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Motor Sich: Facts Support Strong Prospects

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Ukrainian Machinery

Motor Sich: Facts Support Strong Prospects

Bloomberg [MSICH UZ];

Motor Sich is the only Ukrainian company and one of the world's largest companies engaged in the development, production, testing and repair of modern aviation engines. The main driver of the company's net revenue growth is the expected significant increase in helicopter and aircraft production in Russia, as well as the growth in demand for this equipment in other developing countries with which Russia has historically maintained close relationships. Despite Russian authorities' announcement about starting-up the serial production of helicopter and missile engines in Russian plants, we are skeptical about the timely realization of these plans. We see the most probable and advantageous way for both parties is close cooperation in engine production.

Executive summary

- **MSICH's penetration in the CIS region is dramatically high** – almost 90% of mid-weight to heavy helicopters and 60% of aircrafts in use in the region are equipped with Motor Sich engines. Such a market penetration and the 100-year history of the company confirm the high quality of its products. Moreover, high entry barriers to the market and the company's strong collaboration with Russian enterprises provide MSICH with an exclusive position in such sectors as helicopter and missile engines on the Russian market.
- **The core company revenue generators are new engines sales – accounting for 56% of net revenue based on 2007 results.** In our model we estimate the company's output growth for helicopter engines at 6% CAGR during the period 2008-2012. Combined with price increases, we expect revenue from helicopter engine deliveries will grow 12% CAGR during this period. As for aircraft engines, we see the highest prospects with D-436 and AI-222-25, AI-25TLSH engines in the short- to mid-term.
- **We conservatively estimate the net revenue growth of MSICH at 14% CAGR for 2008-2012 and 5% CAGR for 2013-2017.** Also, reflecting the current growth in the cost of debt, as well as the increase in the return on investment capital requested by shareholders, results in WACC of 20% for this year, which decreases slightly to 12% in 2012 due to the anticipated stabilization of the situation.
- **We expect weak financial results in 2008 due to the growth in prices for raw materials and an increase in administrative expenses this year.** Thus, the EBITDA margin is estimated to decline to 14.4% in 2008, compared to the peak 22.8% last year. It is then expected to smoothly recover to 17%.
- **Recommendation.** Our DCF model is based on a three-fold method that equally takes into account perpetuity growth rate, exit EBITDA and P/E multiples. The DCF method valued MSICH at USD 234.4 per share, while the Comparative method resulted in a value of USD 107.1 per share. The average of these two mentioned methods results in a USD 182.9 as a fair value per share, with a 363% upside potential. We reiterate our BUYing recommendation.

Figure 1. Key indicators

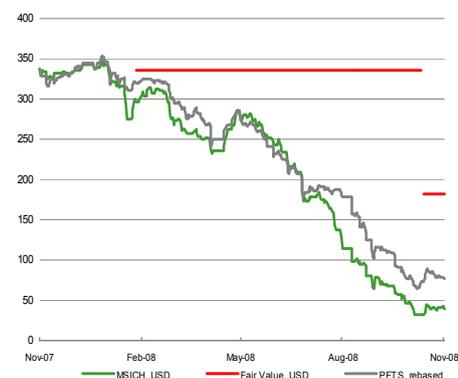
USD mln	2007	2008E	2009F	2010F	2011F	2012F
Net Sales	346.5	392.3	468.0	534.4	566.8	648.7
Gross Income	170.4	170.6	203.6	235.1	249.4	285.4
EBITDA	79.0	56.5	76.7	90.6	96.5	111.0
Depreciation	18.8	20.8	18.5	16.5	17.7	19.3
EBIT	60.2	35.7	58.2	74.1	78.9	91.7
Net Income	41.0	21.3	35.4	45.5	48.7	58.3
Gross Margin	49%	44%	44%	44%	44%	44%
EBITDA Margin	23%	14%	16%	17%	17%	17%
Net Margin	12%	5%	8%	9%	9%	9%

Source: Company Data, Sokrat estimates

BUY

Fair Value	USD 182.9
Price (Nov 20, 2008)	USD 39.54
Upside	363%

Stock data



Shares out, mln	2.1
Market cap., USD mln	82.2
EV, USD mln	158.2
Par value, UAH	135
ADR/GDR Ratio	5:1

Shareholders structure

Management and employees	61%
Bartence Alliance	10%
Treasury Stock	5%
Free float	24%
Free float, USD mln	19.8

Introduction

Motor Sich is the only Ukrainian company and one of world's largest companies engaged in the development, production, testing and repair of modern aviation engines. Nowadays, the company produces more than 60 types and modifications of engines for more than 80 types of airplanes and helicopters.

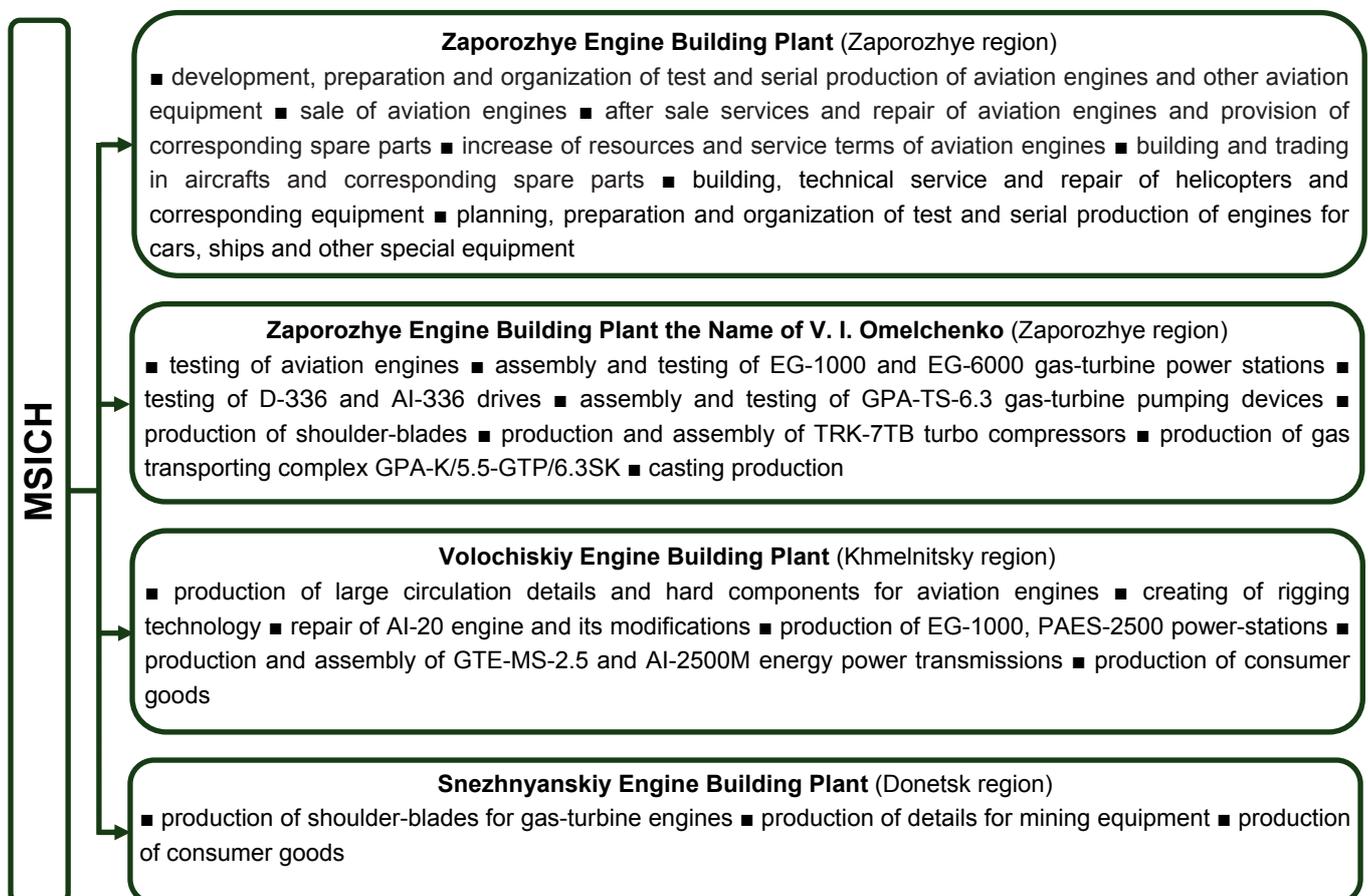
Established in 1907, MSICH has produced a huge amount of engines under the Soviet regime – one in every ten aircraft and every fourth helicopter in the world is equipped with a Motor Sich engine. The market penetration of MSICH in the CIS region is dramatically high – almost 90% of mid-weight to heavy helicopters and 60% of aircrafts used in the region are equipped with Motor Sich engines.

Such penetration into the market and the 100-year history of the company confirms the high quality of its products. While high entry barriers to the market and strong collaboration between the company and Russian enterprises provide MSICH with an exclusive position in such sectors on the Russian market as helicopter and missile engines.

Organization structure

Motor Sich includes 14 structural subdivisions, located in different regions of Ukraine, as well as representative offices in Kiev, Moscow and Delhi. The company produces equipment at the four core enterprises that comprise MSICH.

Figure 2. Motor Sich production assets and their main functions

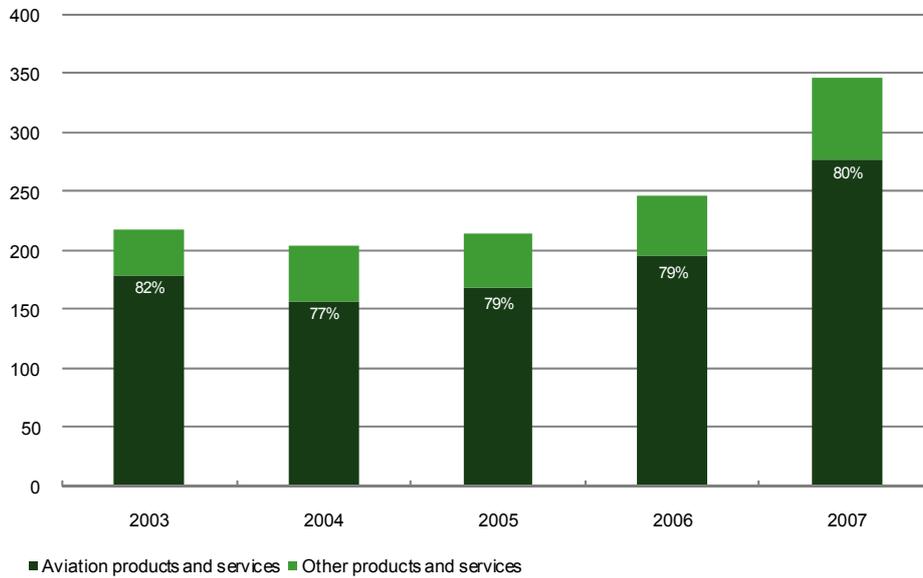


Source: Company Data

Sales structure

Historically the largest USSR aviation engine producer, the company currently maintains an estimated 80% share in terms of the sale of aviation products.

