



## **Novorossiysk Commercial Sea Port: Navigating economic whirlpools**



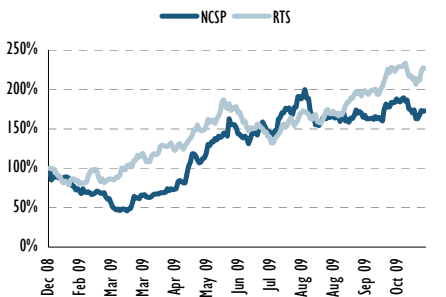
Aleksei Astapov  
+7 (495) 428 49 33  
[Aleksei.Astapov@gazprombank.ru](mailto:Aleksei.Astapov@gazprombank.ru)

# NCSP: Navigating economic whirlpools



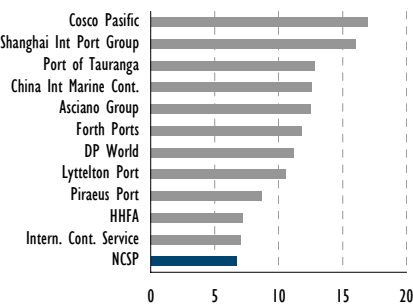
Recommendation	BUY
GDR target price, \$	14.5
GDR closing price, \$ (Nov 26, 2009)	11.1
Upside potential	31%

## Stock Price Performance



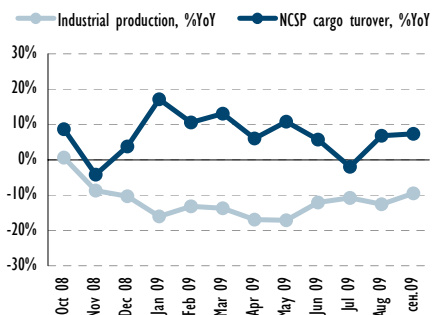
Source: Bloomberg, Gazprombank estimates

## Sector Multiplies, EV/EBITDA2010



Source: Bloomberg, Gazprombank estimates

## NCSP cargo turnover vs. Russia's production index



Source: Bloomberg, Gazprombank estimates

We initiate coverage of NCSP with BUY rating and target price of \$14.5 per GDR which implies a 31% upside potential to the current price level.

- Countercyclical response.** Despite a severe economic contraction Russia's seaports proved to be resilient to the general trend with a robust 5% YoY (excl. NCSP) turnover increase in 1H09. This performance looks even more impressive if compared with global handling at ports (-14% YoY) and Russia's freight rail turnover (-21% YoY). NCSP saw a cargo turnover increase by hefty 10.4% YoY beating industry-average performance and gaining a share of Russia's seaborne traffic at the expense of less flexible single-cargo ports. NCSP outperformed on the back of long-term relationship with Transneft providing for steady stream of crude oil and oil derivatives, company's ability to rapidly readjust cargo to changes in demand and development of high-margin additional services.
- Sound financials and growing margins.** Company's pricing policy (almost all revenues are dollar-denominated and costs are primarily ruble-driven) coupled with strong operating results contributed to superb performance in 1H09. The company's 1H09 EBITDA margin reached impressive 70%, NI margin stood at robust 39%. We see the company's EBITDA2009 at 63% and think this level is sustainable in the long run. At the end of 2008 NCSP scaled down its CAPEX due to an uncertain outlook and lack of demand for new capacities. At the same time, we forecast cash generation to remain strong with cash and cash equivalents reaching \$350 mln. by YE thus opening new opportunities for NCSP in the M&A field.
- Unjust discount to global peers.** NCSP is priced at 6.7x on 2010E EV/EBITDA and at 11.3x on 2010E P/E, which implies an app. 40% discount on EV/EBITDA and a 45% discount on P/E to global peers. In our view, NCSP multiples do not fully capture the company's significant growth potential, one of the highest margins in the industry and strong liquidity position. Hence, we argue that NCSP should trade close to par value of global peers.
- One of the few ways to play backbone industry.** Since almost all the industry players are non-public (except for some privately owned stevedoring and rail transportation companies) the NCSP represents a unique opportunity for investors to play this essential industry and to capture the prospects of future growth.

We derive NCSP's target price based on the DCF approach. In our view, NCSP steady transshipment turnover and predictable cash inflows make DCF valuable in current volatile environment. Thus, we use relative valuation for testing purposes only. We came at \$14.5 per GDR under DCF and \$20.4 per GDR under relative valuation.

We set NCSP's target price at \$14.5 per GDR and assign a BUY rating to NCSP Group implying a 31% upside to the current price level

## Key financial indicators

	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Total cargo turnover, mln. tonnes	86.0	88.9	91.6	96.3	97.0	102.5	107.5
Revenue, \$ mln.	663.7	742.8	813.1	971.9	1023.2	1108.0	1202.7
EBITDA, \$ mln.	415.5	466.2	502.9	621.4	645.4	686.8	741.7
EBITDA margin	62.6%	62.8%	61.8%	63.9%	63.1%	62.0%	61.7%
Finance Debt, \$ mln.	477.5	336.2	300.0	0.0	0.0	0.0	0.0

Source: Company's data, Gazprombank estimates

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#### General information

Ticker	NCSP, NMTP
Closing price, \$ (Nov 26, 2009)	0.15
GDR (=75 shares) closing price, \$	11.1
# of shares outstanding, mln.	19 260
Free float	30%
Market Cap, \$ mln.	2 850
Net debt, \$ mln.	185
Minority Interest, \$ mln.	27
EV, \$ mln.	3 062
52-week high	13.5
52-week low	2.8

Source: Bloomberg, Reuters, Company's data

## Investment Summary

In 1H09 handling at Russia's seaports increased by modest 5,9% YoY to 235.4 mln. tonnes (91.2 mln. tonnes of dry cargo and 144.2 mln. tonnes of liquid cargo) while global seaborne cargo turnover plummeted by app. 14% YoY. The NCSP outperformed domestic and global peers with an impressive 10,5% YoY turnover increase in cargo handling.

Strong operational growth was driven by:

- ▶ **Diversified revenue structure and positive changes in the cargo mix.** The port handles different types of liquid and dry cargoes. This gave NCSP a strong competitive advantage over monoline ports during the downturn. NCSP's cargo-mix flexibility was a major contributor to NCSP's superb 1H09 performance. Timely adjustment of Novolesexport facilities (which are primarily used for shipment of containers and timber products) to cater iron ore allowed the company to capture soaring demand for this type of cargo as well as pick up traffic from Ukrainian ports and enjoy a more than 20-fold turnover increase (1,6 mln. tonnes in 1H09 vs. 65K tonnes in 1H08). NCSP also experienced significant increase in grain export backed by record-breaking 08' harvest and cancellation of export duties. As a result, company's grain turnover more than tripled in 1H09, which positively affected NCSP margins, as grain is one of the higher-priced cargoes. Company's investment plans suggest further diversification of cargo-mix in order to ease potentially stronger pressure from competitors and sustain current profitability levels.
- ▶ **Steady supply of oil and oil derivatives.** Oil handling is the port's core business and accounts for 2/3 of the company's total cargo turnover. Its volumes remained steady in times of turmoil on ruble devaluation and timely readjustment of crude export tariffs. The state switched from the pre-crisis 2-month lag to a monthly recalculation of export duties; thus, oil export remained attractive boosting NCSP's crude turnover by 3% YoY and oil products volume by 21% YoY in 1H09.

Major improvements of company's financials and liquidity position are attributed to:

- ▶ **Pricing policy.** NCSP has benefited from ruble devaluation as most of the regulated tariffs are set in dollars and costs are primarily ruble-driven. It added \$39.2 mln. to the overall EBITDA in 1H09.
- ▶ **Cost control.** NCSP continued cost cutting in 1H09 by, among other measures, reducing its headcount by another 400 employees, lowering its maintenance and SG&A expenses. Decrease of bunkering fuel price and reduction of depreciation charge through reassessment of the useful lives of certain fixed assets also contributed to OPEX contraction.
- ▶ **Optimization of CAPEX.** In late 2008 when the crisis started to unfold NCSP suspended almost all of its investment expenditures amid uncertainties over future demand for new capacities. The company's operating cash inflow remained strong significantly improving its liquidity position. As of 1H09 cash and cash equivalents were over \$277 mln. Given NCSP 09' CAPEX prospects we believe that the company will accumulate over \$350 mln. by the end of the year building up a strong foothold for future M&A and organic expansion.

