



Concern Galnaftogaz

FY09 results and notes from analysts' day

Sector

Retail: Gasoline stations

Credit ratings by Moody's/S&P/Fitch

Not rated

MONDAY, 26 APRIL, 2010

RESEARCH INSIGHT

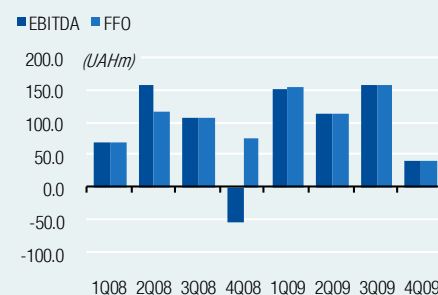
Following are notes from Concern Galnaftogaz's analysts' day held earlier this month (pages 2-4). Alongside, we provided a brief analysis of the company's FY09 financials, which revealed a slowdown in profitability in 4Q09. The key issue regarding the company's operations going forward is whether or not the tough market environment of 4Q09, when the largest player was squeezing margins at second-tier gasoline retailers, will continue in the future.

Operations and financial results for 4Q09. Concern Galnaftogaz disclosed its FY09 audited financials, shedding light on the state of its operations in the final quarter of the year. On a quarterly basis, margins declined amid a tough competitive environment set by Privat Group, the largest gasoline retailer in the space, which forced margin-squeezing across the sector. Galnaftogaz's gross margin in 4Q09 was at 5.1%, down from 12.7% in the previous quarter, while EBITDA margin contracted to 2.4% from 9.8% over the same time span. On a 12-month rolling basis, however, 4Q09 margins slowed only marginally from the levels seen in the previous quarters of 2009, on the back of the company's ending the 4Q08 in the red. The company, which just reported an EBITDA margin of 6.9% in 1Q10 based on UAS financials, expects the government's December 2009 decree to maintain a level playing field for the sector.

Cash flow provided support for increased investments in 4Q09. In terms of cash flow, Galnaftogaz managed to adjust its working capital requirements in 4Q09 in order to greatly increase net cash flow from operating activities (to UAH27m in 4Q09 from UAH4m in 3Q09). Alongside with improved financing conditions, the company continued to increase debt by UAH64.3m, which has allowed Galnaftogaz to accelerate its capital expenditure spending, which amounted to UAH141m in the 4Q09, up from UAH57m and UAH81m, respectively, during the previous two quarters. In total, the company put into operation 26 OKKO-branded filling stations over the course of 2009 and 1Q10, expanding its network of filling stations to 309 units as of 1 April, 2010, of which 286 stations operated under the OKKO brand.

Leverage. The period of 4Q09 delivered poor results for the company, with its EBITDA interest coverage for the period at 0.7x on the back of slim margins in the quarter. On a 12-month rolling basis, the EBITDA interest coverage ratio was at 2.5x as of year-end 2009, up from 2.3x as of end-3Q09, thanks to the fact that the company's FY09 12-month EBITDA rose from the volume seen during the 12-month period to September 2009 (by comparison, the company ended 4Q08 with negative EBITDA). Similarly, debt-to-EBITDA as of year-end of 2009 improved to 4.9x from 6.0x in the 3Q09. The key question mark now is whether Galnaftogaz will be capable of restoring margins back to their norm of 9%, a development that is crucial for the company's credit standing.

Tough market conditions in 4Q09 squeezed Galnaftogaz earnings



Source: Company data.

Quarterly financial figures (UAHm, IFRS)

	1Q09	2Q09	3Q09	4Q09
P&L				
Revenues	1,015	1,237	1,610	1,724
Gross income	173	169	208	88
EBITDA	153	115	158	41
Interest exp [1]	44	50	31	62
Balance sheet (eop)				
Assets	4,424	4,580	4,438	4,974
Equity	1,668	1,595	1,598	1,724
Debt	1,999	2,049	2,253	2,311
LT debt (% of total)	79.1	72.8	69.3	81.0
Cash flow				
FFO	155	115	159	42
Net CFO	173	7	4	27
Capex	55	57	81	141
Free CFO	119	-50	-77	-114
Profitability ratios (% ann'd)				
Gross margin	10.4	11.4	13.2	11.4
EBITDA margin	6.8	6.2	7.2	8.4
Debt ratios (x, eop ann'd)				
Debt/Equity	1.2	1.3	1.4	1.3
Debt/EBITDA	5.4	6.3	6.0	4.9
EBITDA int coverage	2.6	2.0	2.3	2.5

Note: [1] from cash flow statement; eop – end of period; LT – long-term; FFO – funds from operations; CFO – cash flow from operations; ann'd – annualised; exp – expenses; int – interest.

