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Analyst's Notebook

Ukraine / Electricity
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ZAEN Recommendation Downgrade: HOLD

Market price: USD 32.0
12m Target: USD 34.0
Upside: 6%

UCTE Integration Shelved, Trouble For ZAEN?

Deputy Minister of Fuel And Energy, Alexey Sheberstov's recent claim that the Ukrainian power network was not ready to be integrated into the EU's UCTE network signals the start of a more practical approach to increasing electricity exports. Ukraine is likely to shift its focus to an alternate project to raise electricity exports to EU countries in the near future. The project involves the construction a high-voltage direct current (HVDC) system between Ukraine and the UCTE to facilitate exports. The switch will be good for the Ukrainian energy sector in the short- and midterm, but bad news for Zakhidenergo (**ZAEN**), the only company integrated with the UCTE.

ZAEN is now traded at close to our target, and we do not see any triggers that would raise its value in the short-term. We downgrade our recommendation on ZAEN to **HOLD**.

Yanukovich To Export Electricity The Cheap Way

The previous government's plan was to increase energy exports to EU countries by quickly (in 5-6 years) connecting to the UCTE. However, integration requires large investments of about USD 2 bln for modernization and to lower air pollution emissions to meet EU standards, which would only bear fruit in the form of larger exports in 5-6 years. The new government's plan is much simpler.

Yanukovich's government plans to sidestep integration costs and increase electricity exports to the UCTE by building a high-voltage direct current (HVDC) system which will transform Ukrainian electricity to meet UCTE parameters. The government will only need USD 0.2 bln to build an HVDC, ten times less than the original plan required.

Energoatom, a nuclear power producer lobbied for this program a year ago, however, the government was focused on integrating with the UCTE.

In Line With The New Government's Strategy

The previous energy sector regulators indirectly worked in the interest of Zakhidenergo (remember ZAEN's CEO was the president of the National Energy Company), which by virtue of its connection to the UCTE, remained the only exporter of electricity to the EU. With the arrival of the new government, people related to Donetsk Fuel And Energy Company (DFEC) have been given top posts in the energy sector and they want to export electricity from their power plants as soon as possible.

Additionally, the shelving of UCTE integration may also pay political dividends: cooperation with Russia (including exports to Russia) is now more probable.

ZAEN's Export Growth To Slow?

Following construction of the HVDC, all generation companies will be able supply electricity to the UCTE network, which means ZAEN's reign as Ukraine's export monopoly would be over. We do not believe ZAEN will reduce its exports to the UCTE, but it is clear that the company will face stiffer competition when trying to increase its exports and will be less likely to have state backing.

Implication For ZAEN Valuation

We have not revised ZAEN's target price, as we believe the slow down in export growth will be compensated by greater domestic demand. ZAEN has significantly decreased its use of gas, making it more price-competitive:

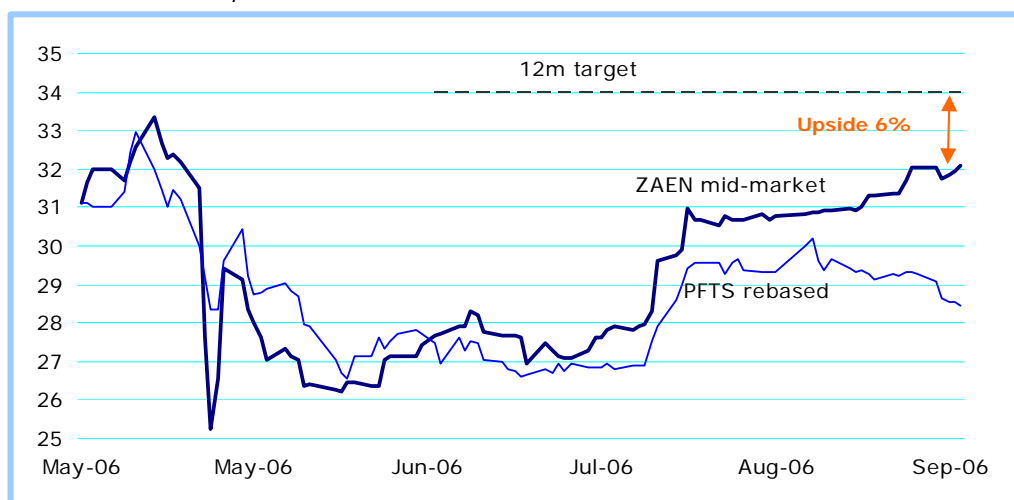
Use Of Fuel By ZAEN

	7m05	7m06
Gas	36.3%	9.8%
Coal	63.6%	90.0%
Oil	0.1%	0.2%

Source: *EnergoBiznes*, Concorde Capital calculations

However, as ZAEN stocks price is approaching our 12m target, we downgrade our recommendation to HOLD.

ZAEN Market Price, USD



Source: PFTS

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