Dragon Capital

EQUITY RESEARCH
Oil & Gas/Retail

GALNAFTOGAZ

December 19, 2007

Optimistic View on Retail Player in Oil Market

Price Target ($)	0.037
Upside (%)	41%
Previous PT ($)	0.010

Sell	Hold	**Buy**

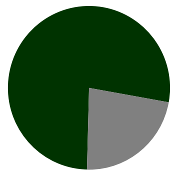
Highlights

- **Sales growth for 9M07 strong, but below forecast.** Galnaftogaz reported 9M07 UAS net sales at $444m (up 21% y-o-y, though we expected growth for the full year at 49% y-o-y). The company increased its gasoline station network by 16% YTD, to 231 stations, with weighted average daily sales per station up 18% y-o-y, to 7.2 tonnes. Retail prices remained mostly flat y-o-y over the period. Due to delays in the financing of new launches, Galnaftogaz has fallen behind its target of bringing its retail network to 300 gas stations by year-end and revised it down to 262 (our forecast is 254 stations).
- **Margins are mixed.** In 9M07, Galnaftogaz improved its EBITDA margin (under UAS) by 0.8pp y-o-y, to 4.8% ($21.2m), and we expect its 2007 IFRS EBITDA margin to increase 1pp y-o-y, to 6.1% ($38.7m). At the same time, the company saw its 9M07 net margin (under UAS) decline by 0.8 pp y-o-y, to 0.9% ($3.8m), due to increased leverage and growth in interest costs of 56% y-o-y, to $10.1m.
- **Outlook has improved significantly.** Galnaftogaz plans to spend nearly $450m to further expand its gasoline station network and bring it to 512 stations in the next five years. Financing sources are well diversified (including debt from IFIs and local banks, future IPO proceeds and a share capital increase) and bear reasonable costs, so we believe the company will be able to meet its plan (though we are more conservative and expect 500 stations as of end-2012). As a result, we have upgraded our long-term forecast for the company and expect its net sales to rise at a 2008-12 CAGR of 43%, reaching $2.6bn (when its aggressive growth phase is over). In terms of profitability, we forecast the EBITDA margin to vary by 5.4-6.5% over 2008-15. The net margin will be depressed for several years due to high leverage, though management plans to improve it to 2.9% by 2011, which we consider an achievable target.
- **Upgraded price target suggests Buy recommendation.** Our updated DCF model for Galnaftogaz yielded a 12-month price target of $0.039/share. Two additional valuation tools, valuation comparison with food retailers and asset-based valuation, suggested 12-m price targets of $0.034/share each. The average of the three estimates, $0.037/share (with 60% weight assigned to DCF and 20% to each of the comparative and asset-based valuations), is 41% higher than the stock's current market price and significantly above our previous price target of $0.010/share. We therefore have upgraded the stock from a Sell recommendation, but due to risks associated with the company's aggressive growth (i.e. its ability to meet its targets), we have assigned a Buy recommendation on the stock rather than a Strong Buy.

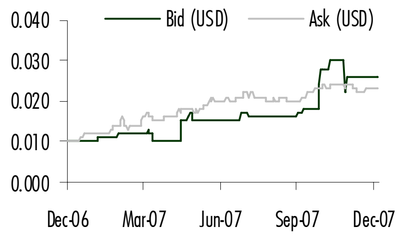
Company Data

Market Price ($)	0.026
Market Cap ($m)	463
Enterprise Value (07E; $m)	646
Free Float (%)	21.87%
Free Float ($m)	101
Shares Outstanding	17,812,500,000
Nominal Value (UAH)	0.01
Bloomberg Code	GLNG UZ
ADR Ratio	1:500
Number of Employees	3,700

Shareholder Structure



Price Performance ($)



12-month Performance	153%
12-month Rel. Perform. (KP-Dragon)	10%
12-month Low/High	0.010-0.030
All-time Low/High	0.008-0.030
12-month PFTS Trading Volume ($m)	77

Valuation Summary

Year	2006	2007E	2008F	2009F	2010F
P/E	50.1	58.5	39.3	14.3	9.4
EV/EBITDA	20.0	17.4	12.5	8.2	6.6
EV/Sales	1.02	1.07	0.69	0.53	0.43
P/Book	4.67	4.71	2.60	1.84	1.52
EV/Output ($/tonne)	1,391	1,203	1,261	602	495

Analyst: Andriy Bespyatov, CFA
(+380 44) 490 7120
Email: research@dragon-capital.com
www.dragon-capital.ua

9M07 Results

Revenue growth in 9M07 strong…

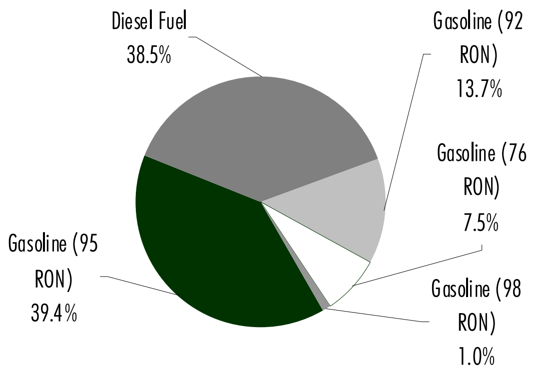
Galnaftogaz increased 9M07 net sales (under UAS) by 21% y-o-y, to $444m, and increased its gasoline station network by 16% YTD, to 231 (including 194 OKKO-branded stations). The weighted average daily sales per station rose 18% y-o-y, to 7.2 tonnes (one of the highest in the sector), including 8.4 tonnes for OKKO stations.

…but below target

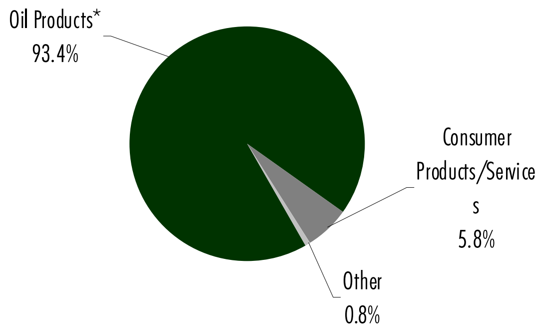
Due to delays in the financing of new launches, Galnaftogaz fell below its target of bringing its retail network to 300 gasoline stations by year-end and now expects to have about 270 such stations in operation by end-2007. We are more skeptical of these forecasts and expect 255 stations in place by year's end.

