SOVLINK
YOUR FIRST CALL – FOR THE SECOND TIER

May 26, 2006

Uralelectromed

COMPANY NOTE

BUY

UPSIDE: 76 %

Target Price: US$216

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STOCK DATA

Ticker	uelm	MCap (US$ mn)	623
Shares Ords	5,071,415	Free Float, %	12
Shares Pref	-	Free Float (US$ mn)	75
Bid Ords (US$)	125	Offer Ords (US$)	130
Bid Prefs (US$)	-	Offer Prefs (US$)	-

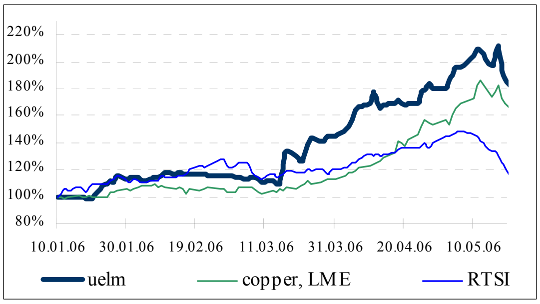
MARKET PERFOMANCE

		1 month	6 months
Absolute	Ords	8%	73%
	Prefs	-	-
Relative to RTSI	Ords	25%	26%
	Prefs	-	-
Price range (US$)			
High	Ords	150	150
Low		120.1	69.5
High	Prefs	-	-
Low		-	-

PERFORMANCE 2005

Sales (US$ mn)	400	P/S	1.56
EBITDA(US$ mn)	102	EV/EBITDA	6.96
Net Income (US$ mn)	47	P/E	13.23

UELM RELATIVE PERFOMANCE



Source: RTS, LME, Sovlink Securities

RIDING THE COPPER RALLY WAVE

• The amazing growth seen in the global non-ferrous metals market (the copper price has risen almost 90% year-to-date) surpassed even the most courageous analyst expectations and created a favorable background for Russian non-ferrous metals producers. Uralelectromed is the second-largest copper producer in Russia after Norilsk Nickel. It exports more than 70% of its copper and is a beneficiary of the current market situation. Despite the substantial increase in share prices since the beginning of the year (the company's share price is strongly correlated with copper prices—see the chart below) we believe that Uralelectromed shares still have considerable upside—76%.

• Rumors of a sale of a stake in UGMK (Ural Mining and Metallurgical Company, Uralelectomed's parent company) to a strategic investor—for example Norilsk Nickel—create a positive background for the shares of UGMK's daughter companies. In this report we present a detailed argument for the possible sale of UGMK's copper assets to Norilsk Nickel.

• Giving the current copper prices ($8,420/ton on May 24, 86% growth since the beginning of the year), we consider the current moment to be particularly favorable for buying shares in Uralelectromed. The company increased its financial results substantially in 1Q06: revenues doubled and net profit tripled year-on-year. The average copper price in 1Q06 was $4,944/ton before rising to $7,086/ton in April-May. We believe Uralelectromed will probably show impressive revenue and net profit growth in 2Q06, both quarter-on-quarter and year-on-year.

• We value Uralelectromed by comparing it to the multiples of foreign peers and Norilsk Nickel. Our aggregate estimate suggests a fair value market capitalization of $1,094 mn or $215.7 per share, which implies 76% potential upside.

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ALJBA ALLIANCE

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Selling a stake to Norilsk Nickel: is it for real?

• We believe that the rumors of the sale of a stake in UGMK to a strategic investor are well-founded and believe that Norilsk Nickel, for example, could play the role of such an investor. Here we give a detailed argument for the probability of such a transaction.

• We regard the recent development of events surrounding the Udokanskoe field as one of the main supports for our idea. Since the beginning of 2006, Uralelectromed's raw materials supply problem has been actively discussed. UGMK was regarded as the main candidate for winning the auction of the Udokanskoe field, which is the largest copper field in Russia, with reserves of 20 mn tons.

• However, being a strategic object, we believe that the Udokanskoe field might be a powerful means of establishing government control over non-ferrous metallurgy in Russia. For example, we see the possibility that an agreement to develop the field between a non-ferrous metal company and the government could be reached with the clause to sell a stake in the company to the government. Although such a transaction could be made directly with Uralelectromed, we see another scenario as more likely.

• Recently it was announced that Norilsk Nickel and the world's second-largest metal & mining company Rio Tinto would create a joint-venture to conduct geological surveys on different fields, including Udokanskoe. Thus, Norilsk Nickel is showing serious intentions to develop the Udokanskoe field. At the same time, if Norilsk Nickel manages to receive access to the development of this field, its revenues structure will change significantly. Copper's share in Norilsk Nickel's revenues is currently 20%, but with the beginning of the development of the field's abundant supplies, we believe this share could rise to 40% or even 50%.

