

Galnaftogaz

Catching up with car market boom

Oil products retail & wholesale

OJSC 'Concern Galnaftogaz', the oil products' retailing business, published its 1Q06 financials revealing robust sales figures thanks to the capital investment programme in expanding the network of fuel stations.

Galnaftogaz continues to deliver strong sales figures thanks to the capital expenditures poured into opening of new retailing sites and renovation of old ones. Such strategy goes in line with robust car sales figures spurred by rising households' real disposable incomes and consumer lending.

In June this year the company is said to publish IFRS consolidated financials for 2005 audited by Ernst & Young, bringing its history of public disclosing of audited consolidated financials to three consecutive years. With planned IPO at one of the major European bourse next year, Galnaftogaz is continuously on track of getting more transparent and better shaped for the event, what may directly benefit the company's bondholders in the near future.

The main risks related to the company are: 1) economic slowdown in the country which may lower consumption negatively affecting gasoline retailing sector, 2) further steep increase in the world price for crude oil provoking steep increase in prices for oil products eating down margins or, if cost transferred to end consumers, contracting revenues as consumers likely to react by decrease in consumption.

Galnaftogaz announced that it set new coupon rate at 14% for its UAH30m bond outstanding (series D). At such, the bond will be yield at level seen as appropriate for the quite same type of bond issues with similar credit risk. This represents an opportunity for current bondholders of the bond to enjoy higher return while staying in the same paper. We assigned the company with marketperform rating.

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Initiating Coverage

Marketperform

5 June 2006

Galnaftogaz consolidated financials (US\$m)

	2004 audited	2005 non- audited	1Q06 non- audited
Sales	241.3	360.8	104.0
Net income	4.2	7.3	1.6
EBITDA	10.8	19.1	4.4
Assets	89.7	157.0	179.8
Equity	38.3	58.9	60.5
Liabilities	51.3	98.0	119.2
Debt	27.4	65.8	89.1
Gross margin (%)	4.8	9.1	7.1
Net margin (%)	1.7	2.0	1.5
EBITDA margin (%)	4.5	5.3	4.3
ROA (%)	5.5	6.0	...
ROE (%)	12.0	15.1	...
EBIT int cov. (x)	2.9	3.2	2.2
EBITDA int cov. (x)	3.9	4.2	3.1
Debt / EBIT (x)	3.4	4.5	...
Debt / EBITDA (x)	2.5	3.4	...
Debt / Equity (%)	71.5	111.7	147.2
Debt / Assets (%)	30.5	41.9	49.6
ST debt / Debt (%)	13.8	24.5	27.5
Current ratio (x)	1.3	1.6	1.7
Quick ratio (x)	1.1	1.3	1.4
Capex	11.8	23.5	9.3
Capex/Sales (%)	4.9	6.5	9.0
Capex/EBITDA (%)	109.2	122.9	210.5

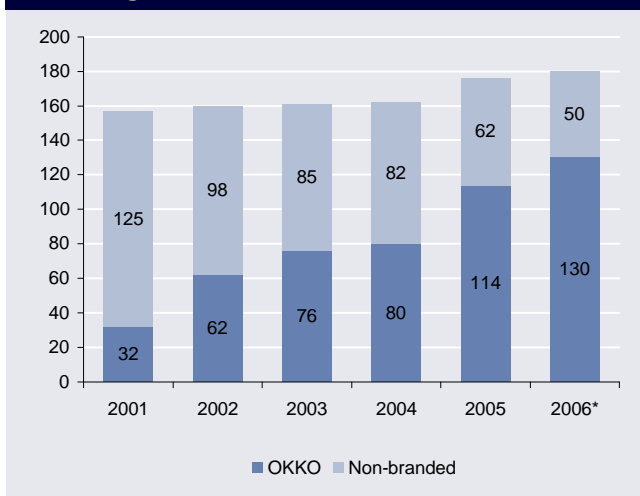
Note: ... - ratio was not calculated due to lack of data to calculate 12-month earnings.