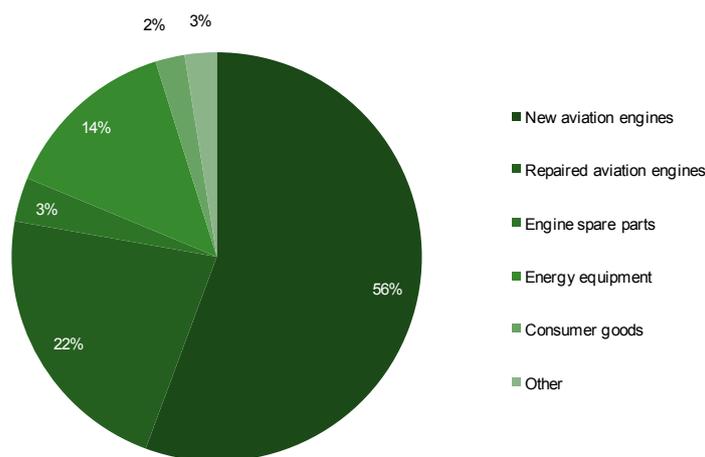
Figure 3. Revenue structure by type of products, USD mln



Source: Company Data

The company's annual engine output was 1.2 thsd units in 2007 and it is expected to exceed the 1 thsd level in 2008. 72% of this figure is new engines, and the rest are repaired units.

Figure 4. Revenue structure by type of service, 2007



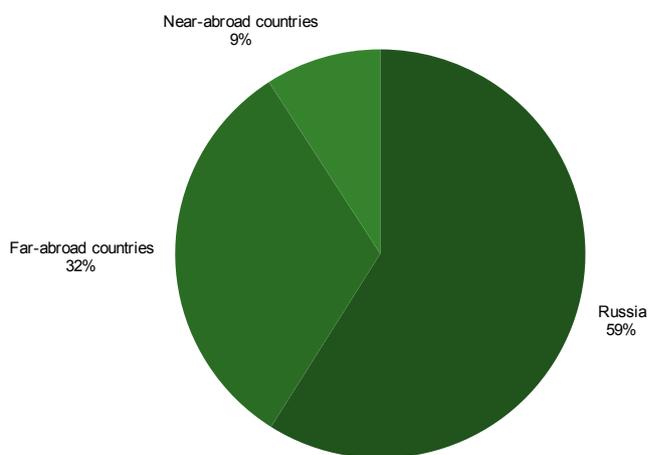
Source: Company Data

MSICH is export-oriented company, with about 87% of the company's revenue obtained from goods and services it delivers outside the Ukraine. MSICH's engines are used in civil and military airplanes and helicopters in more than 120 countries of the world.

Russia has traditionally been a considerable market for sales. A large part of the revenue from Russian clients is collected from supplying different modifications of TV3-117 engines and spare parts for it, as well as VK-2500 and AI-9V engines.

The second-largest market in terms of MSICH's sales are those countries that are not immediate neighbors to Ukraine. Unlike Russia, the bulk of payments from this market is provided by repairing aviation engines of different modifications and supplying spare parts for them. The core customers, based on 2007 results, are India, China, South Korea, Algeria and Poland.

Figure 5. Revenue structure by region, 2007



Source: Company Data

Motor Sich prospects

New engines account for a 56% share in company revenue based on 2007 results. In predicting the prospects of aviation engines, it is particularly important to understand the prospects of the aircrafts and helicopters in which they are being installing. Usually, aircraft engine is originally developed for some special aircraft or helicopter, and only after that, can be used on other models that have been developed later if the technical requirements are upheld.

Therefore, we analyze MSICH challenges separately for the helicopter, aircraft and land sectors, as well as for the missiles engine sector in the order of their respective shares in the company's revenue.

Helicopters and helicopter engines market

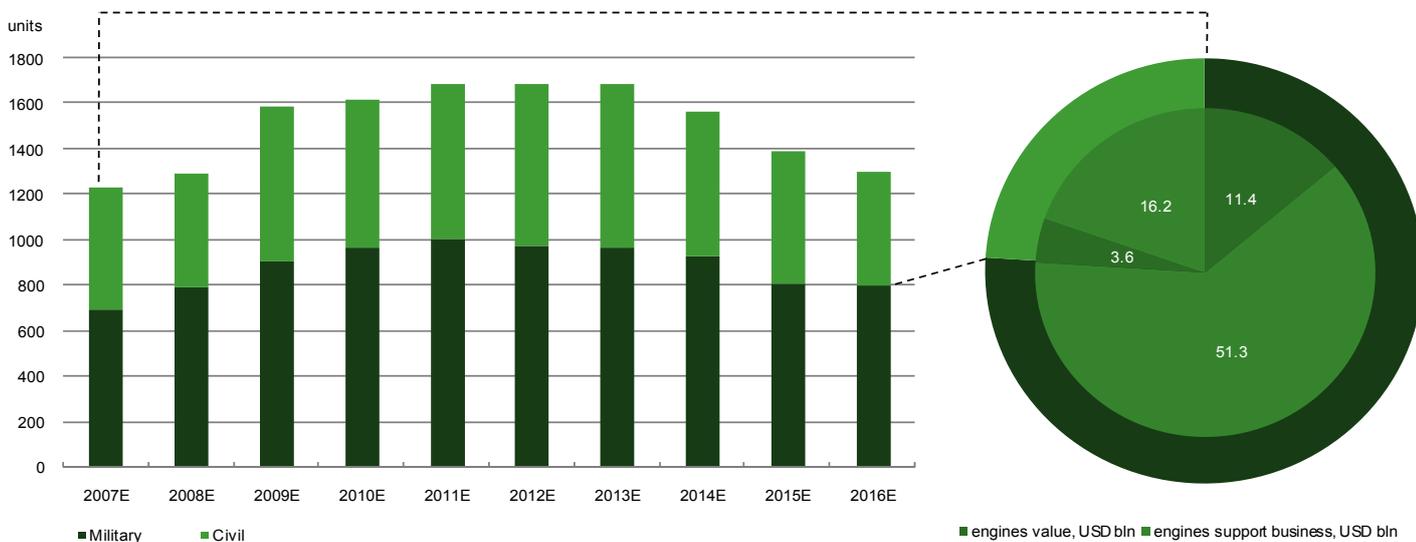
We emphasize the prospects of turbine engines, since they are the core cash generators amongst the company's products. In recent years, we have observed the rapid growth of the world market of both civil and military helicopters. The market peak for turbine-powered machines is expected in 2011-2013, near the level of 1.6 thsd units, while the market for small single-piston type engine helicopters should observe some degree of decline to the level of 500-600 units after their sales peak in 2004-2007.

The main drivers of the helicopter market are:

- an increase in the states' military fleet, as well as the fleet for its emergency services;
- the necessity of renovating the existing helicopters park;
- an increase in passenger turnover for helicopters;
- the development of oil and gas extraction, as well as cargo transportation, in heavily accessible regions.

The value of the 15 thsd turbine-powered helicopters that are expected to be produced over 2007-2016 is estimated at USD 144 bln. 10.4% of that value will be generated from engine sales. Also, the value of engine support services in that period is estimated to be USD 66.5 bln.

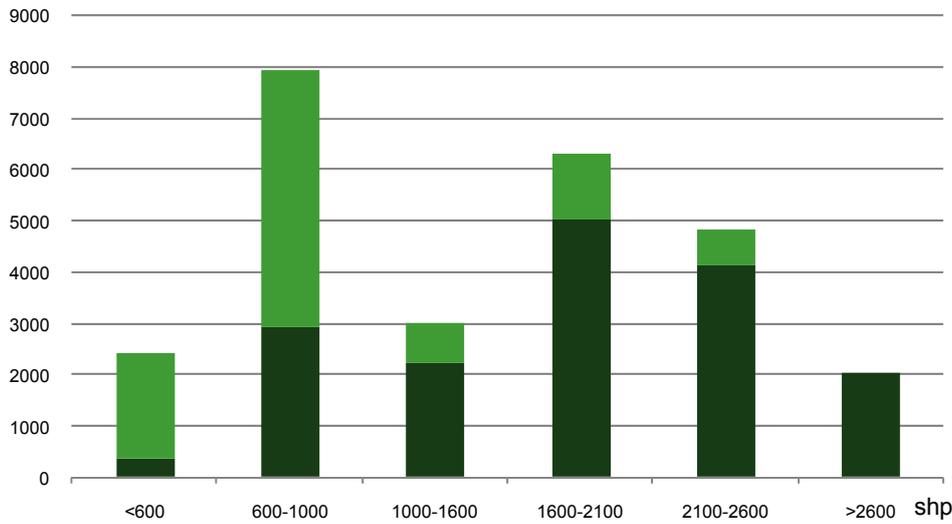
Figure 6. Turbine-powered helicopters production and the value of engines production and support in the world



Source: Rolls-Royce, Sokrat estimates

The highest demand for the engines of civil helicopters will be observed in the 600-1000 shaft horsepower (shp) range, while engines for military rotorcrafts of higher shp (namely 1600-2600) will be most popular.

