

Electrozinc - under UGMK's wing



Timur Khairullin, CFA

Deputy Head of
Equity Research
+7 (495) 2874407

T.Khairullin@grandiscapital.ru

Market environment is getting better. Excess supply, which used to augment warehouse stocks and press zinc quotations, is almost gone. China is actively increasing its consumption and imports. Hence, zinc prices have grown more than twofold since 2009 and may keep the rising trend.

Russia's demand for zinc is going up too. The domestic market is the major one for Russian zinc manufacturers (over 70% sales). The key zinc consumers (construction, metallurgy and automotive industry) have mostly recovered the lost positions, and Olympics-2014 and FIFA World Cup projects, which will take place in Russia, will further zinc consumption growth in the domestic market.

Electrozinc has good positions in the internal market. Electro zinc is the second largest Russian zinc manufacturer. Zinc products account for circa 2/3 of its revenue. In 2011, the company may produce 89k tonnes of zinc and around 25k tonnes of lead. Over a half of the output is produced under the tolling scheme, while the rest is sold to the parent - UGMK.

Financials are improving. In 9M 2010, Electro zinc's revenue gained 40%, and prudent cost management helped to raise profit 6.3 times. Also, Electro zinc substantially reduced its debt burden (NetDebt/EBITDA shrank from the crisis level of 6.8 to 1.5), and net margin is 12.5% now.

UGMK's shareholding of Electro zinc expanded its investment program. Accomplished capacity upgrade will build up zinc and lead output by 25% in the near 2-3 years, and will also resolve environmental issues. Formerly, considerable sulphur dioxide discharges in the atmosphere in late 2009 gave rise to a debate over Electro zinc's shutdown.

Electrozinc's undervaluation is still significant. The company's multiples (P/E11 - 2.4, EV/EBITDA11 - 2.8) are 60% below than comparables'. Our DCF model shows that its net fair value totals USD 83.6m, which is way above the current capitalization.

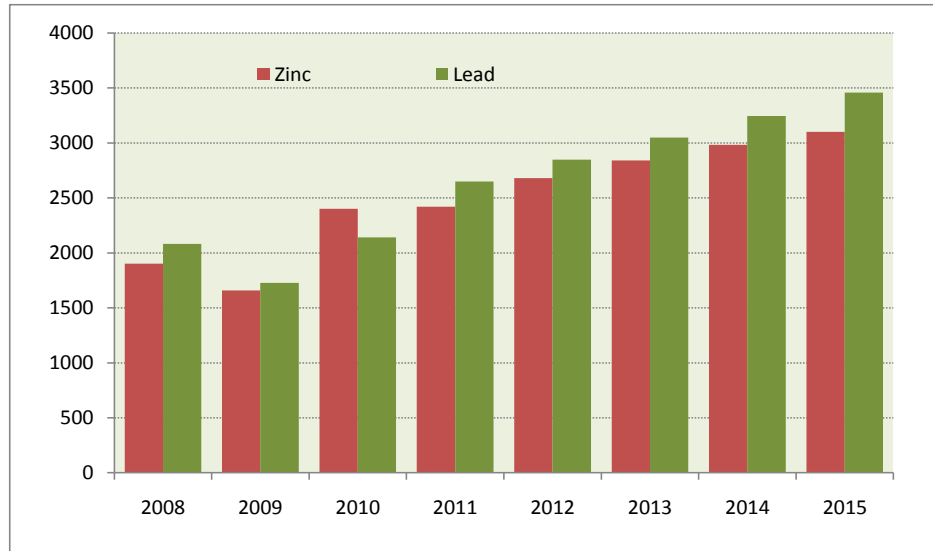
We assign recommendation "BUY" to Electro zinc's stock with the target price of USD 65.9 (growth potential - 65%).

ticker	ELTZ
MCap, USD m	53.35
NetDebt, USD m	54.7
EV, USD m	108.1
EV/S	0.6
EV/EBITDA	2.8
P/E	2.4
Stock price, USD	40
Target price, USD	65.9
Upside	65%

Valuation

We expect that zinc and lead prices may reach roughly USD 3 and 3.5k per tonne, accordingly. Higher-than-anticipated growth in selling prices for zinc and lead compared to feedstock may recover Electrozinc's pre-crisis profit margin.

