

Kalina

COMPANY NOTE

HOLD

Target price: US\$51.95

Upside potential: 16 %

Analysts:

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STOCK DATA

Ticker	KLNA	MCap (US\$ mn)	436.4
Shares Ords	9,752,311	Free Float, %	33%
Shares Pref	-	Free Float (US\$ mn)	144
Bid Ords (US\$)	44.5	Offer Ords (US\$)	45
Bid Prefs (US\$)	-	Offer Prefs (US\$)	-

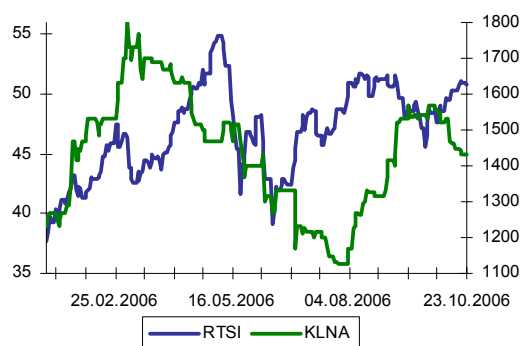
MARKET PERFORMANCE

		1 month	6 months
Absolute	Ords	-6.6%	-5.2%
	Prefs	-	-
Relative to RTSI	Ords	-14.7%	-5.85%
	Prefs	-	-
Price range (US\$)	High	49	49
	Low	45	35.8

PERFORMANCE 2006E

Revenue (US\$ mn)	340	P/S	1.25
EBITDA (US\$ mn)	47.2	EV/EBITDA	9.6
Net Income (US\$ mn)	25	P/E	17

KLNA RELATIVE PERFORMANCE



Growth in competitive conditions

- Kalina is the leading company in Russia's perfume and cosmetics market. Against the background of falling energy prices, investors have been switching their attention from raw-materials exporters to domestic-oriented companies with ruble earnings. We expect the perfume and cosmetic market in Russia to grow at a CAGR of 9% through 2015, and correlate with real income growth. Average income is expected to grow 12–13% in 2006. Kalina's sales should grow at a CAGR of 10% through 2015, while its 2006 sales should rise more than 18%. In spite of this, we believe Kalina's shares to be fairly valued by the market and give the company a **HOLD** recommendation with a \$51.9 target price.

- Despite having double-digit growth rates in perfume and cosmetics, we expect domestic companies' market share to decline. In 2000, Russian companies had about 70% of the market, but now only control half of this. A shift in consumer preferences will inevitably lead to further domestic market share loss, as income growth allows consumers to turn to more expensive and higher quality products, which is currently best represented best by foreign companies' lines.

- The consumer credit boom in Russia is causing an increase in the consumption of long-term goods, such as vehicles or home appliances. At the same time, demand for short-term goods—cosmetics for instance—is declining.

- Our DCF-model results suggest no further upside to Kalina's share price, and a fair value of \$44.2 per share. According to our comparative valuation, Kalina still has an average of 33% upside (44% compared to emerging-market peers, and 21% compared to developed-market peers). Combining our valuation results, we arrive at a price target of \$51.9 suggesting 16% growth potential from current levels.

Cosmetic product market evolution

•The high rate of Russian economic and personal income growth has made the Russian retail and consumer market very attractive. This has led to the intensification of competition, especially due to Western players' more aggressive market strategies. The main risk for Kalina is intensified competition, particularly in the strategic segment of skin care and oral hygiene products. In spite of high share of branded products in its portfolio and Kalina's ability to retain market position, international companies are steadily increasing their presence and becoming more and more active on the Russian perfume and cosmetics market, supplying products at several different price points and taking domestic companies' market share. The relatively low prices of Kalina's products have ceased to be an advantage, as customers' preferences are switching from the low- and mid-priced segment to high-priced and luxury-class products. Further, international companies are rushing to reinforce their positions by building their own production capacity in Russia or by absorbing other small companies. In addition, more and more foreign companies are manufacturing products under license, producing their goods using Russian companies' capacities.

•Despite the natural slowdown in sales growth rates, Kalina's main achievement has been keeping its market share in key segments.