Sources: Company data, Investment Capital Ukraine LLC

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Notes from analysts' day

The following are our notes from the analysts' day the company held on 8 April, 2010.

Galnaftogaz is No.3 in Ukraine in terms of market share and the size of its filling stations network, operating under the OKKO brand

Galnaftogaz has managed to preserve its ranking as the third-largest network of petrol filling stations in Ukraine, operating under the brand OKKO, the number of which grew to 309 in 2009 from 288 a year ago, just less than one-fifth of the number owned by the market leader, Privat group (with 1,638 filling stations in 2009), which has been expanding aggressively in the recent years, in large part due to lobbying efforts and other non-market means, which enabled the group to sell its petrol at lower cost than the market price—dubbed as “dumping” by Galnaftogaz. The company has 309 petrol stations situated in 22 oblasts of Ukraine, with the majority in the Western Ukraine, and owns 98 petrol tank trucks, 11 petroleum storage depots, and eight certified laboratories, and employs 5,415.

Chart 1. Galnaftogaz's network of petrol filling stations

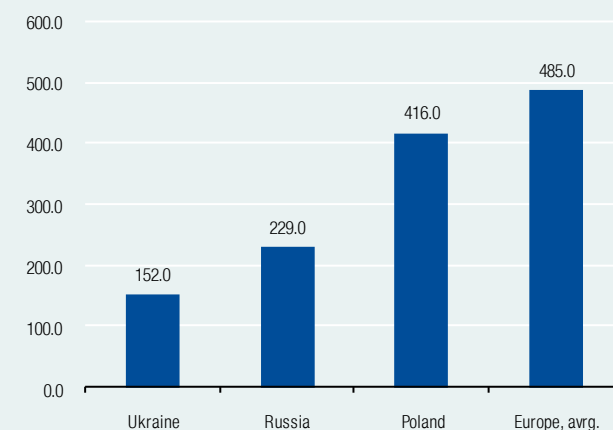
As of end of period



Source: Company data

Chart 2. Number of cars per 1,000 persons in Ukraine

As of year-end of 2009



Source: Company data

Galnaftogaz is No.1 in terms of efficiency of its network (sales per filling station)

According to the company, which has just less than one-fifth the total number of filling stations of its competitor, its OKKO brand realises one-third of its larger competitor's market sales (10% for OKKO stations, compared with 30% for those of Privat group), due to higher efficiency of its filling stations' network, as measured by the ratio of market share sales to market share by number of stations. In terms of the efficiency of the network, OKKO is No.1 in Ukraine, while it is No.3 in market share in sales. The sales-per-filling station ratio is higher at OKKO stations than in Ukraine on average (6.11 tonnes for day at OKKO stations, compared with Ukraine's average of 5.75 tonnes/day in 2009; 7.43 to 6.67 tonnes/day in 2008; and 8.24 to 7.07 tonnes/day in 2007), and far higher than at non-branded stations (1.99, 1.84, and 2.11 tonnes/day for 2009, 2008 and 2007, accordingly).

Galnaftogaz sold 641,655 tonnes of oil products, worth US\$717m, in 2009

Its network of filling stations has reached 309 (20 new stations in 2009)

Galnaftogaz's petrol sales fell 5.5% in 2009, along with the overall market decline linked with economic recession, to 641,655 tonnes of oil products (worth US\$717m) from 678,028 tonnes (worth US\$1.046bn) in 2008. Petrol market sales fell by 8.7% in 2009, which affected Galnaftogaz's sales accordingly. Other factors negatively affecting sales were the dumping by its competitor, Privat, which caused a further 6% in sales decline, and the aggressive expansion of its another competitor, Shell, accounting for a further 1.1% decline, according to the company's own estimates. To offset these negative trends, Galnaftogaz

launched an aggressive marketing campaign (which in effect increased sales by 7.8% in 2009) and put into operation an additional 21 filling stations in 2009 (which were built from scratch and purchased from other smaller gasoline retailers), which in turn provided an upside 2.5% contribution to its overall sales). The major decline in sales was in the corporate client sector, which accounts for around 40% of the company's revenues, but at the same time, the sales to retail clients (for-cash sales) actually rose during the crisis-laden 2009.

