

# Chelyabinsk Pipe

**COMPANY  
NOTE**

**SELL**

**Upside: -8.9 %  
Target Price: \$3.64**

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## Stock data

Ticker	CHEP	M.Cap, \$ mn	1,890
Shares Ords	472,382,880	Free Float, %	16%
Shares Prefs	-	Free Float, \$ mn	299
Bid Ords, \$	3.95	Offer Ords, \$	4.05

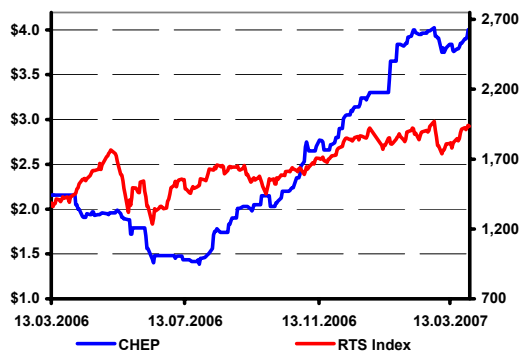
## Market performance

		1 month	6 months
Absolute	Ords	1.66%	88.60%
Relative to RTSI	Ords	-5.68%	51.72%
Price range, \$			
High	Ords	4.00	4.01
Low	Ords	3.76	2.09

## Financials, 2007E

Revenue, \$ mn	1,025	P/S	1.82
EBITDA, \$ mn	149	EV/EBITDA	14.22
Net Income, \$ mn	66	P/E	28.08

CHPEP's market performance



Source: RTS, Sovlink Securities

## Slow production, rapid price

- Chelyabinsk Pipe is part of the ChTPZ Group. It holds a strong position in the production of medium-sized tubes for ductworks. Its share in the Russian market increased to 12.7% in 2006 from 11.6% in 2005. Participation in the Eastern Siberia-Pacific Ocean pipeline (ESPO) managed by Transneft provides the company with stable demand.

- In October 2006, ChTPZ introduced extra tarnishing facilities that will increase its production capacity for tarnished tubes by 300,000 tonnes a year. This will result in a total annual tarnishing capacity of 600,000 tonnes. (Rust-resistance is an essential requirement for tubes used in ESPO construction.)

- The company is collaborating with the Kaizen Institute for the implementation of an effective production programme at the plant. The programme is aimed at increasing the company's competitiveness and customer satisfaction level.

- Chelyabinsk Pipe is highly involved with social responsibility projects in the Chelyabinsk region, and finances social maintenance programmes as well as educational projects.

- The company enjoyed a good financial position in 2006. We estimate its income margin to be 9.1% with an EBITDA margin of 12.3%. These levels closely correlate with the average levels of its global peers. Its liquidity level is also high, with its current assets being almost twice the value of its current liabilities.

- We evaluated Chelyabinsk Pipe using both peer analysis and a DCF model. Both of these evaluations signalled significant overvaluation and led us to conclude that the company has exhausted its growth potential and will either maintain its price in the medium term or will undergo a correction in the short term.

- Based on our valuations, we estimate Chelyabinsk Pipe's fair value at \$1,721 mn or \$3.64 per share with an -8.9% upside potential. Although we have increased our target from our previous \$1.9, we downgrade our rating from **BUY** to **SELL** on share price performance.

## Valuation

### DCF model

We evaluated the growth potential in Chelyabinsk Pipe's capitalization using the DCF method for the period between 2007-16. We applied the following conditions and assumptions in our analysis:

