

### Galnaftogaz

August 16, 2006

Oil & Gas

**Price Target (USD) 0.016**  
Recommended as a

Sell	Hold	<b>Buy</b>	Strong Buy
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Galnaftogaz released 2005 IFRS-audited results and 1H06 NAS financials which demonstrated robust revenue growth driven by aggressive expansion of the company's gasoline station network and strong oil price growth. However, low margins remained an issue. We forecast Galnaftogaz's 2006 net sales at USD 500 mil. (up 39% y-o-y), and NI at USD 9.2 mil. (up 25%). We also maintain our 12-month price target of USD 0.016/share with a Buy recommendation.

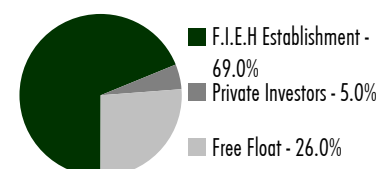
#### Fundamental Highlights

- **2005 IFRS results.** Galnaftogaz released 2005 IFRS-audited results, reporting sales of USD 379.5 mil. (up 57% y-o-y). Revenue growth was driven by a 41% y-o-y increase in retail gasoline prices, to USD 0.6/l, and 12% expansion of the company's gas station network, to 174 stations as of end-2005.
- **1H06 NAS results show strong revenue growth...** Galnaftogaz boosted 1H06 net sales by 86% y-o-y, to USD 221 mil. (under NAS), as the company's network increased by 14% over the period, to 195 stations as of end-June. Besides, Galnaftogaz increased retail prices of gasoline and diesel fuel by 30% y-o-y, to USD 0.71/l, in 1H06.
- **...and mixed profitability.** Galnaftogaz's 1H06 EBITDA rose by 22% y-o-y, to USD 7.4 mil., while net income declined by 2.3% y-o-y, to USD 3.5 mil. The net margin also narrowed, by 1.6 p.p. y-o-y to 1.1%, over the period due to higher growth in operating costs and increased interest costs.
- **Outlook.** We think Galnaftogaz will be able to expand its retail network to over 300 gas stations by end-2008 and reap extra benefits from rising oil prices. We therefore upgraded our long-term forecast for the company. Meanwhile, this year, we expect Galnaftogaz to boost net sales by 39% y-o-y, to USD 500 mil., and raise NI by 25% y-o-y, to USD 9.2 mil.
- **Price target and recommendation unchanged.** We updated our DCF model for Galnaftogaz to account for revised financial estimates, which yielded a 12-month price target of USD 0.0173/share. Based on 2005-2007F asset valuation approach, we projected the company's 12-month price target at USD 0.0155/share. The average of the two estimates thus implies USD 0.0164/share, almost unchanged from our previous valuation and nearly 50% above Galnaftogaz current market price. We maintain a Buy recommendation on the stock.

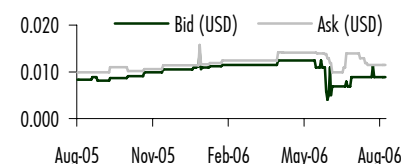
#### Company Statistics

Market Price (USD)	0.011
Market Cap (USD mil.)	176
Enterprise Value (04E; USD mil.)	286
Free Float (%)	26%
Free Float (USD mil.)	45.6
Shares Outstanding	16,000,000,000
Nominal Value (UAH)	0.01
Bloomberg Code	GLNG UZ
ADR Ratio	1:500
Number of Employees	1,634

#### Shareholder Structure



#### Price Performance (USD)



#### Market Performance (USD)

12-m Performance	41%
12-m Relative Performance*	18%
12-m Low/High	0.008/0.014
All-time Low/High	0.008/0.014
12-m Trading Volume (USD mil.)**	14.68
12-m Relative Liquidity (% of SO)	8.5%

\*Relative to KP-Dragon Index; \*\*PFTS trading volume

#### Valuation Summary

Year	2003	2004	2005	2006E	2007F
Net Sales (USD mil., NAS)	50.7	92.4	360.8	500.4	615.3
EBITDA (USD mil., NAS)	3.2	5.9	17.4	20.3	29.2
Net Income (USD mil., NAS)	2.0	3.2	7.4	9.2	9.5
P/E	66.5	44.4	23.9	19.2	29.2
P/B	3.81	3.13	2.99	2.29	1.66
EV/EBITDA	43.9	27.1	13.7	14.1	12.0
EV/Sales	2.80	1.74	0.66	0.57	0.57
EV/Output (USD/tonne)*	464	466	577	495	518

Note: \*Total volume of oil products sold (retail and wholesale volumes included)

## 2005 IFRS Results

Galnaftogaz has released 2005 results audited by Ernst & Young under IFRS. The company's net sales surged by 57% y-o-y, to USD 379.5 mil., driven by strong growth in retail gasoline prices (up 41% y-o-y, to USD 0.6/l) and by 12% expansion of the gasoline station network, to 174 stations as of end-2005 (including 113 gas stations under the OKKO brand). EBITDA and NI both surged by 89% y-o-y, to USD 16.0 mil. and USD 7.9 mil. respectively, implying EBITDA and net margins of 4.2% (up 0.7 p.p. y-o-y) and 2.1% (up 0.4 p.p.).

