

# Galnaftogaz

## 1H05 performance & UAH bond issue on 1 September

### Oil retail & wholesale

**OJSC ‘Concern Galnaftogaz’, the oil products retailer with an upscale network of service stations among the top 5 market players, is set to bring its new debt security in UAH to the local bond market on 1 September.**

**Galnaftogaz has been reporting an encouraging financial performance** thanks to 1) growing sales via its expanding network of upscale OKKO-branded service stations, which dots the country’s map with stations in an eastward direction from its strong hold in the western and central Ukrainian oblasts, and 2) an increase in efficiency, with the ratio of average daily volume of oil product sold via each station having increased throughout 1H05.

**Galnaftogaz appeared to be well shielded** from the turbulence on the local oil market when the government introduced a temporary price cap on oil products in the retail market in a bid to curb the impact of record high world prices on crude oil. Its margins were not squeezed during 1H05. While the government withdrew this regulation and lowered the trade barriers for imported oil products, Galnaftogaz’s position as a pure oil product retailer (with no oil producing or processing assets) became more flexible in choosing suppliers.

**The company went public** and its shares obtained a listing on the local stock exchange, the PFTS, and are available to foreign investors via the ADR programme started this May. Cooperation with international financial institutions such as IFC resulted in a US\$25m 7-year loan facility from this institution and part of this loan (US\$2m) is to be converted into company equity during the term of the agreement. This also results in the lowering of borrowing costs for the company and in a shift from short-term to long-term debt financing.

25 August 2005

#### Bond issue details

Amount outstanding (UAH)	30,000,000
Series	F
ISIN	UA130076AF07
Maturity	26 August 2010
Coupon payment frequency	Quarterly
Coupon rate (%)	12
Embedded option	Annual put
UAH/USD rate *	4.98

\* Market exchange rate  
Source: Reuters

#### Key financial indicators

	2003	2004	1H05
	IAS(a)	IAS(a)	UAS
<b>(UAHm)</b>			
Net sales	942.38	1,283.61	813.1
EBITDA	27.23	57.25	39.4
EBIT	17.57	42.75	29.1
Net income	11.09	22.22	18.4
Interest	4.94	14.80	8.8
Assets	336.09	476.03	678.8
ST debt	11.46	20.05	29.2
LT debt	81.67	125.33	141.8
Capital	93.14	145.38	277.6
<b>(%)</b>			
EBITDA margin	2.89	4.46	4.08
EBIT margin	1.86	3.33	2.94
Net margin	1.18	1.73	1.74
ROA	3.30	4.67	5.11
ROE	6.60	10.92	11.43
ST debt/Debt	12.31	13.79	17.08
LT debt/Capital	32.73	38.12	33.81
Debt/Assets	27.71	30.54	25.19
<b>(x)</b>			
Debt/EBITDA	3.42	2.54	2.57
EBIT/Interest	3.55	2.89	2.87
Current ratio	1.30	1.31	1.36
Quick ratio	0.11	0.10	0.13

Note: IAS – international accounting standards; (a) – audited; UAS – Ukrainian accounting standards; ratios for 1H05 were calculated taking into account the 12-month income statement figures (from July 2004 to June 2005).

Source: Company data, ING

## Proposed bond issue

**Series F bond (5-yr 12% UAH30m) is to be launched on 1 September**

Galnaftogaz's series F bond is the third tranche of the company's UAH90m multi-tranche bond issue (see Fig 1). The bond has the same features as bonds of the previous two tranches (series D and series E), which were launched on 1 July and 1 August, respectively. Its tenor is 5 years, coupon payment frequency is quarterly, and embedded options include the bondholder's option to put the bond and the issuer's option to reset the coupon rate. These options are executable every 364 days, in other words on an annual basis, from the date of issue.

**Previous two tranches (series D and E) were placed at 12.02% and 12.55%, respectively**

**Fig 1 Galnaftogaz's UAH90m bond issue description**

	Series D	Series E	Series F
Amount, UAH	30,000,000.00	30,000,000.00	30,000,000.00
ISIN	UA130076AD09	UA130076AE08	UA130076AF07
Face value, UAH	1,000.00	1,000.00	1,000.00
Issue date	1-Jul-2005	1-Aug-2005	1-Sep-2005
Maturity date	25-Jun-2010	26-Jul-2010	26-Aug-2010
Coupon payment frequency	Quarterly	Quarterly	Quarterly
Embedded options	Y/Annual put	Y/Annual put	Y/Annual put
Coupon rate	12%	12%	12%
Launch price, UAH	1,004.50	1,000.00	...
Launch yield*	12.02%	12.55%	...