Sales structure

Retailing and wholesaling of oil products accounted for 93.4% of Galnaftogaz's 9M07 net sales, followed by sales of consumer products with 5.5%. Retail and wholesale sales of oil products were split 85/15, almost unchanged y-o-y. Gasoline RON 95 and diesel fuel enjoyed the strongest customer demand, each accounting for up to 40% of total oil product sales. We expect the share of diesel fuel to increase further given the rising popularity of diesel-powered automobiles in Ukraine. The share of high octane gasoline (RON 95, RON 98) is also set to increase thanks to increasing sales of new mid-range cars.



Galnaftogaz Oil Products Sales Structure (9M07)*
Note: Both retail and wholesale; Source: Company



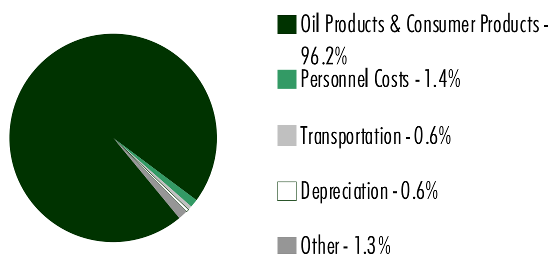
Galnaftogaz Net Sales Structure (9M07)
Note: *Both retail and wholesale; Source: Company

Galnaftogaz oil supplies are well-diversified

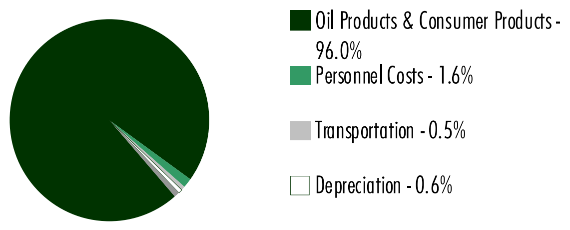
Of its total fuel supply in 2006, Galnaftogaz bought about 51% (down from 75% in 2005) from Ukrtatnafta, the largest domestic oil refinery, and imported the rest from Belarus (Mozyr refinery) and Lithuania (Mazeiku refinery), with smaller volumes coming from Romania and Russia. This year the share of domestic supplies was even lower, so the company was only marginally affected by the ownership dispute at Ukrtatnafta between the Ukrainian government and Russian oil company Tatneft.

Oil products and consumer goods purchased for resale dominate cost structure

As Galnaftogaz is a pure retailer, purchases of oil and consumer products for resale account for most of its costs. The company's 2006 IFRS reports show oil products and consumer goods made up 96.0% of total COGS, or almost flat y-o-y.



Galnaftogaz COGS Structure (2005)



Galnaftogaz COGS Structure (2006)

Source: Company

Margins have improved considerably this year

Galnaftogaz reported a gross margin of 6.0% in 2006 (IFRS), up 0.1pp y-o-y, successfully passing higher oil prices onto customers. In 9M07, its gross margin (under UAS) rose by 2.5pp y-o-y, to 10.6%, on higher sales per station; EBITDA margin also improved, by 0.8pp, to 4.8%. We thus expect Galnaftogaz's 2007 IFRS gross margin to rise by 1.4pp, to 7.4% y-o-y, and its EBITDA margin by 1pp y-o-y, to 6.1%. At the same time, the company saw its 9M07 UAS net margin decline by 0.8pp y-o-y, to 0.9%, due to increased leverage and consequent growth in interest costs of 56% y-o-y, to $10.1m.

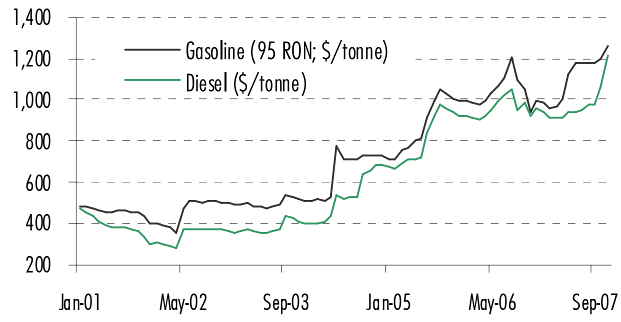
Period	9M05	9M06	9M07	9M06/9M05 Change (%; y-o-y)	9M07/9M06 Change (%; y-o-y)
Net Sales	242.8	367.9	443.6	52%	21%
EBITDA	13.4	14.7	21.2	10%	44%
EBIT	10.2	10.1	14.0	(0%)	38%
NIBT	9.1	6.6	4.9	(27%)	(25%)
Net Income (Loss)	7.4	5.9	3.8	(20%)	(36%)
EBITDA Margin	5.5%	4.0%	4.8%	(1.5pp)	0.8pp
Operating Margin	4.2%	2.8%	3.2%	(1.4pp)	0.4pp
Net Margin	3.0%	1.6%	0.9%	(1.4pp)	(0.7pp)

Summary of Galnaftogaz 9M07 Results ($m)

Source: Company

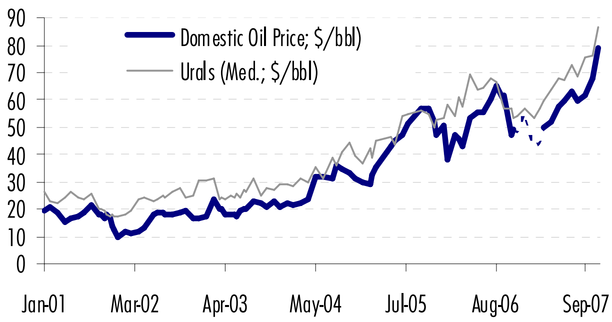
Retail prices increased by only 2% in 9M07 following trends in world oil prices

The Ukrainian retail market of oil products is heavily intergraded into the world economy, as imports account for a significant share of total domestic consumption of oil products. Domestic refineries are mostly outdated and unable to meet the soaring domestic demand for quality high-octane gasoline and diesel fuel. As a result, domestic retail prices of oil products have closely correlated with international oil prices (please see the graph below). In 9M07, the average Brent price was down by a marginal 0.9% y-o-y, while average retail prices of oil products in Ukraine inched up 1.5%, to $0.77/l ($1,007/tonne), over the period.