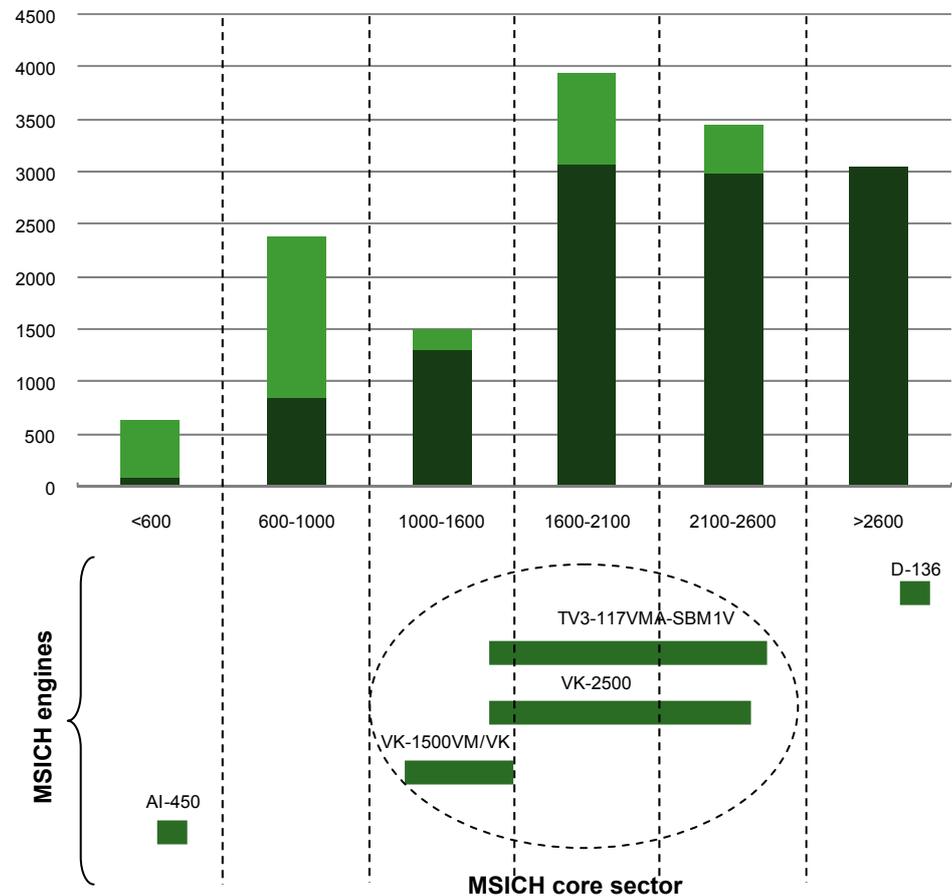
Figure 7. Turbine engines production by power, number of units



Source: Rolls-Royce

The highest share in sales during the period 2007-2016 will be in the sector of military helicopter engines with shaft horsepower higher than 1600 shp. They will account for a 60% share in value terms among turbine-powered helicopters.

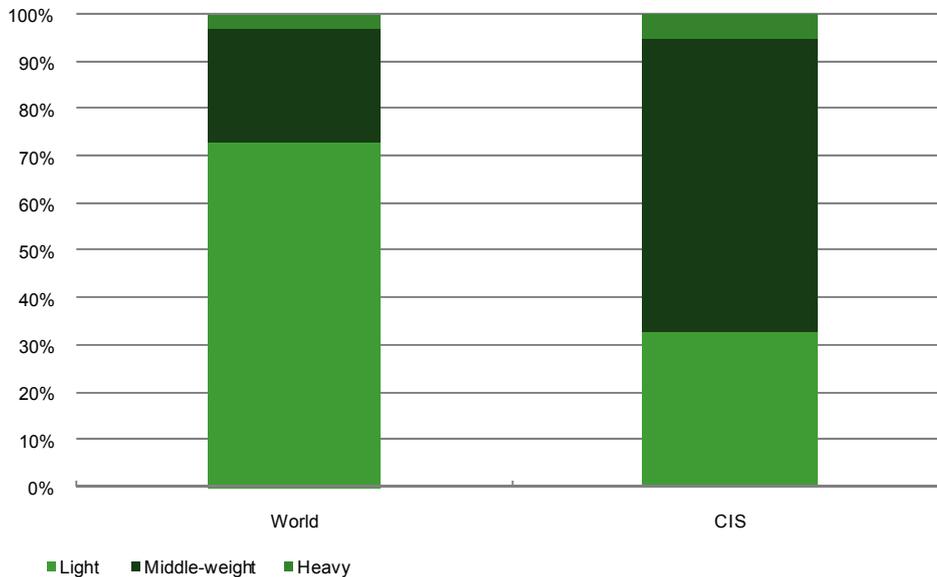
Figure 8. Turbine engines sales by power, USD mln



Source: Rolls-Royce, Company Data

Taking a look at MSICH engines, we see that they cover mainly the power sector between 1100 and 2500 shp, with a deficiency of models in the range between 600 and 1000 shp. This correlates to the fact that the CIS market is more inclined towards middle-weight and heavy machines, compared with the overall world demand.

Figure 9. Helicopter demand by weight, %



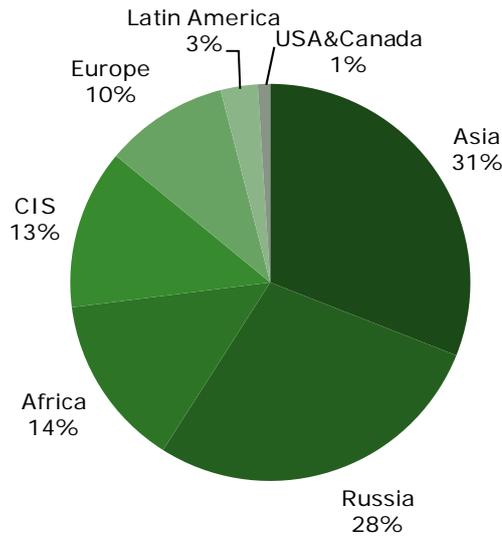
Source: Company Data, Sokrat estimates

Russian market

We hold a special view about the Russian helicopters market due to its high share of MSICH exports. **Approximately 95% of helicopters produced in Russia are equipped with Motor Sich engines. There is practically no serial production of helicopter engines in Russia.** At the same time, there is mutual inter-dependence between Russia and Motor Sich, as more than half of helicopter engines made by the company are supplied to the Russian market, and more than 50% of the equipment and materials for the engines are delivered from Russia.

Currently, more than 5.2 thsd Russian helicopters are used in 80 countries all over the world, which is approximately 10% of the helicopter fleets used in the world. About 87% of Russian helicopter sales are achieved in the CIS, Asian and African markets. Therefore, in all the above-mentioned regions, MSICH has opportunities to strengthen its position.

Figure 10. Mi and Ka helicopters in the world, %

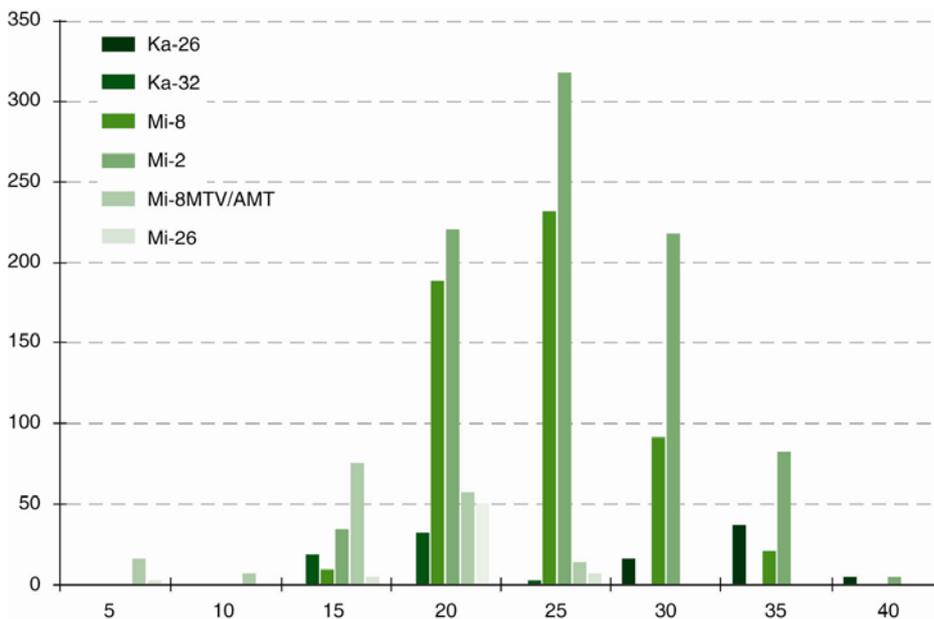


Source: Klimov Plant Data

The Russian market is expected to experience a strong demand in the civil helicopter sector due to the low saturation of that market and an increase in the population's prosperity. Currently there are approximately 14 civil helicopters per million population in Russia, while, for example, this index is at the level of 56 units per million in Canada. According to the federal program of aviation development in Russia, the State plans to purchase 1,150 civil helicopters by 2015. MSICH has good chances to gain revenue from engine sales in the mid-weight sector, while in the light-weight sector the competition with western producers is especially high.

At the end of 2007, the park of helicopter equipment in Russia accounted for about 1,960 machines with an average age of 20 years. We don't expect a decrease in demand for maintenance services for helicopters and engines over the next ten years.

