



Concern Galnaftogaz

A pulse amid deep recession in the economy

Sector

Retail: Gasoline stations

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

Not rated

MONDAY, 5 OCTOBER, 2009

RESEARCH INSIGHT

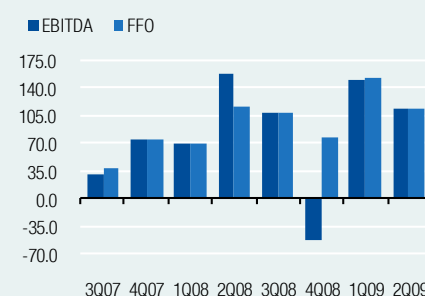
OJSC “Concern Galnaftogaz,” a fully independent player in Ukraine’s downstream petroleum retailing industry, has published its unaudited IFRS financials for 1H09. Our analysis of the company’s semi-annual results yields the following conclusions.

Firstly, there is an early warning of weak consumerism in the numbers that characterise flow of sales. Total volume of sales of petroleum products in 1H09 was 5.6% lower, at 298m tonnes, than in the same period of 2008. Our detailed analysis of sales volume for 1H09 and 1H08 points to the fact that a weaker consumer is emerging in the numbers. Thus, despite a noticeable jump in sales by 17.8% QoQ, to 161,000 tonnes in 2Q09 compared with 137,000 tonnes in 1Q09, the volume of sales per filling station did decline, albeit slowly, by 6.7% YoY in 2Q09. In our view, the economic effects of deep recession that swept across the country have yet to put pressure on industries and companies that depend on consumers’ williness and ability to spend. According to our baseline scenario, Galnaftogaz is likely to show a quarterly volume of sales of 150-157,000 tonnes per quarter in 2H09-FY10.

Secondly, Galnaftogaz shows improved profitability. In our view, the larger part of such an improvement is more a result of the company’s actions than favourable market conditions. Faced with the possible risk of further deterioration in the economy from currency devaluation, and hence a growing bill to the company’s creditors, Galnaftogaz shifted to a cost-cutting and profit-maximizing strategy, which managed to bear fruit. In 1H09, gross margin, at 15.2%, was 6.6ppt higher than in the same period of the previous year. EBITDA margin rose 2.8ppt to 11.9%. In terms of cash flow, Galnaftogaz’s funds from operations (FFO)—earnings before cash expenses on interest payments, taxes, and amortization—rose to 12% of 1H09 revenues, or 4.5ppt, up from 7.8% of 1H08 total sales.

Third, leverage looks manageable. After a deep nominal devaluation of the local currency that took place in 4Q8 and further devolution pressures seen in 1H09 and 3Q09, Galnaftogaz’s book of debt rose by 77% over the 12-month period ending last June, to UAH2.05bn. The company’s balance sheet was propped up in 4Q08 by non-cash means of fixed-assets revaluation, which boosted equity by UAH1.05bn. This helped to restore pre-crisis levels of balance-sheet leverage ratios. The above-mentioned profitability improvement, especially evident when considering FFO as an earnings indicator, helped to mitigate deterioration of leverage ratios that are based on earnings (EBITDA and FFO). Hence, from a cash-flow viewpoint, Galnaftogaz did manage to stabilise its leverage at a level that fits in with the average of the preceding six quarters—as of the end of 2Q09, the ratio of debt to annualised FFO was 4.5x, which is a bit lower than 4.6x, the average for 4Q07-2Q09.

Earnings show a pulse
 quarterly volumes of EBITDA and FFO (UAHm)



Note: EBITDA is operating income plus cash depreciation and amortisation; FFO (funds from operations) is operating cash flow before changes in working capital.
 Source: Company data.

Quarterly financials (UAHm)

	3Q08	4Q08	1Q09	2Q09
P&L				
Revenues	1,635	1,344	1,015	1,237
Gross income	119	137	173	169
EBITDA	109	-53	153	115
Interest exp (cash-based)	33	38	44	50
Balance sheet (eop)				
Assets	2,758	4,219	4,424	4,580
Capital	1,013	1,472	1,668	1,595
Debt	1,415	2,046	1,999	2,049
LT debt (% of total)	74.4	78.6	79.1	72.8
Cash flow				
FFO	110	78	155	115
Net CFO	-66	258	173	7
Capex	-148	-182	-55	-57
Free CFO	-214	76	119	-50
Profitability ratios (% , based on qtlly figures)				
Gross margin	7.3	10.2	17.0	13.7
EBITDA margin	6.7	-3.9	15.1	9.3
Debt ratios				
Debt/Capital (x, eop)	1.4	1.4	1.2	1.3
Debt/EBITDA (x, ann)	3.4	7.1	5.4	6.3
EBITDA int coverage (qtlly)	3.4	-1.4	3.5	2.3

Note: eop – end of period; LT – long-term; FFO – funds from operations; CFO – cash flow from operations; ann – annualized; int – interest. Sources: Company data, ICU.

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Analysis of 1H09 financials

The latest financial results from Concern Galnaftogaz show that the company did improve profitability, stabilising its leverage ratios (based on funds from operations) at a level which is close to its historical average for the last six quarters (4Q07-1Q09). Consumer demand deterioration is a key risk for the company, in our view.

On 28 September, 2009 Concern Galnaftogaz announced its financial results for the first half of the year, recording profitability improvement compared with the same period of 2008 due to better cost controls imposed in the wake of a sizable economic contraction in the country.

Semi-annual versus quarterly financial results

Oil price volatility and local currency devaluation had a key impact on size of sales,...

Amid turbulence of the crude oil price during the course of 2008-1H09 and rocky fluctuations of the local currency exchange rate over the same period, the company's sales showed a degree of change as well. The results of the first half of 2009 recorded an 11.0% contraction of revenues, which are in local currency, to UAH2.3bn compared with UAH2.5bn gathered during 1H08 (see Table 2 on page 4). The volume of petroleum products sold via the company's retail network was down by 5.6% YoY—from 315,200 tonnes in 1H08 to 297,700 tonnes in 1H09. In US dollar terms, revenues plunged by 45%, to US\$284.3m in 1H09 from US\$516.5m in 1H08, according to our estimates of the company's sales in foreign-currency denomination.