The downside risks to the company's value might stem from:

- ▶ **Saturation of the Bosphorus Strait** – the only watergate connecting the Black Sea to the Sea of Marmara and the Mediterranean Sea. The U.S. Energy Information Administration estimates oil transported through the Bosphorus at 3.8 million bbl/d (200 mln. tones per annum) by the end of 2010 from nearly 1.7 million bbl/d in 2000 thus exceeding the Strait's choke point and potentially hurting NCSP oil turnover.
- ▶ **Leasehold of core assets.** NCSP is exposed on the cost side to leasehold agreements of its core assets as most infrastructural objects within the seaport are state-owned and currently leased to NCSP on preferential terms. The leasehold agreements expiration ranges from 5 to as long as 50 years. We stress that revision of the leases, though highly unlikely according to the management, might affect the company's financials and depress its margins.

- ▶ *Currency risk exposure.* The company is highly exposed to the currency risk due to its cost/revenue structure. Though it doesn't use currency hedging to secure its revenue streams it takes advantage of a "natural" hedge, i.e. dollar-denominated debt and revenues. There is also room for currency risk mitigation through rates increase on non-regulated services.

*We see NCSP's competitive edge in its strategic location, dominance in Russia's seaborne traffic, resilience to economic environments and strong corporate governance. We also believe that company's growth prospects have not been fully priced in and its fundamental potential is yet to be appreciated by the market.*

*We set NCSP's target price at \$14.5 per GDR and assign a BUY rating to NCSP Group implying a 31% upside to the current level.*

## Company snapshot

*NCSP is the largest universal deep-sea ice-free year-round port on the Russian coast of the Black Sea*

NCSP is the largest universal deep-sea ice-free year-round port on the Russian coast of the Black Sea, being a key gateway for cargo shipments from/to Southern and Central Russia, Transcaucasia and Central Asia. The port can handle oil tankers with total deadweight (TDW) of up to 150K tones (the largest marine vessels permitted to navigate the Turkish straits) and Panamax class vessels with TDW of up to 60K tones giving it a strong competitive advantage over shallow ports of the Sea of Azov.

*NCSP Group's consolidated cargo turnover in 2008 totaled 81.6 million tonnes making it the sixth largest European port*

NCSP Group's consolidated cargo turnover in 2008 totaled 81.6 million tonnes making it the sixth largest European port and strengthening the its domestic leadership. NCSP accounts for app. 20% of Russia's total seaport handling with individual cargoes (sugar, grain, etc.) being at over 50%. NCSP stevedores approximately 45 mln. tonnes of crude oil annually (20% of Russia's total crude export) through its Shescharis oil terminal. NCSP can handle any types of cargoes: liquid (oil products, mineral fertilizers and seed oils), bulk (ferrous/non-ferrous metals, iron ore, timber, grain sugar, etc.), general cargo and containers thanks to its diversified base of multi-purpose facilities.

*Conveniently located NCSP can serve all strategic destinations: Europe, North and South America and Asia*

Except for traditional stevedore services (loading/unloading) NCSP renders a wide range of auxiliary services (freight forwarding, storage, custom paperwork, repacking, tug and towing fleet services, etc.).

Conveniently located NCSP can serve all strategic destinations: Europe, North and South America and Asia. Most of port's cargoes (~80%) are shipped to Europe, with Asia (12%) being a runner up (predominantly to China). Remainder goes to Africa, Americas and Oceania.

NCSP is best positioned to serve Asia and specifically southern parts of China. We expect the port's destination profile to twist towards China on rising exports of iron ore, ferrous/non-ferrous metals, etc. and container imports.

There are six major subsidiaries within the Group:

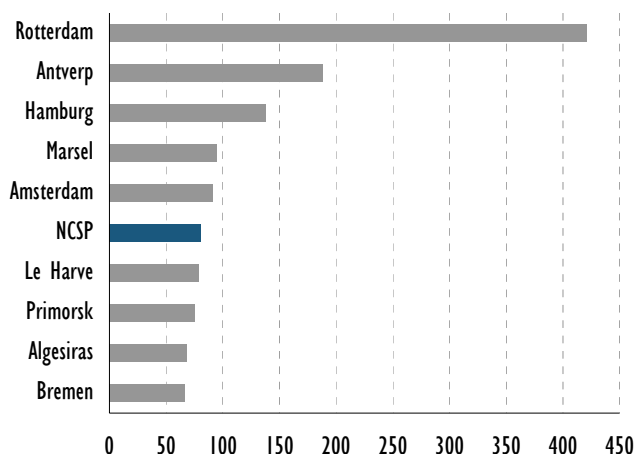
**IPP** operates multiple facilities designed to process liquid cargoes (crude, fuel oil, oil products and liquid fertilizers).

**Novorossiysk Grain Terminal (NGT)** provides storage and shipment services for grain exports, as well as related value-added services (cleaning and drying of grain).

**Novorossiysk Ship Repair Yard (NSRY)** owns the largest cargo vessels repair facilities and dry-docks on the Russian coastline of the Black Sea. In addition to its ship repair services, NSRY provides stevedoring of metals.

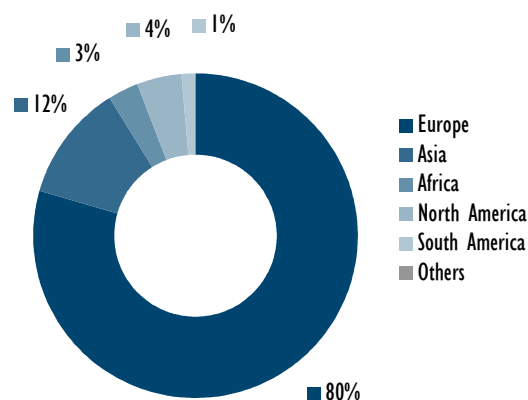
**NCSP Fleet (NCSPF)** is one of the largest private maritime tug and towing companies in Russia, providing bunkering services and a variety of auxiliaries (shelter zones transfers, leakage control, hazardous material response and waste management). Its fleet currently comprises 68 vessels, 15 of them are leased from Rosmorport.

NCSP vs. Europe's largest seaports, mln. tonnes



Source: Company's data, Gazprombank estimates

NCSP's destination profile



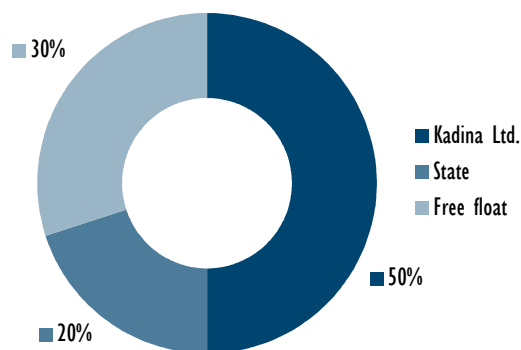
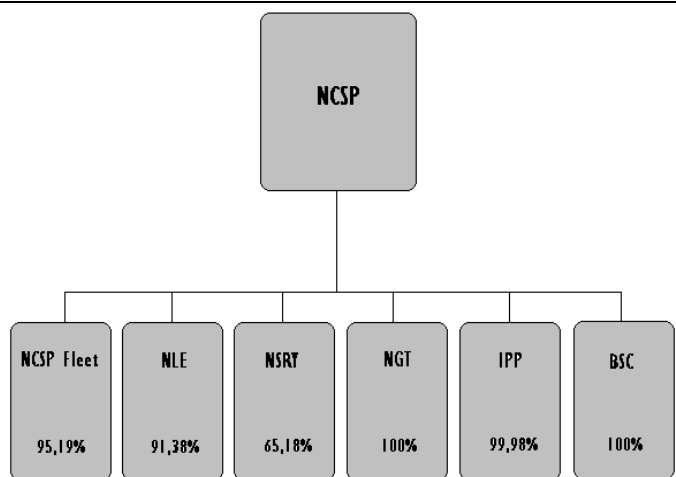
Source: Company's data, Gazprombank estimates

**Novolesexport (NLE)** Timber & Container Terminal provides storage and shipment of containers and timber products and renders a variety of value-added services (warehousing, freight forwarding, etc.). Unlike other local stevedoring companies, NLE focuses on shipment of processed rather than raw timber.