Figure 11. Russian helicopters distribution by age, units

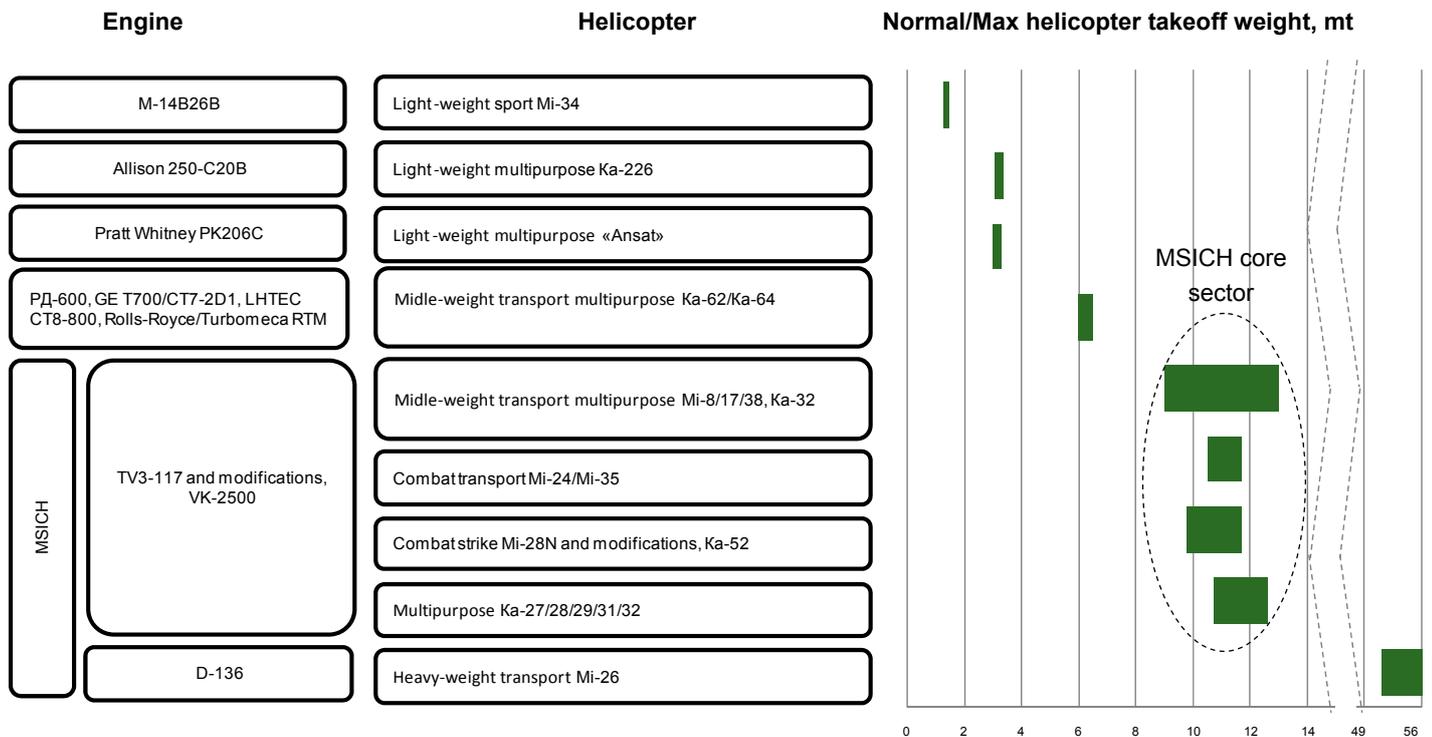


Source: State scientific research institute of civil aviation

According to the plans of Oboronprom, the Russian helicopter building industry should experience strong growth. The country is going to return its lost 15% share in the world market by 2015, comparing to its current 6%. Thus it is planned to produce about 170 machines this year, over 200 in 2009, eventually reaching an annual production level of 500 machines by 2015.

The special purpose development program for helicopter building in Russia for the period before 2015 supposes further development and production of the following helicopters:

Figure 12. Helicopters engines by type



Source: Oboronprom, Company Data, Sokrat Estimates

Apparently the widest range in the takeoff weight scale is held by helicopters equipped with TB3-117 engines and their modifications, which are in Motor Sich's production line. VK-2500 is the later modification of the TB3-117 engine and, therefore, can be used on all helicopters which use the previous model. The VK-2500 is currently undergoing tests on a Mi-28.

According to our estimations, MSICH will produce 1.3 thsd TB3-117 and VK-2500 helicopter engines during the period 2008-2012 with 6% CAGR.

Serial engine production in Russia

According to the plans of Oboronprom, Russia will try to decrease dependence on Ukraine concerning the production of helicopters engines. With this objective, the decree was accepted to begin serial production of TV3-117 and VK-2500 engines and their modifications on Russian plants. A tender for the production was won by the Moscow-based Chernyshev engine-building plant, although the TB3-117 was developed at the Klimov Plant, which also participated in the tender. The TB3-117 and VK-2500 are also currently produced in the Klimov Plant in close cooperation with Motor Sich.

Russia plans to launch the serial production of helicopter engines in 2010. According to announcements of the two above-mentioned Russian engine building plants' management, their capacities will allow to boost engine production to 300 units annually for each entity.

However, there are some facts weighing against the successful and timely start of serial engine production in Russia. One of them is that the Chernysheva Plant still cannot refine the TV7-117 engine, which was supposed to surpass all parameters of the TV3-117. Thus the decision to begin TV3-117 production instead of TV7-117 says something about the low possibility and resources of the plant to develop its own engine. In addition, for the successful start-up of production plants, it will need to master not only USSR but also Motor Sich's own development, which require large resources and is unlikely without the assistance of this Ukrainian company.

Also, in setting up serial production of existing engines in the Russian plans, Motor Sich will be able to go further in terms of engine development and, at the start of engine serial production in Russia, will be able to offer a comparatively better product. According to the president of Motor Sich, Vyacheslav Boguslaev, Ukraine will create a new generation engine by 2010. The new engine will have 12 tons of power, improved performance regarding noise and emissions, as well as 20%-25% efficiency in terms of the economical use of fuel compared with existing engines. The engine will be developed on a new technical framework using new materials.

Another factor against the successful and timely start of serial engine production in Russia is that a lot of investment is required for this purpose. A high level of bureaucracy in Russia, combined with the above-mentioned and other factors, makes 2010 as a target year as the start of serial production to be unrealistic. A more realistic term is 5-7 years.

We believe that the most likely and favorable scenario, both for Ukraine and Russia, is close cooperation between Motor Sich, the Chernyshev Plant, and the Klimov and Salut Plants.

Western engine producers strengthen their positions on the Russian helicopter engine market

- Thus it was decided by Oboronprom to equip the training Ansat-U helicopters, developed by the Ministry of Defense, with engines PW-207K from Pratt & Whitney (Canada).
- Also, at the exhibition 'Helicopter 2008', a Protocol of Intent was signed between Helicopter Russia, the Ufa Engine Production Association and the Canadian engine-building company Pratt & Whitney to cooperate in conducting a program for assembling Mi-38 with PW 127T/S engine. There are also plans to provide this company engine supplies for Mi8 and Mi17.
- At the exhibition, Oboronprom and Augusta Westland signed an agreement about long-term cooperation in the field of helicopter building.

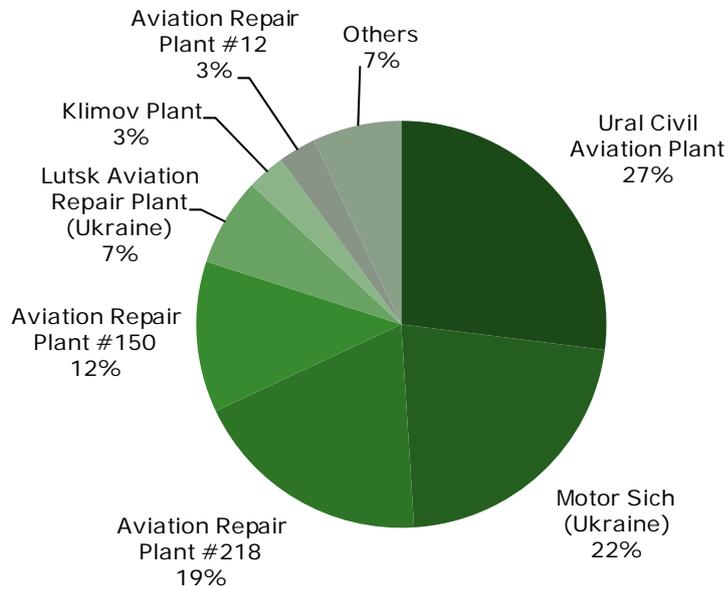
The engine repair and maintenance market

The repair of helicopters and their engines is a significant portion of the producers' earnings and provides them with cash flows for a long time. The world market for the repair of helicopters is valued at USD 1 bln in 2007 and is expected by Forecast International to grow 2.5 times by 2012.

An average helicopter's useful age is 35-40 years, during which it is necessary to perform maintenance, repair and upgrading. Among the entire spectrum of services, helicopter engine capital repairs take the largest share – up to 35%.

The repair of Russian helicopter engines is performed by seven major enterprises. In accordance with the laws the developer, which is mainly the Klimov Plant, is obliged to control the implementation of repairs to aircraft engines. For those services it should earn revenue.

Figure 13. Core engine repair market players in 2006, %



Source: Company Data, Sokrat Estimates

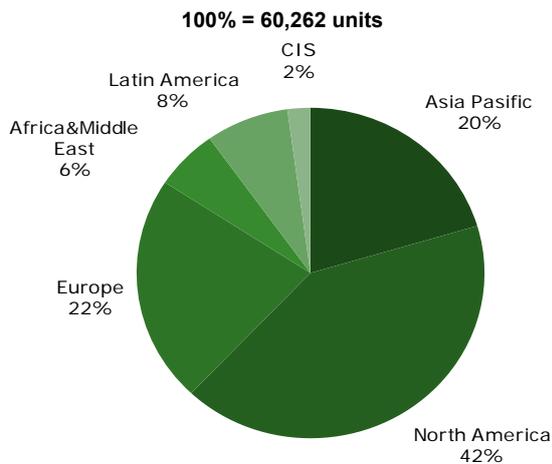
To strengthen its market position, in particular in the engine repair and maintenance market, Motor Sich will start up a plant in Dubna (Russia). The plant should be launched before the end of this year and reach full capacity utilization in 2009. As Vyacheslav Boguslaev announced, first and foremost, the aim is to ensure international standards in maintaining and repairing MSICH's engines. According to him, USD 5 mln has already been invested in the project, while the total investment in the project within four to five years will be USD 80 mln.

Aircrafts and aircraft engines market

Aircraft engine production is one of the core cash generators for Motor Sich. We will look at global and especially at Russian aviation market trends in aim of better understanding MSICH's prospects in the aviation engine market.

The average world growth rate of aircraft traffic is estimated by Rolls-Royce to be 4.9% over next 20 years, while the in-service fleet will grow slowly – at an average 3.3% per year due to improvements in aircraft utilization and load factors, as well as an increase in the average aircraft size. The GDP growth rates of emerging markets such as India, China and Africa are higher than those of developed countries. An increasing number of wealthy individuals and improved local aviation infrastructure will correlate with a robust increase in orders for aircrafts in that region compared to the rest of the world.

