

GALNAFTOGAZ

July 22, 2009

EBRD Deal to Benefit Minority Shareholders

Highlights

- **Share capital increase.** Galnaftogaz has scheduled an EGM for Sept. 14 to approve a 16.7% share capital increase, to UAH 204.6m, as part of a deal with the EBRD providing \$20m of equity capital for the company. The announced capital increase assumes that all existing shareholders will subscribe for new shares. However, we believe that only the EBRD will subscribe, increasing Galnaftogaz's capital by approx. 10%, which implies a price of \$0.0065/share (implied MC of \$200m), or 169% above the stock's current market price. Although the share capital increase will dilute non-subscribing shareholders, the deal will create \$0.0006/share of additional value (15% of the current market price) because of the subscription price being higher than the stock's current market value.
- **Strong financials.** Although Galnaftogaz posted a 46% y-o-y decline in 1Q09 net sales, to \$120m, due to decreasing prices for oil and oil products, the company successfully managed costs, boosting EBITDA over the period by 33% y-o-y to \$18.6m and net income by 39% to \$7.6m. For the full year, we expect the company to decrease sales by 27% y-o-y to \$760.4m, improve EBITDA by 29% to \$90.1m and post net income of \$30.4m, implying EBITDA margin of 11.8% (+5.1pp) and net margin of 4.0% (+10.7pp).
- **Debt burden manageable.** Galnaftogaz's loan portfolio stood at \$262m as of end-1Q09 (2009E Debt/EBITDA of 2.9), consisting mostly of USD-denominated loans with an average maturity of 4.5 years. In 2009 we expect the company to repay some \$25m of long-term obligations while refinancing \$26m of short-term loans. Yet there is a risk to the 2009 bottom line stemming from potential F/X losses on USD-denominated loans due to further hryvnia depreciation.
- **Valuation results.** We updated our DCF model for the company to reflect the faster than expected recovery in oil prices (\$55/bbl in 2009 vs. \$40 expected earlier) and higher margins to be earned on fuel sales. Yet we downgraded growth rates with respect to the number of fuel stations and oil product sales per station in 2009-2010. We thus obtained a DCF-based fair value of 0.0193/share, or 405% above the stock's current market price. We also valued Galnaftogaz based on 2009E-2010F EV/Sales, EV/EBITDA and P/E for its Russian and GEM peers. This valuation, adjusted for a 30% marketability discount to account for low liquidity of Galnaftogaz shares, resulted in \$0.023/share. Finally, our combined valuation, calculated as the average of the DCF and comparative valuations, yielded \$0.0211/share, or 452% above the stock's current market price and 111% above our previous fair value estimate, thus fully justifying a Buy recommendation on the stock.

Valuation Summary

Year	2006	2007	2008	2009E	2010F
P/E	8.1	5.4	neg.	2.2	1.4
EV/EBITDA	6.7	6.3	4.5	3.2	2.8
EV/Sales	0.34	0.36	0.31	0.38	0.28
P/Book	0.75	0.41	0.33	0.31	0.24
DPS (\$)	0.000	0.000	0.000	0.000	0.000
EV/Output (\$/liter)	0.36	0.32	0.36	0.33	0.27
EV/Capacity	-	-	-	-	-

Fair Value (\$)	0.021
Upside (%)	452%
Previous FV (\$)	0.010

Sell	Hold	Buy
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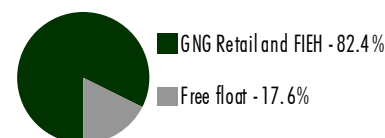
Liquidity	Risk	Analyst Ranking
2	LR	2/7

Note: Definitions of investment recommendations and rankings can be found at the end of this report

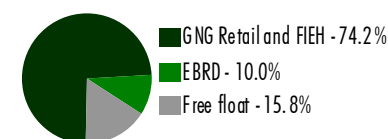
Company Data

Market Price (\$)	0.0038
Market Cap (\$m)	67
Enterprise Value (09E; \$m)	287
Free Float (%)	17.6%
Free Float (\$m)	12
Shares Outstanding	17,523,841,725
Nominal Value (UAH)	0.01
Bloomberg Code	GLNG UZ
DR Ratio	1:500
Number of Employees	5,224

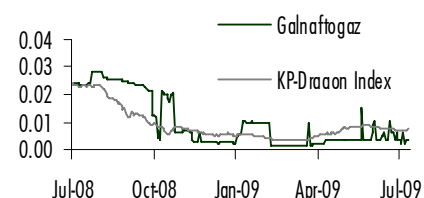
Current Shareholder Structure



Expected Shareholder Structure



12-month Price Performance (\$)