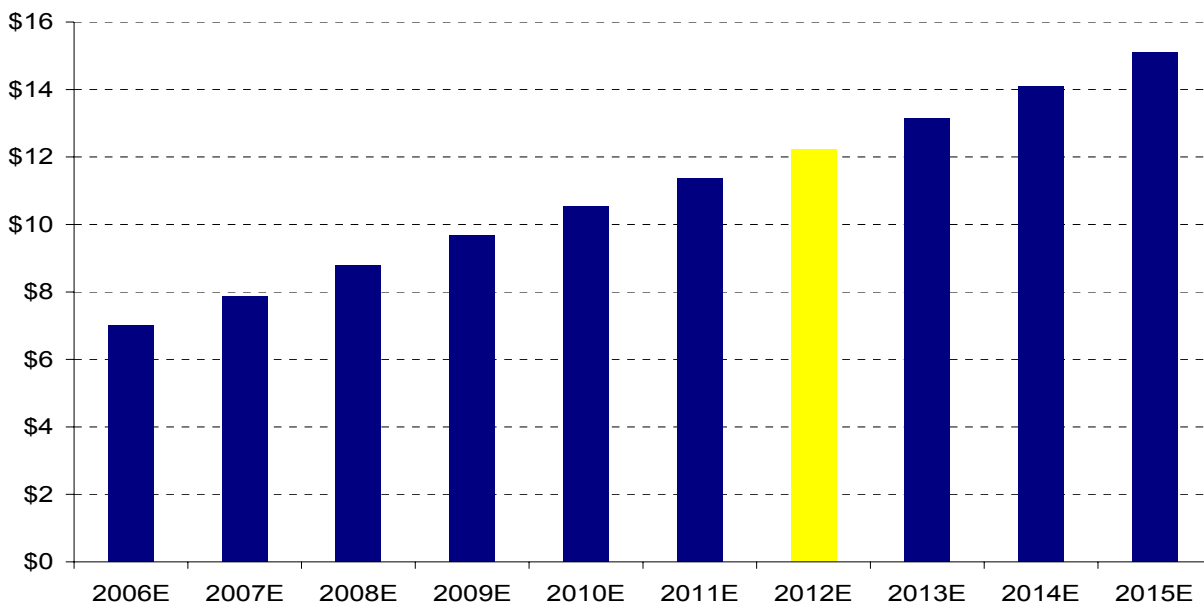
•We believe that before 2010, the Russian cosmetics market will outperform the populace's real earnings growth rate. However, in the future—as the market is saturated—its growth rate will be lower than the populace's real earnings growth rate.

Earnings growth vs. market growth

	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Population real earning growth rate, %	12.5%	10.2%	8.9%	8.2%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Perfume and cosmetics market growth rate, %	12.9%	12.5%	11.5%	10.0%	9.0%	8.0%	7.5%	7.5%	7.2%	7.2%

Source: MEDT, AC Nielsen

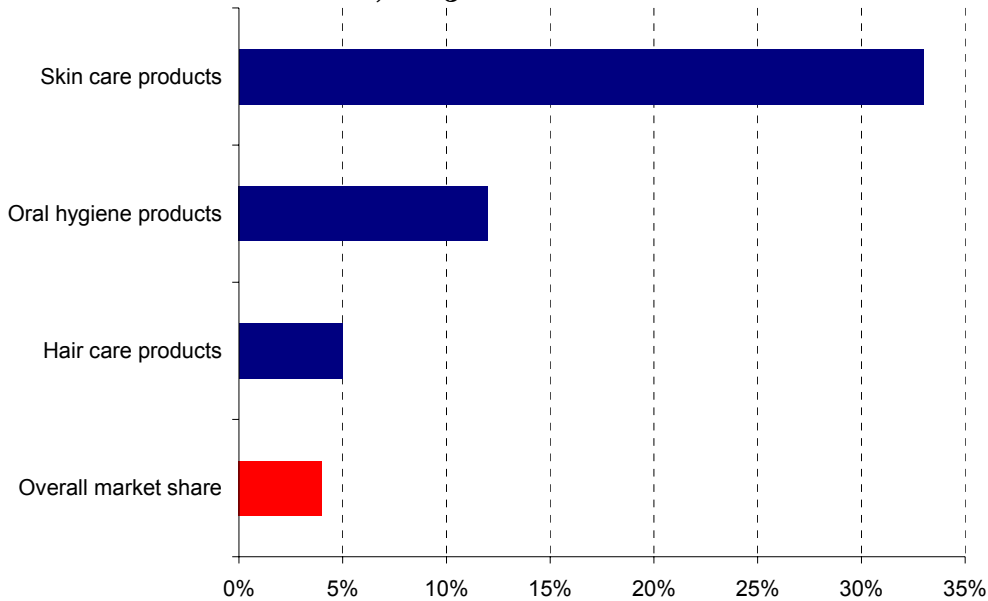
Russian perfume and cosmetics market size in Russia, \$ bn