Retail Prices of Light Oil Products in Ukraine ($/tonne)

Sources: Energobusiness, Dragon Capital

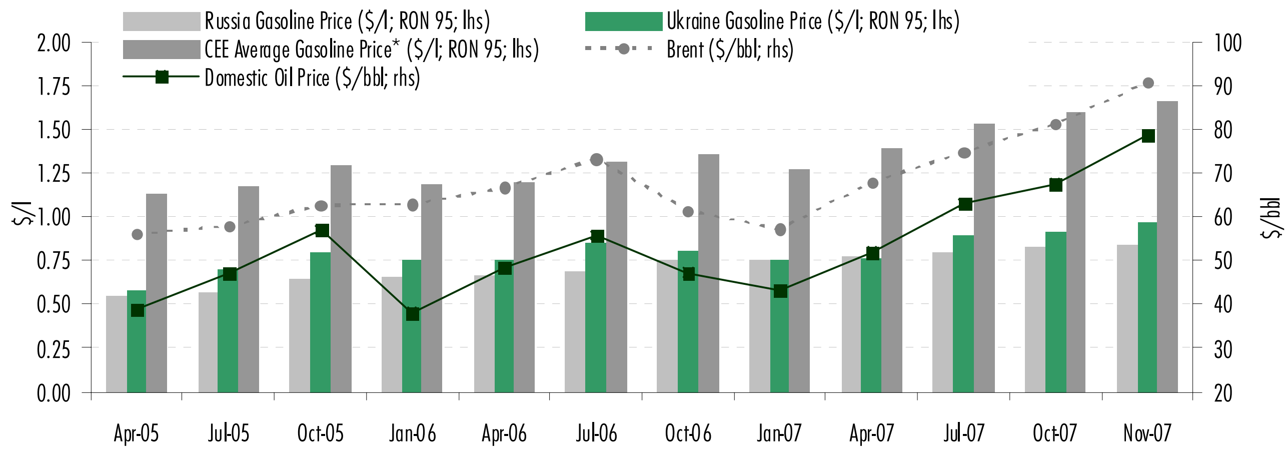


Oil Price Performance: Ukrnafta vs. Urals*

Note: *Urals prices represent Mediterranean spot prices reported on the day Ukrainian oil auctions were held; Sources: UICE, USE, Bloomberg, Dragon Capital estimates

Domestic fuel prices are still below those in CEE and Europe

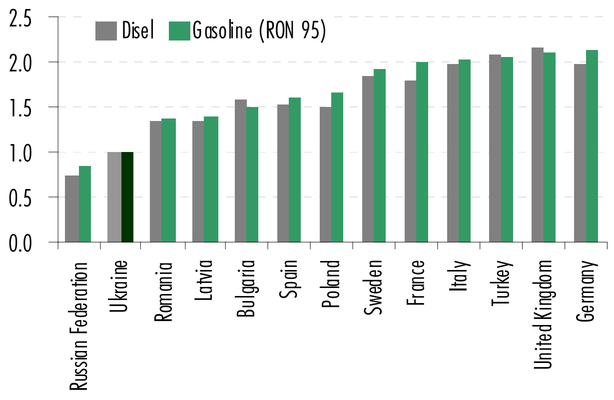
As the graph below shows, domestic retail prices of oil products strongly correlate with world prices, though domestic gasoline is still much cheaper than in Central and Eastern Europe, where it sells for over $1.50/l. Russia is probably the only market in Europe with lower prices than in Ukraine, mostly due to the country's own vast oil reserves.



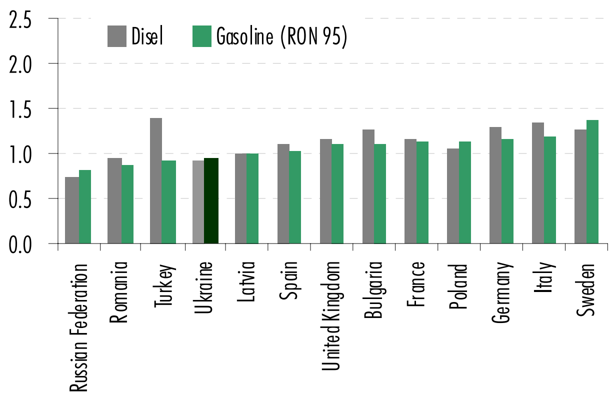
Retail Gasoline Prices in CEE, Ukraine and Russia vs. Oil Price Trends
Note: *Based on prices in the Czech Republic, Hungary, Poland and Romania; Sourcez: Bloomberg, Energobusiness, UICE, USE

Lower prices can be largely explained by a lower applied tax base

An interesting observation comes when we compare European and Ukrainian gasoline prices with excise taxes included and net of taxes. Retail prices paid by consumers are highest in Western Europe and Turkey and are higher than in Ukraine for all countries except for Russia, as we stated above. However, the tax base is also very much different. Net of excise taxes, Ukrainian gasoline prices are no longer viewed as the cheapest in the region and are instead quite comparable to CEE peers. Therefore, if prices grow above the level expected by a regression between in oil prices and the prices of oil products, we would expect the government to absorb all abnormal profits via taxes.



Retail Prices: Ukraine vs. Europe ($/liter)*
Note: Prices are as of end-November; Sources: UICE, USE, Bloomberg, Dragon Capital estimates



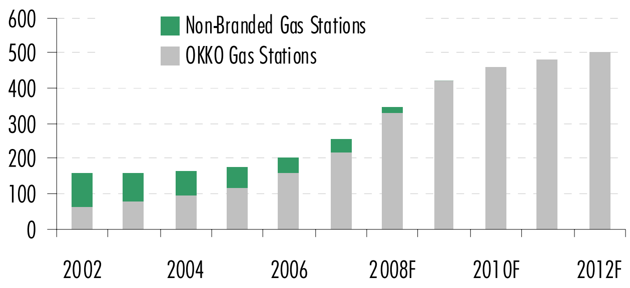
Retail Prices (net of excise): Ukraine vs. Europe ($/liter)*
Note: Prices are as of end-November; Sources: UICE, USE, Bloomberg, Dragon Capital estimates