Galnaftogaz in gasoline retailing

The company's network expanded over the year reaching 180 outlets as at 1 June 2006

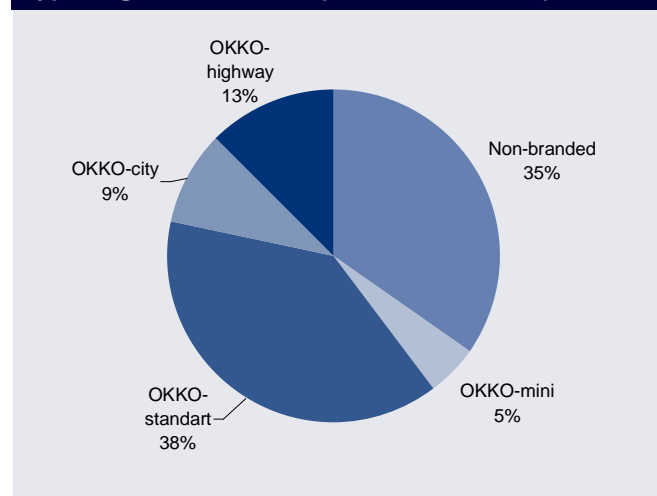
Open joint-stock company 'Concern Galnaftogaz' has been in the oil products marketing business since 2001, when it had been established by private individuals on the back of the merger of the three former state-owned oil products enterprises, which went through the privatisation procedure in the mid-1990s. The company, which is based in the western city of Lviv, has expanded over its home regional market in the western part of the country and during last two years in the central and eastern regional markets. As at 1 June 2006, the company's network of gasoline stations consisted of 180 outlets, growing over the current year from 176 stations as at 31 December 2005. All the stations the company operates are 100%-owned by Galnaftogaz via its several subsidiaries. The network of the flagship OKKO-branded stations expanded over the current year from 114 to 130 sites.

Fig 1 Quantity of gasoline stations in the Galnaftogaz's network, 2001-06



Note: all data as at 31 December of the respective year; * data as at 1 June 2006. Source: Company data

Fig 2 Breakdown of Galnaftogaz's network by the type of gasoline station (as at 31 Dec. 2005)



Source: Company data

The growing numbers of the Galnaftogaz oil products retailing outlets resemble the nowadays drive of all major grocery retailers in their search for best locations available in the regional markets. The company's investment programme, which makes OKKO-network larger, goes in parallel with hot car market (see the following section), where the number of new cars sold is on the considerable rise, what potentially is capable to bring an additional impetus to the gasoline retailing market.

Booming local car market

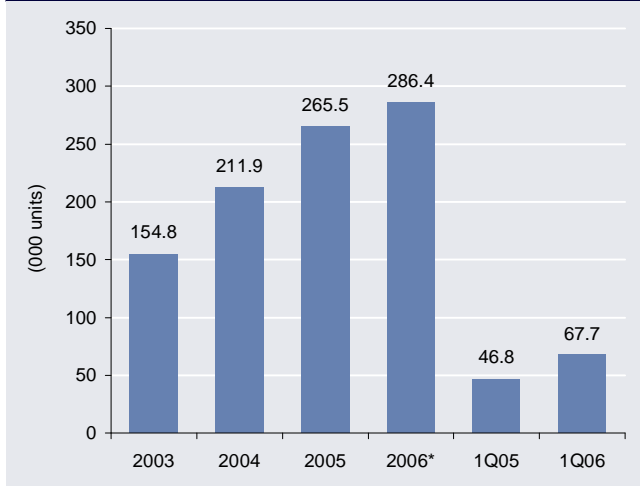
Local car market trends are viewed as supportive for gasoline retailing business