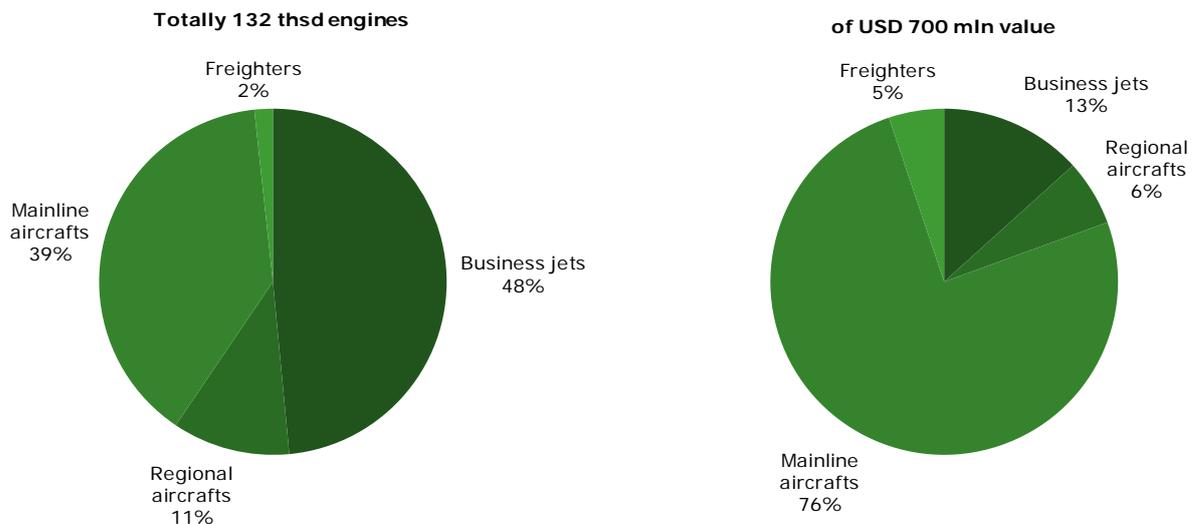
Figure 14. Aircraft deliveries by region over 2007-2026, %



Source: Rolls-Royce

Over the next 20 years, Rolls-Royce forecasts demand for 132 thsd engines worth USD 700 bln. The highest demand is expected in the business jet sector, followed by the large mainline aircraft sector.

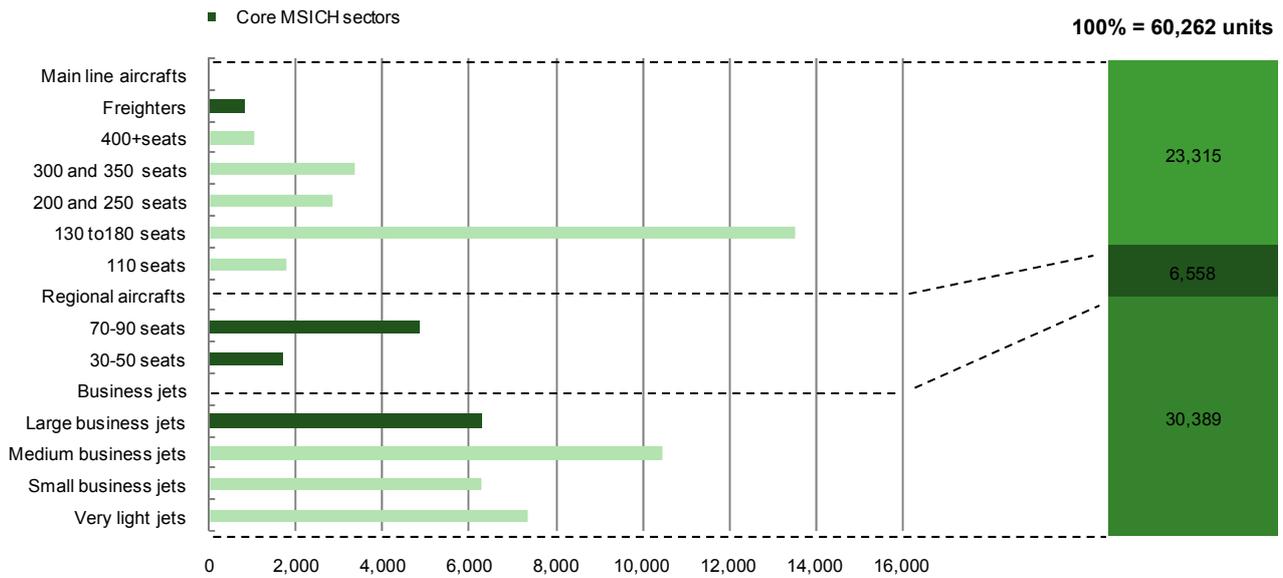
Figure 15. Engine deliveries by airplane size over period 2007-2026



Source: Rolls-Royce

These engines will be installed in 60 thsd airplanes.

Figure 16. Aircraft deliveries by size over 2007-2026 period, units



Source: Rolls-Royce

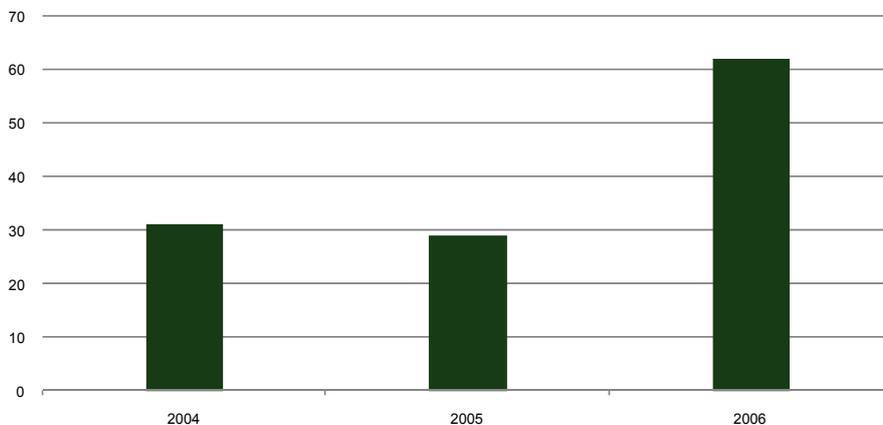
Russian market

Since the Russian aviation market is one of the largest in terms of MSICH exports, the understanding of its trends will result in a better estimation of Motor Sich's prospects.

The rapid growth of air passenger and freight turnover in Russia demands an adequate expansion of Russian carriers' fleets. The high depreciation of aircrafts in use in Russia but inherited from Soviet times is also an important driver for further fleet renovation. The rising costs of maintaining airworthiness and modernization in accordance with international requirements, and sharply increased prices for aviation fuel in many cases, make the operation of these machines ineffective, forcing more and more airlines to begin fleet modernization programs.

Russian aviation industry is only beginning to withdraw from a systemic crisis, which was in force for a long time after the USSR's collapse. In 2007, the main Russian aviation plants produced only 6 aircrafts and, in 2008, 15 aircrafts are expected to be built. Therefore, Russian carriers are increasing their purchases from foreign producers.

Figure 17. Import of foreign airplanes to Russia, units



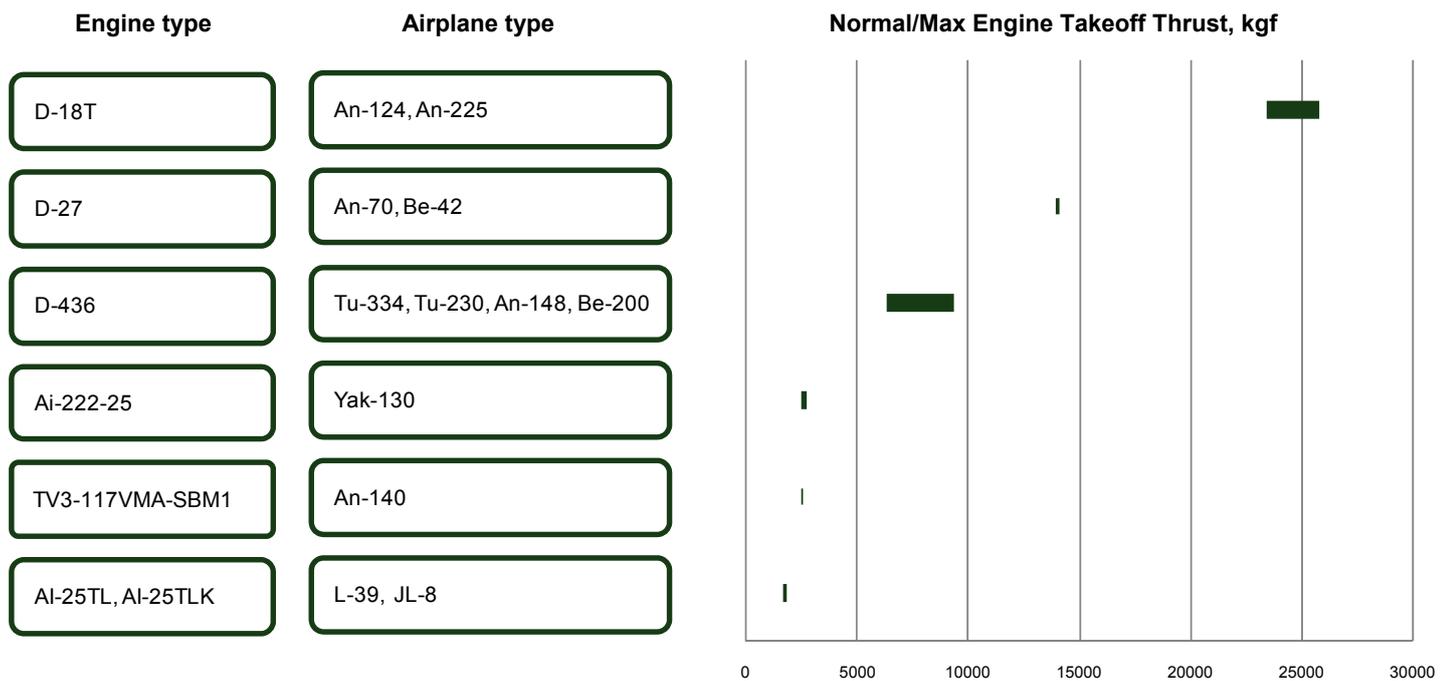
Source: AviaPORT

According to Russia's United Aircraft Corporation (UAC), it plans to produce 15 IL-96 aircrafts, 84 Tu-204/214 models, 236 SSJ models, and 96 An-148 models during the period 2008-2012. Plans for An-124 and Tu-334 are not yet clear. Earlier, plans were announced about the production of 51 Tu-334 models during that particular period.

Motor Sich perspectives in the aircraft engines market

The main prospective aircraft engines for MSICH in the mid term are the D-18T, D-27, D-436, AM-222-25, TV3-117VMA-SBM1, AI-25TLK models and their respective modifications. Their sales depend heavily of the prospects of the aircrafts in which they are used.

Figure 18. Motor Sich aircraft engines portfolio



Source: Company Data, Ivchenko-progress Corporation Data

We discuss the prospects of each MSICH aviation engine separately to reach a better understanding of their chances for the company to generate revenue.

D-18T

The aviation engine D-18T and its modification, developed by the “Progress” Design Bureau (Zaporizhzhya, Ukraine), is the most powerful of all engines used on Russian passenger and cargo aircraft. Its certified engine of the third series, with a takeoff thrust of 23.4 tons, has a resource that is equivalent to 18 thsd hours or 15 calendar years of service.