**Baltic Stevedore Company (BSC)** is the only NCSP subsidiary outside Tsemess bay of the Black Sea. It operates a container terminal in Baltiysk (the Kaliningrad Oblast) with focus on container shipment, storage and vessel mooring services.

**NCSP holding structure**

**Shareholders structure**



Source: Company's data, Gazprombank estimates

Source: Company's data, Gazprombank estimates

*The ultimate controlling shareholders are Mr. Ponomarenko (NCSP's CoB) and Mr. Skorobogatko with a 50.1% stake*

The ultimate controlling shareholders are Mr. Ponomarenko (NCSP's CoB) and Mr. Skorobogatko with a 50.1% stake (secured through Kadina Ltd.). Media reported Arkady Rottenberg to acquire a 20% stake in Kadina Ltd. in early 2009 thus obtaining indirect control over the NCSP.

*NCSP competes with both Russian and Ukrainian seaports across the Southern basin*

**Competitive environment**

NCSP competes with both Russian and Ukrainian seaports across the Southern basin. Positioning in the region is subject to various factors (location, pricing policy, infrastructure, as well as cargo mix). Some cargoes (oil, grains) require unique facilities and/or level of infrastructural development, therefore turnover volumes are only influenced by external suppliers' readiness to ensure stable cargo flow. Pricing flexibility is vital for other cargoes (oil products, iron ore, metals, containers) impacting the ports' ability to maintain stable turnover.

*NCSP capacities allow handling basically any type of cargoes, while other Southern ports are niche players*

NCSP is best positioned in this field as its capacities allow handling basically any type of cargoes, while other Southern ports are niche players. The port's developed infrastructure and diversified facilities assure steady year-round cargo turnover resilient to seasonal fluctuations unlike monoliners. Odessa Port in many respects resembles NCSP business model being capable of carrying almost all cargoes, with own oil, grain and container terminals.

NCSP benefits from its convenient location in the ice-free Tsemess Bay, assuring year-round navigation unlike competing ports (e. g. Taganrog), where weather either totally prevents or hurdles winter-time operations.

We've already mentioned NCSP's ability to service vessels with TDW of up to +150K tonnes (cf. competing Azov seaports handling vessels with TDW of up to only 5K tonnes, due to shallow water averaging ~7 meters in depth).

*Russia's seaports across the Southern basin well outperformed Ukrainian peers*

Its monopolistic position in the Tsemess Bay (NCSP turnover reached 97% of Novorossiysk's total shipments in 2008) prevents external competition from overseas players due to lack of available construction sites.

Russia's seaports across the Southern basin well outperformed Ukrainian peers in 1H09 with the turnover of the former reaching 87.7 mln. tonnes (+14.1%) while the latter's turnover dropped to 52.3 mln. tonnes (-20.1%). Poor performance on the Ukrainian coast was attributed to lower pricing flexibility (they are state-owned and subject to more rigid price caps regulated by the respective authority vs. Russian ports entitled to apply discounts to regulated tariffs). Thus, Ukrainian ports were hit hard by pricing inflexibility.

For instance, Odessa port suffered heavy losses on thinner flows of oil products contracted by 3 mln. tonnes in 1H09 as Kazakh operators redirected their cargoes to Novorossiysk in 2009 to avoid higher bills from Ukrainian ports and railroads with Russia charging approximately \$3.5 less per tonne on average.

### Competitive environment in Southern basin

Port	Country	Sea	Cargo	Turnover, mln. tonne
Novorossiysk	Russia	Black	Liquid, bulk, general, containers	86.1
Odessa	Ukraine	Black	Liquid, bulk, general, containers	33.0
Yuznyi	Ukraine	Black	Liquid, bulk	22.0
Ilyichevsk	Ukraine	Black	Bulk, general, containers	19.0
Tuapse	Russia	Black	Liquid, bulk,	20.0
Mariupol	Ukraine	Azov	Bulk, general, containers	14.0
Taganrog	Russia	Azov	Liquid, bulk,	3.3
Kavkaz	Russia	Azov	Bulk Liquid	6.4
Yeisk	Russia	Azov	Bulk	4.3
Termuk	Russia	Azov	Bulk, liquid	1.4
Taman (under construction)	Russia	Black	Liquid	33.5

Source: Gazprombank estimates

### Operating profile

NCSP's operating profile is influenced by several factors.

*NCSP accounts for app. 20% of the country's total crude overseas transportations*

Being the main gateway of Russia's oil export, it accounts for app. 20% of the country's total crude overseas transportations. NCSP oil turnover demonstrated a modest 3% YoY increase in 1H09 despite plunging oil prices. Its volumes remained steady in times of turmoil on ruble devaluation and timely readjustment of crude export tariffs by the government. The state switched from the pre-crisis 2-month lag to a monthly recalculation of export duties.

*Grain was another contributor to turnover increase in 1H09*

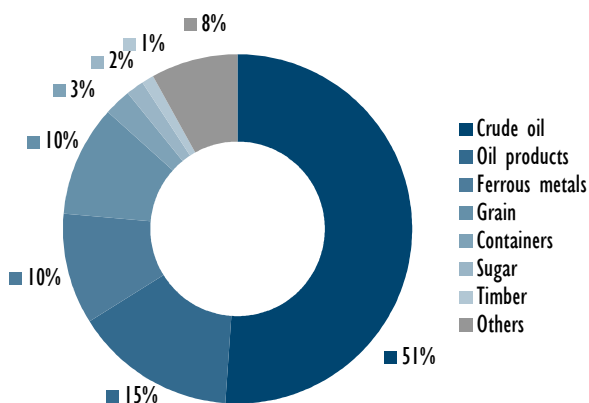
Grain was another contributor to turnover increase. Located in close proximity to Russia's main grain producing regions, NCSP became a major gateway for grain export. Grain transshipment soared more than 4 times to 4.4 mln. tonnes in 1H09 due to record-breaking harvest and cancellation of high export duties boosting revenues and margins, as grain is a high-yielding cargo.

*NCSP also enjoyed a more than 20-fold upsurge in iron ore turnover*

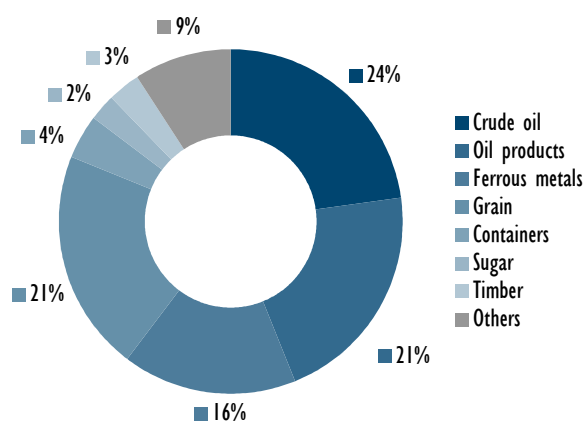
NCSP raised its grain exports thanks to its timely decision to invest over \$80 mln. over the last 2 years in the extension of NGT facilities, bringing terminal's throughput capacity close to 5 mln. tonnes. According to the company's management, NCSP still has potential to expand its grain facilities due to strong demand that is twice the capacity.

NCSP also enjoyed a more than 20-fold upsurge in iron ore turnover from 65K to over 1.6 mln. tones. It managed to timely adjust NLE facilities (primarily used for containers shipments and timber products) in order to cater the soaring demand from China as well as to pick up traffic from faltering Ukrainian ports.

Cargo turnover breakdown, 1H09



Transshipment revenue breakdown, 1H09



Source: Company's data, Gazprombank estimates

Source: Company's data, Gazprombank estimates

*The port's cement and timber shipments dropped sharply due to waning construction*

*Port's total container turnover was severely hit by ruble devaluation*

NCSP saw a moderate increase in other exported cargoes such as non-ferrous metals (+5.1% to 487K tonnes) and mineral fertilizes (+1.2% to 705K tonnes), while ferrous metal remained fairly resilient with only 3.9% drop to 4.4 mln. tonnes.