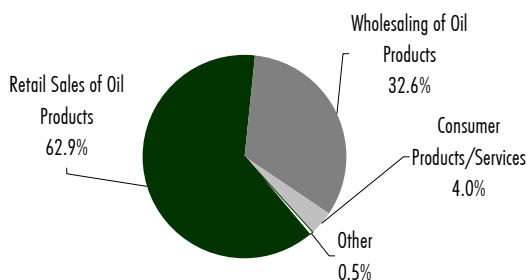
The audited numbers came mostly in line with earlier reported 2005 results under National Accounting Standards (NAS), namely net sales of USD 361 mil. (up 290% y-o-y), EBITDA of USD 17.4 mil. (up 193%) and NI of USD 7.4 mil. (up 129%).

It was reported that retail sales of oil products accounted for 70.6% of Galnaftogaz's 2005 net sales (up 7.7 p.p. y-o-y), followed by wholesaling of oil products with 25.3% (down 7.2 p.p.) and sales of consumer products with 3.8% (down 0.2 p.p.). However, based on information provided by Galnaftogaz management, we think the auditors overestimated the share of wholesale business in the company's revenues. We estimate the latter's share at 5-7%, with almost 90% of total revenues generated from retail sales of oil products.

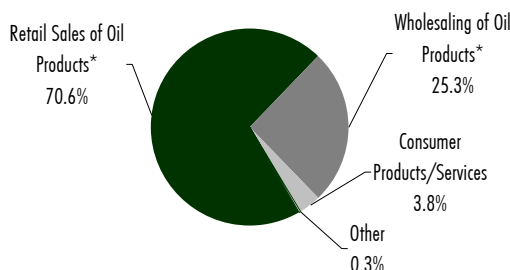
**Galnaftogaz reported 2005 IFRS results...**

**...which were largely in line with NAS**

**Retail sales of oil products accounted for the lion's share of sales**



**Sales Structure (2004)**

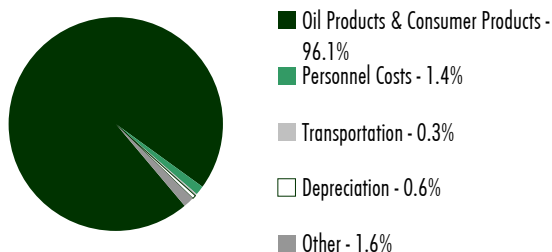


**Sales Structure (2005)**

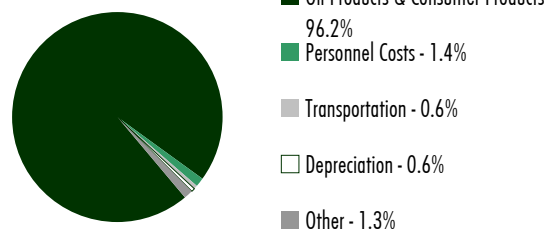
Note: \*Based on information from management, we estimate wholesale share at 5-7% and retail share at about 90%; Source: Company

In 2005, Galnaftogaz bought 75% of oil products from domestic refineries and imported the remainder. Ukrtatnafta refinery accounted for 87% of Galnaftogaz's domestic purchases, followed by LiNOS (TNK-BP) with 12%. Based on the audited results, oil products and consumer goods accounted for 96.2% of Galnaftogaz's 2005 COGS, almost unchanged y-o-y.