During the modernization of the engine, which is now held at Motor Sich, up to 4 series the draft will be increased to almost 26 tons while remaining the fuel consumption and a resource will reach 24 thsd hours. It immediately makes the An-124, which uses the D-18T engine, two times more cost-efficient, taking into account the cost of one-hour of flight – a world record for aircrafts in the load class of 150 tons.

In 2000, the market for transportation at An-124 was estimated at USD 200 mln, and rose to USD 500 mln by 2005. By 2020, the market should reach USD 4.5 bln, and more than USD 7 bln by 2030.



Currently, the demand for the An-124 is estimated at 71 units until 2030. The “Aviastar” Aviation Plant (Ulyanovsk, Russia) and Antonov ASTC (Ukraine) intend to resume production of the An-124-100 “Ruslan” civilian transport aircraft by 2010. The serial production program resume involves the production of 12 An-124-100M-150 aircraft by 2015. A new An-124 currently costs USD 150-160 mln, while the value of a D-18T engine of the 3 series is valued at approximately USD 5 mln.

The D-18T is also used in the An-225 “Mriya” super lift cargo aircraft, with a 250-ton cargo capacity. At the moment, the ship is the biggest heavy cargo aircraft in the world. The world market for transport aircraft of this size is currently so small that we don’t expect orders for that plant in the near future, nor for any engines for it.

D-27

The motor has a take-off thrust of 14 tons and is used mainly in An-70 aircrafts. According to these agreements, Russia and Ukraine planned to produce 164 An-70 military aircrafts for Russia and 65 for Ukraine by 2018. Under the agreement, Russia had to finance 80% of the An-70 project and Ukraine has to fund 20%.

In 2008, Russia declared plans to resume funding for a joint project with Ukraine to establish the An-70 military transport plane. Experts believe that the cost of one machine, with its serial production, will be about USD 60 mln, while its European rival A-400M will cost approximately USD 160 mln.

Almost all tests on the An-70 are already done; however, it is necessary to finish the work remaining for the serial production of the An-70, which requires an appropriation of USD 130 mln. The “Progress” Design Bureau plans to complete tests on the D-27 engine for the An-70 in 2009.

TV3-117VMA-SBM1

This type of engine was also developed by the “Progress” Design Bureau for the regional aircraft An-140. The An-140 was developed to replace the obsolete An-24. Currently, the number of such planes is estimated at 350 in use in the CIS and Africa.

Nowadays, 16 An-140 machines and its modifications are ordered. 5 planes should be delivered this year and in 2009. The capacity of the Russian market for these machines is estimated at 100 units, while in Ukraine this segment requires 40-60 An-140 planes.

The most possible competitor to the An-140 could be IL-114, which was deemed preferable by United Aircraft Corporation (UAC). IL-114 was designed to replace a number of local turbojet aircrafts Yak-40 and Tu-134 the number of which is about 620 units.

The average price for the An-140 is USD 8.5 mln, which is 30-40% cheaper than its western competitors and the construction of this high-winged monoplane is better suited for the CIS as well as Asian and African markets. Therefore, we look positively at the prospects of the An-140 and the TV3-117VMA-SBM1 engine as well.

AI-222-25, AI-25TLSH

The AI-222-25 engine – based on the AI-22 engine, designed by the Progress” Design Bureau, was designed for the training aircraft Yak-130. Yak-130 was created to replace the outdated training combat aircraft L-39, produced in Czechoslovakia for the Air Forces of the Warsaw Pact.



Recently, the decision was made to produce a series of ten planes for military trials in the Russian Air Force. The end of this stage is scheduled in 2009, after which serial production will commence. An annual output of 25-30 Yak-130 units is expected.

The Russian Air Force's need for such aircraft is estimated at 200-250 units and the world market's need is estimated at 2500 aircrafts.

The first AI-222-25 engines were produced in cooperation with Ukrainian and Russian companies. Following the adoption of the Yak-130 aircraft by the Russian Air Force, cooperation with Ukrainian enterprises will continue, while the final assembly, testing, delivery and maintenance is planned to be carried out at the Russian "Salut" Plant.

The AI-25TSLH engine modification was designed for installation on the L-39 aircraft (Czech Republic), and the L-15 and K-8J aircraft (China). The Chinese market for these aircrafts is estimated at 700-1200 units for the next eight years.

Also with respect to China, Motor Sich may be involved in cooperating on the project to modernize the **Y8F600 cargo airplane**. The project is being handled by the Ukrainian ANTONOV ASTC and the Second China Aviation Industry Corporation (AVIC II). It is planned to invite MSICH into this project.

D-436

This engine and its modifications are designed to be installed on airplanes for small and medium-range flights and namely, the following aircraft: Tu-334, An-148, and the multi-purpose amphibian Be-200. Currently, there are three companies cooperating on the serial production of D-436 engines: the Ufa Engine-building Production Association (UEPA), the Moscow Engine-building Plant "Salut", and Ukraine's Motor Sich.

The primary manufacturer of the D-436 in Russia will be UEPA and in Ukraine – Motor Sich; however, the final assembly of engines up to 2010 will be in Ukraine. Since 2010, the UEPA, along with Motor Sich, will produce D-436 proportionally.

The AN-148 – short-haul aircraft designed for the transportation of 70 to 90 passengers must successfully replace the Tu-134 and Yak-42, the number of which is about 400 units.

The cost of one hour of flight and maintenance of the D436-148 is the lowest in the world. The engine is valued at USD 2 mln. The principal of the primary advantages is that the aircraft could use a dirt runway. This makes it attractive to airlines in Africa and the CIS countries.

This aircraft segment – regional aircrafts (with a capacity of 75-110 passengers) – is now the least competitive yet quite promising sector both in Russia and abroad. The estimated capacity of the world market for planes of this class until 2013 is about 500 units. The demand for this type of An-148 aircraft in Russia until 2020 is estimated at 200-250 planes. There is confirmed interest in more than 100 An-148 aircrafts and its modifications.



The direct competitors of the An-148 are the Sukhoi Superjet 100 (SSJ) and Embraer 190, but they are more expensive than the Ukrainian aircraft.

Sukhoi Superjet 100 is the project of "Sukhoi Civil Aircraft" and Boeing for the development and production of short-haul passenger aircraft. Despite grandiose plans and support in the government, the project was confronted with significant challenges, both in the construction of the fuselage, and in finalizing the SaM146 engine.

At the moment, the project is developing strongly behind schedule. In May 2008, the regional aircraft Sukhoi SuperJet 100 made its first flight, which had previously been planned for 2007. The first serial SSJ is planned for release in 2011. Currently, the strong order portfolio for the SSJ 100 accounts for 98 aircrafts and there are possibilities for another 41 aircrafts.

Another project that may be profitable to MSICH with respect to the D-436 engine is the **MS-21** airplane project. The design of the MS-21 aircraft remains the only unrealized Russian aviation industry program. In 2008, the project sketch of the new machine will be prepared and the construction of the engines and avionics for "the aircraft of the future" will be put out to tender.

The aircraft is expected to make its first flight in 2011 and to begin operation in 2012. By 2015 it plans to reach an annual output of 100 MS-21 aircraft.

As for the engine, the developers have proposed several options for the aircraft, with a maximum thrust of 11-12 tons. These include the PS-90A-12 and PS-12 engines (developed by Perm Motors, Russia) and the promising TRDD-2005 and D-436 engines (developed by "Progress" Design Bureau, Ukraine).

Missiles engines market and land equipment sector

Revenue from deliveries of the R95-300 engine for the Russian X-35, X-55 and X-59 missiles account for a 5%-10% share of MSICH's total sales. Since the collapse of the Soviet Union, it is the only producer of the R95-300 engine for missiles.

MSICH produces engines through inter-governmental agreements between the Government of the Russian Federation and the Ukrainian Cabinet of Ministers of 20 August 1997 and 21 December 2000.

However, this year, Russian Prime Minister Vladimir Putin announced the aim to replace Ukrainian engines in Russian missiles with Russian engines, and in doing so, to eliminate dependence on Ukraine in light of its possible accession to NATO. Despite the political aspect of this question, there is also an economic reason for Russia to transfer missile engine production to its own territory. 90% of components for the R95-300 are produced by Russian defense enterprises that are located in Moscow, Kazan, Omsk, Saratov and other cities. Therefore, Russian authorities' plans to transfer the final engine assembly to inside the country, at first glance, appears quite logical.

However, according to Motor Sich's Chief Engineer Paul Zhemanyuk, the implementation of this plan requires an investment of at least USD 50-60 mln. Missile engine production of this type is very time consuming and the start-up of the assembly is extremely difficult. Therefore, even in the case that such investments appear, the project's realization will require at least five years.

Also, in response to V. Putin's announcement, Motor Sich offered the Russian Defense Ministry a new engine for missiles that can be produced at the company's new production facilities in Dubne (Russia). In comparison to the R95-300, the new engine should be lighter and will have better fuel efficiency while maintaining the same power. Also, the new engine for Russian missiles will be 30% shorter than its predecessor. This means that missiles can take significantly more fuel, and will be able to fly 70 km further than the current 130 km.

We therefore see the most probable and advantageous way ahead for both parties being close cooperation in the sphere of missile engine production.

The share of MSICH's sales accounted for by gas turbine drives, energy equipment and consumer goods is approximately 19%, based on 2007 results, with a larger share being had by energy equipment. We don't expect a sharp change in this share over the next four years and estimate the growth in equipment sales at 4% CAGR during the period 2008-2012.

SWOT ANALYSIS

Strengths

- ◆ The uniqueness of engines produced.
- ◆ Close cooperation with one of the world's strongest design bureaus (called "Progress").
- ◆ Great experience and strong position the CIS.
- ◆ MSICH engines are cheaper compared to competitors, while they are of the same good quality.
- ◆ Highly experienced staff.

Weaknesses

- ◆ Lack of government industry support programs.
- ◆ Need for continual large investments in research and upgrading of fixed assets.
- ◆ Shortage of young professionals.

Opportunities

- ◆ Further diversification of product line.
- ◆ Development of new, more competitive products.
- ◆ Development of cooperation with western and Asian aviation products manufacturers.
- ◆ Involved in Russian aviation development program.

Threats

- ◆ An increase in competition from Chinese and American producers.
- ◆ The start-up of serial production of helicopter engines by Russian companies.
- ◆ A decrease in demand for company production in case of the absence of further development.