Oil prices to stay strong; retail gasoline prices will follow this trend

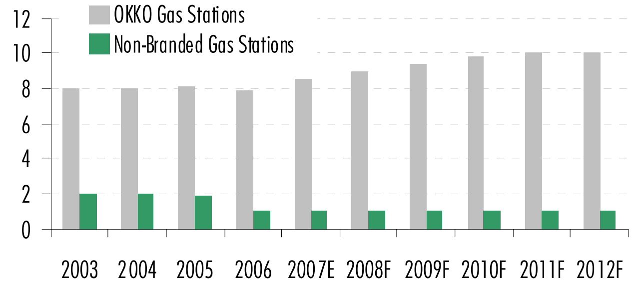
With world oil prices hovering around $90/bbl in 4Q07, chances are high that next year's average oil price will approach $80/bbl. While major world investment banks still expect crude prices to slide to $60/bbl in the long term, we think the oil market remains so volatile that a downward trend is not as obvious; in our model we assumed world oil prices will stay close to $75/bbl. Based on the above analysis of excise taxes and oil forecast, we believe gasoline prices should surge by up to 20% in 2008 (in line with 2008 price growth estimate for Brent blend), to $1,055/tonne, and stabilize around this level even if oil prices fall from $80/bbl to $75/bbl. Should oil prices surge again, surpassing $100/bbl, retail prices of oil products could follow the trend and soar.

New long-term target: 512 gasoline stations

Two years ago, when it placed its shares on the market, the company planned to expand to 265 gasoline stations by 2010. Today Galnaftogaz expects to achieve this goal by end-2007, its new target being 512 gasoline stations (by end-2012). We believe Galnaftogaz, with its very sound financing policy, could come very close to this target, but more conservatively estimate the size of its network at 500 stations by end-2012. Some of our concerns relate to the very aggressive pace of growth and business risks that the acquisition of other networks, construction of new stations and modernization of non-branded stations will go directly according to the company's business plan.



Galnaftogaz Retail Network Breakdown



Galnaftogaz Gasoline Sales Per Station (tonnes/day)

Sources: Company, Dragon Capital estimates

Long-term forecast has improved

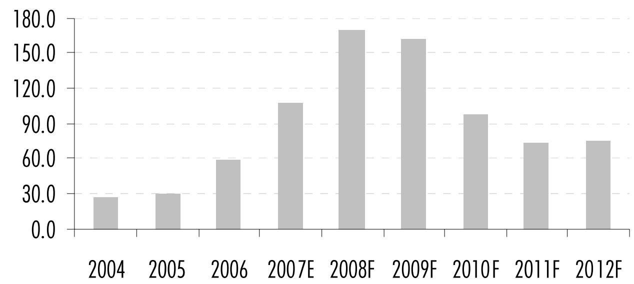
Postponing the launch of new gasoline stations in 2007 resulted in a 23% downward revision of net sales, to $607m. Nevertheless, in applying our updated retail price growth forecast and factoring in Galnaftogaz's much more aggressive expansion plans, we significantly upgraded our long-term outlook for the company. In 2013, when the company should fully benefit from an expanded retail network, net sales are expected to reach $2.5bn, up from $2.1bn expected earlier. EBITDA, meanwhile, should increase to $158m (+18% from the old estimate). In terms of profitability, the company itself plans to maintain its long-term EBITDA margin at 6.4-6.5% (and to have about $40m in 2007), while in our model it varies by 5.5-6.5% over 2008-15 (we estimate $37m for 2007). In terms of net margin, the company – already heavily leveraged – suffers from high interest payments. Management plans to improve net margin to 2.9% by 2012, which we consider an achievable target.

The company has well-diversified sources of financing

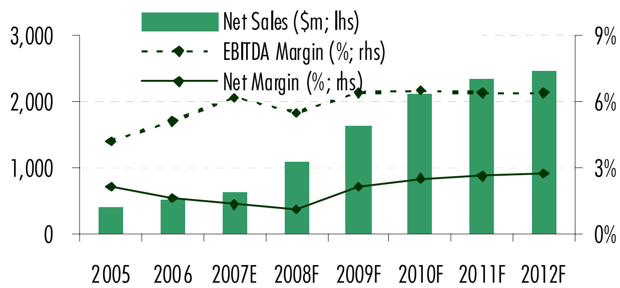
On Nov. 20, Galnaftogaz began a subscription for new shares. As we wrote before, company shareholders approved an 11% share capital increase at a subscription price of $0.0317/share (as compared with par value of $0.002/share, or UAH 0.01). As a result, while the share capital will increase by 11% ($3.6m), the total equity capital injection will reach $57.4m. According to management plans, the company plans to conduct an IPO on a foreign stock exchange in 2H09. We think Galnaftogaz will be able to attract about $150m, of which (based on the management guidance) $40m will be reinvested into the company. The company is also effectively using debt. The most expensive of its debt obligations is now UAH 90m of domestic bonds maturing in 2010 with weighted average interest paid at 11.7% (the company's overall weighted average cost of debt is estimated at 9.7% in 2007 and is not expected to exceed 10.0% in the future). The company also has diversified borrowings. Based on its current debt structure, Galnaftogaz has $25m in outstanding debt from the IFC, $25m from the EBRD (maturing in 2012), $50m from Raiffeisen Bank Aval, $32.4m from the Black Sea Bank of Reconstruction and Development and other loans. The company also approved a $200m credit line from the EBRD and the IFC (split into three loans: direct loans, subordinated portion and syndicated loans).

CAPEX estimates

In order to double its retail network to 500 stations in five years, we expect the company will need $575m, or over $680m if the 2007 CAPEX is also considered. The company has announced comparable figures, stating that 2012 would be the last year of aggressive investments and growth of its network. We assumed that about two-thirds of new gasoline stations will be located on company land and will cost $1.5m on average to build/acquire, while the rest will operate on leased land and the average cost for these would be 50% less than those built on own land (or $0.75m). We also assume that construction/purchase costs will increase annually by 7% and that an average company gasoline station will amortize in about 20 years.