**Cost structure is dominated by oil products and consumer goods purchased for resale**



**COGS Structure (2004)**



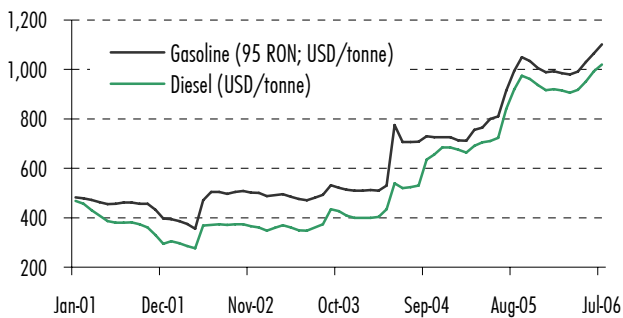
**COGS Structure (2005)**

Source: Company

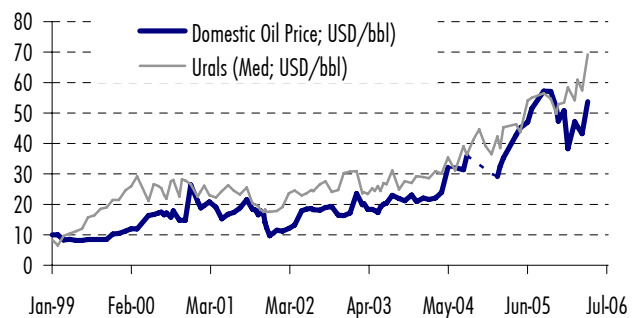
# Analysis of 1H06 NAS Results and Outlook

Galnaftogaz boosted 1H06 net sales by 86% y-o-y, to USD 221 mil. We estimate the company's CAPEX over the period surged by 197% y-o-y, to USD 23.9 mil., translating into 14% YTD growth in the number of gasoline stations, to 195 at the start of July, 142 of them under Galnaftogaz's flagship brand, OKKO (up 25% YTD). Besides, the company's retail prices of gasoline and diesel fuel jumped by 30% y-o-y, to USD 0.71/l, in line with world and domestic oil prices, which rose by 36% and 34% y-o-y, to USD 61.3/bbl (Urals Mediterranean) and USD 49.2/bbl respectively in 1H06.

**Strong 1H06 sales...**



**Retail Prices of Light Oil Products in Ukraine (USD/tonne)**  
Source: Energobusiness, Dragon Capital



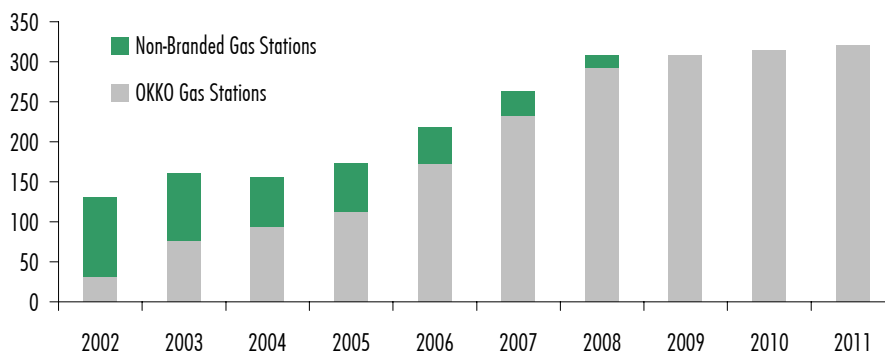
**Oil Price Performance: Ukrnafta vs. Urals\***  
Note: \*Urals prices represent Mediterranean spot prices reported on the day Ukrainian oil auctions were held;  
Source: UICE, USE, Bloomberg, Dragon Capital estimates

Galnaftogaz's 1H06 EBITDA rose by 22% y-o-y, to USD 7.4 mil., EBIT by 9.3%, to USD 4.4 mil., while net income declined by 2.3% y-o-y, to USD 3.5 mil. The gross margin declined by 3.0 p.p. y-o-y, to 7.2%, which we think is attributable to faster growth in oil prices and wholesale gasoline prices versus retail prices. The company's 1H06 net margin also narrowed, by 1.6 p.p. y-o-y to 1.1% over the period, due to increased leverage and consequent growth in interest costs by 194% y-o-y, to USD 5.0 mil.

**...but margins worse than expected**

This year, we expect Galnaftogaz to increase its OKKO network by 60 stations, to a total of 174, and expand the overall network to 218 stations (up 25% y-o-y). This is a conservative assumption compared with the company's target to operate 240 stations by end-2006, 294 by end-2007 and 314 by end-2008. We think Galnaftogaz will continue increasing its OKKO network by 60 stations annually at the expense of non-branded stations through 2008, thus cutting the latter's number to zero by 2009.