Source: AC Nielsen, Sovlink estimates

- We estimate the potential turnover for the Russian perfume and cosmetics market at \$12–13 bn, based on \$7 bn of turnover in 2005. The Russian perfume and cosmetic market should reach its potential value in 2012, when Russian citizens spend as much money on cosmetics, as Western Europeans, and enters its saturation stage. From this moment, market growth rates will be lower than real earnings growth.
- Kalina is still the leader among domestic cosmetics producers, and skin care and oral hygiene products are a strategically significant sector for the company.

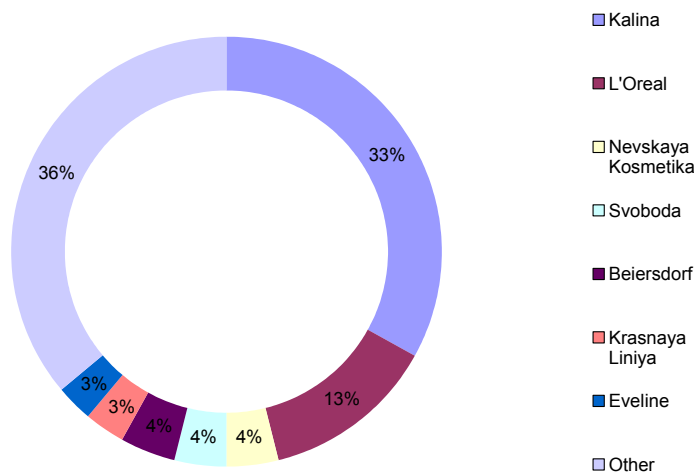
Kalina’s market share in Russia, 2005



Source: Company data

- Kalina controls about 36% of the Russian market for skin care products, making it the absolute leader in this segment. L’Oreal follows at a great distance, with a 13% market share. This segment is the most competitive and more foreign players are expected to enter the market.