... to be determined during the placement auction on 31 August 2005; \* Yield is annualised.  
Source: Company data, ING

## The issuer

Open-joint stock company (OJSC) 'Concern Galnaftogaz' headquartered in the Western Ukraine city of Lviv is one of the leading operators of a network of gasoline station in the country, where the retail market for oil products is near maturity and still far from saturation by upscale services.

**OKKO is the brand name of Galnaftogaz's flagship service station network, which is aspires to achieve a nationwide presence**

The company was established in 2001 and has grown since then on the assets of the former regional oil product enterprises based in the oblasts of western and central Ukraine. These enterprises have been specialising in oil product storage and retail since the 1970-80s and were privatised in the mid-1990s. Each regional enterprise had tank storage facilities and a network of fuel stations. The company does not possess oil producing or processing assets, but positions itself as a pure retailer of oil products as well as a supplier of other additional products and services through its own network of service stations. Galnaftogaz brands its upscale service stations under the logo of OKKO, which competes with other brands on the market for customers (<http://www.okko.ua/en/>).

**Fig 2 Number of gasoline stations in Galnaftogaz's network**

	1-Jan-2002	1-Jan-2003	1-Jan-2004	1-Jan-2005	1-Apr-2005	1-Jun-2005	17-Aug-2005
OKKO-branded stations	32	62	76	94	97	99	107
Unbranded stations	125	98	85	63	61	61	59
<b>Total</b>	<b>157</b>	<b>160</b>	<b>161</b>	<b>157</b>	<b>158</b>	<b>160</b>	<b>166</b>

Source: Company data

The company's network of service stations consists of OKKO-branded stations – the number of which is growing and now stands at 107, up by 14 since the beginning of 2005 – and of old stations, which were either included in the company's assets when it was established in 2001 or bought on the market. The old stations are awaiting refurbishment, equipment and upgrades to the OKKO-brand standard. However, some

of the unbranded stations are poorly situated have no market perspective and are planned be unloaded from the company's accounting book at an appropriate time and price.

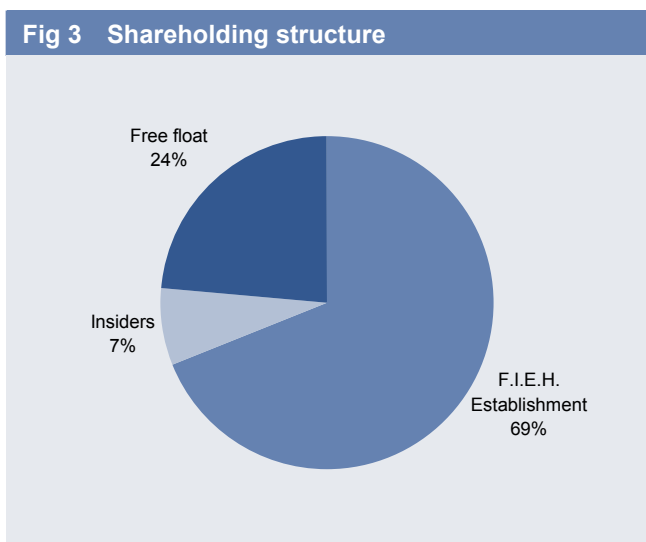
**Route of regional expansion: west → capital & center → east**

**Galnaftogaz buys oil from a range of suppliers and is flexible**

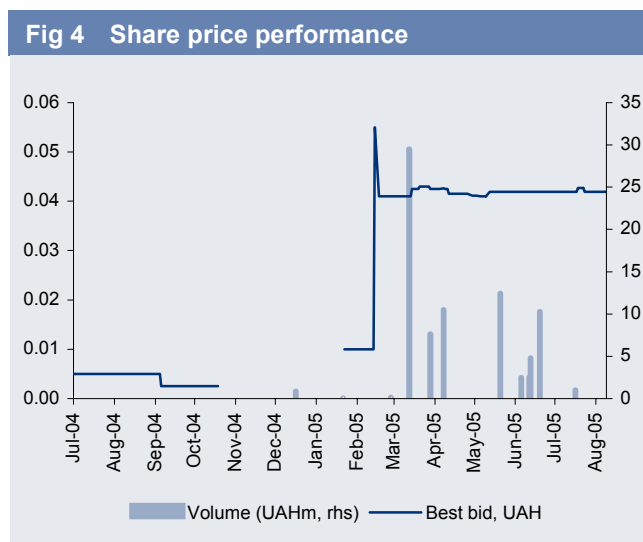
**Galnaftogaz's majority stake is privately owned, free float is 24%**