• Looking at this, Norilsk Nickel's purchase of UGMK's copper-producing facilities or even a stake in UGMK itself seems to be logical. Further, UGMK selling its copper-producing facilities seems to be even more logical, since the company will face a lack of resources in the near future. We note that rumors about Norilsk Nickel selling a stake to the government have been circulating for quite some time.

• We see a UGMK-Norilsk Nickel-Government scenario as the most likely, and in our opinion, this possibility is a positive factor for Uralelectromed's share price.

• In this scenario, we believe Norilsk Nickel will buy UGMK's copper facilities and thus receive permission to develop the Udokanskoe field. In exchange, the government will purchase a substantial stake in Norilsk Nickel from its current core shareholders and pursue a "smooth deprivatization," as with Sibneft.

• We believe this will also contribute to an increase in transparency at UGMK's daughter companies and to boost their corporate governance standards.

Raw materials sources

• Uralelectromed currently receives its copper raw materials (sulfur-copper ore) from firms that are included in the UGMK group—Uchalinsky GOK, Urupsky GOK and Gaisky GOK. Reserves are at a low level—today's reserves will only be enough for the next 12–15 years. For example, Norilsk Nickel has reserves sufficient for at least 30 years. Thus, the company's main problem is its poor raw materials base.

• Until recently UGMK was considered one of the main contenders to win the auction for the Udokanskoe field, which is the largest copper field in Russia (with reserves of 20 mn tons). However, towards the end of 2005 UGMK representatives made several statements suggesting Chinese companies would be the favorites if the auction took place, and UGMK would be unlikely to win.

• We believe the company's plan to construct a subterranean mine at the Safyanovskoe field further confirms management's doubts about winning the auction (the Safyanovskoe field is Uralelectromed's main resource base and it is an open-pit mine). Thus, it looks as if UGMK has given up its place in the Udokanskoe field competition to Norilsk Nickel.

Development strategy.

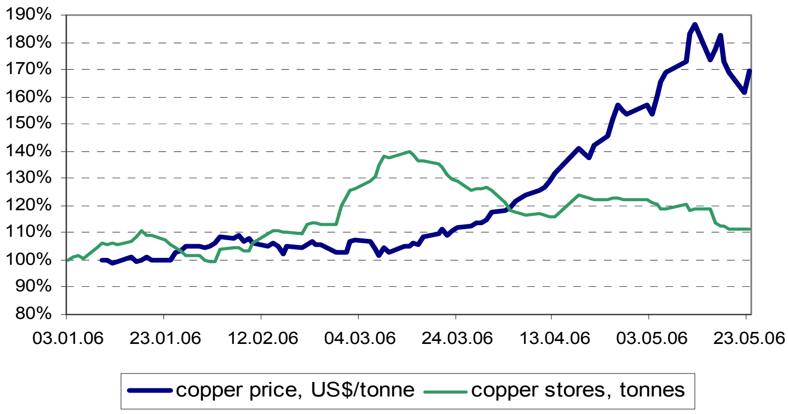
• Uralelectromed's management pursues a consistent policy of increasing production capacity. In April, the company announced that it had signed a contract with the Finnish company OutKumpo, which is going to take part in a project to increase cathode copper production from 352,600 tons per year to 450,000 tons per year. These actions do not contradict our assumption about selling a part of the business to Norilsk Nickel, as the latter will face a substantial lack of manufacturing assets if it wins the Udokanskoe field auction.

• Given the high copper price environment, the reinvestment of super-profits in the production process seems to be the best strategy for non-ferrous metal producers' development. Increasing its raw materials sources and the reconstruction of existing facilities are Uralelectromed's main investment directions. UGMK plans to invest €100 mn in the construction of the first line at Uralelectromed's new cell plant. This project will allow the company to increase its cathode copper output by 150,000 tons and raise Uralelectromed's capacity to 450,000 tons per year. These factors combine to create a positive background for the company's long-term prospects.

• That management has taken the first steps in the direction of increasing transparency also create a long-term positive setting for the company.

World copper market prospects

• The beginning of 2006 saw a dizzying price rally in copper due to the Chinese government's announcement about the creation of strategic reserves of several non-ferrous metals, including copper and zinc. Following this, several international hedge funds turned their attention to these metals. This inflow of money from large investment funds led to copper and zinc prices increasing c90%.



Source: LME, Sovlink estimates

• If we look at diagram of the percent change in the LME's copper store and in copper prices, we can see a clear inverse relationship between these activities. The lowest prices coincided with the maximum volume of LME stores since April 19. This underlines players' fear of a deficit on the copper market.