Russian skin care market structure

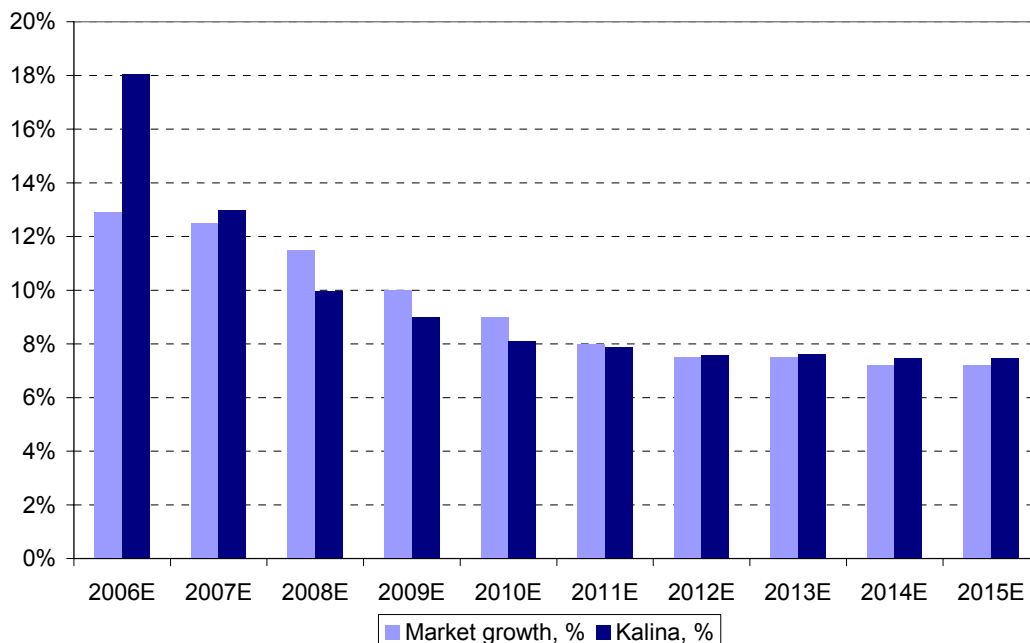


Source: Company data

Business description

- Kalina is the largest Russian producer of cosmetics and personal hygiene products. The company is one of the leaders in the Russian perfume and cosmetics market, with 2006E revenues of \$340 mn.
- Kalina's main brands are: Cherny Zhemchug (Black Pearl), Chistaya Liniya (Clean Line), and MIA in skin care; 32 and Lesnoi Balzam (Forest Balsam) in oral care; and Angelika Varum in perfume. The brands of German producer Dr. Scheller—owned by Kalina and consolidated in 1H05—brands are also being sold in Russia and the CIS: Manhattan, Manhattan Clearface, and Apotheker Scheller.
- Kalina's sales are diversified through different products, brands and regional distribution markets. Diversification steadily increases due to the company's work on new market segments and control of the recently acquired Dr. Scheller. This German company produces and distributes several cosmetics and personal hygiene brands. In 2005, Kalina brought 175 new products on to the market.
- We expect Kalina's revenues to increase more than 18% in 2006, outperforming Russian perfume and cosmetic market growth of 12.9%. At the same time, we expect the company's EBITDA and net margins to continue to decline, because Kalina is increasing its advertising expenses for its more popular products, including its Dr. Scheller brands. Thus, although the April, 2005 consolidation of Dr. Scheller led to increased revenues, it is negatively weighing on margins.
- However, the acquisition looks profitable for Kalina on account of expected synergies in production and logistics.
- We expect that Kalina will outperform market growth rates

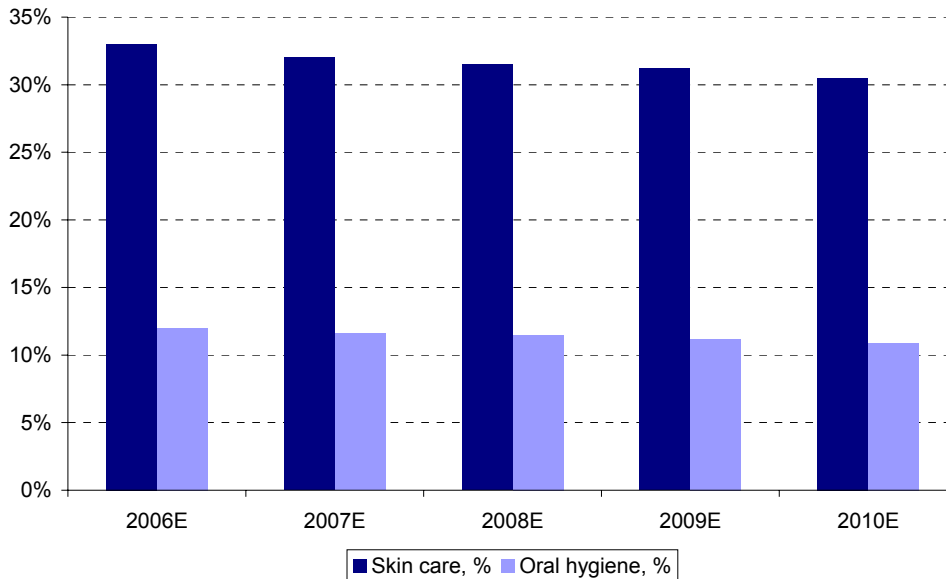
Kalina's sales growth vs. overall perfume and cosmetics market growth



Source: Company data, AC Nielsen, Sovlink estimates

- Nevertheless, in the light of increasing competition and consumer demand switching towards luxury brands, we believe Kalina will lose its position on its strategic segments—skin care and oral hygiene products.