Galnaftogaz CAPEX Estimates ($m)
Sources: Company, Dragon Capital Estimate



Galnaftogaz Revenue and Margin Forecasts
Sources: Company, Dragon Capital estimates

Valuation

DCF MODEL

Assumptions

We have revised our 2007E-15F operating and financial forecasts for Galnaftogaz based on the company's current performance and updated expansion plans. Our model incorporated the announced $57.4m share capital increase, a $200m syndicated loans from the EBRD and the IFC in addition to its outstanding loans and bonds. Based on the management guidance, we also assumed that Galnaftogaz would attract about $40m from an IPO into the company in 2H09 (out of $150m planned to be attracted). Based on management plans, we expect the company's EBITDA and net margins to range 6.0-6.5% and 2.0-3.0% respectively in the long term.

Cost of capital

Calculating WACC, we used the current yield on Ukraine's USD-denominated Eurobond maturing in 2016 as a proxy for the sovereign risk-free rate. Accounting for company-specific risks we applied a 7% equity risk premium and a company risk premium of only 1%, as Galnaftogaz has proved to be one of the leading companies in Ukraine in terms of corporate governance and risk management. We thus estimated Galnaftogaz's 2007 cost of equity at 14.7% and also estimated 2007E cost of debt (before taxes) at 9.7% based on the current weighted average cost of debt.

WACC (%)

	2007E	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F
Sovereign Risk-free Rate	6.7%	6.7%	6.7%	6.5%	6.2%	6.0%	5.7%	5.5%	5.5%
Equity Risk Premium	7.0%	7.0%	7.0%	6.5%	6.0%	5.5%	5.0%	4.5%	4.5%
Company Risk Premium	1.0%	1.0%	1.0%	0.8%	0.6%	0.4%	0.2%	0.0%	0.0%
Cost of Equity	**14.7%**	**14.7%**	**14.7%**	**13.8%**	**12.8%**	**11.9%**	**10.9%**	**10.0%**	**10.0%**
After-tax Cost of Debt	**7.3%**	**7.2%**	**7.2%**	**7.2%**	**7.1%**	**7.1%**	**7.0%**	**7.1%**	**7.1%**
Weight of Equity	30%	33%	43%	48%	53%	58%	65%	68%	70%
WACC	**9.5%**	**9.7%**	**10.5%**	**10.3%**	**10.1%**	**9.9%**	**9.6%**	**9.1%**	**9.1%**

Discounted Cash Flow ($m)

Year	2007E	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F
EBIT Corrected for Tax	0.9	32.3	58.0	74.2	81.9	84.5	85.2	84.3	83.4
Depreciation	0.4	16.0	27.5	38.8	42.2	43.3	44.5	43.5	42.6
Change in Working Capital	(4.5)	(169.0)	(161.1)	(97.3)	(73.2)	(74.6)	(32.7)	(32.7)	(32.7)
CAPEX	(0.0)	(34.4)	(27.5)	(36.2)	(18.4)	(7.6)	(3.8)	-	-
Free Cash Flow to Firm	**(3.2)**	**(155.1)**	**(103.2)**	**(20.5)**	**32.4**	**45.6**	**93.2**	**95.1**	**93.3**
Discount Factor	1.00x	0.91x	0.82x	0.75x	0.68x	0.62x	0.56x	0.52x	0.47x
Present Value of FCFF	**(3.2)**	**(140.9)**	**(84.9)**	**(15.3)**	**21.9**	**28.1**	**52.4**	**49.0**	**44.1**

PV of FCF ($m; 2007E-15F)	(49)
FCF Growth Rate Beyond 2015F	4.0%
WACC Beyond 2015F	9.1%
Terminal Value ($m; 2015F)	1,892
PV of Terminal Value ($m)	894
Enterprise Value ($m)	**845**
Net Debt (07E; $m)	186
PV of 2009 SCI (IPO) ($m)	33
Equity Value ($m)	**626**
# of shares (incl. SCI; millions)	**17.8**
Value per share ($/share)	**0.035**

Sensitivity Analysis ($m)

	g=3.0%	g=3.5%	g=4.0%	g=4.5%	g=5.0%
WACC + 2%	0.011	0.013	0.015	0.018	0.021
WACC + 1%	0.018	0.020	0.024	0.027	0.032
WACC	0.027	0.030	0.035	0.041	0.048
WACC - 1%	0.039	0.045	0.052	0.062	0.075
WACC - 2%	0.057	0.068	0.081	0.100	0.127

Note: The average equity value is $710m

DCF model implies a 12-month price target at $0.035/share

We calculated the terminal value based on a constant terminal growth rate of 4.0% and cost of capital of 9.1%. Our DCF model yielded a fair value estimate of $626m ($0.035/share), implying a 12-month price target, calculated as DCF value times (1+$WACC_{2008}$), of $0.039/share, or 48% above Galnaftogaz's current market price.

Our sensitivity model implies an average fair value of $0.040/share

As the valuation of Galnaftogaz depends to a large extent on future cash flows, our sensitivity analysis showed that changes in terminal growth and WACC have a significant impact on company value. Changing WACC in the range of ±2pp and also changing terminal year growth within the range of 3-5%, the equity fair value varies significantly, from $202m to $2,268m (or $0.011-$0.120/share). The sensitivity analysis yielded an average equity value of $775m, or $0.043/share.

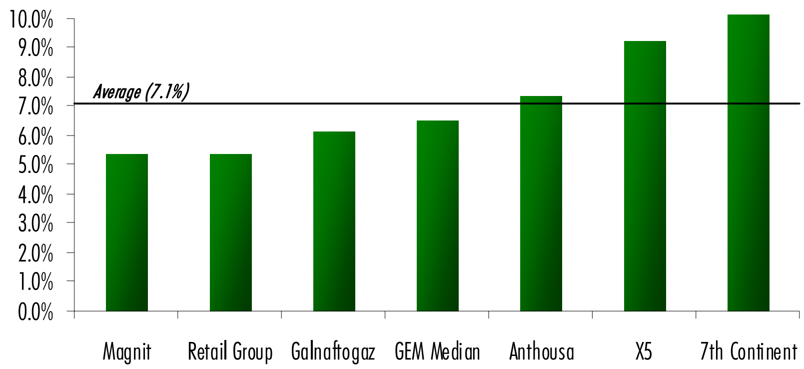
COMPARATIVE VALUATION

No true peers in gasoline retail

In our previous reports on Galnaftogaz we did not apply a comparative valuation approach due to a lack of truly similar listed peers. Of the nearly 20 companies with high exposure to retailing of gasoline whose valuations are available from Bloomberg and Thomson, only two (Turcas Petrol and Petrol Ofisi of Turkey) offer some future estimates, but even these data we do not consider reliable.