12-month Performance	(90%)
12-month Rel. Perform. (KP-Dracoon)	(65%)
12-month Low/High	0.001-0.028
All-time Low/High	0.001-0.033
12-month Trading Volume (\$m)	0.3

Operating and Financial Summary

Operating Summary

Period	2006	2007	2008	2009E	2010F
Number of Gas Stations (units)	200	252	288	296	296
Growth (%; y-o-y)	14%	26%	14%	3%	0%
...including OKKO brand (units)	157	200	260	268	282
Growth (%; y-o-y)	37%	27%	30%	3%	5%
Retail Sales of Gasoline (kt)	377	560	679	679	751
Average Price (\$/tonne)	918	883	1,215	866	963

Profit & Loss Statement (\$m)

Period	2006	2007	2008	2009E	2010F
Net Sales	514.7	635.4	1,037.1	760.4	935.2
EBITDA	26.2	36.4	69.9	90.1	91.7
Depreciation	(4.9)	(7.2)	(11.3)	(10.3)	(10.4)
EBIT	21.3	29.2	58.6	79.8	81.3
Income from affiliated companies	0.0	0.0	0.0	0.0	0.0
Net Financial Income/Loss	(10.3)	(14.2)	(148.7)	(41.8)	(23.4)
NIBT	11.1	14.9	(90.1)	37.9	58.0
Taxes	(2.7)	(2.6)	20.3	(7.6)	(11.6)
Net Income (Loss)	8.3	12.3	(69.8)	30.4	46.4

Balance Sheet (\$m)

Period	2006	2007	2008	2009E	2010F
Total Assets	248.6	403.0	560.4	551.7	605.1
Fixed Assets	150.1	292.8	456.4	436.5	461.3
PPE	146.4	289.1	438.3	421.3	447.5
Current Assets	98.6	110.2	104.1	115.2	143.8
Inventories	20.8	29.3	26.8	26.1	33.0
Accounts Receivable	41.5	31.0	46.6	40.4	50.1
Cash & Cash Equivalents	10.4	11.2	9.6	33.9	42.5
Total Liabilities & Equity	248.6	403.0	560.4	551.7	605.1
Total Liabilities	159.4	240.2	356.1	333.6	320.7
Accounts Payable	27.4	44.3	30.9	26.1	34.1
S/T Debt	48.3	57.1	55.6	44.9	44.9
L/T Debt	70.3	115.6	204.9	208.9	190.7
Other Liabilities	13.4	23.3	64.6	53.7	51.0
Equity	89.1	162.7	204.2	218.0	284.3

Financial Ratios

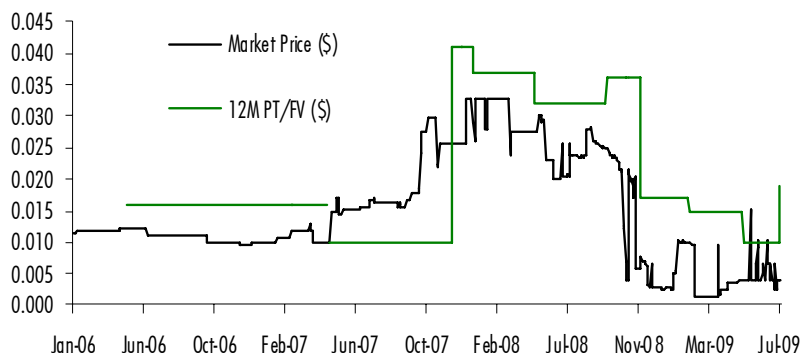
Period	2006	2007	2008	2009E	2010F
Sales Growth (y-o-y)	36%	23%	63%	(27%)	23%
EBITDA Growth (y-o-y)	64%	39%	92%	29%	2%
Net Income Growth (y-o-y)	5%	48%	nm	nm	53%
EBITDA Margin	5.1%	5.7%	6.7%	11.8%	9.8%
Net Margin	1.6%	1.9%	(6.7%)	4.0%	5.0%
Net Debt/Equity	121%	99%	123%	101%	68%
ROE	11.0%	9.8%	(38.0%)	14.4%	18.5%