The company is achieving its strategic goal of increasing shareholders' value via the expansion of own network of OKKO-branded service stations in the central and eastern oblasts of Ukraine and the strengthening of its position in the oblasts, where it started its business activity. The company places its services stations in the most populated areas – in the cities and key transport routes outside the cities. In the last two years, Galnaftogaz invested in stations situated in the western and central oblasts, but the boldest move was made to enter the market of Kyiv, the capital of Ukraine, which features the intense oil product consumption, a high ratio of motor vehicle usage and the most affluent customers in the country. Today, among 107 stations under the OKKO brand, two are in the Kyiv area. This summer, the company expanded into new strategically important areas: the town of Kharkiv, Ukraine's second-largest city by population and oblast centre, where the company launched one OKKO service station, and the central oblast of Kirovohrad, which borders Vinnytsya oblast where 15 stations or 14% of the total are functioning. In Kirovohrad oblast, the company built three OKKO service stations.

Galnaftogaz buys oil products from diverse suppliers on the internal wholesale oil product market and/or directly from Ukrainian and foreign oil product producers. The company is not tied to one oil product producer by a long-term contract. Instead, it is flexible to choose from the best suppliers with the best terms. At the moment, the company buys oil products on the internal market from traders dealing with large wholesale supplies. The purchased oil products are produced by Ukraine's Ukratnafta and the Lisichansk oil refinery, Lithuania's AB 'MAŽEIKIŲ NAFTA', and Belarus's Mozyr oil refinery. The bought oil products are delivered to the company's storage facilities by rail and then from storage facilities to service stations by the company's own gasoline tankers.



Source: Company data



Source: PFTS

**Galnaftogaz's market value is US\$132m (2.4x book equity, 0.4x net sales and 9.9x EBITDA)**

The shareholding structure of Galnaftogaz see Fig 3 comprises a controlling stake of 69% in the hands of a Liechtenstein-based entity, and insiders who hold the key seats in the supervisory board control a 7% stake, while free float amounts to 24%. The shares are listed on the PFTS and there is an ADR (Reg S) programme on the shares

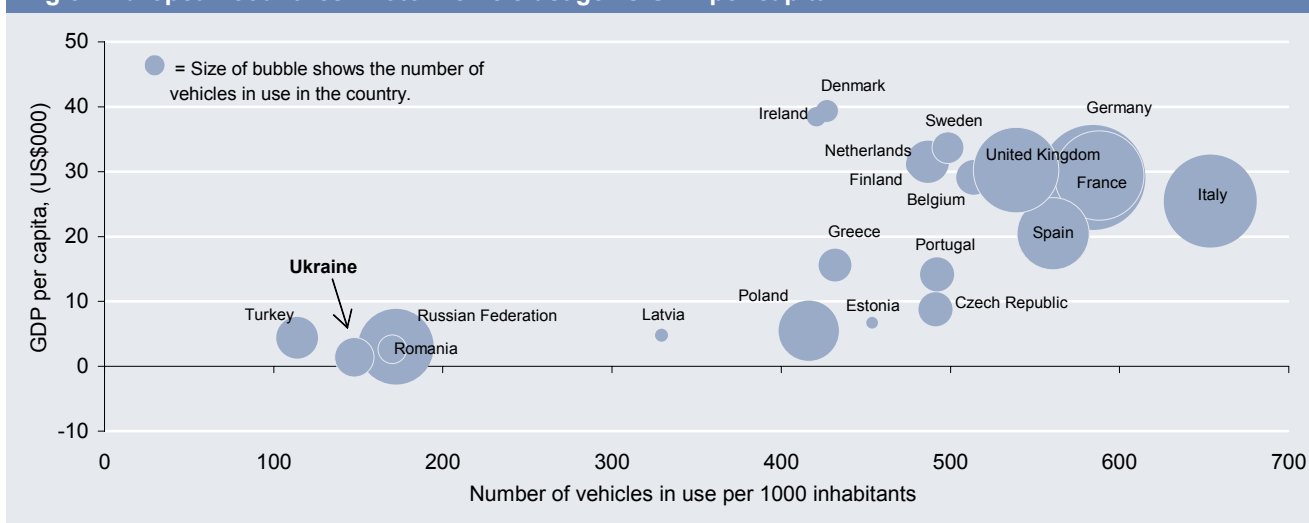
that was launched in May this year<sup>1</sup>. The latest quote on the PFTS values the company at US\$132m (2.4x of its book shareholders' equity).