Galnaftogaz compared with traditional retailers

At the same time, Galnaftogaz is a retail market player whose growth trend and margins are very similar to those of Ukrainian, Russian and GEM food retailers. Therefore, after comparing the growth and profitability of oil and food retailers (please see the chart below), and taking into account that food retail accounts for about 10% of Galnaftogaz's sales, we decided to perform a valuation comparison of Galnaftogaz with food retailers in Ukraine, Russia and the GEM universe. Our comparison was based on 2007E-09F EV/Sales, EV/EBITDA and P/E.



EBITDA Margin: Galnaftogaz vs. Regional Food Retailers (2007E)
Sources: Companies, Dragon Capital estimates

Our analysis yielded a 12-month PT of $0.034/share

Although Galnaftogaz is highly leveraged, with high net debt and interest payments that make it look expensive on current multiples, the company's current strong growth, expected stable performance and profitability of mature gasoline stations and the availability of cheap financing from IFIs and its prospective IPO should help it offset the costs of its aggressive expansion. Our valuation comparison yielded an average fair value of $0.031/share for Galnaftogaz, implying a 12-month price target of $0.034/share, or 30% above the current market price.

Comparative Valuation: Galnaftogaz vs. Domestic & International Retail Peers*

Company	MC	EV/Sales			EV/EBITDA			P/E		
	$m	2007E	2008F	2009F	2007E	2008F	2009F	2007E	2008F	2009F
Galnaftogaz	463	1.07	0.69	0.53	17.4	12.5	8.2	58.5	39.3	14.3
GLNG Premium to GEM Peers		*10%*	*(20%)*	*(29%)*	*24%*	*3%*	*(16%)*	*128%*	*82%*	*(24%)*
GLNG Premium to RU Peers		*(34%)*	*(40%)*	*(33%)*	*(3%)*	*1%*	*(22%)*	*34%*	*37%*	*(28%)*
GLNG Premium to UA Peers		*(14%)*	*(19%)*	*(16%)*	*(13%)*	*(10%)*	*14%*	*73%*	*69%*	*(21%)*
Bim Birlesik Magazalar (TR)	2,097	0.85	0.68	0.55	17.7	13.8	11.0	27.5	21.9	15.9
CBD (BR)	4,429	0.67	0.59	0.55	9.3	8.0	7.3	34.4	26.2	20.0
Cencosud (CL)	7,775	1.23	1.04	0.89	14.1	11.9	9.8	19.8	20.1	15.4
Dairy Farm International	5,927	1.02	0.91	0.85	13.9	12.3	10.9	23.6	20.9	18.8
Distribucion Y Servicio (CL)	3,294	1.18	1.02	0.92	14.5	12.6	10.71	32.8	24.8	19.0
Lojas Americanas (BR)	6,646	2.25	1.73	1.47	19.6	13.9	9.7	68.4	37.8	29.5
Migros Turk (TR)	3,354	0.93	0.81	0.62	12.7	11.4	8.9	25.9	22.8	19.1
President Chain (TW)	2,365	0.73	0.68	0.64	10.6	9.8	9.0	17.6	16.64	16.33
Shinsegae (KR)	14,327	1.86	1.70	1.52	16.1	14.1	12.5	25.52	21.32	18.71
Wumart Stores (CN)	970	0.82	0.64	0.56	11.5	9.0	8.2	23.6	18.1	15.2
GEM Retail Median**	**5,118**	**0.97**	**0.86**	**0.74**	**14.0**	**12.1**	**9.8**	**25.7**	**21.6**	**18.7**
X5	7,101	1.63	1.15	1.00	17.8	12.4	10.5	45.3	28.6	21.1
7th Continent	1,970	1.63	1.19	0.79	16.2	11.9	8.0	26.5	22.7	16.3
Magnit	3,528	1.06	0.81	0.64	20.3	14.5	11.0	43.6	30.0	19.9
Russian Retail Median**	**4,199**	**1.63**	**1.15**	**0.79**	**17.8**	**12.4**	**10.5**	**43.6**	**28.6**	**19.9**
Retail Group	775	1.25	0.88	0.62	23.3	18.4	7.80	49.4	35.4	26.1
Anthousa Ltd.	760	1.24	0.82	0.63	16.8	9.6	6.50	18.2	11.2	10.2
Ukrainian Retail Median**	**767**	**1.24**	**0.85**	**0.63**	**20.0**	**14.0**	**7.2**	**33.8**	**23.3**	**18.2**

Note: *Prices are as of December 18; **Except for MC, where a simple average is used; Sources: Dragon Capital estimates, Bloomberg, Thomson

ASSET-BASED VALUATION

We expect Galnaftogaz to complete network development by 2012

As noted above, Galnaftogaz plans to bring its network to 512 gasoline stations as of end-2012 using debt financing as well as funds attracted from a share capital increase and an IPO planned in 2009. We take a more conservative line and forecast the company network to reach 500 stations (marginally, or 3%, below management expectations), all OKKO-branded, as compared with 231 stations as of now (84% of them OKKO-branded).

Based on recent deals, the value per station could reach $2m

To perform an asset-based valuation of Galnaftogaz, we conservatively estimated the company to have a valuation of $2m per station in 2010. This projection is based on the recently announced acquisition by TNK-BP of another local gas station network, Zolotiy Gepard ("Golden Cheetah"), with 36 stations. Although the deal value was not disclosed, market talk has it that the valuation per station exceeded $2m and could reach $5m given that almost the whole Zolotiy Gepard network is located in Kyiv, a city with the strongest consumer purchasing power, highest car penetration and largest land prices across Ukraine.

The value of land owned by the company should appreciate by 40% by 2012

According to information provided by Galnaftogaz, the current weighted average value of land (historical value plus revaluation) under a given gasoline station is about $0.7m, and the company owns land plots under 50 of its gasoline stations. Further on, Galnaftogaz plans to acquire land under about two-thirds of its newly built or purchased gas stations. This implies that by 2012 over 40% of the Galnaftogaz network will be located on the company's own land, which we very conservatively estimate will appreciate by 40% from its current value. As a result, the total value of Galnaftogaz-owned land could add more than $193m to the company valuation.