Comparative Valuation

Company	Price	Currency	MC (\$m)	EV/Sales		EV/EBITDA		P/E	
				2009E	2010F	2009E	2010F	2009E	2010F
Galnaftogaz	0.004	USD	67	0.38	0.28	3.19	2.84	2.2	1.4
<i>Premium/Discount to RU Peers</i>			<i>(97%)</i>	<i>(44%)</i>	<i>(50%)</i>	<i>(58%)</i>	<i>(55%)</i>	<i>(89%)</i>	<i>(89%)</i>
<i>Premium/Discount to GEM Peers</i>			<i>(98%)</i>	<i>(61%)</i>	<i>(68%)</i>	<i>(72%)</i>	<i>(72%)</i>	<i>(91%)</i>	<i>(92%)</i>
Russian Peers									
X5	15.75	USD	4,277	0.72	0.56	8.4	6.6	28.4	13.8
Seventh Continent	8.00	USD	600	0.67	0.55	7.5	6.3	19.8	12.6
Magnit	34.75	USD	2,893	0.61	0.47	7.6	6.0	14.2	10.1
Russian Peers' Median	-	-	2,590	0.67	0.55	7.6	6.3	19.8	12.6
Emerging Market Peers									
Bim Birlesik Magazalar (TR)	57.0	TRY	2,883	0.79	0.60	15.3	12.0	24.0	19.0
Cencosud (CL)	1,467	CLP	6,029	0.74	0.69	10.9	9.6	23.8	18.8
Dairy Farm International (HK)	6.15	USD	8,287	1.17	1.03	14.8	12.8	24.0	21.2
Distribucion Y Servicio (CL)	219.0	CLP	2,684	1.02	0.98	12.8	8.63	21.4	10.6
Lojas Americanas (BR)	9.9	BRL	3,674	1.37	1.19	10.0	8.4	46.3	26.3
President Chain (TW)	83.8	TWD	2,339	0.75	0.73	11.3	10.6	20.34	18.38
Shinsegae (KR)	511,000	KRW	7,735	1.35	1.24	11.4	10.3	15.92	13.90
Wumart Stores (CN)	9.66	HKD	1,521	0.89	0.74	10.9	9.1	23.2	19.8
GEM Peers' Median	-	-	4,394	0.96	0.86	11.4	10.0	23.5	18.9

HISTORICAL PRICE TARGETS/FAIR VALUES

Galnaftogaz (GLNG)



DRAGON CAPITAL EQUITY RESEARCH COVERAGE POLICY

Investment Recommendations

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

Fair Value Upside to Current Market Price	Recommendation
>50%	Buy
0% - 50%	Hold
<0%	Sell

In addition, we may rate a stock as a Strong Buy in case its valuation upside exceeds 100%, there are no material risks that could jeopardize our valuation and we see a high probability for the stock to outperform the market in the short-term perspective based on available information and our fundamental valuation. Stocks that are either suspended from trading or do not have a recommendation assigned by Dragon analysts are designated as Not Rated.

In case an analyst's individual rating of a stock (please see definition below) is low, leaving it outside his/her top five recommendations, this stock can be assigned only a Hold or Sell recommendation regardless of its upside suggested by fundamental valuation.

We put a stock Under Review if its fair value 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 fair values on stocks under review in the shortest possible time. Finally, we suspend a traded company from coverage in case Dragon Capital signs an investment banking services mandate with such company (for example, to place its shares on the market). Coverage is reinstated after the relevant investment banking transaction is closed.

Current Distribution of Investment Recommendations

Companies Covered	Recommendation					
	Buy	Hold	Sell	Under Review	Not Rated	Suspended
119	12	22	12	3	67	3
% of Total	10%	18%	10%	3%	56%	3%

Dragon Capital also structures its universe of covered stocks using three parameters: liquidity, risk level and analyst's view. The ranking based on liquidity is used to select stocks that are assigned investment recommendations in addition to the three above parameters.

Analyst's View

In order to provide for our analysts' views on the stocks they cover, each analyst ranks all stocks in his or her coverage universe (usually for stocks from more than one sector), assigning #1 to his/her top pick, #2 to the next-best pick and so on. In addition to pure financial modeling, such rankings are based on the analysis of a broader set of factors that may not be captured by valuation, including relative comparison of company-specific opportunities, threats, etc.

Liquidity

We split our coverage universe into three tiers:

- 1) Relatively liquid stocks
- 2) Less liquid stocks
- 3) Illiquid stocks

We determine the liquidity rank based on available historical trading statistics and our estimates of trading activity not reported officially (e.g. over-the-counter transactions). Stocks on the third (illiquid) list are not assigned recommendations and are designated as Not Rated. The composition of liquidity tiers is subject to a semiannual review but substantial market-wide or company-specific developments may warrant a more frequent revision.

Risk Grade

We apply two risk measurements: higher risk (HR) and lower risk (LR). We assign the higher risk grade to a stock in case of a substantial degree of uncertainty in relevant valuation assumptions and volatility in valuation estimates (i.e. when different valuation approaches result in divergent recommendations). Conversely, we consider a stock to be in lower-risk territory if relevant valuation assumptions are more certain, different valuation methods suggest uniform recommendations and the analyst covering the stock in question does not see significant short-term risks attached to it.

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