Table 1. Impact of new business environment of 2008-09 on Concern Galnaftogaz's financials

	1H08	1H09	Change
Profitability (%)			
Gross margin	8.6	15.2	6.6ppt
Operating margin	8.0	9.7	1.7ppt
EBITDA margin	9.1	11.9	2.8ppt
Leverage			
Debt/Assets (%)	44.3	44.7	0.4ppt
Debt/Equity (x)	1.2	1.3	5.9%
Debt/EBITDA (x, annualised)	3.4	6.3	85.0%
EBITDA interest coverage (x, semi-annual)	6.2	2.8	-54.3%
Cash flow			
FFO/Revenues (%)	7.5	12.0	4.5ppt
Capex (UAHm)	224.7	111.6	-50.3%
Net borrowing (UAHm)	395.1	21.0	-94.7%

Notes: calculation of the ratio of EBITDA interest coverage is based on semi-annual financials; FFO – funds from operations.

Sources: Company data, Investment Capital Ukraine LLC.

...which dropped by 45% in US dollar terms to US\$284m in 1H09,...

However, the company did make progress in the sphere of cost control, as seen from improved profitability ratios depicted in the table above. Improved earnings were attained largely thanks to favourable market conditions, as gross margin increased by 6.6ppt to 15.2% in 1H09. The company's addressing of self-efficiency cut operating costs and improved operating margin by 1.7ppt to 9.7%. At the same time, EBITDA margin rose to 11.9%, up 2.8ppt from the same period in 2008.

...deteriorating leverage ratios

As for any domestic company that borrowed mostly in a foreign currency, deteriorating leverage level is an issue. While balance-sheet deterioration in 4Q08 due to devalued currency was prevented by revaluation of fixed-assets (land and filling stations), an exercise that was previously postponed, deterioration of earning-based leverage indicators has been extended—for instance, the ratio of debt to annualised EBITDA rose 85.0% YoY, to 6.3x as of 30 June, 2009.

On the brighter side of the story, profitability on cash-based earnings has been rising...

In fact, Concern Galnaftogaz appeared to be in better shape during 1H09 than in 1H08, in terms of converting revenues to cash earnings. Funds from operations, a truer indicator of operating cash flow than EBITDA, rose from UAH188.5m in 1H08 to UAH269.2m. Such an increase supports our previous notion of Galnaftogaz's improved profitability as share of FFO in revenues, in that FFO margin, which rose 4.5ppt to 12.0% from 7.5%, shows a healthier profitability improvement than 2.8ppt on EBITDA.

Galnaftogaz's semi-annual financials recorded a sizable increase in interest expenses and debt book value

The fact of the matter is that 1H08 EBITDA captured non-cash addition due to appreciation of the currency, while 1H09 EBITDA absorbed non-cash charges on earnings due to a much stronger depreciation than the currency's 1H08 shift into stronger territory. All in all, this proves that Galnaftogaz became more profitable on a cash basis, in local currency terms as well in US dollar terms. In the latter case, FFO margin improved 4.4ppt, versus the 2.7ppt increase in EBITDA margin.

Table 2. Concern Galnaftogaz's 1H09 results against the same period of 2008 (UAH 000s)

	1H08	1H09	Change	Change (% YoY)
P&L				
Revenues	2,529,680	2,251,384	(278,296)	-11.0
Gross income	216,596	341,542	124,946	57.7
Operating income	201,448	218,143	16,695	8.3
Net income	117,199	123,485	6,286	5.4
EBITDA	230,254	268,217	37,963	16.5
Interest expenses (cash-based)	37,019	94,270	57,251	154.7
Balance sheet				
Assets	2,619,357	4,579,947	1,960,590	74.9
Equity	956,727	1,595,407	638,680	66.8
Debt	1,160,632	2,049,225	888,593	76.6
Long-term debt	836,383	1,492,508	656,125	78.4
Short-term debt	324,249	556,717	232,468	71.7
Net debt	1,057,087	1,973,376	916,289	86.7
Cash flow				
FFO (funds from operations)	188,505	269,195	80,690	42.8
CFO (cash flow from operations)	(91,644)	153,587	245,231	-267.6
Net CFO (cash flow from operations)	(103,673)	180,556	284,229	-274.2
Capital spending	(224,715)	(111,601)	113,114	-50.3
FCF (free cash flow)	(328,388)	68,955	397,343	-121.0
Net borrowings	395,089	21,049	(374,040)	-94.7

Sources: Company data

A historical perspective about quarterly financial results adds optimism to our view on the company,...

From a quarterly perspective, Galnaftogaz has stabilised its credit standing since 4Q08 by, as we noted above, improved profitability, especially on a cash basis. In particular, as we depict in the calculations of the quarterly financials and key financial ratios for the year 2008 and 1H09 (see Table 3 on next page), after the crisis hit in 4Q08, the company managed to recover and improve its cash earnings (i.e., funds from operations) from UAH77.7m in 4Q08 to UAH154.6m in 1Q09, and then generating UAH114.6m in 2Q09. In terms of profitability, 1Q09 was quite favourable, as EBITDA margin topped 15.1% in the quarter, with the share of FFO in sales at 15.2%. Compared to previous periods, this is remarkable improvement,

because in a time when the economy was rising, for instance in 2Q08, the quarterly share of FFO in sales was marginally lower, at 8.5%. In 4Q07, the share was 7.4%. However, 2Q09 brought somewhat narrower earnings, but still, the share of FFO in quarterly volume of revenues was above the historical average, at 8.7%.