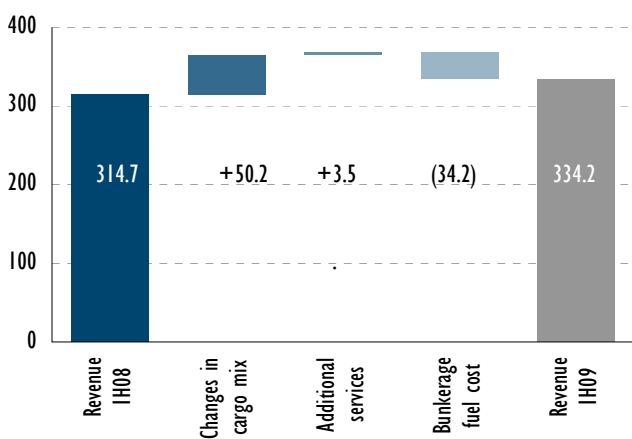
Though NCSP greatly benefited from upsurging grain and oil derivatives handling, the economic slowdown couldn't but affect its performance. The port's cement (-91% to 66K tonnes) and timber (-28% to 446K tonnes) shipments dropped sharply due to waning construction.

The port's containers cater mostly fairly cheap Asian textiles, hence the experienced drop in container turnover was less severe than that of the other ports. Nevertheless, total turnover declined by 57% to 1.1 mln. tonnes in 1H09 as amid ruble devaluation import became no longer attractive (approx. 80% of NCSPs containers are used for imports). We expect container business to bounce back partially by the end of the year as economy and, consequently, consumer demand recovers.

All other categories remained virtually unaffected or even demonstrated some improvements.

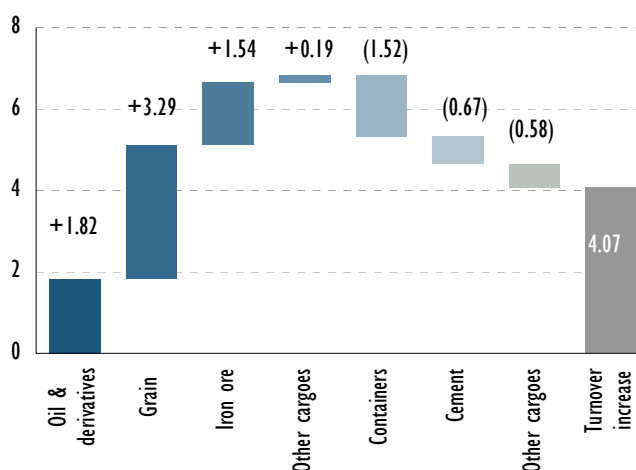
Below are the charts mirroring the major contributors to revenue and traffic increases in 1H09.

Revenue development, \$ mln., 1H08/1H09



Source: Company's data, Gazprombank estimates

Cargo traffic development, mln. tonnes, 1H08/1H09



Source: Company's data, Gazprombank estimates

*Highly congested Bosphorus Strait that could limit effective capacity of oil pipelines to Novorossiysk*

### Potential risks

We would like to highlight several factors, potentially jeopardizing NCSP operating performance in the long run.

A major negative potentially affecting NCSP's oil shipments is highly congested Bosphorus Strait that could limit effective capacity of oil pipelines to Novorossiysk. Oil transshipment through the Turkish straits (Bosphorus and the Dardanelles) has been growing at exponential rate over the last 15 years. Nearly 60 mln. tones of oil were shipped through the straits in 1996. Oil turnover almost reached 90 mln. tonnes in 2000 and exceeded 134 mln. tonnes in 2004. The U.S. Energy Information Administration predicts oil transshipments through the Bosphorus Strait to reach 3.8 million bbl/d (~200 mln. tonnes per year) over the next several years, which is well above the coke-point limit of 120 mln. tonnes considered by Turks.

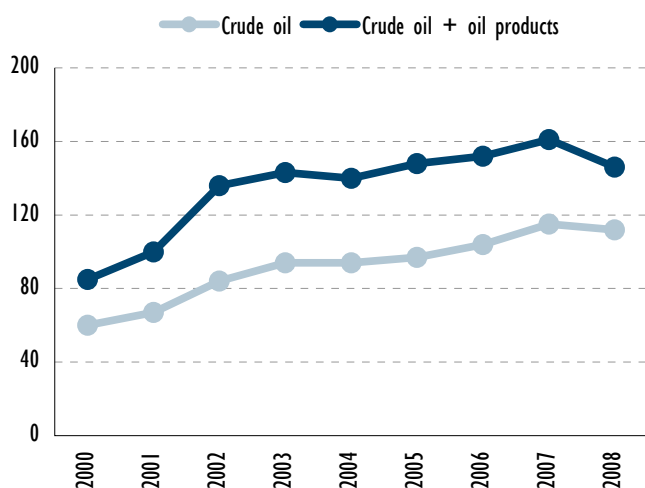
In early 2000s Turkey placed restrictions (especially a ban on nighttime transit for ships longer than 200 meters) for environmental and safety reasons following the accident with the oil tanker Nassia, hampering and slowing down tanker transits.

In our view, the Strait will not be able accommodate any extra tankers, for instance, if exploration of Caspian greenfields commences in the near future. As Russian oil companies get fully engaged and the Caspian Pipeline Consortium (CPC) rolls out full-fledged oil transportations from Kazakhstan to the Black Sea, the tanker traffic is most likely to get paralyzed. Hence, we see Bosphorus throughput capacity as a natural barrier for NCSP oil transshipment increase.

*On the other hand, commissioning of the BAP might trigger NCSP's oil/oil derivatives transshipment increase*

On the other hand, forthcoming Bosphorus congestion is likely to necessitate construction of Burgas-Alexandroupolis pipeline (BAP) designed to connect the Black and the Adriatic seas through Bulgaria and Greece. BAP (if completed) will ease the pressure on the Turkish straits, as total throughput capacity of the project is estimated at 35 mln. tonnes (with potential to expand to 50 mln. tones). Commissioning of the BAP might trigger NCSP's oil/oil derivatives transshipment increase.

**Bosphorus Strait transit in both directions, mln. tonnes**



**Burgas-Alexandroupolis pipeline**



Source: EIA, Gazprombank estimates

Source: Hellenic Petroleum

*NCSP turnover became increasingly susceptible to grain volumes and, consequently, to crop yields*

NCSP turnover became increasingly susceptible to grain volumes handled (over 20% in total revenues/10% of shipments) and, consequently, to crop yields. With last year's crop yield at over 100 mln. tonnes Russia returned to world's top league of grain producers and exporters after US, Canada and EC.

According to the Ministry of Agriculture (MoA), this year's yield is expected to surpass 90 mln. tonnes (well above the last 10-year average), which would suffice to meet domestic demand (estimated at 77 mln. tonnes) and leaves room for exporting.

According to the MoA, 20 mln. tonnes of grain will be exported in 2009/10 (compared to 12.6 mln. tonnes in 2008/2009). Grain export is expected to reach 50 mln. tonnes in the next 8 to 10 years.

Almost half of grain is exported via Novorossiysk, hence the demand for the port's grain capacities is expected to reflect yields.

**Financial profile**

*NCSP is subject to state tariff regulation (tariffs for regulated services are set in dollars), which historically provided adequate cost recovery but lacked some transparency*

NCSP is subject to state tariff regulation, which historically provided adequate cost recovery but lacked some transparency. About 3/4 of services provided by NCSP are the so-called regulated services (stevedoring, storage, etc.) and set by FTA (Federal Tariff Authority).

Tariffs for regulated services are set in dollars and NCSP periodically applies for tariff hikes (tariffs were last increased in June 2008). Almost all requests were approved by the regulator.

*Unregulated services are set both in rubles and dollars. NCSP is flexible in adjusting these services*

Unregulated services (tug and towing, bunkerage, forwarding, repackaging, custom documentation, etc.) are set both in rubles and dollars. NCSP is flexible in adjusting these services in order to minimize devaluation side effects and capture maximum producer's surplus given monopolistic position in the region.