Kalina's market share



Source: Company data, AC Nielsen, Sovlink estimates

Financial results

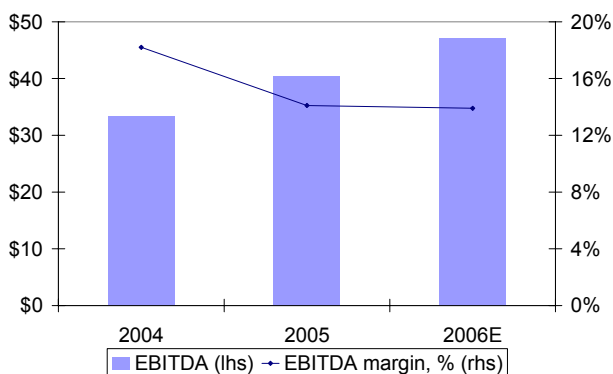
Kalina's financials, \$ mn

	2004	2005	2006E
Sales	182.6	288.0	339.6
EBITDA	33.4	40.5	47.2
Net profit	19.0	22.9	25.0
EBITDA margin, %	18.2%	14.1%	13.9%
Net margin, %	10.4%	8.4%	7.5%

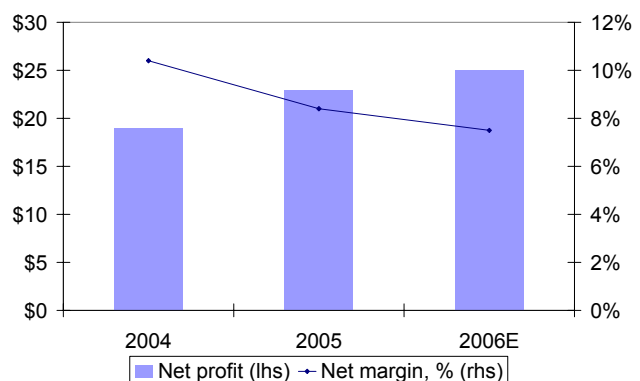
Source: Company data, Sovlink estimates

- At the same time, increased competition between powerful retail networks and further rises in expenses will hinder management's abilities to retain positive margin dynamics.

EBITDA dynamics, \$ mn



Net profit dynamics, \$ mn



Source: Company data, Sovlink estimates

- The increase in advertising expenses occurred with Kalina bringing the Dr. Scheller brands to the Russian market. This resulted in lower margins in 2005, while EBITDA increased 21% year-on-year and net profit rose

20%. We expect these trends to continue in 2006, with the company's EBITDA margin sliding to 13.9% and its net margin to 7.5%.

Multiples

	2005	2006E	2007E
P/S	1.47	1.25	1.1
EV/EBITDA	11.1	9.55	8.44
P/E	18.5	16.9	14.8

Source: Sovlink estimates

Valuation

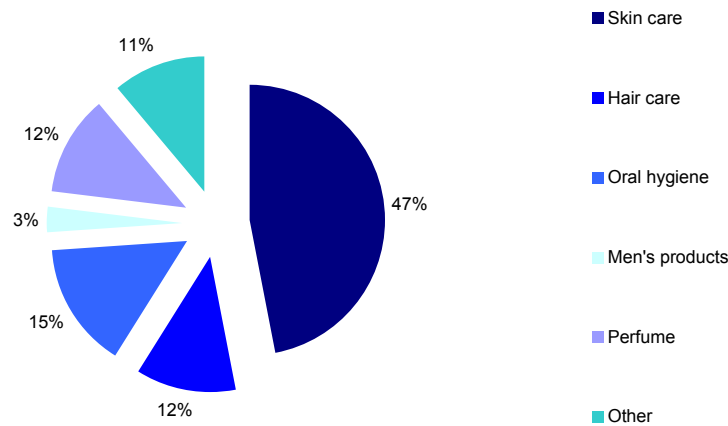
- We come to our fair price for Kalina's shares by using comparative and DCF methods.
- Our DCF model uses consolidated IFRS results, including Dr. Scheller. We expect Kalina's growth to 2015 at a CAGR of 9.8% and that—on average—surpasses by 0.8 percentage points the expected CAGR for the perfume and cosmetics market on the whole: 9%. At the same time, in 2006 Kalina could achieve sales growth of more than 18% because of sales growth in its Dr. Scheller cosmetic brands. In 2006 we expect the company's EBITDA margin to slide to 13.9% and its net margin to drop to 7.3%. According to our expectations, the company's EBITDA and net margins will not change dramatically through 2015.