Forecast zinc and lead prices, USD/t

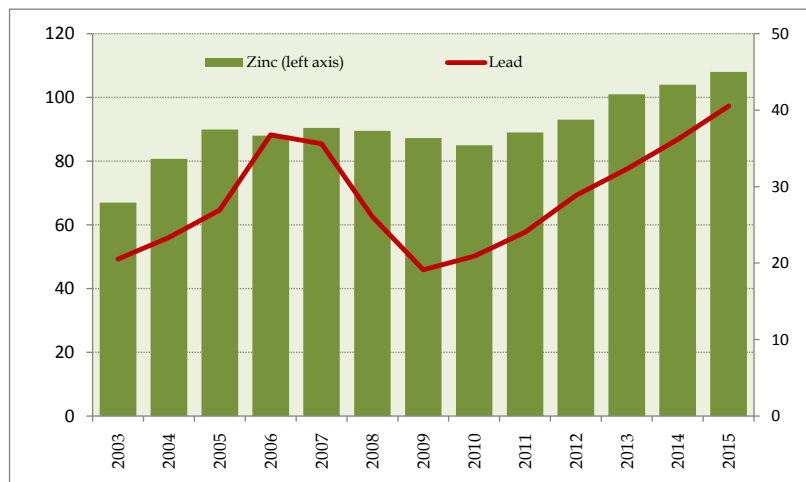


We expect zinc price growth up to 3,000 USD/t amid rising consumption

Company data, Grandis Capital estimates

Moreover, Electrozinc displays expansion of production capacity. Completion of the electrolysis shop will enable the company to boost output up to 110k tonnes per year. Last year, Electrozinc upgraded also lead production division, therefore in future it could raise lead output up to 50k annually.

Electrozinc's output, t'000



Company data, Grandis Capital estimates

Our analysis shows that in the projection period, Electrozinc's net margin will amount to around 12-14%, and EBITDA margin - 17-23%. The company's development plan assumed investments in the amount of RUB 4.4bn (below

USD 17m per year) in 2007–2105. But for the purpose of more conservative valuation, we use other assumptions. Most investments will be made in the near five years since capacity requires upgrade. Further, investments will reach USD 23–24m per year. Thus, we expect that Electrozinc's capital expenditures will exceed its targets.

The key risk for Electrozinc's business is barely predictable decision-making of its major shareholder – UGMK. It could decide to change business model of subsidiaries to select the desirable profit center.

Forecast financial performance, USD m

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenue	167.8	193.0	218.0	246.4	274.7	304.9	338.5	372.3	400.3	428.3
EBITDA	38.5	44.3	50.8	57.8	59.0	59.9	62.3	66.4	69.6	74.5
<i>EBITDA margin</i>	<i>23%</i>	<i>23%</i>	<i>23%</i>	<i>23%</i>	<i>21%</i>	<i>20%</i>	<i>18%</i>	<i>18%</i>	<i>17%</i>	<i>17%</i>
Net income	22.7	26.2	29.9	34.0	37.4	39.9	43.0	45.8	48.0	51.4
<i>Net margin</i>	<i>13.5%</i>	<i>13.6%</i>	<i>13.7%</i>	<i>13.8%</i>	<i>13.6%</i>	<i>13.1%</i>	<i>12.7%</i>	<i>12.3%</i>	<i>12.0%</i>	<i>12.0%</i>
CAPEX	36.1	32.3	30.6	29.7	28.1	25.8	24.5	23.5	23.5	23.5
Changes in working capital	2.9	3.3	3.7	4.2	4.7	5.2	5.8	6.3	6.5	7.0
Cash flows		1.3	7.8	14.2	15.6	17.4	19.7	23.4	25.8	29.2
Disc. cash flows		1.1	5.9	9.2	8.8	8.6	8.4	8.6	8.3	8.2

Company data, Grandis Capital estimates

Fair value, USD m

Indicator	Value
Cost of capital	18.0%
After-tax cost of debt	7.0%
Debt/(Debt+Equity)	25%
WACC	15.3%
Present value of FCF	67.1
Present terminal value	73.2
Company net value	83.6
Target price	65.9