Risks

- **We think that the key risk for Motor Sich is debates regarding the possibility of Ukraine being given a Membership Action Plan (AIP), which related to the possibility of becoming a member of NATO.** Currently Motor Sich, just as other machinery sector producers, has a closed relationship with Russian suppliers and customers. As we described above, Russia accounts for about 50% of all Motor Sich revenues. Together with Russian partners, most of which are helicopter (Ka and Mi) producers, Motor Sich promotes its engines on foreign markets. In the same time company depends from Russian suppliers which produce engine components. We expect if the situation with AIP will develop further, it may impact significantly on Motor Sich's business. It means that Russia will probably limit or even stop purchasing military equipment from Motor Sich and will try to develop domestic production. However, we think that the development of local products in Russia will take a long time; therefore, in the short-term and mid-term we think Motor Sich will retain its position because Russian military producers do not have any alternatives to quickly replace Ukrainian engines.
- **Political instability in Ukraine. For a long time we have been seeing political instability in Ukraine.** Ukrainian political quotes regarding war in Georgia, location of Russian fleet in Crimea can influence on companies which work with Russia first of all and other countries which has closed relationship with Russia.
- We also hold the skeptical view that, in the current global crisis, all **programs announced by the Russian government for aircraft development will occur in terms of the expected aircrafts volume to be produced.**
- **Unfortunately, the Ukrainian Government limits the financial resources allocated to supporting local military producers with investment,** which is required by companies in order to stay on the same technological level and produce new types of military equipment. Motor Sich is in the list of these companies.
- **Increasing completion on global markets** will impacted on Motor Sich in future if the company does not produce new engines. The Russian Government has recently announced plans to create its own engines comparable to Motor Sich products.

Valuation

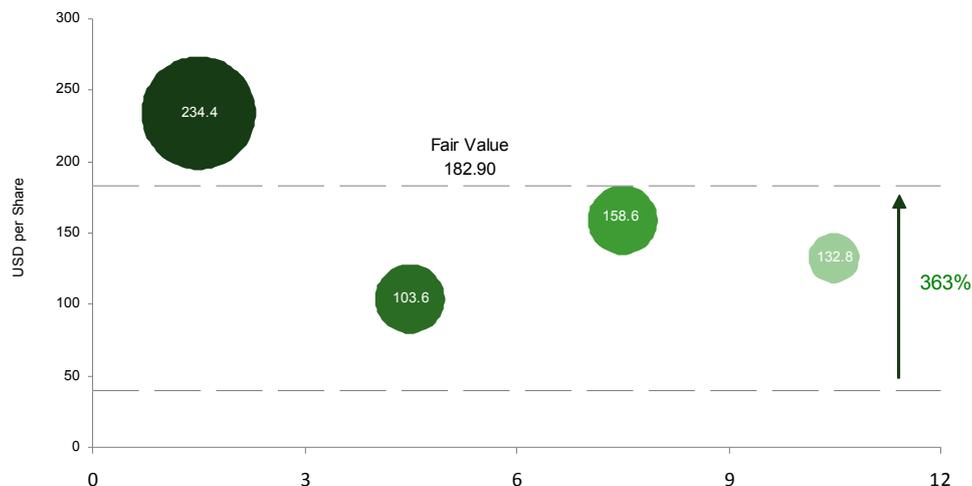
We reiterate our BUY recommendation for Motor Sich, but we decreased the fair value from USD 335 to USD 182.9 based on next assumptions. In our model we estimate the company's helicopter engines output growth at 6% CAGR for 2008 -2012. Combined with the price increase, we expect the revenue from helicopter engine deliveries will grow 12% CAGR during this period. We conservatively estimate the growth of repair services at 4% CAGR for 2008-2012, while we assess the growth of Net Sales at 14% CAGR for this period.

We expect weak financial results in 2008 due to the growth in prices of raw materials and an increase in administrative expenses this year. Thus, the EBITDA margin is estimated to decline to 14.4% in 2008 compared to the peak 22.8% last year, and then experience a smooth recovery to 17%.

Our DCF model is based on a three-fold method that equally takes into account perpetuity growth rate, exit EBITDA and P/E multiples. The DCF method valued MSICH at USD 234.4 per share, while the Comparative method ended up at USD 107.1 per share. The average of these two methods arrives at a USD 182.9 as a fair value per share.

Figure 19. Valuation by DCF and Comparative methods

The diameter of a circle represents the weight of the method in Motor Sich fair value



Source: Bloomberg, Sokrat estimates

Figure 20. DCF Valuation

DCF valuation

USD mln	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F
Net Sales	392.3	468.0	534.4	566.8	648.7	713.7	756.9	794.8	826.5	859.6	894.0
EBITDA	56.5	76.7	90.6	96.5	111.0	122.4	130.1	136.9	142.6	148.6	154.9
EBIT	35.7	58.2	74.1	78.9	91.7	101.0	110.6	120.7	127.3	132.9	138.1
Tax	(7.1)	(11.8)	(15.2)	(16.2)	(19.4)	(21.5)	(23.8)	(26.1)	(27.7)	(29.2)	(30.6)
EBIAT	28.6	46.3	59.0	62.6	72.3	79.5	86.8	94.6	99.5	103.7	107.5
Depreciation	20.8	18.5	16.5	17.7	19.3	21.4	19.5	16.1	15.4	15.8	16.8
CapEx	(48.0)	(48.0)	(42.0)	(32.0)	(42.0)	(36.0)	(33.0)	(30.0)	(27.0)	(28.0)	(29.0)
Change in WC	4.9	(8.5)	(21.9)	(22.7)	(15.2)	(12.3)	(12.6)	(11.3)	(7.1)	(7.6)	(8.7)
Unlevered Free Cash Flow	6.3	8.3	11.6	25.7	34.4	52.5	60.7	69.4	80.8	83.8	86.6
WACC	20.1%	17.5%	14.6%	13.0%	11.9%	10.9%	10.1%	9.7%	9.2%	8.8%	8.4%

	Key Assumptions		Enterprise Value	
	min	max	min	max
WACC to Perpetuity	10.9%	12.9%		
Perpetuity Growth Rate	-1.0%	-	589	589
Implied EBITDA multiple	4.0	8.0	559	559
Implied P/E multiple	6.0	10.0	556	556
Average Enterprise Value			568	
Net Debt			81	
Equity			487	
Fair Value per Share, USD			234.36	
Current Price, USD			39.54	
Upside			492.7%	

Source: Company data, Sokrat estimates

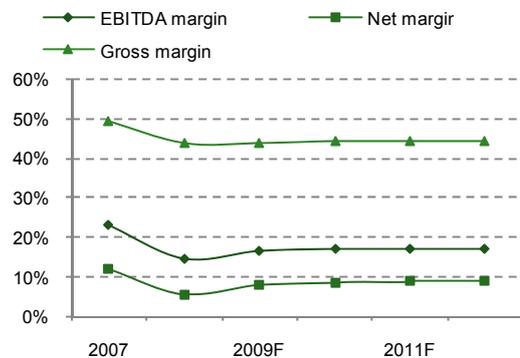
Figure 21. Sensitivity Analysis

Implied Enterprise Value, USD mln					
WACC	Perpetuity Growth Rate				
	-1.0%	-0.5%	0.0%	0.5%	1.0%
10.9%	600	623	650	680	716
11.4%	573	594	618	645	675
11.9%	549	568	589	613	640
12.4%	527	544	563	584	608
12.9%	507	522	539	558	580

Implied Enterprise Value, USD mln					
WACC	Exit Multiple (EBITDA)				
	4.0	5.0	6.0	7.0	8.0
10.9%	487	545	603	661	718
11.4%	470	525	580	636	691
11.9%	453	506	559	612	665
12.4%	437	488	538	589	639
12.9%	422	470	519	567	615

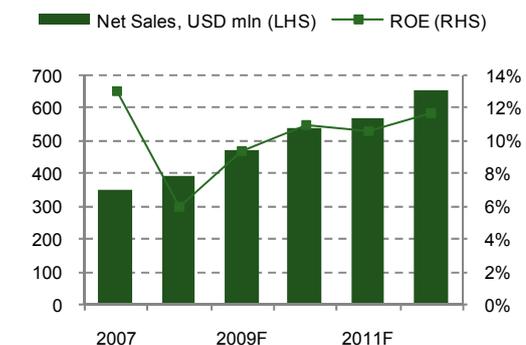
Implied Enterprise Value, USD mln					
WACC	Exit Multiple (P/E)				
	6.0	7.0	8.0	9.0	10.0
10.9%	531	565	599	634	668
11.4%	512	544	577	610	643
11.9%	493	524	556	587	618
12.4%	476	505	535	565	595
12.9%	459	487	516	545	573