...as leverage based on cash earnings was prevented from deteriorating

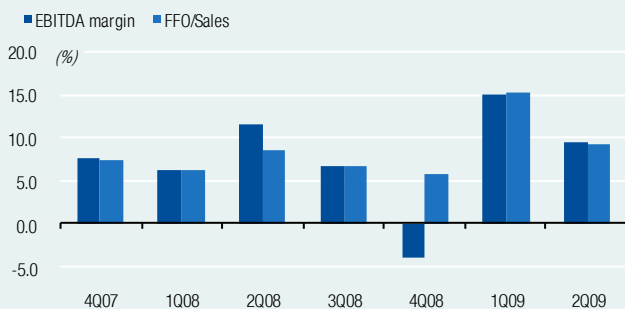
Leverage ratios, calculated from quarterly financials, were indeed rather volatile. This is true for ratios based on EBITDA, which, as we noted above, absorbs non-cash charges/additions arising from devaluation/appreciation of the local currency. Thus, debt to annualised EBITDA deteriorated from 3.4x as of end-2Q08 to 7.1x in 4Q08, albeit sliding back to 6.3x in 2Q09. However, the ratio of debt to annualised funds from operations of 4.5x in 2Q09 is in the range of values seen in recent quarters, i.e., lower than 5.2x in 1Q08 but prevailing above the 3.8x seen in the following quarter of 2Q08.

Table 3. Concern Galnaftogaz's financials from a quarterly perspective

	4Q07	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09
QUARTERLY FINANCIALS (UAH 000s)							
P&L							
Sales	1,006,360	1,149,657	1,380,023	1,635,233	1,344,349	1,014,616	1,236,768
Gross income	84,232	85,626	130,970	119,315	137,356	172,613	168,929
Operating income	66,635	58,112	143,336	95,470	-71,918	126,839	91,304
EBITDA	77,148	71,962	158,292	109,234	-52,757	152,733	115,484
Balance sheet (eop)							
Assets	2,035,196	2,441,915	2,619,357	2,757,860	4,219,454	4,424,265	4,579,947
Equity	822,274	866,770	956,727	1,012,624	1,471,922	1,667,609	1,595,407
Debt	871,739	1,087,996	1,160,632	1,414,655	2,045,567	1,999,350	2,049,225
Cash flow							
FFO (funds from operations)	74,662	71,870	116,635	109,906	77,687	154,552	114,643
Net CFO (cash flow from operations)	199,372	-169,315	65,642	-65,517	258,177	173,240	7,316
Capital expenditures	-261,971	-75,111	-149,604	-148,260	-182,354	-54,724	-56,877
FCF (free cash flow)	-62,599	-244,426	-83,962	-213,777	75,823	118,516	-49,561
Net borrowing	-50,830	232,958	162,131	203,888	-72,801	-43,225	64,274
Interest expenses	26,035	12,185	24,834	32,517	37,892	44,122	50,148
RATIOS							
Profitability (% , qtlly)							
Gross margin	8.4	7.4	9.5	7.3	10.2	17.0	13.7
Operating margin	6.6	5.1	10.4	5.8	-5.3	12.5	7.4
EBITDA margin	7.7	6.3	11.5	6.7	-3.9	15.1	9.3
FFO/Sales	7.4	6.3	8.5	6.7	5.8	15.2	9.3
Profitability (% , ann'd)							
Gross margin	6.8	6.8	8.1	8.1	8.6	10.4	11.4
Operating margin	4.6	4.5	6.6	7.0	4.1	5.5	4.6
EBITDA margin	5.7	5.6	7.7	8.1	5.2	6.8	6.2
FFO/Sales	5.7	5.6	6.8	7.2	6.8	8.5	8.7
Leverage (x, if not otherwise indicated)							
Debt/Assets (%)	42.8	44.6	44.3	51.3	48.5	45.2	44.7
Debt/Equity	1.1	1.3	1.2	1.4	1.4	1.2	1.3
Debt/EBITDA	4.7	5.1	3.4	3.4	7.1	5.4	6.3
Debt/FFO	4.8	5.2	3.8	3.8	5.4	4.4	4.5
EBITDA interest coverage (qtlly)	3.0	5.9	6.4	3.4	-1.4	3.5	2.3
FFO interest coverage (qtlly)	2.9	5.9	4.7	3.4	2.1	3.5	2.3
EBITDA interest coverage (ann'd)	2.6	2.9	5.6	4.4	2.7	2.6	2.0
FFO interest coverage (ann'd)	2.6	2.8	5.0	3.9	3.5	3.3	2.8

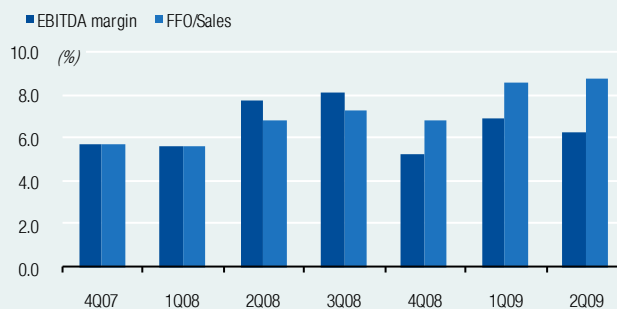
Note: eop – end of period, qtlly – quarterly figures, ann'd – annualised figures. Sources: Company data, Investment Capital Ukraine LLC.

Chart 1. Profitability based on quarterly financials (4Q07-2Q09)



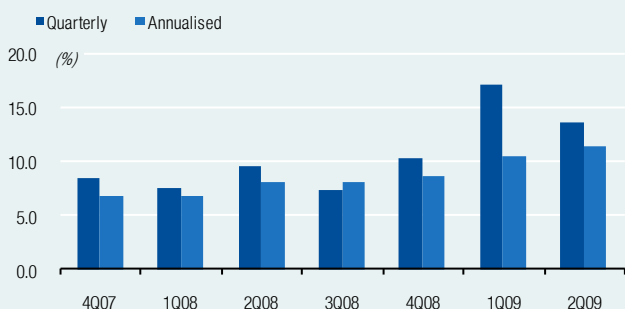
Sources: Company data, Investment Capital Ukraine LLC.