• Global consumption exceeding production remains the main fundamental factor encouraging the metals market. Markets were strained in 2005 because of strikes at the Chilean state-owned company Codelco. As a result, copper became a scarce metal. Also, Chinese demand remains an important factor. Despite increasing production in 10 metals by 18.4% to 16.32 mn tons, Chinese metallurgists did not manage to meet high internal demand for non-ferrous metals. The import of metals to China caused a correction in metal prices on world markets. The Chinese purchase of metals—including copper—for reserves remains a supporting factor for current price levels. At the same time, China is actively developing an ambitious program of creating production facilities for copper processing in order to lower the import of this metal in favor of copper concentrated product. A decrease in Chinese demand looks to be the main negative factor for copper prices. We do not exclude that a market slowdown could take place even in 2H06 followed by a correction at the beginning of 2007.

Uralelectromed's 1Q06 financial results

• Taking into account current world copper prices ($8,420/ton on May 24, an 86% increase year-to-date) we regard the present situation as highly favorable for purchasing Uralelectromed shares or adding to existing positions. Since the company's financial results are based on the average price in the quarter, Uralelectromed will probably show impressive revenue and net profit growth in 2Q06.

• The average copper price on the LME reached $3,678/ton in 2005, while the average price in 1Q06 was $4,944/ton. At the same time, Uralelectromed's revenues rose nearly 100% year-on-year in 1Q06, while net profit rose over 300%.

Uralelectromed 1Q06 results

	1Q05	1Q06	% chg.
Sales, $ mn	74.5	147.2	98%
Net profit, $ mn	7.6	32.7	327%
Average LME copper price, $/ton	3,266	4,944	51%

Source: Company data, Sovlink estimates

• The average LME copper price in April-May was $7,068/ton, exceeding the 1Q06 average by 44%. As such, we expect the company to show even more impressive results in 2Q06. We consider the current situation favorable for buying Uralelectromed shares, as this has not been reflected in prices yet.

Uralelectromed full-year results

	2004	2005	% chg.
Sales, $ mn	234.9	400.4	70%
EBITDA, $ mn	49.7	102.3	106%
Net profit, $ mn	31.8	47.1	48%
EBITDA margin, %	21%	26%	
Net profit margin, %	14%	12%	

Sources: Company data, Sovlink estimates

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Valuation estimate

• We do not use a DCF model to value Uralelectromed, as parent company UGMK is the seller of the company's production and receives the profit, and we believe that transfer pricing schemes between Uralelectromed and UGMK are evident.

• For our valuation estimate we use the method of market comparisons, selecting the world's copper producing peers and adding Norilsk Nickel to this sample. We applied a weight for each multiple which we use in our fair value estimation. We believe that the use of smaller weights for profit-based multiples (P/E, EV/EBITDA) are well-grounded, because the usage of transfer pricing significantly disfigures true financial results.

Uralelectromed valuation comparison

Company	Country	P/S	P/E	P/BV	EV/EBITDA	EV/S
Phelps Dodge	USA	1.96	10.62	3.01	7.76	2.12
Norilsk Nickel	Russia	3.59	10.58	2.47	6.45	3.89
BHP-Billiton	UK-Australia	4.04	16.77	6.15	10.20	4.16
Freeport-McMoRAn Copper	USA	2.31	11.72	13.77	4.55	2.59
Southern Copper Corporation	USA	2.85	8.74	3.68	5.28	3.05
Dowa Mining	Japan	1.26	23.15	2.85	13.48	1.53
Inco Limited	Canada	2.56	16.59	2.31	9.12	3.17
average		**2.65**	**14.02**	**4.89**	**8.12**	**2.93**
Uralelectomed		**1.56**	**13.23**	**2.00**	**6.96**	**1.78**
upside potential, %		**71%**	**6%**	**144%**	**17%**	**65%**
weights for multiples		30%	10%	25%	10%	25%
					weighted upside	**76%**

Sources: Bloomberg, Factiva, Sovlink estimates

• Uralelectromed looks undervalued relative to its global peers according to all of the multiples we used in our valuation. We note that the company looks undervalued according to profit-based multiples even taking into account the usage of transfer pricing and the evident disparagement of financial results. We believe the company's real financial activities are significantly greater than its declared results, and imply lower P/E and EV/EBITDA multiples, which raises the attraction of Uralelectromed relative to its peers. However, in our analysis we do not think that "correcting" the company's financial results to "real ones" is necessary because we believe that the company made its first steps in the direction of increasing transparency and departing from transfer prices in 1Q06. We see upside potential of 76%, noting that it could be higher if transfer pricing ceased between Uralelectromed and UGMK.

• We receive an aggregated average fair value of Uralelectromed of $1,094 mn, or $215.7 per share, which implies potential upside of 76%. At the same time, we note once again that by ending the usage of transfer pricing and improving the company's transparency this could be even higher.

STOCK RATING POLICY

STRONG BUY:	Target price offers upside of over 100%; confidence level – high
STRONG BUY (SPEC):	Target price offers upside of over 100%; confidence level – low
BUY:	Target price offers upside of between 25% and 100%; confidence level – high
BUY (SPEC):	Target price offers upside of between 25% and 100%; confidence level – low
HOLD:	Target price offers upside of less than 25%
SELL:	Target price at or below current price levels

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