Debt and equity attracted were excluded in calculating current value for investors

As in the case of the FCFF valuation, we subtracted from the 2012F asset value of Galnaftogaz its net debt for that period and discounted equity value back to today. We also subtracted the present value of company share capital ($40m), which we expect shareholders will invest during the IPO in 2009.

Fair value is $542m, implying a 12-m PT of $0.034/share

In addition to the retail business and value of land owned by Galnaftogaz, we estimated that the company's wholesale business could be valued at 5% of its retail business given its 2012 share of sales (14% as compared with 77% for retail) and also its much lower profitability (nearly 3% versus 10-11% for retail sales). As a result, we valued Galnaftogaz at $542m, implying a fair value per share of $0.031 and a 12-month price target of $0.034/share (up 29% from the current stock price).

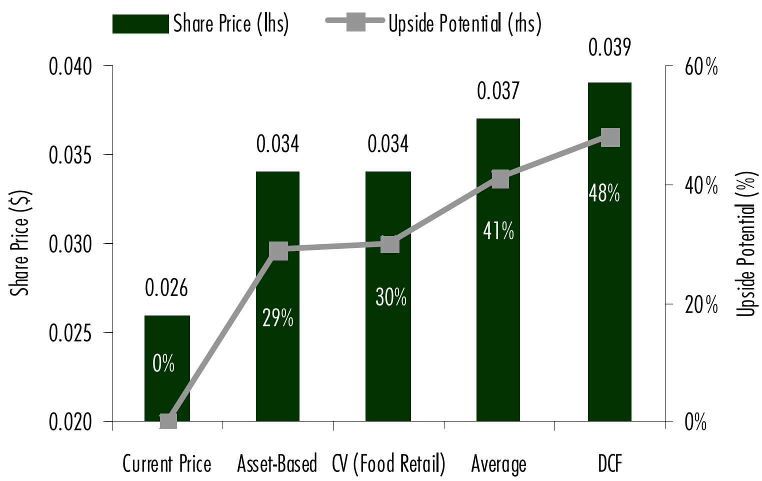
Asset-Based Valuation

2012F # of Gasoline Stations	500
Value per Station ($m)	2
Valuation of Retail Business (2012F; $m)	1,000
Valuation of Land (2012F; $m)	193
Valuation of Wholesale Business (2012F; $m)	50
Total Valuation (2012F; $m)	**1,242**
Net Debt (2012F; $m)	303
Equity Value (2012;$m)	939
PV of Equity Value ($m)	575
Less PV of 2009 IPO ($m)	33
Equity Value ($m)	546
Value per Share ($/share)	**0.031**

RECOMMENDATION

We rate Galnaftogaz as a Buy with a 12-month PT of $0.037/share

Combining the fair value estimates suggested by the DCF model, valuation comparison with food retailers and the asset-based valuation, we calculated the combined 12-month price target for Galnaftogaz at $0.037/share, or 41% above its current market price (and up from our previous price target of $0.010/share). However, due to risks associated with the aggressive growth of the company, we assign a Buy as opposed to a Strong Buy recommendation on the stock.



Galnaftogaz 12-month Price Target Estimates
Source: Dragon Capital

Risks

Delays in expansion

Over the last few years the company has experienced delays in fulfilling its expansion plans for different reasons, and 2007 proved a relevant example of such delays. The company's plans to deliver more 80-90 new gasoline stations per year in 2008-09 and will prove to be a challenging task. While we believe that with enough funding this is an achievable target, we view as moderate the risk of underperformance due to slower than planned expansion.

Transition period in the oil and gas market

The domestic oil and gas market is currently going through a transition period, which means the situation can change quickly, with threats of increased government regulation, corporate conflicts at refineries and more intensive consolidation in the industry ever present. But management has so far proven to be ahead of the market, successfully managing internal risks and lessening the potential consequences of external risks through diversification of financing and supplies, broader regional expansion and considerable quality control, so we consider this risk as moderate to low.

Financial Summary (IFRS)

Profit & Loss Statement ($ '000)

Period	2004	2005	2006	2007E	2008F	2009F	2010F
Net Sales	241,338	379,534	514,688	606,887	1,075,630	1,628,815	2,105,646
Costs of Goods Sold	(229,874)	(357,328)	(483,925)	(561,821)	(1,001,051)	(1,503,024)	(1,943,029)
Gross Income	11,464	22,206	30,763	45,066	74,579	125,792	162,617
SG&A	(5,825)	(8,948)	(12,990)	(15,620)	(28,222)	(43,551)	(57,354)
Other Operating Income/Expenses	67	(988)	3,540	(1,821)	(3,227)	(4,886)	(6,317)
EBIT	5,707	12,270	21,313	27,625	43,129	77,354	98,946
Income from Associates	622	294	0	0	0	0	0
Net Financial Income/Loss	(1,073)	(2,760)	(10,262)	(17,737)	(28,387)	(34,301)	(33,812)
NIBT	5,255	9,804	11,051	9,889	14,743	43,053	65,134
Taxes	(1,072)	(1,902)	(2,740)	(1,978)	(2,949)	(8,611)	(13,027)
Net Income (Loss)	4,183	7,902	8,310	7,911	11,794	34,442	52,107
Minority Interest	5	13	8	0	0	0	0
EBITDA	8,433	15,968	26,243	37,336	59,122	104,852	137,734
Depreciation	(2,726)	(3,698)	(4,930)	(9,711)	(15,993)	(27,498)	(38,788)

Balance Sheet ($ '000)