Formerly, when NCSP didn't control all stevedoring companies in Novorossiysk the company applied discounts to regulated services to win the market. Over the years through multiple M&As NCSP has grown to a monopoly operating in competition-free environment. In 2007 NCSP started gradually raising its tariffs reaching the cap set by the regulator. Through tariff hikes it added \$56 mln. to revenues in 2007 and \$38 mln. in 2008.

*Bulk of 2008 and 1H09 revenue growth was attributed to VAS*

Bulk of 2008 and 1H09 revenue growth was attributed to VAS (navigation, tug and towing, freight forwarding, etc.), adding another \$54.8 and \$3.5 mln. to company's top-line, respectively.

Declining bunkering price affected the company's revenues. NCSP purchases diesel and fuel to refill marine vessels. The company generates a constant mark-up (app. 10–12%) on resale of oil derivatives, therefore, global crude price drop though reduced consolidated revenues, but at the same time improved overall margins.

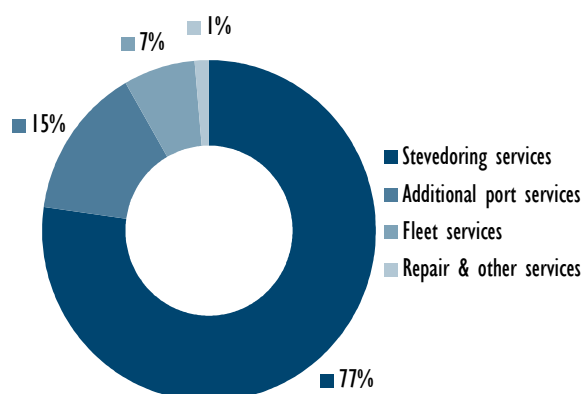
NCSP continued cost cutting in 1H09 by, among other measures, reducing its headcount by another 400 employees, lowering its maintenance and SG&A expenses.

However, the major factor of lower costs was ruble devaluation, as company's cost structure is almost 100% ruble-driven. As of 1H09 NCSP's EBITDA margin stood at impressive 70% and NI margin reached 39%. To our view, EBITDA margin might come off in the future, while 60% level is sustainable in the long run.

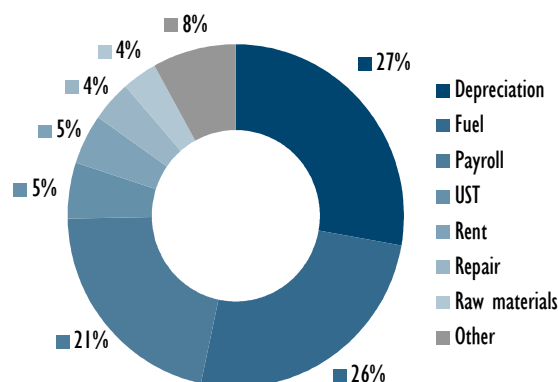
NCSP has outstanding cash management. NCSP's receivables have always been small as cash is mostly collected couple of days before the service is rendered. For example, oil shipment bills are paid 3–5 days prior to the date of service.

*Declining bunkering price, headcount reduction and ruble devaluation effect were the major factors of lower costs in 1H09*

Revenue structure, 1H09



Cost structure, 1H09



Source: Company's data, Gazprombank estimates

Source: Company's data, Gazprombank estimates

Key negatives for the company's financials:

*NCSP is exposed to revision of leasehold agreements and currency risk*

- ▶ **Leasehold agreements** for its core assets as most infrastructural objects within the seaport are state-owned and currently leased to NCSP on preferential terms. The leasehold agreements expiration ranges from 5 to as long as 50 years. We stress that revision of the leases, though highly unlikely according to the management, might affect the company's financials and depress its margins.
- ▶ **Currency risk exposure.** The company is highly exposed to the currency risk due to its cost/revenue structure. Though it doesn't use currency hedging to secure its revenue streams it takes advantage of a "natural" hedge, i.e. dollar-denominated debt and revenues. There is also room for currency risk mitigation through rates increase on non-regulated services.

### CAPEX

NCSP is engaged in a capital investment program. Its project pipeline includes expansion and renovation of existing and construction of new facilities.

*NCSP invested over \$340 mln. in stevedore capacities during 2006-2008*

NCSP invested over \$340 mln. in stevedore capacities during 2006-2008. Major projects included commissioning of new grain (~5 mln. tonnes), container (350K TEU), bunkering (648K tonnes), timber products (3 mln. m<sup>3</sup>), oil products (1 mln. tonnes) terminals and completion of the first stage of the BSC extension (100K TEU).

*In late 2008 NCSP halted almost all projects amid unfolding crisis and lack of demand for new capacities.*

In late 2008 NCSP halted almost all projects amid unfolding crisis and lack of demand for new capacities. The port has frozen the container terminal and fertilizer cargo complex expansion and cut Sheshkaris financing.

NCSP has reduced its CAPEX by almost 60% to \$12.9 mln. (tug & towing fleet acquisitions) in 1H09. According to the management, the company doesn't plan any significant expenditures till the year-end.

*Two projects are at designing stage: fuel oil terminal (4 mln. tonnes) and a 1.2 mln. TEU container terminal*

*NCSP's CAPEX will be internally funded.*

*Debt is not an issue for NCSP with over \$ 270 mln. in cash and short-term deposits (as of 1H09)*

As economy starts to improve, NCSP is looking to unlock its investment potential and is currently engaged in preparing drafts and doing paperwork for two projects: fuel oil terminal (4 mln. tonnes) and a 1.2 mln. TEU container terminal. The former project is estimated at around \$100 mln. and NCSP has entered into a 50/50 JV with Gunvor (the largest Russian oil products trader controlled by Gennady Timchenko).

The latter project is also at the designing stage with construction of new berths and inland container terminal in Novorossiysk under its scope.

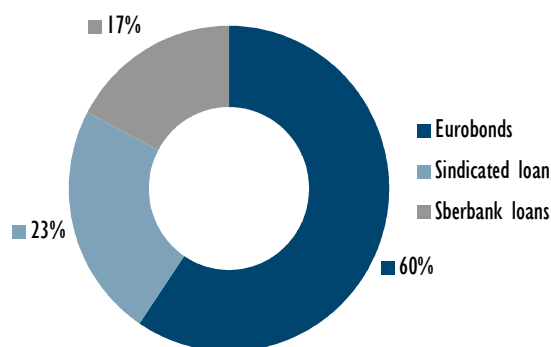
NCSP gradually upgrades its tug and tow (T&T) marine vessels. This year the company purchased four new tugboats either already built or near completion. Investments into T&T segment amounted to EUR 25 mln. and are internally funded. The first tugboat will arrive in the nearest future; other tugboats will add to company's fleet next year.

NCSP management particularly stressed several times that its future CAPEX will be internally funded. We believe ongoing investment program will contribute to further cargo diversification mitigating growing pressure from competitors and help NCSP retain its margins.

### Debt

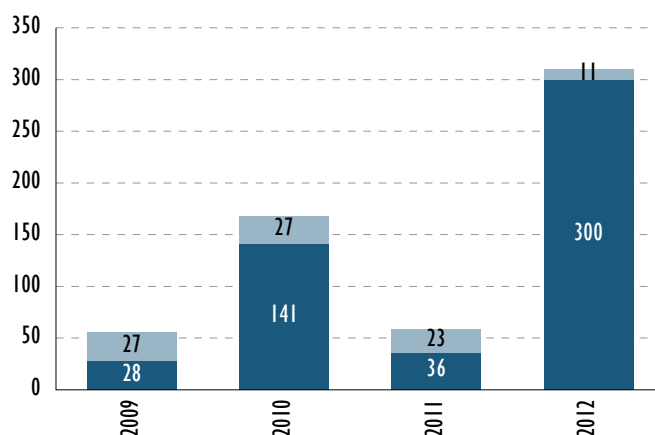
Debt is not an issue for NCSP. Significant free cash flow generation allowed the company to hoard over \$270 mln. in cash and short-term deposits (as of 1H09) and we expect this number to exceed \$350 mln. by the end of 2009. With the total \$480 mln. of debt outstanding only \$28 mln. are due in 2009 and \$140 mln. in 2010 (a floating-rate loan syndicated by Unicredit and several small fixed-rate loans from Sberbank). We don't see any imminent risk to NCSP's solvency taking into account its sound liquidity and refinancing possibilities.