Chart 2. Profitability based on annualised financials (4Q07-2Q09)



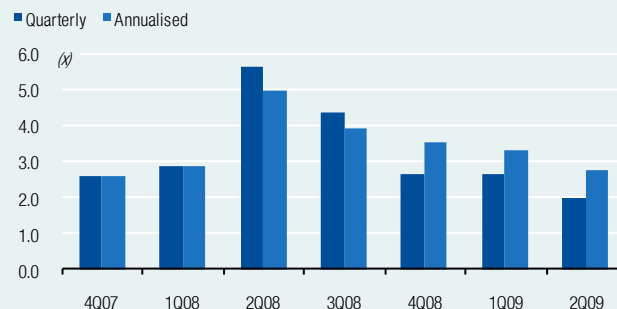
Sources: Company data, Investment Capital Ukraine LLC.

Chart 3. Gross margin (4Q07-2Q09)



Sources: Company data, Investment Capital Ukraine LLC.

Chart 4. Interest coverage by FFO (4Q07-2Q09)



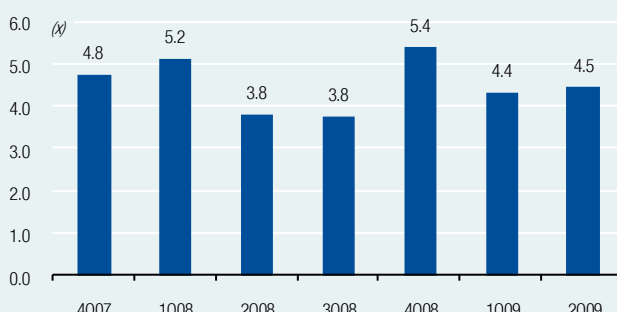
Sources: Company data, Investment Capital Ukraine LLC.

Chart 5. Debt to annualised EBITDA (4Q07-2Q09)



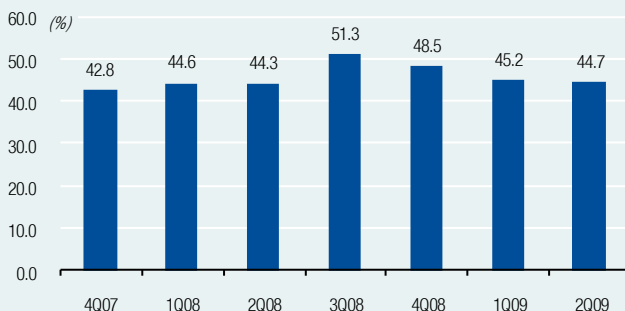
Sources: Company data, Investment Capital Ukraine LLC.

Chart 6. Debt to annualised FFO (4Q07-2Q09)



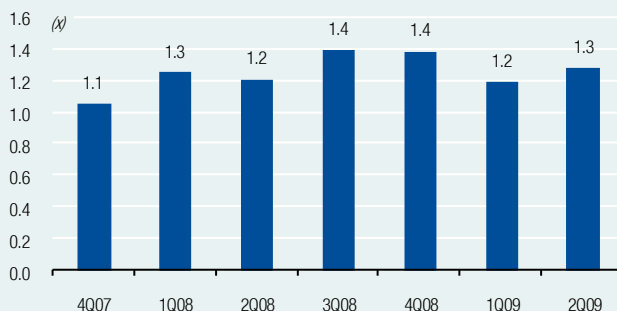
Sources: Company data, Investment Capital Ukraine LLC.

Chart 7. Debt-to-assets (4Q07-2Q09)



Sources: Company data, Investment Capital Ukraine LLC.

Chart 8. Debt-to-equity (4Q07-2Q09)



Sources: Company data, Investment Capital Ukraine LLC.

Assessing the risk environment

Macroeconomic backdrop: weak consumption is key risk factor

The real GDP decline in 1H09 was likely in the range of 18-20% YoY, according to the latest quarterly statistics data

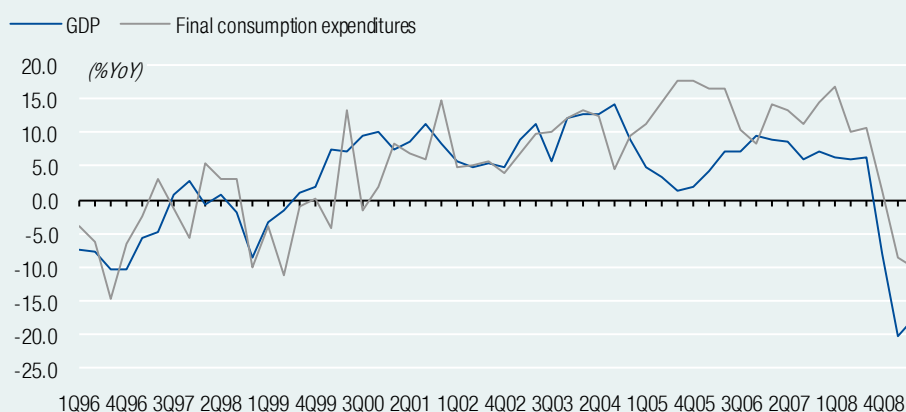
Galnaftogaz sold 298m tonnes of fuel in 1H09, down 5.6% from the 315m tonnes sold in 1H08

The company continues to weather the negative impact of the economic recession in the country, where the real GDP decline was registered at 20.3% YoY in the first quarter, followed by 18.0% YoY in the second, according to a preliminary reading by the State statistics office. According to the company's presentation on 1H09 results, it sold 297,700 tonnes of petroleum products via its retail network of fillings stations, 5.6% less than the 315,200 tonnes in volume of petroleum products it sold in 1H08.