## The market

**Ukraine's retail market of oil products has room for growth as the country lags behind its CEE counterparts in the ratio of motor vehicle usage**

Ukraine, which houses a population of 47.3m and occupies a territory of 603,700 sq km, is the largest country in CEE in terms of population and territory and is quite similar in this regard to the likes of France and Spain. However, the economic woes of the mid 1990s, when the nation's economy experienced a decade of consecutive declines on the back of an economic model from the Soviet era, meant car ownership for the general public was not a reality. So with a low ratio of motor vehicles in use, the current state of the country's retail oil product market is one which lags behind its counterparts in the CEE and far beyond that of Western European countries (see Fig 5). At the moment, Ukraine's ratio of motor vehicles in usage per 1,000 inhabitants amounts to 148 units, while Poland's ratio stands at above 400. In addition, the road infrastructure in Ukraine lags as well: the ratio of road length with a hard surface per 100sq km of the territory equals 27.3km, while the Polish and German figures respectively amount to 80km and 64.8km. Taking into account that Ukraine's low GDP per capita ratio is still quite low, its economic recovery since 2000 should result in a higher car usage ratio.

**Fig 5 European countries: motor vehicle usage vs GDP per capita**



Source: National statistics offices, World Bank, European Automobile Manufacturers Association, ING

**The market is highly fragmented as the top 5 market players have a total 40% market share**

Ukraine's retail market for oil products is still highly fragmented with the top five companies holding about 40% of the market (this figure is measured by the volume of oil products in tons sold via each company's own network of gasoline stations). According to the data gathered by the company, annual volume of the oil products sold in Ukraine during 2004 amounted to 6.7m tons. Galnaftogaz sold about 0.37m tons, while the leader, Uknafta, sold 0.985m tons. The market shares of these companies are 5.5% and 14.7% respectively, see Fig 6.

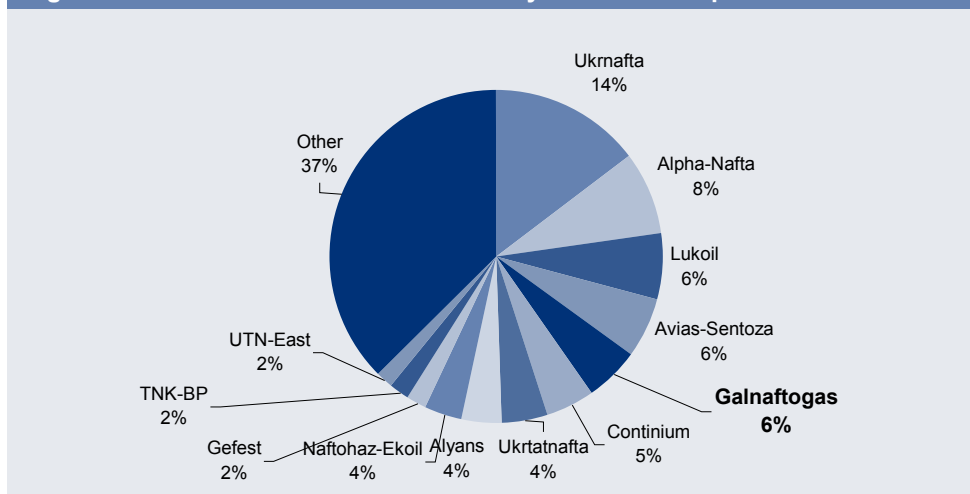
The current state of the market, with high global prices on crude oil and still low consolidation, attracts such oil producers as Ukranaftha and Ukgazvydobuvannya, in which Naftogaz of Ukraine, a major corporate entity in the country, holds 51% and 100% stakes, respectively. Ukranaftha is already the market leader in terms of volume of oil products sold via its own network of service stations, and thanks to government

<sup>1</sup> See [http://www.adrbny.com/dr\\_profile.jsp?cusip=20601L104](http://www.adrbny.com/dr_profile.jsp?cusip=20601L104)

**More competition to come as rivals invest in network expansion**

control, has been buying out small regional networks (from 10 to 20 stations) with an aim to cover a wider territory. Ukrgazvydobuvannya announced recently its desire to enter the market thanks to its own oil producing and processing assets; it was said the company will run a 150-strong network of gasoline stations in its base oblast of Kharkiv. This means more competition is to come on the regional level, however, the market standard now is not only to pump gasoline into the car, but rather to provide customers with services such as those performed at OKKO stations.