1. The interest rate for loans was used to calculate the discount rate for companies, taking into consideration different debt/equity ratios. The standard required rate of return for Russian equities was assumed to be 13% and was applied to calculate the applicable discount rate to the equity portion of the company. The company's Beta rate was calculated relative to the RTS index for 2005-06.
2. The annual growth rates for the main production segments are held constant at 2.5%. This corresponds to average historic growth rates and takes into account the growth in production capacities due to acquisitions.
3. We assume that pipe production costs include the price of 1 tonne of steel, and the costs for the production of railroad wheels include the price of 1.2 tonnes of steel.
4. We believe that pipe prices will remain steady in the future, moving only slightly towards average historic values.
5. Pipe production costs consist of two different cash streams, expressed in dollars and the rouble equivalent. The calculations of both types of expenses take into account the inflation rates and currency dynamics applicable to each currency.
6. We applied an income tax rate of 24%. However, in some cases, the effective tax rate may differ due to the fact that we have calculated the profit tax according to Russian accounting standards.
7. Our calculations led us to conclude that given the above assumptions, the company's free cash flows would steadily grow. In fact, this will not happen, because the cash flows will be redirected to investments in new projects and acquisitions or paid out as dividends. However, in the absence of information regarding the precise nature of such projects and their relative profitability, we have assumed that their profitability level would be equal to the average industry profitability level. In this case, there's no difference between investments made in cash or reinvested as dividends.
8. We assume that as of 2007, investments in PPE will be made at a sufficiently high level, so that their value in dollar equivalent terms will be maintained.

**CHEP: DCF SUMMARY, \$ mn**

	2004	2005	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Non-current Assets	396.8	389.2	395.1	378.7	379.5	380.4	381.2	382.0	382.9	383.7	384.6	385.4	386.3
Current Assets	285.0	227.9	240.8	513.2	596.8	688.9	789.0	897.7	1,015.7	1,143.3	1,281.2	1,430.0	1,590.1
Non-current Liabilities	235.7	266.0	211.3	283.0	291.1	299.3	307.9	316.6	325.7	334.9	344.5	354.3	364.3
Current Liabilities	207.8	98.9	122.2	166.1	170.3	174.5	178.8	183.3	187.9	192.7	197.5	202.5	207.7
Total Shareholders' Equity	238.3	252.2	302.5	442.7	515.0	595.4	683.5	779.8	885.0	999.5	1,123.8	1,258.6	1,404.4
<b>Total assets</b>	<b>681.8</b>	<b>617.1</b>	<b>636.0</b>	<b>891.9</b>	<b>976.4</b>	<b>1,069.2</b>	<b>1,170.2</b>	<b>1,279.7</b>	<b>1,398.6</b>	<b>1,527.1</b>	<b>1,665.8</b>	<b>1,815.4</b>	<b>1,976.4</b>
<b>Revenues</b>	<b>563.4</b>	<b>715.4</b>	<b>1,008.6</b>	<b>1,025.0</b>	<b>1,054.7</b>	<b>1,085.2</b>	<b>1,116.5</b>	<b>1,148.8</b>	<b>1,181.9</b>	<b>1,216.0</b>	<b>1,251.1</b>	<b>1,287.2</b>	<b>1,324.3</b>
Gross profit	96.3	167.0	268.8	259.9	272.5	285.6	299.3	313.4	328.0	343.2	358.9	375.2	392.1
Non-operating costs	15.6	44.9	38.5	36.9	39.1	38.8	39.7	40.7	41.3	42.1	43.0	43.8	44.7
EBITDA	17.9	28.9	124.4	97.3	104.1	113.5	122.2	131.2	141.0	151.0	161.3	172.2	183.5
Amortization & Depreciation	13.2	17.6	17.5	16.6	16.7	16.7	16.8	16.9	16.9	17.0	17.0	17.1	17.2
EBIT	4.7	11.3	107.0	80.7	87.4	96.8	105.4	114.4	124.1	134.0	144.3	155.1	166.3
Interest payments	1.8	22.2	20.0	18.5	19.2	19.9	20.7	21.4	22.2	23.0	23.8	24.7	25.5
<b>Net income</b>	<b>1.8</b>	<b>22.8</b>	<b>91.9</b>	<b>66.3</b>	<b>72.3</b>	<b>80.4</b>	<b>88.1</b>	<b>96.3</b>	<b>105.2</b>	<b>114.5</b>	<b>124.3</b>	<b>134.8</b>	<b>145.8</b>
EBITDA margin, %	3.2%	4.0%	12.3%	9.5%	9.9%	10.5%	10.9%	11.4%	11.9%	12.4%	12.9%	13.4%	13.9%
Net Income margin, %	0.3%	3.2%	9.1%	6.5%	6.9%	7.4%	7.9%	8.4%	8.9%	9.4%	9.9%	10.5%	11.0%
Amortization & Depreciation	13.2	17.6	17.5	16.6	16.7	16.7	16.8	16.9	16.9	17.0	17.0	17.1	17.2
Capex	53.9	42.1	42.1	17.4	17.5	17.6	17.6	17.7	17.8	17.8	17.9	18.0	18.0
WC (change)		50.8	-8.7	63.8	5.9	6.1	6.3	6.5	6.7	6.8	7.0	7.2	7.4
FCFF	-38.9	49.1	58.6	129.3	77.4	85.6	93.6	101.9	111.0	120.5	130.5	141.2	152.4
<b>FCFF discounted</b>				<b>119.5</b>	<b>66.1</b>	<b>67.6</b>	<b>68.2</b>	<b>68.7</b>	<b>69.2</b>	<b>69.4</b>	<b>69.4</b>	<b>69.4</b>	<b>69.2</b>
Russian 30-year government eurobond yield	5.60%												
Russian equity standard premium	13.00%												
Beta	0.5												
Required return on equity	9.30%												
Cost of debt	9.50%												
Cost of debt adjusted for tax	7.22%												
Share of liabilities in book value	52.43%												
Share of equity in book value	47.57%												
WACC	8.21%												
Terminal growth rate	2.50%												
NPV of forecasted years	736.7												
NPV of terminal value	1,242.7												
Fair EV, \$ mn	1,979.4												
Net debt, \$ mn	117.7												
Minority interest, \$ mn	0.0												
<b>Fair M.Cap, \$ mn</b>	<b>1,861.8</b>												
<b>Fair price, ordinary share, \$</b>	<b>3.9</b>												