Severe numbers on real GDP contraction in 1Q09 and in 2Q09 mask the key drivers of such declines. In fact, these were fixed investments and exports, which dragged on economic activity. They decreased by 48.7% and 15.9%, respectively, in year-on-year and real terms during the first quarter, and fell by 57.8% and 32.2% in the second one.

Chart 9. Real growth of GDP and final consumption expenditures (from 1996 to 1Q 2009)

Quarterly figures, in year-on-year terms



Source: State Statistics Committee of Ukraine.

Consumption declined more moderately than the economy as a whole,...

At the same time, final consumption expenditures declined by 8.6% YoY in 1Q09 and 10.0% YoY in real terms, apparently minor figures if compared to the plunge in fixed investments and exports. In the second quarter, in our view, contraction in the fixed investments, and especially in exports, are likely toned down if compared to the previous quarter's declines. But, final consumption expenditures driven by a number of household-related factors—like wages, income and employment just to name few—are likely to keep declining at the pace seen in the 1Q09.

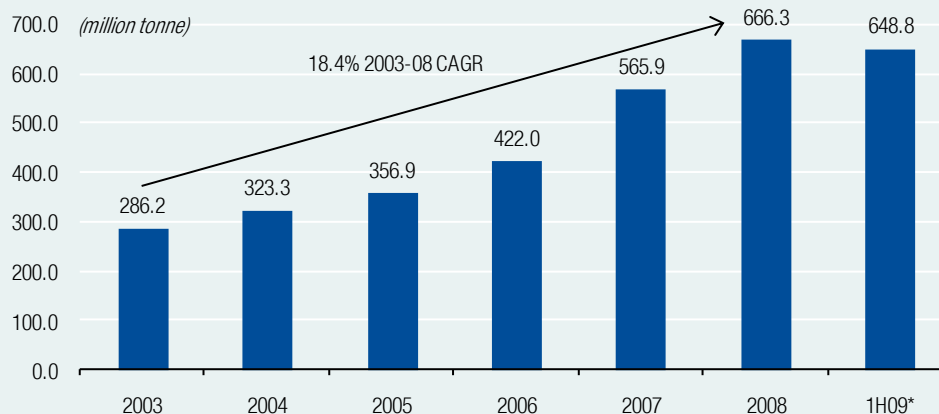
...but, driven by wages, incomes, and employment, it is likely to remain weak,...

Worse, domestic consumption is likely to be the primary victim of the recession in the economy, in our view, and its recovery is not going to be evident soon (as is expected in exports, thanks to sizable gains in competitiveness after a series of nominal devaluations seen in 2H08-1H09). Due to increased unemployment (9.4% as of end of 1H09, up 2.8ppt from 6.0% as of end 1H08) and stretched balance sheets of the foreign-currency indebted households (the volume of household loans in foreign currency as a share of GDP was 19.5% as of end-1H09), domestic consumption is likely to experience weakness even if other parts of the economy start recovering.

...translating into some contraction of sales volumes

For Concern Galnaftogaz, this may translate into weaker sales figures ahead in 2H09 and in 2010, i.e., there will be no repeat of growth seen in 2003-08 (18.4% CAGR) achieved as a mixture of organic growth and business expansion via investing in new retail outlets. Already in 2009, the annualised sales volume of petroleum products was 648,800 tonnes, down from 666,300 for the entire year 2008.

Chart 10. Concern Galnaftogaz's sales volume of petroleum products (2003-1H09)



Note: 1H09 figure is annualised volume of sales. Source: Company data, Investment Capital Ukraine LLC.

In our view, Galnaftogaz is likely to enjoy sales volume of 150-157m tonnes a quarter in 2H09-FY10

In fact, sales volume is to stabilise, according to our model (see our research report "Concern Galnaftogaz: Initiation of coverage" published on 17 August, 2009), at 150-157 thousand tonnes a quarter till year-end 2010. However, on a quarterly basis, Concern Galnaftogaz has already reported an increase of sales of 17.8% QoQ, from 136,700 tonnes in 1Q09 to 161,000 tonnes in 2Q09; such a rise is a seasonal factor, in our view. In the second quarter of 2008, sales volume was 159,500 tonnes, as the filling stations network was 269 outlets strong. As of the end of 2Q09, the network comprised 291 stations. On a basis of unit comparison, the quarterly sale volumes per station did slow to 5,600 tonnes in 2Q09 from 5,900 tonnes, or by 6.7% YoY. Such a slowing in sales, coupled with the above-mentioned rationale on consumer demand weakness, allows us to stay inclined to a 150-157,000 tonnes tonne-per-quarter sales outlook in 2H09-FY10.

Exchange-rate risk: local currency remains sizably devalued in real terms

Since 4Q08, the local currency has been under devaluation pressure, depreciating by more than 60%

Devaluation pressure has been hanging over the local currency hryvnia throughout this year. A series of devaluations in the market exchange rate of the hryvnia against the US dollar: 53.8% QoQ in 4Q08, 2.6% QoQ in 1Q09, and some 9.3% QoQ in 3Q09 (these numbers are based on the exchange rates as of end of respective period) has had its impact on the entire economy, businesses and consumers, and on Concern Galnaftogaz in particular.

This strained Galnaftogaz's balance sheet and cash flow

The company's expenses on financial obligations, which are predominantly in US dollars (82%, according to our estimates based on data presented by the company in its 1H09 financial results presentation), grew 2.5x times in 1H09 compared to the same period in 2008. Its balance sheet rose as book value of debt grew by UAH0.89bn, or 76.6%, from UAH1.16bn as of end-1H08 to UAH2.05 as of end-1H09, to a greater extent due to devaluation and less on the back of borrowing activity. In fact, net borrowings amounted to UAH0.15bn during the 12-month period to this June, leaving the rest of the debt size rise on the company's book, or UAH0.74bn, as the product of currency devaluation.