Ukraine's car market is amidst its hottest time as sales of the new cars, the data of which is most readily available in the open sources, experience high double digit growth rates. The country's consumers, which used to consider the car ownership as luxury during the soviet past and economic turbulence of the 1990s, now appear more generously spending on durable goods and personal cars. While the growth rate of the new cars in 1Q06 surged to 44.8% compared to the period of the previous year, the total number of new cars sold in the country during the period amounted to 67.7 thousand units according to the Kiev-based motor-vehicle market research company Auto-Consulting¹. During 2005, the new cars' market grew by a quarter to 265.5 thousand cars sold that year alone, while the whole car market including the sales of the second hand motor vehicles grew by 5.9% to 644.6 thousand cars over the same

¹ See more at www.autoconsulting.com.ua

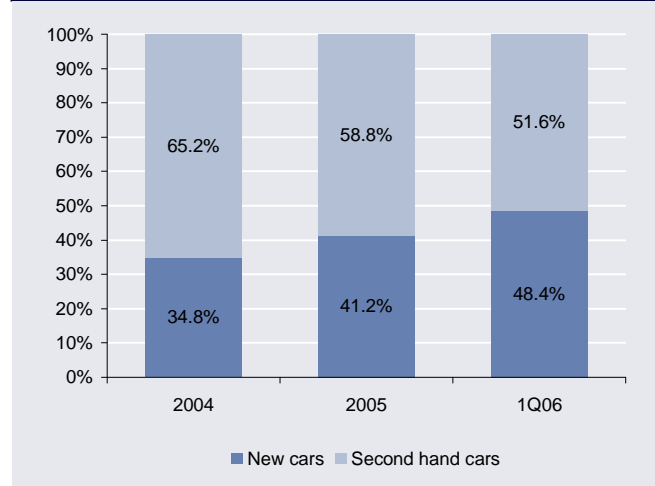
year. This research company also reveals another trend of the local market that Ukrainians have been shifting their preferences to the new car purchases thanks to their growing purchase power – in 1Q06 the share of the new cars sold in the total amounted to 48.4% marginally higher than in 2004 (34.8%), when Ukraine’s economy experience record breaking real GDP growth of 12.1% since independence.

Fig 3 Local market of new cars, 2003-06 (in number of new cars sold in the country)



Note: * for the last 12-month period ended on 31 March 2006.
Source: Auto-Consulting

Fig 4 Breakdown of the local car market: the share of the new cars’ market has expanded



Source: Auto-Consulting

Two things boost car market: real disposable incomes grow (by 24.2% in 1Q06) and consumer lending increases (by 16.2% in 1Q06)

Although Ukraine’s 47m nation still enjoys low (at Eastern European standards) level of just US\$1800 GDP per capita, since recently the economy started to generate the middle class consumers, which fuel the demand for the goods like good-quality cars and services associated with their functioning and maintenance. The buying spree in the car market by local consumers at large has been spurred by double-digit growth of real disposable incomes (by 18.9% in 2005 and by 24.2% in 1Q06) and extended consumer lending by commercial banks (by 126.4% in 2005 and by 16.2% in 1Q06).

Within the booming car market there are two segments which have their own driving features:

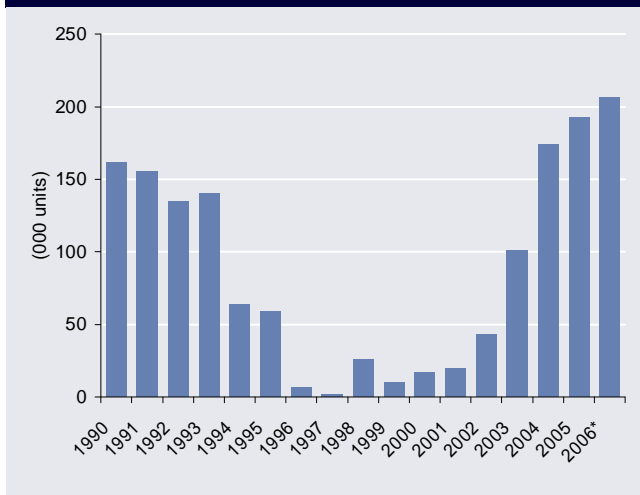
Local car producers are busy with meeting demand for good-quality cars at decent price