**Network growth targets largely unchanged**



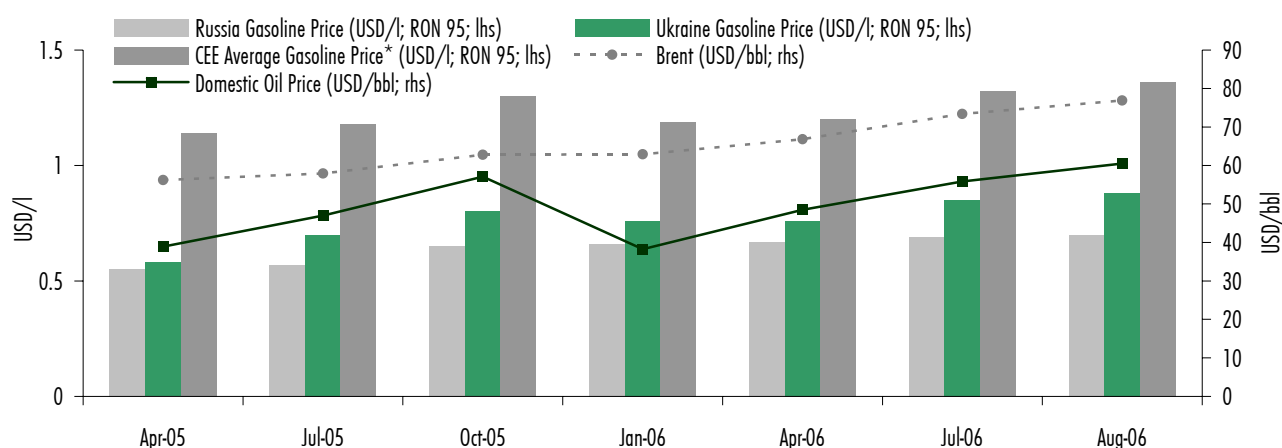
**Galnaftogaz Retail Network Breakdown**  
Source: Company, Dragon Capital estimates

In view of rising world oil prices, we upgraded our forecast of domestic retail oil product prices (gasoline and diesel fuel) by 4.2%, to USD 1,000/tonne (USD 0.77/l) on average, or up 23% y-o-y. We expect retail prices to range USD 0.70-0.83/l this year.

**We marginally improved our retail price forecast**

The graph below shows that while domestic retail oil product prices strongly correlate with world oil prices, domestic gasoline is still much cheaper than in Europe where it sells for USD 1.3-1.8/l. In CEE, in particular, retail gasoline prices average USD 1.32-1.36/l, or 55-56% more than in Ukraine. Therefore, we expect gradual convergence of domestic gasoline prices towards CEE levels. However, in Ukraine, gasoline prices is a socially sensitive issue, which tempted the government in the past to impose price caps.

**...envisaging further gradual convergence to CEE prices**



**Retail Gasoline Prices in CEE, Ukraine and Russia vs. Oil Price Trends**

Note: \*Based on prices in the Czech Republic, Hungary, Poland and Romania; Source: Bloomberg, UICE, USE, Energobusiness

Applying our updated retail price growth forecast and factoring in Galnaftogaz's expansion plans, we upgraded our financial estimates for the company. In 2006, we expect Galnaftogaz to raise net sales by 39% y-o-y, to USD 500 mil. (up 11% from our previous forecast). However, based on 1H06 results and the company's high leverage, we expect its full-year net income to increase by 25% y-o-y, to USD 9.2 mil. (up 6% from our previous estimate), implying a net margin of 1.8%, down 0.2 p.p. y-o-y.

**Full-year forecast for Galnaftogaz also improved**

## Operating Summary

Period	2003	2004	2005	2006E	2007F	1H05	1H06
Number of Gas Stations (units)	161	156	174	218	263	-	195
Growth (% y-o-y)	24%	-3%	12%	25%	21%	-	na
Incl. OKKO (units)	76	94	113	173	233	-	142
Growth (% y-o-y)	145%	24%	20%	53%	35%	-	na

## Financial Summary (NAS)

### Profit & Loss Statement (USD ths.)

Period	2003	2004	2005	2006E	2007F	1H05	1H06
Net Sales	50,700	92,436	360,776	500,377	615,344	118,703	220,906
EBITDA	3,231	5,932	17,370	20,256	29,245	6,033	7,361
Depreciation	(1,788)	(3,103)	(4,461)	(5,985)	(11,418)	(1,978)	(2,927)
EBIT	1,443	2,829	12,908	14,271	17,827	4,055	4,434
Net Financial Income (Loss)	(1,426)	(2,771)	(4,126)	(8,358)	(11,621)	(1,553)	(3,736)
Other Non-operating Income (Loss)	2,130	3,418	1,328	6,337	6,400	1,408	3,147
NIBT	2,147	3,475	10,111	12,249	12,607	3,910	3,845
Taxes	(163)	(257)	(2,752)	(3,062)	(3,152)	(361)	(378)
Net Income (Loss)	1,985	3,218	7,359	9,187	9,455	3,550	3,467

