



# Elektrozinc

## COMPANY NOTE

**STRONG BUY**

**UPSIDE: 116 %**

**Target Price: \$246**

**A good time to buy**

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### STOCK DATA

Ticker	eltz	MCap (US\$ mn)	161
Shares Ords	1,404,308	Free Float, %	30
Shares Pref	-	Free Float (US\$ mn)	48
Bid Ords (US\$)	115	Offer Ords (US\$)	134
Bid Prefs (US\$)	-	Offer Prefs (US\$)	-

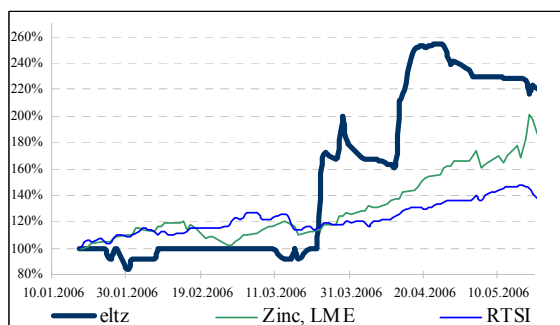
### MARKET PERFORMANCE

		1 month	6 months
Absolute	Ords	-6%	125%
	Prefs	-	-
Relative to RTSI	Ords	2.5%	55%
	Prefs	-	-
Price range (US\$)	High	138	153
	Low	125	50
	High	-	-
	Low	-	-

### PERFORMANCE 2005

Sales (US\$ mn)	103	P/S	1.54
EBITDA(US\$ mn)	20.2	EV/EBITDA	10.9
Net Income (US\$ mn)	7.3	P/E	21.7

### eltz RELATIVE PERFORMANCE



Source: RTS, Sovlink Securities

- The unprecedented growth seen in the global non-ferrous metal market—the zinc price has risen 92% year-to-date—has surpassed the most courageous analyst expectations and created a favorable background for Russian non-ferrous metal producers. UGMK (Ural Mining and Metallurgical Company) subsidiary Elektrozinc is the second-largest zinc producer in Russia after Chelyabinsk Zinc Plant and is a beneficiary of the current market situation. Despite a substantial share price increase since the beginning of the year (the company's share price is correlated with zinc prices—see the chart below) we believe that Elektrozinc shares still have considerable upside—116%.

- Elektrozinc's share price dynamic has shown spasmodic growth. At the present time, we see a slight decrease in the cost of the company's shares caused by the overall market correction. Nevertheless, global zinc prices have jumped again recently. We consider the current time to be a good opportunity for buying Elektrozinc shares, as we believe that the conditions exist for a new round of share price growth.

- The current zinc price (\$3,800/ton on May 29, 92% growth since the beginning of the year) suggests the substantial upside potential of Elektrozinc's share price. Elektrozinc noticeably increased its financial results in 1Q06: sales grew 88% year-on-year, while net profit increased nearly 700%. The average zinc price in April-May was \$2,957/ton, 30% above the average level of 1Q06. We believe Elektrozinc will probably show impressive revenue and net profit growth in 2Q06, both quarter-on-quarter and year-on-year.

- We value Elektrozinc by comparing it to the multiples of its foreign peers as well as its domestic competitor Chelyabinsk Zinc Plant. Our aggregate estimate suggests a fair value market capitalization of \$345 mn or \$246 per share, which implies 116% potential upside.

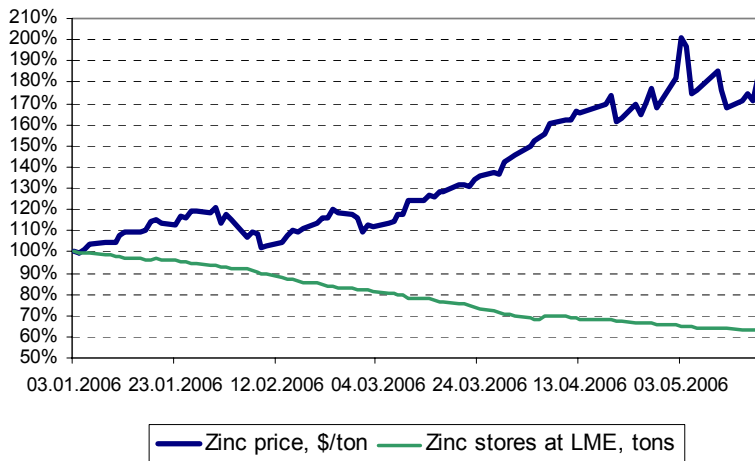


## World zinc market prospects

- Unprecedented price growth on the zinc market started at the beginning of this year, mostly due to significant money inflow related to the Chinese government's announcement of 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 by c90% year-to-date.