**Fig 6 Breakdown of the market in 2004 by volume of oil products sold**



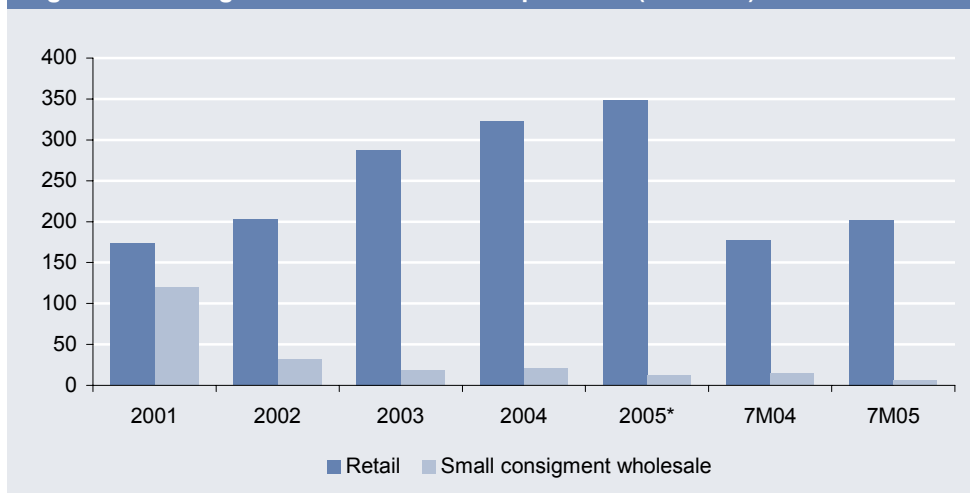
Note: Only volumes sold via own network (not via jobbers) are considered.  
Source: Company data

**In 7M05 the increase in volume of oil products sold via Galnaftogaz's network over the same period of 2004 amounted to 14%**

**Operating results**

Galnaftogaz's operations during the year were quite successful not only in terms of network expansion, but also in the growth of its financial results. Despite the spike in prices for oil products due to the rise of world crude oil prices to record highs, customer demand for gasoline has remained solid. As a result, Galnaftogaz increased the volume of oil product sold in its retail network by 14% during January-July of 2005 to 201,800 tons from 176,800 tons during the same period of 2004. In July, the company's annual sales via its retail network amounted to 348,300 tons, up by 7.7% from the level seen in 2004.

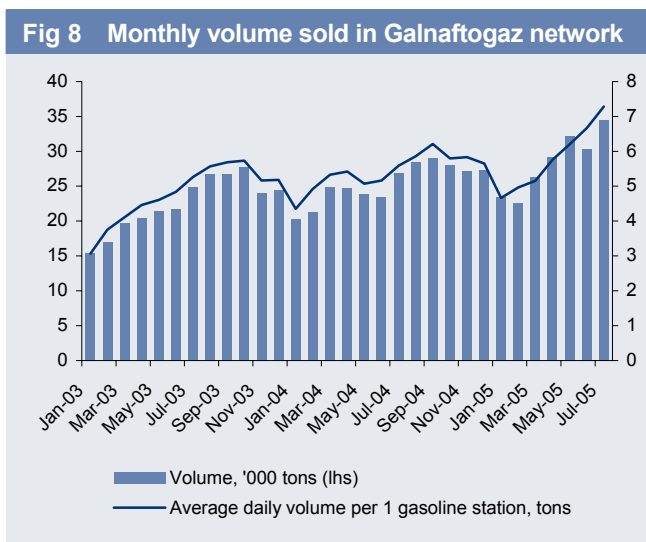
**Fig 7 Galnaftogaz's sales volume of oil products (000 tons)**



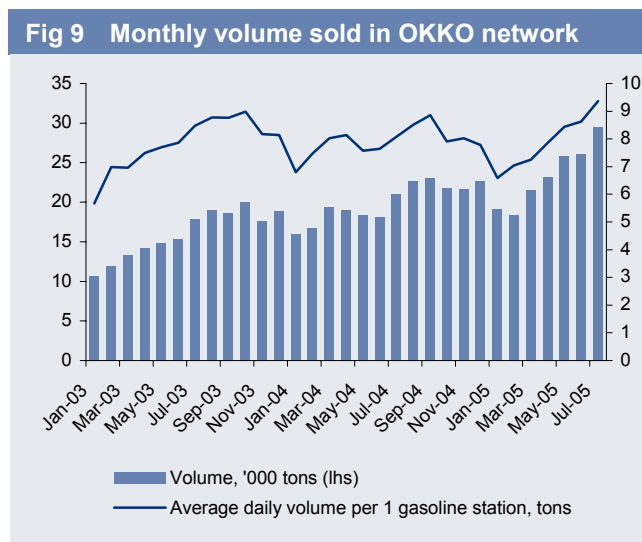
\* For the 12-month period ended 31 July 2005.  
Source: Company data