The local market still has a high potential of further growth for the petrol-distribution business

The company's higher growth prospects for 2010 are based on the fact that the local market is still far from being saturated, according to the European average. Despite the auto selling boom in 2005-2008, when new auto sales in the country rose at 33% CAGR, Ukraine in 2009 still had a lower number of cars per capita (152 cars per 1,000 persons) than Russia (229), Poland (416), and Europe (485 on average). In 2010, with the expected end to the economic recession, new car sales are expected to start growing again (the 71% drop in car sales in 2009 means that a portion of demand was delayed which should be realised in coming years). In addition, the number of petrol stations per capita is still lower in Ukraine (7,399) as of 2009 than in other European countries (5,978 in Turkey, 5,563 in Poland, and 6,612 in Great Britain). The total number of filling stations grew at a mere 6% CAGR over 2005-08, despite the soaring numbers of new car sales, leaving filling networks with vast expansion capacities for the years to come. At present, there is still a large share of non-branded stations, around 43% of the total, while the current market trend and consumer sentiments lean towards well-known networks which benefit from strict quality control and the additional services they provide.

In 2009, the company imported all its inputs

The number of filling stations owned by Galnaftogaz has increased to 14.2% CAGR over the past five years (2004-09), and the company plans to further expand its network through deeper penetration into the South and Eastern regions' largest cities and the city of Kiev. The management reported having a large quantity of land plots under ownership or long-term lease to support its expansion plans.

Galnaftogaz's petrol-filling business is supplemented by peripheral services, such as restaurants and grocery stores

The company is well diversified in terms of supplies of its inputs, or oil products, which it imports from Belarus (57% of total supplies in 2009), Poland (19%), Lithuania (16%) and Romania (8%). In earlier years, the company also purchased its oil products from Ukrainian and Russian oil refineries, but allegedly stopped doing so because of their poor quality. As a result of such a supply policy, as well as maintaining strict quality control with its own certified laboratories at each of the four stages of the products' transportation process, OKKO filling stations are known among the local consumers for the quality of their petrol.

The company supports its main business, petrol filling, with peripheral services, such as a grocery store, restaurant, and fast food, which successfully supplement the main business and generate extra revenues. Revenues from this segment have been growing steadily over the past years, both in absolute numbers and as a share of sales of 1,000 litres of petrol, which in 2009 comprised 7.5% of total sales (UAH416.7m, or US\$53.5m)

EBITDA grew 63% in UAH terms, but fell 6.9% in USD terms, to US\$58.2m in 2009; EBITDA margin rose to 8.4%

According to our calculations EBITDA in 2009 was at UAH467.3m, or 63.0% higher than in 2008, if measured in hryvnia terms. However, as a result of sharp devaluation of the local currency, in U.S. dollar terms, EBITDA fell by 6.9%, to US\$58.2m in 2009, compared with US\$71.4 in 2008. Other factors negatively affecting EBITDA were the overall economic slowdown and resulting drop in physical volumes of sales, and the use of non-market measures by key player Privat Group such as marketing a special type of gasoline that qualifies for a lower excise duty by the state.

Revenues barely rose in nominal terms throughout 2009, increasing by 1.4% to UAH5.6bn. In US dollar terms, total revenues of 2009 amounted to US\$694.9m, down from US\$1.071.6bn in 2008. EBITDA margin rose to 8.4% in the full year of 2009, up from 5.2%

in 2008 and 4.2% in 2005.

Galnaftogaz has a total of US\$291.6m of loans outstanding, and open credit lines

Galnaftogaz has a total of US\$291.6m of investment credits outstanding as of year-end 2009, all dollar-denominated and linked to LIBOR. This includes US\$118.7m from EBRD and US\$114m from IFC, both due in 2012-16; US\$35.6m from Raiffeisen Bank Aval, due in 2014; and US\$22.6m from Black Sea Trade and Development Bank, due in 2011-15. For 2010, the amount to be repaid on loans equals US\$55.2m, and US\$56.2m for 2011, and will gradually decrease in the following years, to reach US\$28.6m in 2016. In the beginning of 2009, a US\$50m funding agreement was reached with EBRD, out of which US\$20m has been transferred in exchange for 10% of the company's shares; the management now has the option of using the remaining US\$30m, but is likely to withdraw from this additional funding option, it says. All short-term loans have been successfully extended during 2009 for financing working capital. So far, all creditor obligations have been fulfilled in a complete and timely manner. No new bond issues are envisaged for the foreseeable future.