- In the segment of cars with a price tag up to US\$10 thousand, these are the local car producers which compete tensely among themselves for the consumers enjoying robust demand. Their sales represent the biggest share in the new cars market – 57% for the period of January-April of 2006. To depict the current nature of the market it is interesting to note that this March alone the number of new cars sold grew by 43.3% compared to the same month of 2005. The feature is that in March 2005 the quantity of new cars sold grew substantially on the back of the consumers’ reasonable fear that domestic and foreign made cars would get dearer due to parliament’s adoption (in March 2005) of the package of laws which brought tariffs on imported cars revised upwardly and eliminated tax privileges to local car producers. All of that sent sales rapidly higher at that period; however, nowadays the growth in the market has no such support driver. In the supply side, those local car producers which weathered the elimination by the Tymoshenko-led government of the tax privileges managed to increase production meeting demand – in 2005 car production in Ukraine rose by 10.7% to 192.2 thousand units, in last 12-month period ended in March 2006 the annual production in the domestic car sector amounted 206.5 thousand

Local car sector now produces more than 200 thousand cars a year

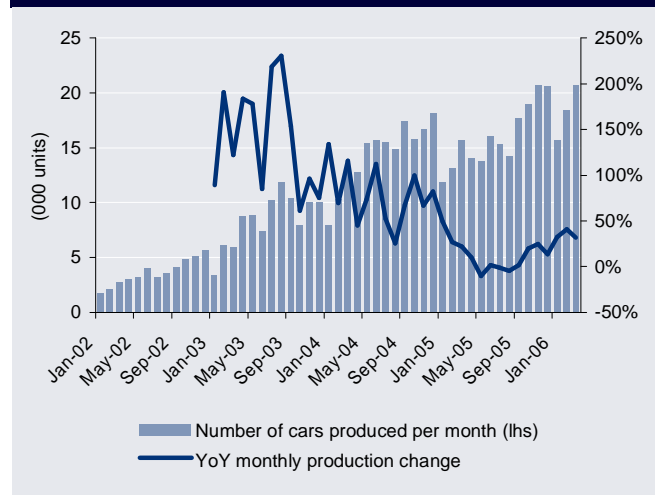
units representing a further hike in 1Q06. It is interestingly to note that now domestic sector produces the cars in numbers which exceed the level seen in 1990, the year after which the 1990s economic collapse followed. The main difference is that now the sector produces quite decent cars while those produced till 1990 were notoriously famous for their poor quality. More notably, even the political preferences of the local car producer lobby speak for themselves – the lobby which is represented in the parliament with the likes of Tariyel Vasadze, the owner of ZAZ the flagship car maker in the country, who naturally opposed to the government-led break-up of the sector tax privileges but he eventually ended the recent parliamentary re-election campaign in the ranks of the political bloc of Yulia Tymoshenko.

Fig 5 Annual car production in Ukraine, 1990-06



Note: * for the last 12-month period ended on 31 March 2006.
Source: State Statistics Committee

Fig 6 Monthly car production in Ukraine, 2002-06



Source: State Statistics Committee

Foreign made cars are queued for by local affluent consumers

- In the segment of cars with middle price tag of up to US\$25 thousand, there is hot demand too. It is common story for a newspaper article depicting that local dealerships selling imported car brands experience the deficit of cars amidst high demand environment, what creates one- or two-month waiting queues. The dealerships appear competing among themselves for the consumers in time during which they deliver the car of certain brand, stuffing and colour to the buyer.