Leverage ratios deteriorated since 2008

Leverage ratios (based on annualised financial figures in local currency) worsened against such a backdrop: debt-to-EBITDA ratio moved to 6.3x as of end-1H09 from 3.4x a year ago; during the same time span, the EBITDA interest coverage ratio declined from 5.6x to 2.0x. However, if one takes a look at the company's cash flow through the prism of funds from operations (FFO), which is a measure of earnings that eliminates non-cash items like currency revaluation of the company's book (it perceived capturing company's cash flow better than EBITDA), then debt-to-FFO ratio rose to 4.5x from 3.8x, or less dramatically than debt-to-EBITDA. And, interest coverage by FFO contracted from 5.0x to 2.8x.

Obviously, further devaluation of the local currency would force Galnaftogaz to pass through additional cost to consumers, who may appear sensitive to such changes, thus decreasing overall consumption of petroleum products. In effect, this may put downward pressure on the company's revenues.

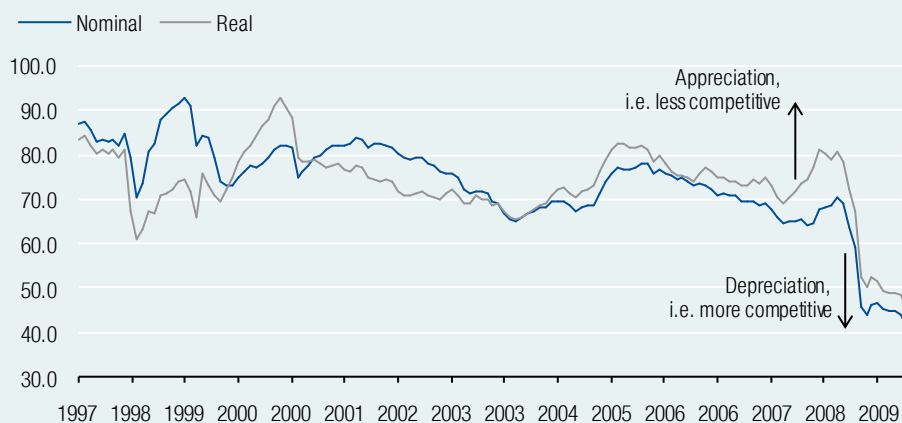
However, fundamentals point to the fact that deep devaluation has already taken place,...

Nevertheless, in our view, the local currency has been sizably devalued yet back in late of 4Q08. We based our view on the calculation of the trade-weighted index (TWI) of the hryvnia. As of year-end 2008, real TWI was at 52.4 points, down 25.3% down from the level of 70.2 points seen as of end-December 2007. Throughout the current year, economic developments (exchange rates and inflation) in the countries, which are key trading partners of Ukraine, and movements of prices and the nominal exchange rate of hryvnia against the US dollar resulted in a further slip of real TWI from 52.4 points as of 31 December, 2008 to 45.1 points as of the end of August 2009, according to our calculations. Such a depreciation of the TWI in real terms, in our view, afforded the economy greater competitiveness in foreign trade, which is likely to translate into a recovery of exports.

...improving Ukraine's external competitiveness and promising recovery in exports

Chart 11. Trade-weighted index of the local currency hryvnia (1997-2009)

Calculation is based on monthly data on f merchandise trade, consumer price inflation indices and average exchange rates of 26 countries that account for a 75% share of Ukraine's annualised trade turnover



Source: Investment Capital Ukraine LLC.

Trade deficit narrowed by 78%

On the other hand, devaluation of the currency cut domestic demand for imports, effectively resulting in a narrower trade deficit (by 78.3% YoY to US\$1.9bn in 1H09 from US\$8.7bn in 1H08). With the trade balance still in the red, its underlying structure obscures the fact that excluding trade in minerals, which largely comprises trade in hydrocarbons (oil and natural gas), the economy has adjusted itself to run a trade surplus (of US\$3.2bn in 1H09, up from US\$0.2bn in 1H08). In our view, while the economy has been adapting towards a higher natural gas price since 2006 (since the start of this year, the price level has risen towards the market level), its efficiency in terms of natural gas usage has to improve, having a material impact on the trade deficit.

In terms of balance of payments, devaluation pressures on the currency this year have

been driven by deleveraging of local businesses and households that borrowed heavily in the US dollar, and by the run on the currency in a time of economic and political uncertainty. A drought of inflow of foreign portfolio and direct investments also left the exchange market without an additional source of supply of foreign currency.

In our view, additional devaluation in 2H09 is not likely

Summing it all up, we tend to conclude that additional devaluation of the currency is not likely in 2H09, let alone a sizable devaluation of more than 15%. In our view, further pressures on the currency are likely to remain in the local market due to upcoming elections (presidential elections are scheduled for mid-January 2010, and there is a sizable possibility of snap parliamentary elections later in 2010) and to fears over the financing of the budget deficit (higher than previously expected), which may translate into lower purchasing power of the local currency. However, economic fundamentals are in favour of a stronger currency in nominal terms. An inflation slowdown, which has been evident this year, is seen rather as a long-term trend than a one-off move in price level. The credit boom of the last several years, where foreign currency borrowing was a favourable choice for many businesses and consumers alike, exposed them towards the need to conserve liquidity on the books and then deleverage. While a sizable nominal appreciation (of more than 15%) could be politically resisted for the sake of the export-oriented industrial sector, the base-case scenario is about moderate exchange rate fluctuations tending to be inside the range of 8.0-8.5/USD.

Interest-rate risk: LIBOR pick-up likely a distant event

US monetary stimulus is likely to leave interest-rate policy unchanged till 2010, ...

Concern Galnaftogaz's exposure to foreign currency borrowings with US dollar LIBOR-based interest rates attached means it has been enjoying (aside from the devaluation effect) the effects of the monetary stimulus of the US authorities. US dollar LIBOR rates lowered to nearly a zero level (3-month LIBOR rate stood at 0.595% as of market close on 30 June 2009, at 1.24% on average in 1Q09 and 0.84% in 2Q09, compared with the 1Q08 average of 3.29% and 2.75% in 2Q08).