Galnaftogaz invested US\$41.4m in 2009, and will invest over US\$48m in both 2010 and 2011

Galnaftogaz invested UAH333m (US\$41.4m) in 2009, and plans to invest around UAH375m (US\$48m) in 2010 and about the same amount in 2011. The management plans the purchase of new filling stations and land plots where new stations can be built, as well as the construction of new filling stations (costs are around US\$1.2-2m per station). Regarding new filling stations, the company is mainly interested in large stations (over 10 tonnes per day), situated in busy locations in big cities (with populations of over 1m). Galnaftogaz plans to open 20-30 new stations a year, until their total number reaches 500, which is seen as an optimal level.

IPO plans might not materialise until 2011, or until market capitalisation reaches US\$500m

Since 2008, Galnaftogaz has been ready for an IPO, but has postponed these plans till 2011-12, when the market conditions should improve. By that time, the management believes the company's capitalisation will reach US\$450-500m, and its share price will stand at UAH0.2 (it is currently quoted at UAH0.15 at a local stock exchange, although trading is at very low volumes), while the EV/EBITDA multiple will be around 10x. So, the company expects that it will attract around US\$125m for the 25% of the shares that are likely to be offered.

The company's recent initiatives, aimed at further increasing efficiency and reaching new clients, include the introduction of an ERP (enterprise software solution) system on the SAP platform, client loyalty schemes, the launching of a traffic-coordinating service (aimed to reduce transport expenses by 30%), a tender committee (aimed to minimise non-operational expenses), and the launching of energy-saving practices and a "Go Green" campaign.

Financial statements (IFRS, 2003-09)

Income statement

Table 1. Concern Galnaftogaz's income statement 2003-09 (UAH 000s)

	2003	2004	2005	2006	2007	2008	2009
Revenues	942,375	1,283,605	1,944,616	2,599,175	3,208,848	5,509,262	5,585,509
Cost of sales	-897,692	-1,222,630	-1,830,841	-2,443,822	-2,989,237	-5,035,995	-4,947,896
Gross income	44,683	60,975	113,775	155,353	219,611	473,267	637,613
General & administration expenses	-22,449	-30,979	-45,848	-65,598	-79,551	-135,277	-195,758
Other operating income	0	4,315	587	24,790	24,949	15,728	32,274
Other operating expenses	-2,832	-3,958	-5,647	-6,914	-17,697	-128,718	-109,912
Operating income	19,402	30,353	62,867	107,631	147,312	225,000	364,217
Financial expenses	-7,786	-6,073	-22,422	-52,067	-72,442	-127,458	-171,864
Financial income	1,007	3,672	9,789	242	561	-660,307	-60,949
Profit before income tax	12,623	27,952	50,234	55,806	75,431	-562,765	131,404
Income tax	-1,536	-5,704	-9,745	-13,839	-13,195	141,828	-39,690
Net income	11,087	22,248	40,489	41,967	62,236	-420,937	91,714

Notes: 2003-09 are audited accounts.

Source: Company data

Balance sheet

Table 2. Concern Galnaftogaz's balance sheet 2003-09 (UAH 000s)