- However, the significant increase in zinc prices has less of a speculative reason than, for example, the case of copper. Global consumption exceeding production remains the main fundamental factor encouraging the metals market. Zinc is currently in more of a deficit than copper. At the beginning of May, the copper deficit was 200,000 tons, the highest level in 2006. Meanwhile, zinc production was in a 500,000-ton deficit at 11 mn tons of market volume demand (according to the International Lead and Zinc Study Group). There is no acute copper deficit on the world market, while world commodity stocks experience a significant lack of zinc, especially after August 2005's Hurricane Katrina, when a substantial part of world zinc stores was flooded in New Orleans.

### LME zinc prices and stores dynamics, % chg. year-to-date



Source: LME, Sovlink estimates

- If we look to LME store volume dynamics from the beginning of the year, we can easily find a clear bearish trend. The chart above plainly illustrates the existence of a zinc deficit. If this tendency remains, the psychological support line of \$4,000/ton may be crossed in June, 2006.

- Production facilities' lack of investment also remains one of the main reasons for the zinc deficit. There were no significant investments in this sector in the last 20 years, which is why metal producers did not manage to meet increasing demand, especially from the Chinese, whose zinc consumption rose by 40% in 2005 and now makes up a quarter of global demand.



- World zinc prices are less volatile than copper prices and they react to external factors to a smaller extent. The copper market is speculatively overheated; meanwhile, the high zinc price is due to fundamental factors—to a deficit of this metal above all. This permits us to conclude that if metals market correct, the decrease in zinc prices would not be as deep as the decrease in copper prices, for example. We believe that the shares of zinc producers have a lower risk of negative external influence than the shares of copper producers.

- This is confirmed by the fact that a significant amount of the zinc produced by Elektrozinс is realized on the internal market, where demand demonstrates stable growth. The company's main consumers are metal producers focused on the production of zinc-coated metal plates (NLMK, MMK and Severstal). The main sectors utilizing zinc-coated metal plates are the metallurgy, machine-building and construction industries. Thus, the Russian zinc market appears to have the fundamental factors for long-term growth, and internal demand for zinc-coated metal plates should come from the rapidly growing construction industry.

### Development strategy

- The favorable global market conditions and the “super-profits” received from currently-high zinc prices allow the company to pursue a substantial investment programs. In our opinion, an extension of zinc production facilities and diversification are the best directions for the investment process.

- The construction of a metallic zinc factory with capacity of 150,000 tons per year is a significant point of the company's medium-term development strategy. Construction is to start in 2007 in the Sverdlovsk region. The necessity of new production facilities is predicated by the fact that the company's existing processing assets do not allow it to refine all of its available raw materials.

- Earlier, UGMK planned to build a new factory in the Bashkir Republic; however, the Sverdlovsk region ultimately won out. We believe that the reason for this is the relatively high political risk of the Bashkir Republic. Investment of \$400 mn is expected in this project. The new factory should prove both the efficiency of the UGMK group and the profitability of Elektrozinс. The company's current facilities are insufficient to refine about 50,000 tons of raw materials received from Uchalinsky GOK. After the development of new fields, this surplus could reach 150,000 tons per year. With the construction of new facilities, Elektrozinс could significantly raise its efficiency and become the biggest Russian zinc producer, outrunning its only competitor—Chelyabinsk Zinc Plant.

### Elektrozinc's 1Q06 financial results

#### Elektrozinc 1Q06 results

	1Q05	1Q06	% chg. y-o-y
Sales, US\$ mn	25.6	48.2	88%
Net profit, US\$ mn	1.5	11.9	693%
Average LME zinc price, \$/ton	1,256	2,273	81%

Source: Company data, Sovlink estimates



• The average LME zinc price in 2005 was \$1,064/ton, while the average price in 1Q06 was \$2,273/ton. At the same time, the company's revenue increased by 88% in 1Q06, and net profit rose nearly 700%. Such dynamics—the revenue growth is correlated to the growth in zinc prices, but the net profit growth surpasses this—could be evidence that Elektrozinc is making serious steps towards improving its transparency and ending transfer pricing schemes.

• The average LME zinc price in April-May was \$2,957/ton, exceeding the 1Q06 average by 30%. As such, we expect the company to show even more impressive results in 2Q06. We believe that pursuing a policy of increasing transparency and ceasing transfer pricing will substantially shape the company's financial results during 2006. We think that the company will be able to demonstrate greater increase in net profit than it did in 1Q06 and to achieve a significant increase in full-year revenues and net profit. We consider the present situation to be a favorable moment for buying Elektrozinc shares, because these forecasted results are not reflected in current prices.