Kalina sales forecasts, \$ mn

	2005	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Sales	288	340.0	384.2	422.5	460.5	497.8	537.1	577.9	621.8	668.4	718.4
Growth rate, %		18%	13%	10%	9%	8%	8%	8%	8%	7%	7%
Skin care	135.36	161.1	183.6	202.0	220.2	237.8	256.8	277.4	299.5	323.5	349.4
Growth rate, %		19%	14%	10%	9%	8%	8%	8%	8%	8%	8%
Hair care	34.56	41.5	47.3	52.5	57.7	62.9	68.6	74.8	81.5	88.0	95.0
Growth rate, %		20%	14%	11%	10%	9%	9%	9%	9%	8%	8%
Oral hygiene	43.2	49.2	54.2	59.0	63.8	68.2	73.0	77.4	82.0	87.0	92.2
Growth rate, %		14%	10%	9%	8%	7%	7%	6%	6%	6%	6%
Men's products	8.64	10.0	11.1	12.2	13.3	14.4	15.6	16.6	17.8	19.1	20.4
Growth rate, %		16%	11%	10%	9%	8%	8%	7%	7%	7%	7%
Perfume	34.56	40.8	46.1	50.7	55.8	60.8	65.6	70.2	75.2	80.4	86.0
Growth rate, %		18%	13%	10%	10%	9%	8%	7%	7%	7%	7%
Other	31.68	37.4	41.9	46.1	49.7	53.7	57.5	61.5	65.8	70.4	75.3
Growth rate, %		18%	12%	10%	8%	8%	7%	7%	7%	7%	7%

- We forecast the company's revenues from looking at the product segments and a detailed growth forecast for each segment. Each segment forecast was based on the market saturation coefficient in each segment and its historical correlation with income growth rate.
- At the moment, the skin care segment is strategically significant for Kalina, supplying about 50% of the company's revenues.

Revenues structure, 2005



Source: Company data

• At the same time, this segment is the most competitive and attractive for foreign players. Taking into account the strong competition, it is difficult to maintain growth rates on the 2005–06 levels.

Financial forecasts, \$ mn

	2005	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Revenues	288.0	340.0	384.2	422.5	460.5	497.8	537.1	577.9	621.8	668.4	718.4
Cost of sales	153.2	181.9	205.5	226.0	246.4	268.8	290.0	312.1	335.8	360.9	387.9
Gross profit	134.8	158.1	178.6	196.5	214.1	229.0	247.1	265.8	286.0	307.4	330.5
SG&A	102.8	121.0	136.4	149.6	162.6	175.2	188.5	202.3	222.6	237.0	247.1
Operating profit	32.0	37.1	42.3	46.9	51.6	53.8	58.5	63.6	63.4	70.4	83.3
Amortization & depreciation	8.6	10.2	11.1	11.8	12.9	14.4	14.5	15.6	17.4	19.4	18.0
EBITDA	40.6	47.3	53.4	58.7	64.5	68.2	73.0	79.2	80.8	89.8	101.3
Other expenses	-4.1	-3.4	-3.8	-2.1	-2.3	-2.5	-1.3	-1.4	-1.6	-1.7	-1.8
EBT	27.9	33.7	38.4	44.8	49.3	51.3	57.2	62.1	61.9	68.8	81.5
Taxes	3.1	8.1	9.2	10.7	11.8	12.3	13.7	14.9	14.8	16.5	19.6
Minority interest	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Net income	24.2	25.0	28.6	33.4	36.8	38.4	42.9	46.6	46.4	51.7	61.4
EBIT	32.0	37.1	42.3	46.9	51.6	53.8	58.5	63.6	63.4	70.4	83.3
EBITDA margin, %	14.1%	13.9%	13.9%	13.9%	14.0%	13.7%	13.6%	13.7%	13.0%	13.4%	14.1%
Net margin, %	8.4%	7.3%	7.4%	7.9%	8.0%	7.7%	8.0%	8.1%	7.5%	7.7%	8.5%