	2003	2004	2005	2006	2007	2008	2009
ASSETS							
Non-current assets							
PP&E	179,194	239,895	405,818	739,084	1,460,108	3,440,626	3,412,198
Intangible assets	8,930	7,777	8,123	7,112	5,780	5,409	70,009
Investments	35,249	41,986	2,264	31	31	0	1
Deferred tax assets	5,775	7,085	10,330	11,178	12,401	136,145	88,442
Other non-current assets	917	125	284	351	347	340	334
Total non-current assets	230,065	296,868	426,819	757,756	1,478,667	3,582,520	3,570,984
Current assets							
Inventories	15,156	30,210	72,042	104,990	148,186	209,997	356,746
Trade & other receivables	60,569	89,929	239,619	209,719	156,356	365,651	298,925
Prepayments and other current assets	20,723	44,570	38,868	130,277	194,987	134,715	574,324
Prepaid income tax	270	1,107	0	0	328	31,439	4,852
Cash & cash equivalent	9,308	13,348	16,342	52,766	56,672	75,057	168,397
Other current assets	0	0	33,430	0	0	0	0
Total current assets	106,026	179,164	400,301	497,752	556,529	816,859	1,403,244
TOTAL ASSETS	336,091	476,032	827,120	1,255,508	2,035,196	4,399,379	4,974,228
LIABILITIES & EQUITY							
Equity							
Share capital, retained earnings & other capital	167,890	203,412	312,790	450,025	821,522	1,603,088	1,723,083
Minority interest	48	494	560	523	752	1,013	767
Total equity	167,938	203,906	313,350	450,548	822,274	1,604,101	1,723,850
Non-current liabilities							
Loans & borrowings	81,674	125,327	155,657	354,965	583,614	1,608,733	1,872,491
Deferred tax liabilities	4,787	9,608	26,782	66,929	116,469	507,054	436,264
Total non-current liabilities	86,461	134,935	182,439	421,894	700,083	2,115,787	2,308,755
Current liabilities							
Loans & borrowings	11,461	20,049	176,434	244,006	288,125	436,834	438,611
Income tax payable	82	0	577	449	0	0	0
Payables & advances received	62,984	113,092	154,161	138,507	223,742	242,368	494,552
Other current liabilities	7,165	4,050	159	104	972	289	8,460
Total current liabilities	81,692	137,191	331,331	383,066	512,839	679,491	941,623
TOTAL LIABILITIES & EQUITY	336,091	476,032	827,120	1,255,508	2,035,196	4,399,379	4,974,228

Notes: 2003-09 are audited accounts.

Source: Company data

Cash flow

Table 3. Concern Galnaftogaz's cash flow statement 2003-1Q09 (UAH 000s)

	2003	2004	2005	2006	2007	2008	2009
Cash flow from operating activities							
Profit before income tax	12,623	27,952	50,234	55,806	75,431	-478,872	157,992
Adjustments for:							
Depreciation, amortisation and impairment of goodwill	9,665	14,499	18,946	24,898	36,514	60,282	75,619
Interest expense, net	4,998	5,908	21,613	51,825	71,881	126,374	124,545
other adjustments	775	-6,111	-8,436	-294	-1,538	673,087	70,197
Operating profit before changes in working capital	28,061	42,248	82,357	132,235	182,288	380,871	428,353
Increase in inventories	-2,793	-12,667	-41,817	-32,899	-43,037	-61,811	-125,332
Decrease/(Increase) in current assets (ex. Inventories)	-28,349	-49,714	-129,638	-23,182	114,723	-148,614	-113,135
Increase/(Decrease) in current liabilities	24,144	38,933	30,754	-9,715	-21,346	13,816	-22,649
Cash flow generated from operations	21,063	18,800	-58,344	66,439	232,628	184,262	167,237
Income tax paid	-913	-2,977	-10,983	-9,356	-12,355	-33,628	17,028
Net cash flow from operating activities	20,150	15,823	-69,327	57,083	220,273	150,634	184,265
Cash flow from investing activities							
Purchases of PPE	-102,852	-61,735	-96,480	-215,738	-548,771	-607,140	-188,151
Purchases of intangible assets	-6,608	-100	-1,932	-561	-326	-4,719	-4,257
Proceeds from sale of equipment	3,621	4,776	3,856	1,237	1,656	38,616	1,169
Interest received	0	30	801	242	561	563	1,571
Dividend received	0	0	0	0	0	0	0
Other cash flows from investing activities	-25,399	-5,497	-10,938	-8,513	-102,156	0	0
Net cash used in investing activities	-131,238	-62,526	-104,693	-223,333	-649,036	-572,680	-189,668
Cash flow from financing activities							
Issue of share capital	60,563	13,300	18,380	0	226,578	16,264	0
Proceeds from loans & borrowings	128,942	118,617	222,076	328,780	431,230	720,474	389,355
Repayments of loans & borrowings	-69,505	-66,376	-42,700	-61,728	-154,255	-188,934	-249,500
Interest paid	-4,942	-14,798	-20,742	-64,378	-70,884	-107,373	-125,226
Net cash provided by financing activities	115,058	50,743	177,014	202,674	432,669	440,431	14,629
Cash & cash equivalent at the beginning of period	5,338	9,308	13,348	16,342	52,766	56,672	69,693
Net increase in cash & cash equivalent	3,970	4,040	2,994	36,424	3,906	18,385	9,226
Cash & cash equivalent at the end of period	9,308	13,348	16,342	52,766	56,672	75,057	78,919

Notes: 2003-09 are audited accounts.

Source: Company data

Disclosures

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