.3	75.1	152.8
EBITDA	81.6	48.7	4.7	9.1
<i>EBITDA mgn</i>	16.1%	10.8%	6.3%	6.0%
Net income	61.1	36.6	3.5	6.8
<i>Net mgn</i>	12.1%	8.1%	4.7%	4.4%
Total assets	53.7	27.2	31.2	27.7
Current assets	53.6	25.2	27.1	23.6
Current liabilities	53.6	26.7	24.7	27.5

ZARS's assets are mostly comprised of trade receivables and inventory, while liabilities are mostly trade payables. We think the company is not doing business independently, but rather is a vehicle for the business groups that control it, and thus its financials can exhibit high volatility.

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