Credit portfolio breakdown, 1H09



Source: Company's data, Gazprombank estimates

Debt redemption schedule, \$ mln.



Source: Company's Data, Gazprombank estimates

*NCSP's organic growth is conditional on tariff increase, further development of cargo mix and new facilities commissioning*

*Growth drivers:*

*Adjustment of unregulated services*

### Triggers

NCSP is benefiting from its strategic location, supportive regulatory regime and moderate traffic volatility through the economic cycle. The company utilizes its capacity almost to the full implying that organic growth is conditional on tariff increase, further development of cargo mix and new facilities commissioning. Further improvements on the cost side are doubtful, given company's current profitability level.

As 3/4 of services are subject to FTA regulation and NCSP is already charging the maximum allowed by the regulator, the company doesn't have enough flexibility in changing its pricing and, thus, growing its revenues. However, it periodically applies for tariff revisions and almost all of them were approved. Average annual tariffs hikes are estimated at 5%. This year, however, it won't apply for tariff increase given significant ruble devaluation gains.

Below are several factors that could boost the company's revenue and value:

- ▶ **NCSP is more flexible with unregulated services.** Thus company could adjust its unregulated services to capture maximum producer's surplus given mo-

*Cargo mix improvements*

nopolistic position in the region

- ▶ **Improvements in cargo mix and switch towards higher marginal cargoes.** The company can ensure its growth by further adjustments of cargo mix (increasing share of high-margin cargoes) and development of existing and new facilities. The management adheres to reasonable and discreet CAPEX investing only in projects with estimated IRR of over 25%. Implemented projects and operating results of the company proved management's prudence to be efficient.

*Container segment*

- ▶ **Significant upside in container segment.** NCSP high bid on container turnover growth didn't work out this year, as this business was one of the weakest. Nevertheless, container segment has a huge upside potential as Russia is still far behind its global peers in terms of market saturation in this field. In 2008 global ratio of container-handled cargo to total cargo turnover reached 63%, while Russia's stood at modest 25%. Currently the company's container facilities are utilized by approx. 60% implying a wide room for future growth. Furthermore, CAPEX development focuses on, among other projects, construction of new berths and inland container terminal in Novorossiysk.

*M&A prospects outside Novorossiysk*

- ▶ **Stevedore acquisition opportunities outside Novorossiysk.** Until recently the only investment outside the Black Sea coastline was Baltiysk container terminal in Kaliningrad region. Given the company's accumulated cash of approx. \$300 mln., we believe NCSP could grow into a major M&A player. Though further M&As in the southern basin are quite limited, it may expand to the northwestern basin, abundant with attractive small and medium stevedores.

**M&A playground**

Location	Port	Cargo turnover, mln. tonnes	Standalone stevedores	Companies with turnover >2 mln. tonnes
Southern basin	Novorossiysk	-	-	-
NW basin	St. Petersburg	54	30	7
NW basin	Arkhangelsk	11	10	2
NW basin	Kaliningrad	19	18	3
NW basin	Murmansk	15	16	2
Far Eastern basin	Vostochnyi	21	9	2
Ukraine	Odessa	20	12	4

Source: Company's data, Gazprombank estimates

We see NCSP's competitive edge in its strategic location, dominance in Russia's seaborne traffic, resilience to economic environments and strong corporate governance. We also believe that company's growth prospects backed by continuous growth of Russian seaborne traffic, strong competitive position and superior profitability have not been fully priced in and its fundamental potential is yet to be appreciated by the market.

## Valuation

**Projections.** NCSP total cargo turnover reached 81.6 mln. tonnes last year. As of 9M09, NCSP carried 65.2 mln. tonnes demonstrating an 8.1% YoY increase. We believe that the growth will slow down by the end of the year due to declining crude oil and grain transshipments. We see total cargo turnover reaching 86 mln. tonnes in 2009 implying a 5.4% increase.

Our revenue forecast is based on development of 5 major types of cargo – oil, oil products, grain, metals and containers, comprising almost 90% of the company's total cargo turnover. Given that only 10% of NCSP's revenues are generated otherwise we scale them down to derive gross revenue from stevedoring activities.

To project cargo developments we use NCSP's CAPEX disclosure. As almost all stevedoring facilities operate close to full utilization (exp. containers), we stress that further cargo development is conditional upon facilities expansion. We believe the company will be able to retain its current utilization ratio in the long run.

The company's revenue development is impacted by tariff decisions. We forecast an average 5% tariff increase per annum (exp. 2008), which is reasonable given former tariff developments.

Revenue forecast for auxiliary services is progressively linked to the total cargo increase, as the ratio of auxiliary to stevedore services remained relatively stable over the last couple of years. Bunkerage revenues are derived from forecasted underlying price of diesel/fuel oil and the company's planned expansion of bunkerage premises.

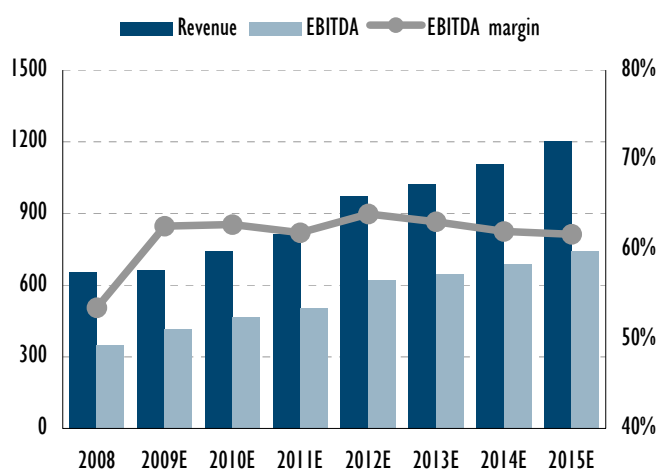
OPEX estimation is mainly based on the total turnover forecast and expected dollar inflation. We believe raw material supply and maintenance costs will remain relatively stable and grow in line with company's total turnover increase and expected dollar inflation. Fuel costs will be determined by global oil pricing and development of bunkerage segment.

We anticipate salary expenditures to grow faster than other costs. Nevertheless, future payroll growth might, in our view, be partially offset by gradual headcount reduction.

We link our depreciation forecast to a recent reassessment of the useful lives of certain fixed assets.

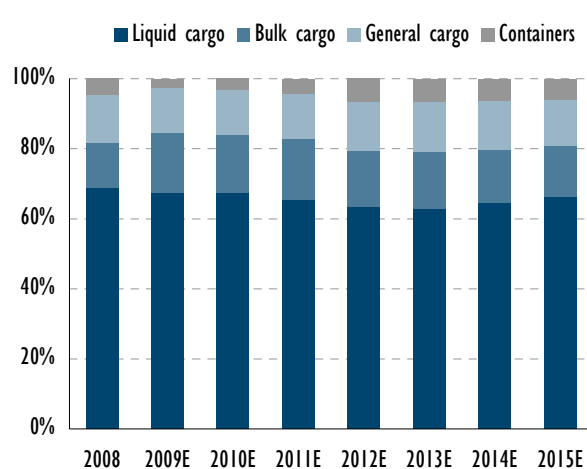
NCSP didn't disclose its actual CAPEX size for 2010. However, the company announced several prospective projects, which might be launched if market recovers. We forecast '09'CAPEX at around \$48 mln., to be primarily designated for new tug and towing vessels acquisitions. Subsequent investment expenditures are estimated at app. \$100 mln. annually.

Financial performance forecast, \$ mln.



Source: Company's data, Gazprombank estimates

Cargo development forecast



Source: Company's data, Gazprombank estimates

## DCF approach

We derive our NCSP target price based solely on DCF. We use relative valuation approach for testing purposes only.

Our DCF valuation is based on the company's financial model till 2015, pursuant to its IFRS statements. We've calculated NCSP target price using a 12.3% WACC. We used Russia's risk-free rate of 5.7%, representing a yield on Russian euro-bonds maturing in 2030. CDS on Russian sovereign debt was employed to assess country risk (3%). We assigned an equity risk premium of 5%, which we consider appropriate given the government affiliation and a stock status as a proxy for Russian transportation industry.