## Production

### Elektrozinc's sales structure

	2005	2006E
Zinc production, '000 tons	89.9	98.9
Zinc price at LME, \$/ton	1,375	2,273
% of zinc in total sales	<b>81.3%</b>	<b>83.3%</b>
Lead production, '000 tons	26.9	28.25
Lead price at LME, \$/ton	935	1,224
% of lead in total sales	<b>16.5%</b>	<b>12.8%</b>
Sulphuric acid production, '000 tons	162	186.3
Sulphuric acid price, \$/ton	16	24.6
% of sulphuric acid in total sales	<b>1.7%</b>	<b>1.7%</b>
Cadmium production, '000 tons	203	223.3
Cadmium price, \$/kg	3.3	4.3
% of cadmium in total sales	<b>0.4%</b>	<b>0.4%</b>
Indium production, '000 tons	-	5
indium price, \$/kg	-	1,000
% of indium in total sales	-	<b>1.9%</b>
Sales evaluated on global prices (estimation), \$ mn	152	270
Sales on Russian Accounting Standards, \$ mn	100.2	180

Source: Company data, Sovlink estimates

• The main items that the company produces are zinc, lead, cadmium and sulphuric acid. In 2005, Elektrozinc increased production of all articles: zinc by 11%, lead by 6.3%, cadmium by 27%, and sulphuric acid by 20%.

• In estimating the company's sales for 2006, we assume the retention of positive production dynamics. At the same time, we give a conservative estimate of production growth rates at levels below last year's. We expect zinc production to increase by 10%, lead production by 5%, sulphuric acid production by 15%, and cadmium production by 10%. Further, in 2006 the company resumed production of indium. We expect indium's share of Elektrozinc's 2006 sales at approximately 2%.



- Elektrozinc's sales at world price levels exceed the company's sales based on Russian Accounting Standards (RAS) by 50%. After estimating average global prices in 2006, we arrive at an estimation of the company's sales for 2006. Applying a discount for transfer pricing and taking into consideration that the company sells a considerable amount of its production on the domestic market, we estimate the company's RAS sales at \$180 mn for 2006.

### Valuation estimate

- We do not use a DCF model to value Elektrozinc, as parent company UGMK is the seller of the company's production and receives the profit, and we believe that transfer pricing schemes between Elektrozinc and UGMK are evident.
- For our valuation estimate we use the method of market comparisons, selecting the world's zinc producing peers and adding Chelyabinsk Zinc Plant 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 the company's true financial results.

#### Elektrozinc valuation comparison

Company	Country	P/S	P/E	EV/EBITDA	EV/S	P/BV
Chelyabinsk Zinc Plant	Russia	1.88	88.62	27.79	1.93	1.52
Eurozinc Mining Corporation	Canada	3.63	12.83	5.83	3.72	5.07
Yunnan Chihong Zinc&Germanium	China	4.19	37.19	9.04	6.47	6.75
Compania Minera Milpo S.A.A.	Peru	2.83	16.97	16.35	7.94	3.42
Espanola del Zinc SA	Spain	3.54	-	11.88	0.97	1.35
Hindustan Zinc Limited	India	7.20	18.94	31.65	12.63	13.42
Huludao Zinc Industry Co	China	1.26	-	18.97	2.06	1.56
Kagara Zinc	Australia	9.28	40.49	19.79	9.42	7.13
Toho Zinc	Japan	1.72	36.21	12.36	2.22	3.69
<b>Average</b>		<b>3.95</b>	<b>35.89</b>	<b>17.07</b>	<b>5.26</b>	<b>4.88</b>
<b>Elektrozinc</b>		<b>1.54</b>	<b>21.74</b>	<b>10.94</b>	<b>2.15</b>	<b>2.67</b>
<b>Upside potential, %</b>		<b>156%</b>	<b>65%</b>	<b>56%</b>	<b>145%</b>	<b>83%</b>
Weights for multiples		30%	10%	10%	25%	25%
				<b>Weighted upside</b>		<b>116%</b>

Source: Bloomberg, Factiva, Sovlink estimates

- Elektrozinc 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. 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 116%, noting that it could be higher if transfer pricing ceased between Elektrozinc and UGMK.

- We receive an aggregated average fair value of Elektrozinc of \$345 mn, or \$245.9 per share, which implies potential upside of 116%. 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.



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## STOCK RATING POLICY

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

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