Figure 22. Margins' Trends



Source: Company Data, Sokrat estimates

Figure 23. Net Sales growth



Source: Company Data, Sokrat estimates

Figure 24. Comparative Valuation

	Shares Outstanding, mln	Share Price, USD	MCap, USD mln	EV, USD mln	EV/S			EV/EBITDA			P/E				
					2007	2008E	2009F	2007	2008E	2009F	2007	2008E	2009F		
Motor Sich	MSICH UZ	2.1	39.5	82.2	158.2	0.4	0.4	0.3	1.8	2.5	1.8	2.5	4.0	2.4	
Developing Markets															
IRKUT-CLS	IRKT RU	978.1	0.4	391.3	1,022.2	1.0	1.0	0.8	9.6	9.2	8.7	8.0	7.7	7.5	
KAZAN HELICOPTER PLANT-CLS	KHEL RU	154.7	1.0	148.5	324.2	1.2	1.2	1.0	n.a.	n.a.	n.a.	5.4	13.5	9.0	
UFIMSKIYE MOTORS-CLS	UFMO RU	266.1	0.8	212.9	797.2	1.5	1.6	1.3	n.a.	7.9	9.9	13.3	14.0	12.1	
KAZANSKOE MOTOROST-BRD	KPMO RU	6.3	7.0	44.5	79.0	0.4	0.5	0.3	n.a.	6.2	5.9	4.8	37.0	n.a.	
SATURN RESEARCH & PROD-\$	SATR RU	3,983.7	0.0	79.7	562.3	1.5	1.1	0.7	n.a.	20.4	10.9	1.0	-3.6	-7.5	
Developing Markets, average					1.2	1.1	0.8	9.6	8.6	9.3	5.4	13.5	8.2		
Developed Markets															
MAGELLAN AEROSPACE CORP	MAL CN	18.2	1.1	19.4	256.1	0.4	0.4	0.4	5.9	5.2	4.5	-1.8	10.3	4.0	
MTU AERO ENGINES HOLDING AG	MTX GR	52.0	19.8	1,029.2	1,407.2	0.4	0.4	0.4	2.1	2.8	3.0	4.9	4.5	5.1	
VECTOR AEROSPACE CORP	RNO CN	37.7	4.0	151.4	215.3	0.6	0.5	0.4	5.2	4.8	3.9	13.4	6.7	5.3	
GENERAL ELECTRIC CO	GE US	10,495.9	18.8	197,322.0	650,263.0	3.6	3.5	3.4	18.3	14.7	14.7	8.9	8.8	9.1	
BOMBARDIER INC 'B'	BBD/B CN	1,752.3	3.4	6015.236	6,806.2	0.4	0.3	0.3	4.2	3.4	3.0	19.0	6.1	5.1	
BAE SYSTEMS PLC	BA/LN	3,525.5	5.2	18454.16	17,006.8	0.6	0.6	0.5	4.3	4.5	4.2	10.2	8.3	7.6	
Developed Markets, average					0.5	0.5	0.4	4.8	4.6	4.1	9.6	7.5	5.2		
Motor Sich Upside															
					EV/S			EV/EBITDA			P/E				
					2007	2008E	2009F	2007	2008E	2009F	2007	2008E	2009F		
vs. Developed Markets peers					205%	217%	178%	438%	244%	406%	119%	242%	246%		
vs. Developing Markets peers					19%	26%	40%	169%	87%	122%	286%	89%	118%		
Motor Sich Fair Value															
					EV/S			EV/EBITDA			P/E				
					2007	2008E	2009F	2007	2008E	2009F	2007	2008E	2009F		
Implied by Developing Markets multiples		Weight:	50%		120.71	125.18	109.87	212.74	135.97	199.91	86.42	135.03	136.93		
Implied by Developed Markets multiples		Weight:	50%		47.00	49.97	55.26	106.22	73.82	87.81	152.70	74.83	86.17		
Fair Value, weighted average over regions					83.9	87.6	82.6	159.5	104.9	143.9	119.6	104.9	111.6		
Weights						15%	25%		15%	25%		10%	10%		
Fair Value, USD														107.12	
Current Price, USD														39.54	
Upside														171%	

Source: Company Data, Sokrat estimates

Figure 25. Balance Sheet*

USD mln	2007	2008E	2009F	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F
Total Assets	577.3	676.5	742.0	798.1	839.7	932.3	1,010.4	1,079.5	1,134.7	1,174.3	1,216.5	1,260.2
Non-current Assets	229.4	262.2	280.5	298.1	312.4	341.1	369.4	386.6	400.5	412.2	424.4	436.6
PP&E, Net	155.7	168.1	168.2	169.9	176.4	185.4	198.1	205.0	209.8	213.8	218.1	222.0
Other NCA	73.7	94.1	112.3	128.3	136.0	155.7	171.3	181.7	190.7	198.4	206.3	214.6
Current Assets	347.9	414.3	461.4	500.0	527.3	591.1	641.0	692.8	734.2	762.1	792.1	823.6
Cash&Equivalents	16.6	18.8	20.6	21.4	22.7	25.9	28.5	30.3	30.6	30.6	31.8	33.1
Accounts Receivable	23.0	19.6	28.1	32.1	34.0	38.9	42.8	45.4	47.7	49.6	51.6	53.6
Inventories	227.7	296.6	339.7	368.1	390.4	435.9	471.6	512.9	547.4	569.3	592.1	615.8
Other CA	80.6	79.3	73.0	78.4	80.2	90.3	98.0	104.3	108.5	112.6	116.6	121.1
Total Liabilities & Equity	577.3	676.5	742.0	798.1	839.7	932.3	1,010.4	1,079.5	1,134.7	1,174.3	1,216.5	1,260.2
Total Liabilities	222.9	291.8	339.3	362.5	367.6	413.2	441.5	476.3	504.1	522.8	543.1	563.9
Long-Term Liabilities	20.4	21.6	24.3	26.7	27.2	28.0	27.7	26.5	25.0	23.4	21.9	20.5
Long-Term Debt	4.0	3.1	2.2	1.5	0.4	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other Long-Term Liabilities	16.4	18.5	22.1	25.2	26.8	27.9	27.6	26.4	24.9	23.3	21.8	20.4
Short-Term Liabilities	202.5	270.2	315.0	335.7	340.4	385.2	413.7	449.8	479.0	499.4	521.2	543.4
Short-Term Debt	70.9	97.1	127.0	141.1	134.5	146.3	155.5	174.9	190.7	200.1	209.7	219.5
Accounts Payables	42.2	51.0	52.9	53.9	57.1	65.4	71.9	76.3	80.1	83.3	86.6	90.1
Other Short-Term Liabilities	89.4	122.1	135.1	140.8	148.8	173.5	186.3	198.7	208.2	216.0	224.8	233.8
Equity	354.4	384.7	402.7	435.6	472.1	519.1	568.9	603.2	630.6	651.4	673.3	696.3
Share Capital	55.6	56.9	54.5	52.9	52.9	53.9	56.1	56.7	56.7	56.7	56.7	56.7
Reserve Capital & Other	174.2	179.9	172.2	167.4	167.4	170.6	177.4	179.2	179.2	179.2	179.2	179.2
Retained Earnings	124.7	147.9	176.0	215.3	251.8	294.5	335.4	367.3	394.8	415.6	437.5	460.4

Figure 26. Income Statement*

USD mln	2007	2008E	2009F	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F
Net Sales	346.5	392.3	468.0	534.4	566.8	648.7	713.7	756.9	794.8	826.5	859.6	894.0
COGS	(176.1)	(221.6)	(264.4)	(299.3)	(317.4)	(363.3)	(399.6)	(423.9)	(445.1)	(462.9)	(481.4)	(500.6)
Gross Profit	170.4	170.6	203.6	235.1	249.4	285.4	314.0	333.0	349.7	363.7	378.2	393.4
SG&A	(78.9)	(98.5)	(108.6)	(124.0)	(131.5)	(150.5)	(165.6)	(175.6)	(184.4)	(191.8)	(199.4)	(207.4)
Other Operating Profits/(Expenditures)	(12.5)	(15.7)	(18.3)	(20.5)	(21.3)	(23.9)	(26.1)	(27.4)	(28.5)	(29.3)	(30.2)	(31.1)
EBITDA	79.0	56.5	76.7	90.6	96.5	111.0	122.4	130.1	136.9	142.6	148.6	154.9
Depreciation	(18.8)	(20.8)	(18.5)	(16.5)	(17.7)	(19.3)	(21.4)	(19.5)	(16.1)	(15.4)	(15.8)	(16.8)
EBIT	60.2	35.7	58.2	74.1	78.9	91.7	101.0	110.6	120.7	127.3	132.9	138.1
Interest Expense	(7.4)	(10.5)	(13.4)	(15.4)	(15.2)	(14.9)	(15.4)	(15.8)	(16.5)	(16.6)	(16.4)	(16.1)
EBT	55.6	28.4	47.2	60.7	64.9	77.7	86.1	95.1	104.6	111.0	116.8	122.4
Income Tax	(14.6)	(7.1)	(11.8)	(15.2)	(16.2)	(19.4)	(21.5)	(23.8)	(26.1)	(27.7)	(29.2)	(30.6)
Net Income	41.0	21.3	35.4	45.5	48.7	58.3	64.6	71.3	78.4	83.2	87.6	91.8
EBITDA Margin	23%	14%	16%	17%	17%	17%	17%	17%	17%	17%	17%	17%
EBIT Margin	17%	9%	12%	14%	14%	14%	14%	15%	15%	15%	15%	15%
Net Income Margin	12%	5%	8%	9%	9%	9%	9%	9%	10%	10%	10%	10%

* Statements are based on UAS

Source: Company Data, Sokrat estimates

Figure 27. Statement of Cash Flows*

USD mln	2007	2008E	2009F	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F
Operating Activities												
Net Income	41.0	21.3	35.4	45.5	48.7	58.3	64.6	71.3	78.4	83.2	87.6	91.8
Depreciation	18.8	20.8	18.5	16.5	17.7	19.3	21.4	19.5	16.1	15.4	15.8	16.8
Change in Receivables	5.5	4.0	(9.3)	(4.8)	(1.9)	(4.3)	(2.3)	(2.2)	(2.3)	(1.9)	(2.0)	(2.1)
Change in Inventories	(63.4)	(63.3)	(55.9)	(37.9)	(22.3)	(38.0)	(18.2)	(36.5)	(34.5)	(21.9)	(22.8)	(23.7)
Change in Other CA	(42.6)	3.3	2.9	(7.5)	(1.8)	(8.5)	(4.1)	(5.3)	(4.2)	(4.2)	(4.0)	(4.5)
Change in Payables	11.3	7.8	4.1	2.5	3.3	7.2	3.9	3.6	3.8	3.2	3.3	3.5
Change in Other Short-Term Liabilities	22.5	30.5	18.2	9.5	8.0	21.8	5.9	10.5	9.6	7.8	8.8	8.9
Change in Other Long-Term Liabilities	4.9	1.8	4.4	3.8	1.5	0.6	(1.4)	(1.5)	(1.4)	(1.6)	(1.5)	(1.4)
Cash from Operating Activities	(1.9)	25.9	18.3	27.5	53.1	56.3	69.8	59.4	65.5	80.0	85.3	89.3
Investing Activities												
CapEx	(41.1)	(48.0)	(48.0)	(42.0)	(32.0)	(42.0)	(36.0)	(33.0)	(30.0)	(27.0)	(28.0)	(29.0)
Cash from Investing activities	(41.1)	(48.0)	(48.0)	(42.0)	(32.0)	(42.0)	(36.0)	(33.0)	(30.0)	(27.0)	(28.0)	(29.0)
Financing Activities												
Short-Term Debt	7.1	24.5	34.0	17.7	(6.6)	9.3	3.3	17.8	15.8	9.4	9.6	9.8
Long-Term Debt	4.0	(1.1)	(0.7)	(0.7)	(1.0)	(0.3)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)
Equity Financing	37.4	0.4	(1.1)	(1.1)	(12.2)	(20.4)	(35.5)	(42.8)	(51.0)	(62.4)	(65.7)	(68.8)
Cash from Financing Activities	48.6	23.8	32.3	15.9	(19.8)	(11.5)	(32.3)	(24.9)	(35.2)	(53.0)	(56.1)	(59.1)
Total Change in Cash	5.6	1.8	2.6	1.4	1.3	2.8	1.6	1.4	0.3	(0.0)	1.2	1.3

* Statements are based on UAS

Source: Company Data, Sokrat estimates

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