...benefiting Galnaftogaz, whose US dollar debt is linked to LIBOR

With US monetary authorities expecting sluggish growth in its economy, there is a broad consensus among policymakers and inside the markets that rate increases in the US are still a distant event, at least until the second half of 2010, a development that is favourable for Concern Galnaftogaz's cash flow, if our estimates on the exchange-rate movement of the local currency, mentioned above, prove right.

Regulatory risk: fiscal policy considerations as priority for authorities

Ukraine's policymakers raised the excise tax on diesel fuel in a bid to hike budget revenues;...

It appears that the times when Ukraine's authorities occasionally tried to directly influence price settings at pumps of private companies operating filling stations are a distant memory. However, currently, Ukrainian authorities are giving consideration to the implementation of a policy that would cap volatility of prices on petroleum products. Still under discussion, the policy is likely to be introduced later, probably in 2010. There is a risk that such a policy, drawn upon the best practices and experiences of retail petroleum products market regulation in European countries, may be implemented by the local authorities in a way that would create distortions, albeit temporarily ones, on the domestic market and explicit preferences to some market players at the expense of other ones.

...such a practice should not be viewed as one-off if the current economic recession appears lengthy

Despite above-mentioned regulatory considerations, the most apparent risk for the industry of petroleum products retailing stems from fiscal policy considerations. As Ukraine's economy has been in deep recession of late (real GDP decline in 1Q09 was 20.3% YoY and followed by a 17.8% YoY contraction in 2Q09), the issue of financing of increased budget deficit is a priority for the authorities. Addressing the issue in March this year, they upped excise duties for a number of goods, including diesel fuel (whose tax was raised by €10-20 a tonne, depending on the type of diesel fuel). Additional revisions of excise duties on petroleum products should not be ruled out.

Oil market: volatility of prices and pass-through of price increases by retailers to consumers

Local authorities have a poor record of regulating prices when oil price rise

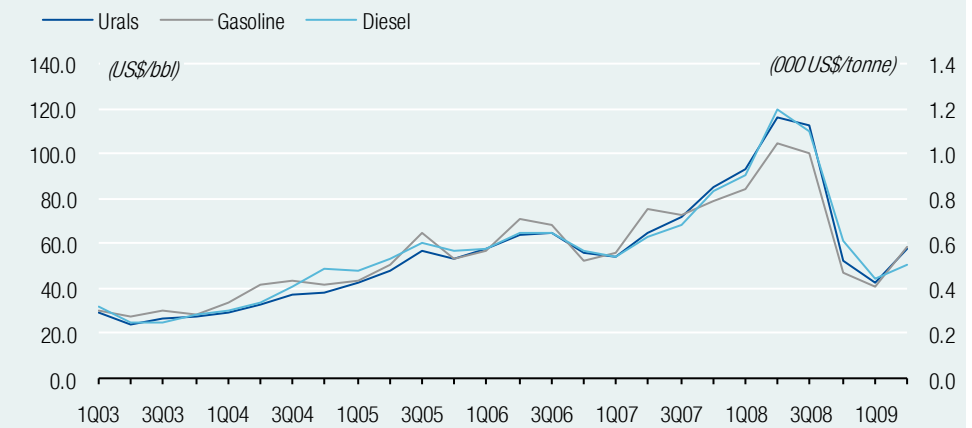
During last couple of years, the crude oil price has proved highly volatile, and prices on petroleum products (gasoline and diesel fuel) followed suit. The domestic retail industry managed to pass through the price increases to the global oil market in the past. However, there were episodes when authorities introduced price caps (in 1H05, for instance), disrupting profitability and then the operations of the retailers. The shortages of supply of petroleum products, which appeared to be a result of price caps from authorities, produced more social discontent than price increases on petroleum products themselves.

Since 2005, authorities have realized capping gasoline prices is socially and politically unacceptable

The period of 2007-08 has seen local petroleum products retailers passing through the price increases on the oil market relatively smoothly. While political culture in the country is evolving, it has emerged that disruptive interferences by the authorities into retail market operations are becoming less socially and politically acceptable.

Chart 12. Quarterly averages of crude oil price and prices on petroleum products (2003-1H09)

Crude oil is Russia's Urals; gasoline is premium unleaded 10ppm (95 R, CIF); diesel fuel is 10ppm (ULSD, CIF).



Source: Reuters.

Financial statements (IFRS, 2003-1H09)

Income statement

Table 4. Concern Galnaftogaz income statement 2003-1H09 (UAH 000s)

	2003	2004	2005	2006	2007	2008	1H08	1H09
Revenues	942,375	1,283,605	1,944,616	2,599,175	3,208,848	5,509,262	2,529,680	2,251,384
Cost of sales	(897,692)	(1,222,630)	(1,830,841)	(2,443,822)	(2,989,237)	(5,035,995)	(2,313,084)	(1,909,842)
Gross income	44,683	60,975	113,775	155,353	219,611	473,267	216,596	341,542
General & administration expenses	(22,449)	(30,979)	(45,848)	(65,598)	(79,551)	(135,277)	(61,082)	(81,136)
Other operating income	0	4,315	587	24,790	24,949	15,728	67,476	15,328
Other operating expenses	(2,832)	(3,958)	(5,647)	(6,914)	(17,697)	(128,718)	(21,542)	(57,591)
Operating income	19,402	30,353	62,867	107,631	147,312	225,000	201,448	218,143
Financial expenses	(7,786)	(6,073)	(22,422)	(52,067)	(72,442)	(127,458)	(47,239)	(85,448)
Financial income	1,007	3,672	9,789	242	561	(660,307)	194	17,317
Profit before income tax	12,623	27,952	50,234	55,806	75,431	(562,765)	154,403	150,012
Income tax	(1,536)	(5,704)	(9,745)	(13,839)	(13,195)	141,828	(37,204)	(26,527)
Net income	11,087	22,248	40,489	41,967	62,236	(420,937)	117,199	123,485

Notes: 2003-08 are audited accounts, 1H08 and 1H09 are non-audited accounts.