Company data, Grandis Capital estimates

Cash flows will grow, and net margin will exceed 10%

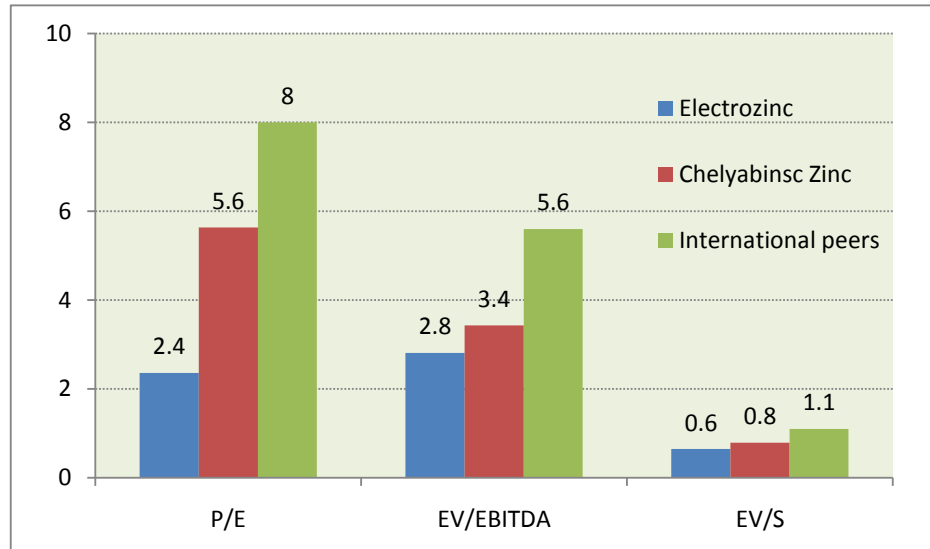
Our DCF model shows that the company's fair value totals USD 140.3m, with debt accounting for USD 56.7m. This estimate assumes Electrozinc's target price of USD 65.9, which is 57% over the current quotations.

Electrozinc is twice cheaper than comparables

The current Electrozinc's multiples are considerably below than comparables' too. The company's forecast P/E11 is 2.4, EV/EBITDA – 2.8. The only competitor in Russia (Chelyabinsk Zinc) displays 5.6 and 3.4, while foreign comparables have even higher values.

We took relatively moderate target indicators: EV/S - 0.9, EV/EBITDA - 4.5, P/E - 6.8 and to make estimates more conservative, we applied an additional discount of 15% owing to Electrozinc's corporate risks. Even with this approach given comparative valuation, the target price for Electrozinc's stock amounts to \$75.

Electrozinc's and comparables' multiples, 2011



The company is cheap and significantly undervalued vs. comparables (discount over 50%)

Company data, Grandis Capital estimates

For target price calculations, we assigned weight of 60% in DCF-based valuation and 40% in multiples-based valuation. Thus, the fair value of Electrozinc's share totaled USD 65.9.

Share value estimate, USD

Indicator	Value
Target price (comparables)	75.4
Target price (DCF)	59.6
Total target price	65.9
Growth potential	65%

We assign recommendation "BUY" to Electrozinc's stock with the target price of USD 65.9 (growth potential - 65%).

OOO Grandis Capital Investment Company

6 Puteisky Tupik, Moscow, 105064
tel.: +7 495 287 44 07, fax: +7 (495) 287 44 07
www.grandiscapital.ru, info@grandiscapital.ru

Department of Financial Markets

Mikhail Kozakov
Director of the Department
M.Kozakov@grandiscapital.ru

Anton Makarov
Deputy Head of the Department
Head of the Sales Division
A.Makarov@grandiscapital.ru

Sales Division

Dmitry Shatsky
Head of the Sales
D.Shatskiy@grandiscapital.ru

Konstantin Lynov
Vice president, Sales Division
K.Lynov@grandiscapital.ru

Denis Vakhrushev
Vice president, Sales Division
D.Vachrushev@grandiscapital.ru

Research

Denis Barabanov
Head of Research
D.Barabanov@grandiscapital.ru

Timur Khairullin, CFA
Deputy Head of Research
T.Khairullin@grandiscapital.ru

Dmytry Terekhov
Senior Analyst
D.Terekhov@grandiscapital.ru

Portfolio Investments Division

Dmitry Ivanov
Head of the Portfolio Investments Division
D.Ivanov@grandiscapital.ru

Andrey Tolstousov
Asset Manager
Portfolio Investments Division
A.Tolstousov@grandiscapital.ru

Customer Relations

Ekaterina Kharchenko
Head of the Customer Relations
E.Kharchenko@grandiscapital.ru

Exchange Operations

Maxim Bersenev
Head of the Exchange Operations
M.Bersenev@grandiscapital.ru

Mikhail Kan
Senior Trader
m.kan@grandiscapital.ru

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