Galnaftogaz financials

It's first time the company presents its consolidated financials for the first quarter of the year

This is the first time when the company published its consolidated financials for the first quarter of the year. That is why we do not have opportunity to calculate sales and earnings figures for the last 12-month period and hence those ratios where these figures could be used. The 1Q06 financials, compiled in accordance to Ukrainian accounting standards, revealed the company naturally succeeded in sales growth thanks to the launch of several new gasoline stations – in the first quarter net sales amounted to US\$104.0m what is roughly one third of the sales volume reached in 2005. Company's 1Q06 EBITDA amounted to US\$4.4m reflecting a margin of 4.3%, one percentage point down from full-year result in 2005. The investment programme on the expanding OKKO-branded network amounted to 1Q06 capital expenditures of US\$9.3m what appeared the highest level in last two years in relative terms – ratio of capex to EBITDA amounted to 2.1 times and ratios of capex to net sales reached 9%. This need to finance working capital and investing activities moved the company to

In 1Q06 net sales at US\$104 represent one third of 2005 revenues

borrow further predominantly the long-term funds what increased both the leveraged and liquidity ratios.

Fig 7 Galnaftogaz's financials and ratios

Financials	2003	2004	2005	1Q06	Ratios	2003	2004	2005	1Q06
	Audited IFRS	Audited IFRS	Non-audited UFRS	Non-audited UFRS					
Income statement (US\$m)									
Net sales	176.7	241.3	360.8	104.0	Gross margin (%)	4.7	4.8	9.1	7.1
Gross profit	8.4	11.5	32.7	7.4	Operating margin (%)	2.1	2.4	3.6	1.7
Profit from operations	3.6	5.7	12.9	1.7	Net margin (%)	1.2	1.7	2.0	1.5
Interest expense	0.9	2.8	4.5	1.4	EBITDA margin (%)	2.9	4.5	5.3	4.3
EBT	2.4	5.3	10.1	1.6					
Net income	2.1	4.2	7.3	1.6	ROA (%)	3.3	5.5	6.0	...
EBIT	3.3	8.0	14.7	3.1	ROE (%)	6.6	12.0	15.1	...
EBITDA	5.1	10.8	19.1	4.4					
Balance sheet (US\$m)									
Assets	63.0	89.7	157.0	179.8	EBIT int coverage (x)	3.6	2.9	3.2	2.2
Current assets	19.9	33.8	77.6	93.2	EBITDA int coverage (x)	5.5	3.9	4.2	3.1
Inventories	2.8	5.7	14.4	18.7	Debt / EBIT (x)	5.3	3.4	4.5	...
Cash	1.7	2.5	3.2	5.4	Debt / EBITDA (x)	3.4	2.5	3.4	...
Equity	31.5	38.3	58.9	60.5	Debt / Equity (%)	55.5	71.5	111.7	147.2
Liabilities	31.5	51.3	98.0	119.2	Debt / Assets (%)	27.7	30.5	41.9	49.6
LT	16.2	25.4	50.1	65.0	ST debt / Debt (%)	12.3	13.8	24.5	27.5
ST	15.3	25.9	47.9	54.1	Current ratio	1.3	1.3	1.6	1.7
Debt	17.5	27.4	65.8	89.1	Quick ratio	1.1	1.1	1.3	1.4
LT	15.3	23.6	49.6	64.6					
ST	2.1	3.8	16.1	24.5	Capex	24.6	11.8	23.5	9.3
Net debt	15.7	24.9	62.5	83.7	Capex / Sales (%)	13.9	4.9	6.5	9.0
Capex	24.6	11.8	23.5	9.3	Capex / EBITDA (%)	482.0	109.2	122.9	210.5

Note: ... - ratio can not be calculated due to lack of information or the data component used in the calculation of the ratio is equal to zero/null.
Source: Company data

Galnaftogaz at the local bond market

Galnaftogaz is the only local oil products retailer which disclose its financials

In the table below we summarized the financials for 2005 of those Ukrainian retailing businesses, the bonds of which are available on the domestic bond market. So far Galnaftogaz is the only oil products retailer in the country disclosing extensively its financials to the market. That is why we compare its financial standing with such top retailers as metal products retailer UGMK and grocery retailers in the likes of Furshet, Fozzi, Kviza Trade and others. While marketing different products and goods, they are, at some extent, similar in dealing with locations and premises via which they serve customers.