**Efficiency of the network, measured by the average daily volume of oil products sold through a station, has improved**

In terms of efficiency, Galnaftogaz has improved as the average daily volume of oil product sold at a service station (for its entire network of OKKO-branded stations) reached 7.3 tons in July this year, the highest figure since January 2003, when data was first made available (see Fig 8). At the same time, the average daily volume of oil product sold at an OKKO-branded service station reached new highs as well – in July it reached 9.4 tons (see Fig 9). The latter figure is high in comparison with the same ratio of its competitors.



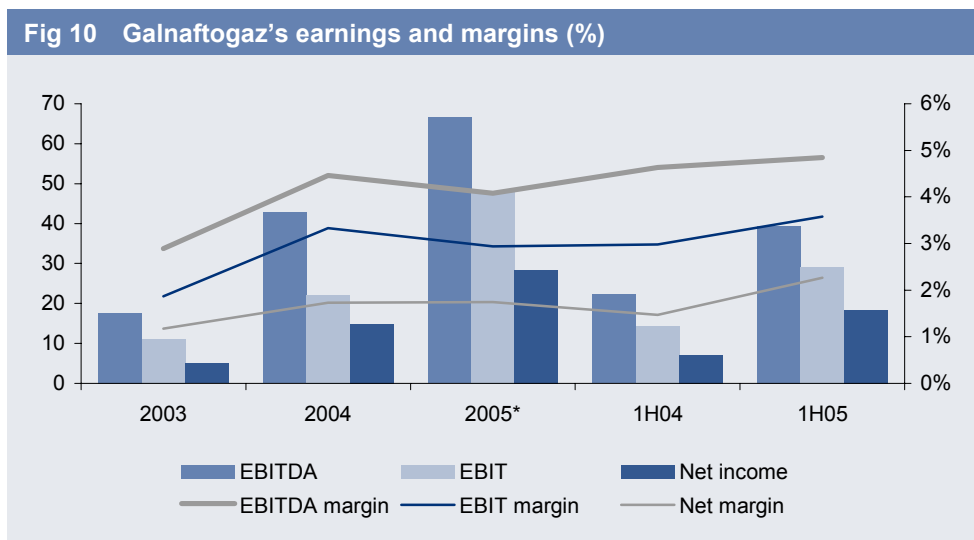
Source: Company data



Source: Company data

**Galnaftogaz's earnings and margins are climbing**

Galnaftogaz continues to perform quite robustly in terms of earnings. As shown in the chart below, earnings nearly doubled in 1H05 in comparison with 1H04. EBITDA grew 77% from UAH22.3m last year to UAH39.4m this year, earnings before interest and taxes doubled from UAH14.3m to UAH29.1m, and net income increased 1.6 times from UAH7.1m to UAH18.4m. At the same, the company's margins improved in the first half of 2005.

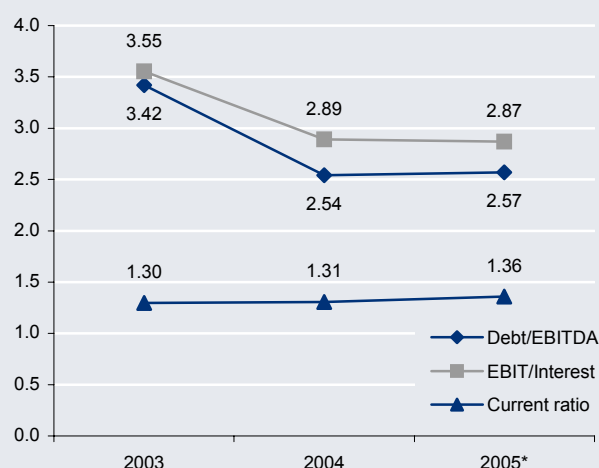


Note: 2003 and 2004 figures are from audited IAS financial statements; 1H04 and 1H05 are from UAS financial statements; \* Figures for the 12-month period ended 31 July 2005.  
Source: Company data, ING