### Balance Sheet (USD ths.)

Period	2003	2004	2005	2006E	2007F	1H05	1H06
Total Assets	65,240	100,057	157,008	241,971	332,997	-	201,649
Fixed Assets	38,547	53,512	79,331	130,652	187,410	-	97,971
PPE	31,451	47,083	59,851	114,180	170,747	-	80,432
Current Assets	26,692	46,545	77,677	111,319	145,587	-	103,678
Inventories	2,843	5,899	14,448	18,936	20,948	-	19,278
Accounts Receivable	15,388	30,427	56,664	75,399	74,179	-	68,435
Cash & Cash Equivalents	7,782	9,387	3,661	14,013	47,490	-	13,385
Total Liabilities & Equity	65,240	100,057	157,008	241,971	332,997	-	201,649
Total Liabilities	30,575	54,369	98,018	165,105	166,478	-	131,124
Accounts Payable	11,527	23,360	23,111	31,561	34,914	-	29,300
S/T Debt	1,373	3,109	16,138	17,822	15,842	-	21,176
L/T Debt	16,126	24,292	49,622	105,822	105,822	-	75,570
Equity	34,665	45,688	58,881	76,865	166,518	-	70,425

### Financial Ratios

Period	2003	2004	2005	2006E	2007F	1H05	1H06
Sales Growth (y-o-y)	-	82%	290%	39%	23%	32%	86%
EBIT Growth (y-o-y)	-	96%	356%	11%	25%	218%	9%
Net Income Growth (y-o-y)	-	62%	129%	25%	3%	167%	(2%)
EBITDA Margin	6.4%	6.4%	4.8%	4.0%	4.8%	5.1%	3.3%
EBIT Margin	2.8%	3.1%	3.6%	2.9%	2.9%	3.4%	2.0%
Net Margin	3.9%	3.5%	2.0%	1.8%	1.5%	3.0%	1.6%
Net Debt/Equity	28%	39%	105%	143%	45%	-	118%
ROE	11.5%	8.0%	14.1%	13.5%	7.8%	-	10.7%

## Financial Summary (IFRS)

### Profit & Loss Statement (USD ths., IFRS)

Period	2003	2004	2005
Net Sales	176,726	241,338	379,534
Costs of Goods Sold	(168,347)	(229,874)	(357,328)
Gross Income	8,380	11,464	22,206
SG&A	(4,210)	(5,825)	(8,948)
Other Operating Income/Expenses	(531)	67	(988)
EBIT	3,639	5,707	12,270
Income from Associates	185	622	294
Net Financial Income/Loss	(1,457)	(1,073)	(2,760)
NIBT	2,367	5,255	9,804
Taxes	(288)	(1,072)	(1,902)
Net Income (Loss)	2,079	4,183	7,902
Minority Interest	(0)	5	13
EBITDA	5,451	8,433	15,968
Depreciation	(1,813)	(2,726)	(3,698)

### Balance Sheet (USD ths., IFRS)

Period	2003	2004	2005
Total Assets	63,039	89,726	163,786
Fixed Assets	43,152	55,956	84,519
PPE	33,610	45,217	80,360
Investments	6,611	7,914	448
Intangible and Other Assets	2,930	2,825	3,710
Current Assets	19,887	33,770	79,268
Inventories	2,843	5,694	14,266
Accounts Receivable	11,412	17,159	47,449
Prepayments and Other Assets	3,887	8,401	14,316
Cash & Cash Equivalents	1,746	2,516	3,236
Total Liabilities & Equity	63,039	89,726	163,786
Total Liabilities	31,540	51,292	101,737
L/T Debt	15,319	23,623	30,823
S/T Debt	2,150	3,779	34,937
Accounts Payable	11,829	21,316	30,641
Other Liabilities	2,242	2,574	5,335
Equity	31,490	38,341	61,939
Minority Interests	9	93	111

### Financial Ratios

Period	2003	2004	2005
Sales Growth (y-o-y)	-	37%	57%
EBIT Growth (y-o-y)	-	57%	115%
Net Income Growth (y-o-y)	-	101%	89%
EBITDA Margin	3.1%	3.5%	4.2%
EBIT Margin	2.1%	2.4%	3.2%
Net Margin	1.2%	1.7%	2.1%
Net Debt/Equity	50%	65%	101%
ROE	-	12.0%	15.8%

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