### WACC calculation

Risk-free rate	5.7%
Country risk premium	3.0%
Equity premium	5.0%
Beta	1.6
Cost of equity	18.5%
Debt premium	1.8%
Cost of debt	7.5%
Tax rate	20.0%
After tax cost of debt	6.0%
Target D/EV	50%
WACC	12.3%

Source: Bloomberg, Reuters, Gazprombank estimates

Our DCF approach shows NCSP's target price of \$14.5 per GDR.

### Consolidated financial model, \$ mln.

	2009E	2010E	2011E	2012E	2013E	2014E	2015E
EBITDA	415	466	503	621	645	687	742
Tax shield	-75	-79	-98	-127	-134	-142	-154
CAPEX	-49	-100	-100	-100	-100	-100	-100
Working Capital Changes	-11	-5	-5	-8	-11	-5	-10
Free Cash Flow (FCF)	281	282	300	386	401	440	478
Discounted Cash Flow (DCF)	0	251	238	273	252	247	239
WACC	12.3%						
Net Present Value (NPV)	1 500						
Terminal Growth Rate	2%						
Terminal Value	2 377						
Fair Value	3 878						
Net Debt	125						
Minority interest	27						
Equity Value	3 725						
# of shares, mln.	19 260						
Target price, \$	0.19						
GDR (75 shares) target price, \$	14.5						

Source: Gazprombank estimates

Our DCF model is sensitive to WACC and terminal growth rate.

### Sensitivity matrix

WACC	Terminal Growth Rate					
	1%	1.5%	2.0%	2.5%	3.0%	
11.3%	15.1	15.7	16.3	16.9	17.7	
11.8%	14.3	14.8	15.3	15.9	16.6	
12.3%	13.6	14.0	14.5	15.0	15.6	
12.8%	12.9	13.3	13.8	14.2	14.7	
13.3%	12.3	12.7	13.1	13.5	13.9	

Source: Gazprombank estimates

## Multiples-based valuation

To test our DCF valuation we use multiples-based approach.

### Multiples-based comparison

Company	MCap, \$ mln.	EV/EBITDA			P/E			P/S		
		2009E	2010E	2011E	2009E	2010E	2011E	2009E	2010E	2011E
NCSP	3 017	7.0	6.7	5.9	13.4	11.3	9.5	4.5	4.1	3.6
<b>Developed Markets Peers</b>										
Forth Ports	881	12.5	11.9	11.1	22.5	20.3	17.8	3.0	2.9	2.8
Port of Tauranga	699	14.8	12.8	12.0	23.7	19.9	18.4	2.4	6.1	5.8
Piraeus Port Authority	637	13.2	8.7	N/A	18.9	28.6	N/A	2.8	2.9	N/A
Asciano Group	4 366	15.5	12.5	10.4	154.9	25.7	18.1	1.8	1.6	1.4
Lyttelton Port Company	195	10.9	10.6	10.0	25.8	24.8	21.8	3.3	3.0	2.9
HHFA	2 972	8.6	7.2	6.2	33.4	21.9	17.1	2.0	1.9	1.7
Average		12.6	10.6	9.9	46.5	23.5	18.7	2.6	3.1	2.9
<i>NCSP(discount) premium to avg.</i>		<i>-44%</i>	<i>-37%</i>	<i>-40%</i>	<i>-71%</i>	<i>-52%</i>	<i>-49%</i>	<i>75%</i>	<i>32%</i>	<i>25%</i>
<b>Emerging Markets Peers</b>										
Tianjin Port	692	N/A	N/A	N/A	90.6	15.9	12.0	4.35	4.12	3.91
DP World	7 719	12.4	11.2	9.6	24.8	19.7	14.6	2.72	2.47	2.19
Cosco Pacific	3 240	18.7	16.9	15.8	13.0	14.9	13.4	9.86	8.25	7.57
Shanghai Int. Port Group	17 126	18.2	16.0	14.5	31.7	28.7	23.5	7.10	6.49	6.07
Int. Container Term Services	830	7.6	7.1	6.8	16.6	14.6	14.1	2.13	2.00	1.78
China Intern. Marine Cont.	3 578	15.5	12.6	9.3	23.5	23.8	17.4	1.24	0.87	0.65
Average		14.5	12.8	11.2	21.9	20.3	16.6	4.6	4.0	3.7
<i>NCSP(discount) premium to avg</i>		<i>-25%</i>	<i>-27%</i>	<i>-36%</i>	<i>-39%</i>	<i>-44%</i>	<i>-43%</i>	<i>-3%</i>	<i>2%</i>	<i>0%</i>

Source: Bloomberg, Reuters, Gazprombank estimates

To estimate NCSP value we use industry average EV/EBITDA and P/E multiples for 2010E and 2011E. We also use our projections for NCSP's EBITDA and earnings. We apply higher weighting to EV/EBITDA multiples over P/E as, to our view, the former focuses on regular operating activities.

### Relative valuation approach

	EV/EBITDA2010	EV/EBITDA2011	P/E2010	P/E2011	Target
Net income, \$ mln.			280.4	347.3	
EBITDA, \$ mln.	466.2	502.9			
Average multiple	11.7	10.6	21.9	17.7	
Emerging markets	12.8	11.2	20.3	16.6	
Developed markets	10.6	9.9	23.5	18.7	
EV, \$ mln.	5 454	5 306			
Net debt, \$ mln.	185.2	185.2			
Minority interest, \$ mln.	27.4	27.4			
Market Cap, \$ mln.	5 242	5 093	5 423	5 569	
GDR target, \$ mln.	20.4	19.8	21.1	21.7	20.4
Weightings	40%	40%	10%	10%	100%

Source: Bloomberg, Reuters, Gazprombank estimates

Based on relative valuation we estimate NCSP target price at \$20.4 per GDR, which supports our view that NCSP stocks are significantly undervalued. However, we use relative valuation for testing purposes only.

We use DCF approach to set \$14.5 target price per GDR and assign a BUY rating to NCSP Group implying 31% upside to the current price level.

## Appendices

### Financial Model

	2008	2009E	2010E	2011E	2012E	2013E	2014E	2015E
<b>ASSETS</b>	1 206	1 405	1 503	1 768	1 854	2 260	2 691	3 158
Non-current assets	1 010	992	1 029	1 066	1 104	1 141	1 178	1 214
PPE	576	558	595	632	670	708	745	781
Goodwill	406	406	406	406	406	406	406	406
Mooring rights	11	11	11	11	11	11	11	11
Other non-current assets	17	17	17	17	17	17	17	17
Current assets	196	413	474	702	751	1 118	1 513	1 943
Inventories	6	7	8	9	10	10	11	12
Trade and other receivables	30	40	45	49	58	61	66	72
VAT recoverable and other taxes receivable	29	13	15	16	19	20	22	24
Investments in securities	86	286	286	350	350	350	350	350
Other current assets	2	0	0	0	0	0	0	0
Cash and cash equivalents	43	66	121	278	313	676	1 063	1 485
<b>LIABILITIES AND EQUITIES</b>	1 206	1 405	1 503	1 768	1 854	2 260	2 691	3 158
Equity	615	841	1 080	1 375	1 757	2 160	2 588	3 052
Share capital	10	10	10	10	10	10	10	10
Share premium	9	9	9	9	9	9	9	9
Foreign currency translation reserve	-38	-32	-74	-76	-76	-76	-76	-76
Retained earnings	606	820	1 094	1 383	1 755	2 147	2 563	3 014
Equity attributable to shareholders	588	808	1 040	1 327	1 699	2 091	2 507	2 958
Minority interest	27	33	40	48	58	69	81	94
Non-current liabilities	512	527	387	351	53	55	57	59
Long-term debt	463	477	336	300	0	0	0	0
Defined benefit obligation	8	8	9	10	12	13	16	17
Deferred tax liabilities	41	41	41	41	41	41	41	41
Current liabilities	79	37	37	42	44	45	46	48
Current portion of long-term debt	42	0	0	0	0	0	0	0
Trade and other payables	7	7	7	12	15	15	17	18
Other current liabilities	30	30	30	30	30	30	30	30