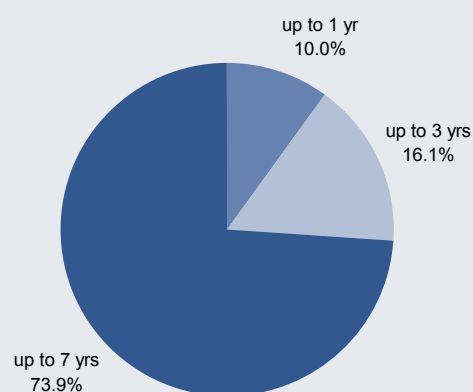
To finance its regional expansion, Galnaftogaz relies on the debt capital obtained via the local and foreign bank credit market and via the local capital market. The bank loans consist of credit agreements with Ukrainian banks with foreign capital, which provide Ukrainian companies with better terms on interest and tenor. On the local

capital market, the company is a frequent issuer, and has proved itself to be a transparent company and reliable borrower that fully services its bond payments in a timely manner.

In 1H05 the debt on the company's balance sheet increased from UAH145m to UAH171m, but the debt payment ratios such as debt/EBITDA and pre-tax interest coverage remained stable thanks to growing earnings, see Fig 11 and Fig 13.

**Fig 11 Galnaftogaz's debt & liquidity ratios (x)**


Source: Company data, ING

**Fig 12 Galnaftogaz's debt as of 1 July by tenor**


Source: Company data

**Fig 13 Galnaftogaz's key financial indicators**

	2003	2004	2003	2004	1H04	1H05	2005*
(UAHm)	IAS(a)	IAS(a)	UAS	UAS	UAS	UAS	UAS
Net sales	942.38	1,283.61	817.48	1,299.41	480.69	813.06	1,631.78
EBITDA	27.23	57.25	28.61	49.48	22.27	39.38	66.59
EBIT	17.57	42.75	19.07	33.22	14.33	29.10	47.99
Net income	11.09	22.22	10.58	17.05	7.08	18.43	28.40
Interest	4.94	14.80	7.62	14.80	6.87	8.80	16.73
Assets	336.09	476.03	347.82	530.84	433.78	678.77	678.77
Cash	9.31	13.35	9.31	13.35	7.78	13.66	13.66
ST debt	11.46	20.05	7.32	16.50	10.53	29.21	29.21
LT debt	81.67	125.33	85.98	128.88	99.28	141.80	141.80
Debt	93.14	145.38	93.30	145.38	109.81	171.01	171.01
Net debt	83.83	132.03	83.99	132.03	102.03	157.36	157.36
Capital	167.89	203.41	184.82	242.39	219.46	277.60	277.60
(%)							
EBITDA margin	2.9%	4.5%	3.5%	3.8%	4.6%	4.8%	4.1%
EBIT margin	1.9%	3.3%	2.3%	2.6%	3.0%	3.6%	2.9%
Net margin	1.2%	1.7%	1.3%	1.3%	1.5%	2.3%	1.7%
ROA	3.3%	4.7%	3.0%	3.9%	...	...	5.1%
ROE	6.6%	10.9%	5.7%	8.0%	...	...	11.4%
ST debt/Debt	12.3%	13.8%	7.8%	11.3%	9.6%	17.1%	17.1%
LT debt/Capital	32.7%	38.1%	31.8%	34.7%	31.1%	33.8%	33.8%
Debt/Assets	27.7%	30.5%	26.8%	27.4%	25.3%	25.2%	25.2%
(x)							
Debt/EBITDA	3.42	2.54	3.26	2.94	4.93	4.34	2.57
EBIT/Interest	3.55	2.89	2.50	2.24	2.09	3.31	2.87
Current ratio	1.30	1.31	1.87	1.55	1.78	1.36	1.36
Quick ratio	0.11	0.10	0.55	0.31	0.48	0.13	0.13
Net debt/EBITDA	3.08	2.31	2.94	2.67	4.58	4.00	2.36
Sales/Net debt	11.24	9.72	9.73	9.84	4.71	5.17	10.37

Note: IAS – international accounting standards; (a) – audited; UAS – Ukrainian accounting standards; ... ratio was not calculated for 6-month periods;