Galnaftogaz is compared with other retailing business like metal products retailing and grocery retailing

Relative to the selected retailers Galnaftogaz's financial standing is featured by the following:

- In the size of the business, measured by annual sales, Galnaftogaz has a weight among these companies as its annual net sale amounted to US\$360.3m and the figure is set to increase further as 1Q06 sales (US\$104.0m) represent roughly one third of the last annual sales. Its capacity in turning revenues into earnings measured by EBITDA margin is quite strong at 5.1% among the largest retailers depicted in the table.
- Interest coverage capacity is also strong in comparison with this set of peers. As annual EBITDA exceeded 4.2 times interest expense in 2005, Galnaftogaz looks stronger others but Furshet, which had lowest debt burden among grocery retailers represented on the debt market.

Galnaftogaz appears one of the biggest in revenues size among these selected retailers...

...while stronger in debt servicing and leverage

- In terms of leverage, which measured by the ratio of debt to EBITDA, Galnaftogaz has good shape as well among large retailers (net sales above US\$200m). Galnaftogaz's leverage at 3.4x lower than Fozzi's and Kviza-Trade's ones (4.5x and 5.2x respectively). Thanks to low debt burden only Furshet stands out among these retailers with debt/EBITDA of 1.5x in 2005.

Taking into account the above mentioned comparison, Galnaftogaz's move to increase coupon rate on its local bond of series D to 14% per annum (announced on 30 May 2006) shifts its bond into the universe, where the bonds of the selected retailers are quoted and traded (see chart below).

Fig 8 Galnaftogaz versus its local peers in the retailing business

Sector	Galnaftogaz Oil products retailing 2005	UGMK Metal products retailing 2005	Furshet Grocery retailing 2005	Fozzi Grocery retailing 2005	Kviza-Trade Grocery retailing 2005	Tavria-V Grocery retailing 2005	Karavan Grocery retailing 2005
US\$m							
Net sales	360.8	372.3	347.7	530.4	213.8	60.0	67.7
Net income	7.3	4.26	13.8	3.9	2.0	0.4	1.1
EBITDA	19.1	19.7	21.1	24.3	11.2	5.5	1.4
EBITDA margin (%)	5.3	5.3	6.1	4.6	5.2	9.1	2.1
Interest expense	4.5	7.8	1.4	n/a	6.2	2.2	0.0
EBITDA interest coverage (x)	4.2	2.5	15.5	...	1.8	2.5	...
Assets	157.0	164.6	133.1	279.5	123.4	39.0	10.3
Equity	58.9	17.0	39.5	53.1	15.7	15.7	1.1
Debt	65.8	99.8	31.7	108.4	57.9	17.6	0.0
Long-term debt	49.6	35.6	24.1	n/a	57.6	9.1	0.0
Debt/Equity (%)	111.7	586.1	80.2	203.9	369.2	112.1	0.0
Debt/Assets (%)	41.9	60.6	23.8	38.8	46.9	45.3	0.0
Debt/EBITDA (x)	3.4	5.1	1.5	4.5	5.2	3.2	0.0
LT debt/Total debt (%)	75.5	35.7	76.3	...	99.4	51.6	...
ROA (%)	4.7	2.6	10.4	1.4	1.6	1.1	11.0
ROE (%)	12.5	25.0	34.9	7.3	12.8	2.6	105.8

Note: ... - ratio can not be calculated due to lack of information or the data component used in the calculation of the ratio is equal to zero/null; all figures are from companies' financials compiled in accordance to Ukrainian Financial Reporting Standards (UFRS).

Source: Company data

Fig 9 UAH-denominated bonds by Ukraine's retailing companies relative to municipal and government bonds (prices as at 6 June 2006)



Note: yields are annualised.
Source: PFTS.