Source: Company's data, Gazprombank estimates

	2008	2009E	2010E	2011E	2012E	2013E	2014E	2015E
<b>PROFIT AND LOSS</b>								
Revenue	654	664	743	813	972	1 023	1 108	1 203
Stevedoring services	506	512	512	575	627	748	784	850
Additional port services	87	96	108	118	141	148	160	173
Fleet services	51	47	52	60	75	82	89	101
Ship repair services	1	0	0	0	0	0	0	0
Other	9	8	7	8	9	9	9	9
Cost of services	-342	-245	-265	-291	-322	-341	-375	-406
Gross profit	312	419	478	522	650	682	733	796
Operating profit	234	353	406	444	563	587	628	682
Interest income on deposits	5	9	23	25	25	21	18	18
Finance costs	-40	-27	-27	-23	-11	0	0	0
Foreign exchange (loss)/gain	-83	6	-43	-2	0	0	0	0
Other income/(expenses), net	4	0	0	0	0	0	0	0
Profit before income tax	121	341	360	445	577	608	645	699
Income tax	-25	-75	-79	-98	-127	-134	-142	-154
Profit for the year	96	266	280	347	450	474	503	545

Source: Company's data, Gazprombank estimates

<b>CASH FLOW STATEMENT</b>	<b>2008</b>	<b>2009E</b>	<b>2010E</b>	<b>2011E</b>	<b>2012E</b>	<b>2013E</b>	<b>2014E</b>	<b>2015E</b>
Profit for the year	96	266	280	347	450	474	503	545
Cash from operations before working capital	376	420	471	508	627	651	693	747
Cash from operationing activities	374	427	464	507	615	647	686	740
Net Cash flow from operating activities:	275	325	358	386	478	513	544	587
Cash flow from investing activities:	-242	-240	-77	-139	-76	-79	-83	-83
Cash flow from financing activities:	-47	-68	-183	-88	-368	-71	-75	-82
Net increase in cash and cash equivalents	-13	17	97	159	35	363	386	422
Cash at the beginning of the year	67	43	66	121	278	313	676	1 063
Effect of exchange rate change	-11	6	-43	-2	0	0	0	0
Cash at the end of the year	43	66	121	278	313	676	1 063	1 485

Source: Company's data, Gazprombank estimates

## Gazprombank

HQ: 16/1 Nametkina str., Moscow 117420, Russia  
(Office: 63 Novocheremushkinskaya St.)

### Research Department

**Andrei Bogdanov**  
Head of Research

+7 (495) 988 23 44

#### Equity/Fixed Income Strategy

**Andrei Bogdanov**  
**Artem Arkhipov**  
**Anna Bogdyukevich**

+7 (495) 988 23 44

[Andrei.Bogdanov@gazprombank.ru](mailto:Andrei.Bogdanov@gazprombank.ru)

+7 (495) 980 41 82

[Artem.Arkhipov@gazprombank.ru](mailto:Artem.Arkhipov@gazprombank.ru)

+7 (495) 983 18 00 ext. 54085

[Anna.Bogdyukevich@gazprombank.ru](mailto:Anna.Bogdyukevich@gazprombank.ru)

#### Metals & Mining

**Sergei Kanin**

+7 (495) 988 24 06

[Sergei.Kanin@gazprombank.ru](mailto:Sergei.Kanin@gazprombank.ru)

#### Transportation & Manufacturing

**Aleksei Astapov**

+7 (495) 428 49 33

[Aleksei.Astapov@gazprombank.ru](mailto:Aleksei.Astapov@gazprombank.ru)

#### Oil & Gas, Electric Utilities

**Ivan Khromushin**  
**Dmitry Kotlyarov**

+7 (495) 980 43 89

[Ivan.Khromushin@gazprombank.ru](mailto:Ivan.Khromushin@gazprombank.ru)

+7 (495) 913 78 26

[Dmitry.Kotlyarov@gazprombank.ru](mailto:Dmitry.Kotlyarov@gazprombank.ru)

#### Telecom & Media

**Andrei Bogdanov**  
**Anna Kurbatova**

+7 (495) 988 23 44

[Andrei.Bogdanov@gazprombank.ru](mailto:Andrei.Bogdanov@gazprombank.ru)

+7 (495) 913 7885

[Anna.Kurbatova@gazprombank.ru](mailto:Anna.Kurbatova@gazprombank.ru)

#### Fixed Income

**Artem Arkhipov**  
**Yakov Yakovlev**

+7 (495) 980 41 82

[Artem.Arkhipov@gazprombank.ru](mailto:Artem.Arkhipov@gazprombank.ru)

+7 (495) 988 24 92

[Yakov.Yakovlev@gazprombank.ru](mailto:Yakov.Yakovlev@gazprombank.ru)

#### Macroeconomics & Banking

**Artem Arkhipov**  
**Anna Bogdyukevich**

+7 (495) 980 41 82

[Artem.Arkhipov@gazprombank.ru](mailto:Artem.Arkhipov@gazprombank.ru)

+7 (495) 983 18 00 ext. 54085

[Anna.Bogdyukevich@gazprombank.ru](mailto:Anna.Bogdyukevich@gazprombank.ru)

#### FMCG & Retail

**Rustam Shikhakhmedov**

+7 (495) 428 50 69

[Rustam.Shikhakhmedov@gazprombank.ru](mailto:Rustam.Shikhakhmedov@gazprombank.ru)

#### Editor/Translator

**Tatiana Kumosenko**

+7 (495) 983 18 00 ext. 54084

[Tatiana.Kumosenko@gazprombank.ru](mailto:Tatiana.Kumosenko@gazprombank.ru)

**Julia Melnikova**

+7 (495) 983 18 37

[Julia.Melnikova@gazprombank.ru](mailto:Julia.Melnikova@gazprombank.ru)

## Debt Product Department

**Pavel Isaev**

Senior DCM Manager

+7 (495) 980 41 34

[Pavel.Isaev@gazprombank.ru](mailto:Pavel.Isaev@gazprombank.ru)

#### Debt Capital Markets

**Igor Eshkov**

Head of DCM, Executive Director

+7 (495) 429 96 44

[Igor.Eshkov@gazprombank.ru](mailto:Igor.Eshkov@gazprombank.ru)

#### Fixed Income Sales and Trading

**Andrei Mironov**

Head of FI S&T, Executive Director

+7 (495) 428 2366

[Andrei.Mironov@gazprombank.ru](mailto:Andrei.Mironov@gazprombank.ru)

#### Sales

**Dmitry Kuznetsov**

+7 (495) 428 49 80

[kuzd@gazprombank.ru](mailto:kuzd@gazprombank.ru)

**Ilya Remizov**

+7 (495) 983 18 80

[Ilya.Remizov@gazprombank.ru](mailto:Ilya.Remizov@gazprombank.ru)

**Sergey Yablonskiy**

+7 (495) 719 17 74

[sy@gazprombank.ru](mailto:sy@gazprombank.ru)

## Equity Product Department

**Maxim Shashenkov**

Head of Equity

+7 (495) 988 23 24

[Maxim.Shashenkov@gazprombank.ru](mailto:Maxim.Shashenkov@gazprombank.ru)

#### Equity Sales and Trading

**Sales**

**Konstantin Shapsharov**

Director

+7 (495) 983 18 11

[Konstantin.Shapsharov@gazprombank.ru](mailto:Konstantin.Shapsharov@gazprombank.ru)

**Evgeniy Tereschenko**

+7 (495) 428 49 80

[Evgeniy.Tereschenko@gazprombank.ru](mailto:Evgeniy.Tereschenko@gazprombank.ru)

**Maria Bratchikova**

+7 (495) 988 24 03

[Maria.Bratchikova@gazprombank.ru](mailto:Maria.Bratchikova@gazprombank.ru)

#### Equity Capital Markets

**Andrey Chicherin**

+7 (495) 983 19 14

[Andrey.Chicherin@gazprombank.ru](mailto:Andrey.Chicherin@gazprombank.ru)

#### Online Brokerage

**Andrey Blokhin**

+7 (495) 983 17 28

[Andrey.Blokhin@gazprombank.ru](mailto:Andrey.Blokhin@gazprombank.ru)

#### Trading

**Valeriy Levit**

Director

+7 (495) 988-24-11

Va-

[leriy.Levit@gazprombank.ru](mailto:leriy.Levit@gazprombank.ru)

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