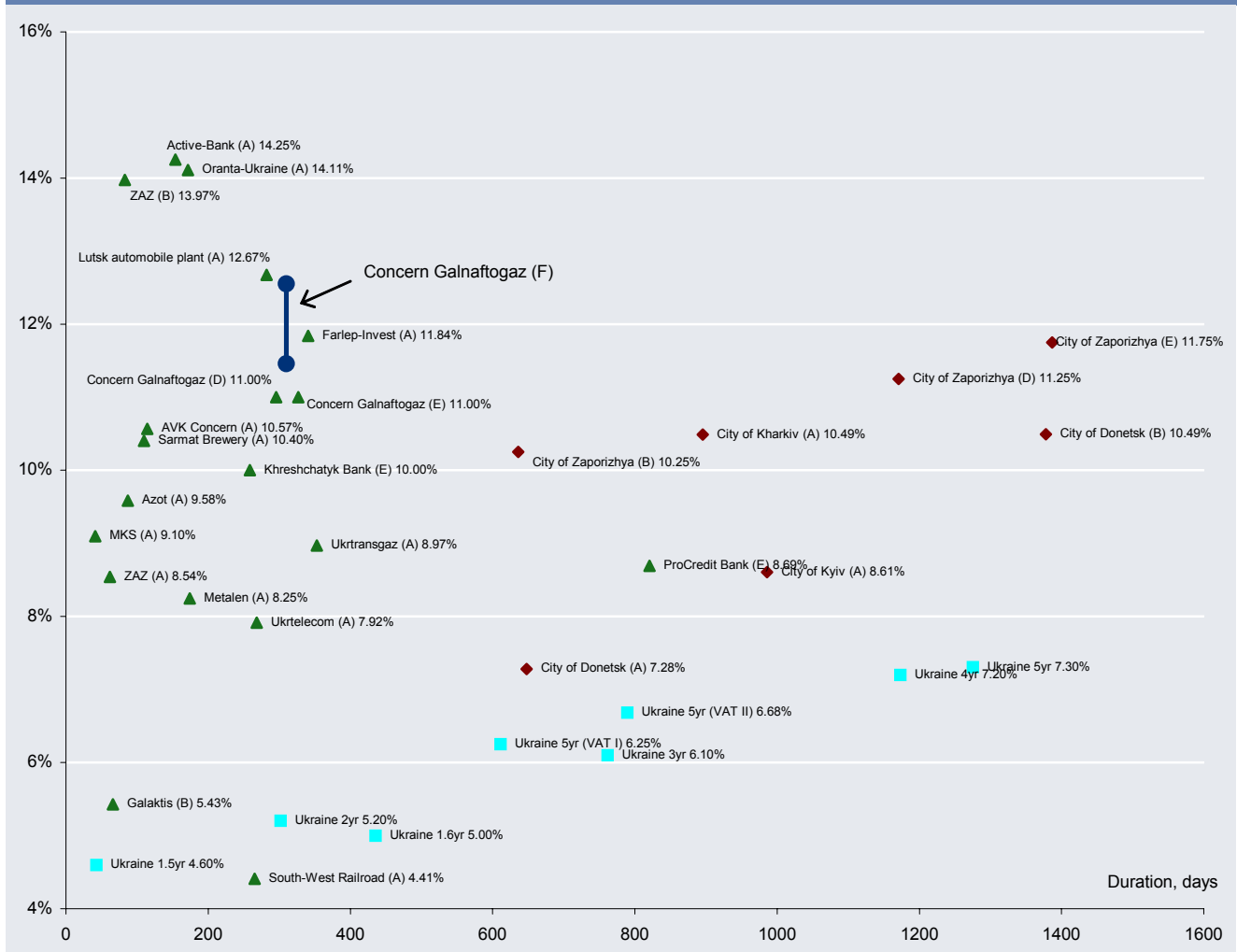
\* Figures for the 12-month period ended 31 July 2005.

Source: Company data, ING

## Positioning of the proposed bond

At the moment, the series F bond by Galnaftogaz provides an opportunity to invest in a corporate fixed-income security with a two-digit yield. We estimate that the annualised yield-to-put of the bond will be in the range of 11.46-12.55% depending on the aggressiveness of bidders and suggesting a placement price in the range of 100-100.933% of par value.

Fig 14 Term structure of yields on Ukraine's domestic bond market



Note: Yields are yields-to-maturity/yields-to-put; yields are annualised; all calculations are made taking into account ask quotes on the bonds listed in the PFTS. We have indicated on the chart the indicative yields at issue date of the series F bond by Galnaftogaz.  
 Source: PFTS, ING

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**Outperform:** expected 1-year total return that modestly exceeds the 1-year expected total return of the relevant market.

**Marketperform:** expected 1-year total return that will be in line with the 1-year expected total return of the relevant market.

**Underperform:** expected 1-year total return that is modestly below the 1-year expected total return of the relevant market.

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*Outperform has been included in the Buy category, Underperform in the Sell category and Marketperform in the Hold category. The distribution breakdown is based on our Latin American, Central and East European Corporate Debt and European High Yield universe as of end 2Q05.*

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