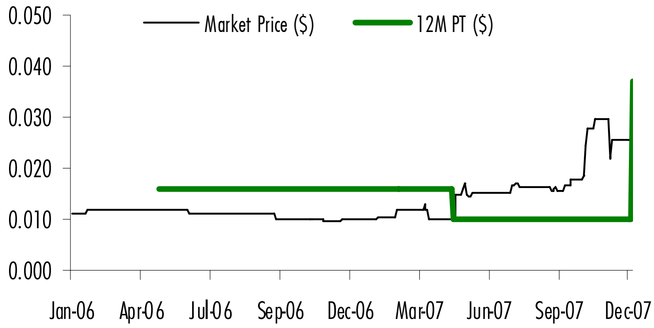
Period	2004	2005	2006	2007E	2008F	2009F	2010F
Total Assets	89,726	163,786	248,615	366,921	604,626	702,231	790,549
Fixed Assets	55,956	84,519	150,051	228,199	364,606	481,687	523,670
PPE	45,217	80,360	146,353	224,140	360,148	476,791	518,292
Intangible and Other Fixed Assets	10,739	4,159	3,697	4,060	4,458	4,896	5,378
Current Assets	33,770	79,268	98,565	138,722	240,020	220,544	266,879
Inventories	5,694	14,266	20,790	23,089	41,139	61,768	79,851
Accounts Receivable	16,950	47,449	41,529	53,873	82,278	102,947	133,084
Prepayments and Other Assets	8,401	7,697	25,797	23,089	27,426	41,179	53,234
Cash & Cash Equivalents	2,516	3,236	10,449	38,671	89,177	14,650	711
Total Liabilities & Equity	89,726	163,786	248,615	366,921	604,626	702,231	790,549
Total Liabilities	51,292	101,737	159,398	268,542	426,319	435,230	467,541
L/T Debt	23,623	30,823	70,290	187,922	347,922	347,922	346,222
S/T Debt	3,779	34,937	48,318	37,189	18,595	0	9,901
Accounts Payable	21,316	30,527	27,427	38,481	54,852	82,357	106,467
Other Liabilities	2,574	5,449	13,363	4,950	4,950	4,950	4,950
Equity	38,341	61,939	89,114	98,280	178,213	266,913	322,924
Minority Interests	93	111	104	98	93	89	84

Financial Ratios

Period	2004	2005	2006	2007E	2008F	2009F	2010F
Sales Growth (y-o-y)	37%	57%	36%	18%	77%	51%	29%
EBITDA Growth (y-o-y)	55%	89%	64%	42%	58%	77%	31%
Net Income Growth (y-o-y)	101%	89%	5%	(5%)	49%	192%	51%
EBITDA Margin	3.5%	4.2%	5.1%	6.2%	5.5%	6.4%	6.5%
EBIT Margin	2.4%	3.2%	4.1%	4.6%	4.0%	4.7%	4.7%
Net Margin	1.7%	2.1%	1.6%	1.3%	1.1%	2.1%	2.5%
Net Debt/Equity	65%	101%	121%	190%	156%	125%	110%
ROE	12.0%	15.8%	11.0%	8.4%	8.5%	15.5%	17.7%

HISTORICAL PRICE TARGETS

Galnaftogaz (GLNG)



DRAGON CAPITAL STOCK RATINGS

Dragon Capital employs three basic recommendations to rate stocks under coverage: Buy, Hold and Sell. The recommendations are assigned according to the table below.

12-m Upside from Current Market Price	Recommendation
>20%	Buy
0% - 20%	Hold
<0%	Sell

In addition, the Buy recommendation has two variations, Strong Buy and Speculative Buy. We rate a stock as a Strong Buy if its upside exceeds 40% and we see no material risks that could jeopardize our valuation. We assign a Speculative Buy recommendation to a stock whose valuation justifies a Buy or Strong Buy recommendation but is vulnerable to downside risks, particularly adverse corporate governance developments. Stocks that are either suspended from trading or do not have price target and recommendation assigned by Dragon analysts are designated as Not Rated.

We put a stock Under Review if its price target and/or recommendation are subject to change based on latest financial results, newly arisen risk factors, or other important events. We make all reasonable effort to reinstate recommendations and price targets on stocks under review in the shortest possible time. Finally, we suspend a traded company from coverage if Dragon Capital signs an investment banking mandate with the said company (for example, to place its shares on the market). Coverage is reinstated after the relevant investment banking transaction is closed.

Current Rating Distribution

Companies Covered	Recommendation					
	Buy*	Hold	Sell	Under Review	Not Rated	Suspended
111	26	14	48	15	7	1
% of Total	23%	13%	43%	14%	6%	1%

Note: *Stocks rated as Buy, Strong Buy and Speculative Buy

Dragon Capital
36D Saksahanskoho,
01 033 Kyiv, Ukraine
Tel.: (+380 44) 490 7120
Fax: (+380 44) 490 7121
www.dragon-capital.ua

Managing Director
Tomas Fiala
fiala@dragon-capital.com

SALES

Director,
Head of Trading and Domestic Sales
Dmytro Tarabakin
tarabakin@dragon-capital.com

Director, Head of International Sales
Sandro Salsano
salsano@dragon-capital.com

Director, International Sales
Peter Bobrinsky
bobrinsky@dragon-capital.com

Vice-President, International Sales
Andriy Dmytrenko, CFA
dmytrenko@dragon-capital.com

Director, Trading and Domestic Sales
Denis Matsuyev
matsuyev@dragon-capital.com

RESEARCH

Head of Research
Andriy Bespyatov, PhD, CFA
bespyatov@dragon-capital.com

Economics
Vitaliy Vavryshchuk
vavryshchuk@dragon-capital.com

Politics
Viktor Luhovyk
luhovyk@dragon-capital.com

Banking, Insurance
Oleg Pronin
pronin@dragon-capital.com

Metals & Mining
Ivan Kharchuk
kharchuk@dragon-capital.com
Sergiy Gayda
gayda@dragon-capital.com

Chemicals, Food & Beverage
Pulp & Paper, Retail
Tamara Levchenko
levchenko@dragon-capital.com

Machine-Building, Real Estate,
Telecommunications
Taisiya Shepetko
shepetko@dragon-capital.com

Energy
Dennis Sakva
sakva@dragon-capital.com

Oil & Gas
Andriy Bespyatov
bespyatov@dragon-capital.com

Fixed Income
Andriy Bespyatov
bespyatov@dragon-capital.com
Olga Slyvynska
slyvynska@dragon-capital.com

Editing
Viktor Luhovyk
luhovyk@dragon-capital.com

Research Assistants
Volodymyr Skepskiy
skepskiy@ dragon-capital.com
Olga Slyvynska
slyvynska@dragon-capital.com