Source: Company data, Sovlink estimates

DCF Summary, \$ mn

	2005	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Revenues	288.00	339.98	384.16	422.50	460.51	497.85	537.08	577.89	621.84	668.35	718.38
Gross profit	63.30	69.88	76.87	83.79	91.33	98.63	106.52	113.98	121.96	129.28	137.03
EBITDA	43.80	46.77	54.65	59.57	64.93	74.24	80.18	85.79	96.88	102.69	108.85
Net profit	26.00	29.01	34.77	38.27	42.09	48.92	53.17	57.18	65.34	69.51	73.93
EBITDA margin, %	17%	16%	17%	17%	17%	18%	18%	18%	19%	19%	19%
Net margin, %	10%	10%	11%	11%	11%	12%	12%	12%	13%	13%	13%
EBIT*(1-t)	24.30	28.16	32.12	35.64	39.20	40.86	44.49	48.31	48.20	53.54	63.33
Amortization	8.64	10.20	11.14	11.83	12.89	14.44	14.50	15.60	17.41	19.38	17.96
Capex	14.42	7.50	7.50	7.80	8.00	8.10	8.20	8.50	8.80	9.00	9.50
FCFF	18.52	30.86	35.76	39.67	44.09	47.20	50.79	55.41	56.82	63.92	71.79
FCFF discounted		27.31	28.00	27.49	27.04	25.62	24.40	23.55	21.37	21.28	21.15

Source: Company data, Sovlink estimates

WACC	13%
Terminal growth rate	3%
NPV of forecasted years	247.22
NPV of Terminal Value	225.2
Fair EV, US\$ mn	472.5
Net Debt, US\$ mn	26.8
Fair MCAP, US\$ mn	445.7
Number of shares	9 752 311
Target price, \$	45.70

Source: Sovlink estimates

Comparative valuation

• Companies in the perfume and cosmetics sector from emerging markets are valued higher than their developed market peers. On average, they trade at premiums of 107% on P/S, 22% on EV/EBITDA and 30% on P/E. Emerging market companies trade at more expensive multiples due to the sharper growth rates of consumer markets. In BRIC countries, growth rates are in the double-digits, while growth rates are 3%–4% annually in Europe and the US.

	Country	P/S	EV/EBITDA	P/E
Wella	Germany	1.57	13.18	19.73
Beiersdorf	Germany	1.00	6.48	13.78
Robertet	France	1.77	7.63	10.49
L'OREAL	France	1.87	11.35	27.12
Ales Groupe	France	1.03	8.86	16.24
Ulric de Varens	France	2.74	14.23	20.19
Inter Parfums	US	1.24	12.39	32.93
Avon Products	US	1.87	11.25	17.13
Colgate-Palmolive	US	1.41	9.78	25.31
Procter&Gamble	US	1.65	10.46	15.85
Developed markets		1.9	10.6	21.0
Dabur India Limited	India	2.74	16.31	24.28
Colgate-Palmolive India	India	2.40	14.59	20.65
Natura Cosmetics	Brazil	6.29	15.77	36.20
Esthetics International	Malasia	4.24	5.21	28.04
Emerging markets		3.9	13.0	27.3
Kalina		1.25	9.55	16.96
Premium/discount to emerging markets		-68%	-26%	-38%
Premium/discount to developed markets		-34%	-10%	-19%

Source: Bloomberg, Factiva, Sovlink estimates

• Kalina trades at an average discount on P/S, EV/EBITDA and P/E of 21% to its developed market peers and 44% to emerging market peers. The overall average discount is 33%.

Final valuation

	price, \$	weight
Multiples	59.7	50%
DCF	44.2	50%
Target price, \$	51.95	

Source: Sovlink estimates

• Combining our DCF and comparative valuation results, we receive a fair value for Kalina's shares of \$51.95, suggesting 16% potential growth from current prices.

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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