Sources: Company data.

Balance sheet

Table 5. Concern Galnaftogaz balance sheet 2003-1H09 (UAH 000s)

	2003	2004	2005	2006	2007	2008	1H09
ASSETS							
Non-current assets							
PP&E	179,194	239,895	405,818	739,084	1,460,108	3,440,626	3,247,769
Intangible assets	8,930	7,777	8,123	7,112	5,780	5,409	64,486
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	122,041
Other non-current assets	917	125	284	351	347	340	340
Total non-current assets	230,065	296,868	426,819	757,756	1,478,667	3,582,520	3,434,637
Current assets							
Inventories	15,156	30,210	72,042	104,990	148,186	209,997	261,295
Trade & other receivables	60,569	89,929	239,619	209,719	156,356	365,651	283,308
Prepayments and other current assets	20,723	44,570	38,868	130,277	194,987	134,715	520,325
Prepaid income tax	270	1,107	0	0	328	31,439	4,533
Cash & cash equivalent	9,308	13,348	16,342	52,766	56,672	75,057	75,849
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	1,145,310
TOTAL ASSETS	336,091	476,032	827,120	1,255,508	2,035,196	4,399,379	4,579,947
LIABILITIES & EQUITY							
Equity							
Share capital, retained earnings & other capital	167,890	203,412	312,790	450,025	821,522	1,603,088	1,594,629
Minority interest	48	494	560	523	752	1,013	778
Total equity	167,938	203,906	313,350	450,548	822,274	1,604,101	1,595,407
Non-current liabilities							
Loans & borrowings	81,674	125,327	155,657	354,965	583,614	1,608,733	1,492,508
Deferred tax liabilities	4,787	9,608	26,782	66,929	116,469	507,054	457,056
Total non-current liabilities	86,461	134,935	182,439	421,894	700,083	2,115,787	1,949,564
Current liabilities							
Loans & borrowings	11,461	20,049	176,434	244,006	288,125	436,834	556,717
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	471,182
Other current liabilities	7,165	4,050	159	104	972	289	7,077
Total current liabilities	81,692	137,191	331,331	383,066	512,839	679,491	1,034,976
TOTAL LIABILITIES & EQUITY	336,091	476,032	827,120	1,255,508	2,035,196	4,399,379	4,579,947

Notes: 2003-08 are audited accounts; 1H08 and 1H09 are non-audited accounts.

Sources: Company data.

Cash flow

Table 6. Concern Galnaftogaz cash flow statement 2003-1Q09 (UAH 000s)

	2003	2004	2005	2006	2007	2008	1H08	1H09
Cash flow from operating activities								
Profit before income tax	12,623	27,952	50,234	55,806	75,431	(478,872)	154,403	150,012
Adjustments for:								
Depreciation, amortisation and impairment of goodwill	9,665	14,499	18,946	24,898	36,514	60,282	28,806	50,074
Interest expense, net	4,998	5,908	21,613	51,825	71,881	126,374	47,045	84,320
other adjustments	775	(6,111)	(8,436)	(294)	(1,538)	673,087	(41,749)	(15,211)
Operating profit before changes in working capital	28,061	42,248	82,357	132,235	182,288	380,871	188,505	269,195
Increase in inventories	(2,793)	(12,667)	(41,817)	(32,899)	(43,037)	(61,811)	(132,936)	(47,045)
Decrease/(Increase) in current assets (ex. Inventories)	(28,349)	(49,714)	(129,638)	(23,182)	114,723	(148,614)	(248,812)	(310,730)
Increase/(Decrease) in current liabilities	24,144	38,933	30,754	(9,715)	(21,346)	13,816	101,599	242,167
Cash flow generated from operations	21,063	18,800	(58,344)	66,439	232,628	184,262	(91,644)	153,587
Income tax paid	(913)	(2,977)	(10,983)	(9,356)	(12,355)	(33,628)	(12,029)	26,969
Net cash flow from operating activities	20,150	15,823	(69,327)	57,083	220,273	150,634	(103,673)	180,556
Cash flow from investing activities								
Purchases of PPE	(102,852)	(61,735)	(96,480)	(215,738)	(548,771)	(607,140)	(224,149)	(111,151)
Purchases of intangible assets	(6,608)	(100)	(1,932)	(561)	(326)	(4,719)	(566)	(450)
Proceeds from sale of equipment	3,621	4,776	3,856	1,237	1,656	38,616	758	1,164
Interest received	0	30	801	242	561	563	168	1,128
Dividend received	0	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	0
Net cash used in investing activities	(131,238)	(62,526)	(104,693)	(223,333)	(649,036)	(572,680)	(223,789)	(109,309)
Cash flow from financing activities								
Issue of share capital	60,563	13,300	18,380	0	226,578	16,264	16,264	0
Proceeds from loans & borrowings	128,942	118,617	222,076	328,780	431,230	720,474	460,463	243,100
Repayments of loans & borrowings	(69,505)	(66,376)	(42,700)	(61,728)	(154,255)	(188,934)	(65,374)	(222,051)
Interest paid	(4,942)	(14,798)	(20,742)	(64,378)	(70,884)	(107,373)	(37,019)	(94,270)
Net cash provided by financing activities	115,058	50,743	177,014	202,674	432,669	440,431	374,334	(73,221)
Cash & cash equivalent at the beginning of period	5,338	9,308	13,348	16,342	52,766	56,672	56,672	69,693
Net increase in cash & cash equivalent	3,970	4,040	2,994	36,424	3,906	18,385	46,872	(1,974)
Cash & cash equivalent at the end of period	9,308	13,348	16,342	52,766	56,672	75,057	103,544	67,719

Notes: 2003-08 are audited accounts; 1H08 and 1H09 are non-audited accounts.

Sources: Company data.

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