### Comparative valuation, 2007E

	P/S	P/E	P/BV	EV/EBITDA	EV/S
Vallourec	1.73	10.04	3.68	5.63	1.63
Mueller Water Products Inc-A	0.81	17.68	1.21	7.66	1.37
Jindal Saw Ltd	0.60	10.94	3.18	7.51	0.75
Tubacex SA	1.40	18.37	3.20	6.58	1.63
Welspun-Gujarat Stahl Ltd	0.51	12.25	1.64	10.38	0.60
Khartsyzsky Trubny Z	2.96	19.51	5.07	12.81	2.90
Wah Seong Corp Bhd	0.65	15.57	3.24	9.47	0.99
Steel & Tube Holdings Ltd	0.86	13.10	2.79	7.90	0.96
Maharashtra Seamless Ltd	2.47	14.29	2.47	11.51	2.37
Man Industries (India) Ltd	0.43	8.17	1.58	4.39	0.48
<b>Average</b>	<b>1.24</b>	<b>13.99</b>	<b>2.80</b>	<b>8.38</b>	<b>1.37</b>
CHEP	1.83	28.28	2.10	20.48	1.94
Fair M.Cap, \$ mn	1,273	928	2,500	768	1,319
Weights	30%	10%	20%	20%	20%
<b>Weighted M.Cap, \$ mn</b>					<b>1,392</b>

Source: Bloomberg, Sovlink Securities estimates

### Valuation summary

	Fair M.Cap, \$ mn	Weight	Average
Multiple valuation	1,392	30%	
DCF valuation	1,862	70%	
Fair M.Cap, \$ mn			1,721
Fair price, ordinary share, \$			3.64
<b>Upside potential, %</b>			<b>-8.9%</b>

Source: Sovlink Securities estimates

- Combining our valuations, we use a weight of 70% for our DCF estimate and 30% for our peer comparison estimate. The DCF method provides a closer valuation estimate for the LDP market, whose dynamics are determined by huge pipe construction projects. Based on our valuations, we estimate Chelyabinsk Pipe's fair value at \$1,721 mn or \$3.64 per share with an -8.9% upside potential. Although we have increased our target from our previous \$1.9, we downgrade our rating from **BUY** to **SELL** on share price performance.

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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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