SOVLINK
YOUR FIRST CALL – FOR THE SECOND TIER

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Nizhegorodoblgaz

Flash Note

Meeting with management

BUY
Upside: 56%
Target Price: $4.6

Analyst: Nikolay Saperov
saperovn@sovlink.ru

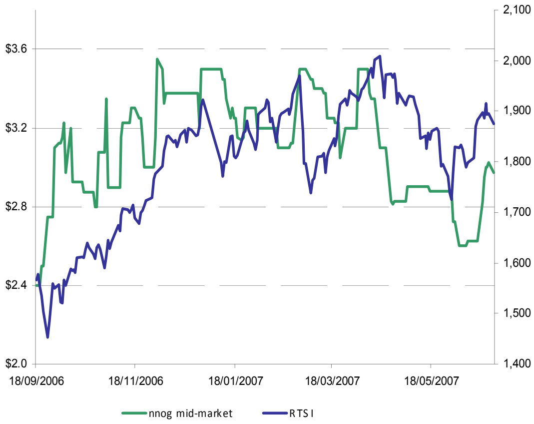
Stock Data			
Ticker	nnog	M.Cap, $ mn	83.3
Shares Ords	27,778,800	Free Float, %	10.0%
Shares Pref	-	Free Float, $ mn	8.3
Bid Ords, $	2.85	Offer Ords, $	3.10

Market performance		1 month	6 months
Absolute	Ords	7%	0%
Relative to RTSI	Ords	2.5%	-1.3%
Price range, $			
High	Ords	3.00	3.75
Low		2.45	2.45

Financials 2007E			
Revenue, $ mn	78.6	P/S	1.1
EBITDA, $ mn	22.7	EV/EBITDA	3.5
Net Income, $ mn	13.8	P/E	6.0

Financials 2006			
Revenue, $ mn	63.1	P/S	1.3
EBITDA, $ mn	18.4	EV/EBITDA	4.3
Net Income, $ mn	11.1	P/E	7.4

Nizhegorodoblgaz – Relative performance



Source: RTS, Sovlink Securities

During our meeting with Nizhegorodoblgaz' management, we found the company's management to be market-oriented and willing to enter into an open dialogue with investors. In our discussions, we clarified the following important points:

1) Nizhegorodoblgaz' management explained in detail the changes occurring in the industry. The information gained during our meeting confirmed our previously held view that Gazprom will try to obtain control of the entire gas distribution system in Russia and make it more efficient.

2) According to Nizhegorodoblgaz' CEO – Feliksa Verhovodova – Gazprom is to buy government stakes in 79 Russian regional natural gas distributors in the near future. Verhovodov also confirmed our previous idea that a group of oblgazes own a combined total of about 1% of Gazprom's shares (through Rosgazifikatsia). According to Verhovodova, this is the main reason why Gazprom plans to acquire the government's stakes in the oblgazes.

3) Nizhegorodoblgaz' management is trying to optimize the company's business processes. For example, some non-core assets were sold last year, management reduced a number of subsidiaries' correspondence accounts, and the system used for collecting payments was also improved. All these steps should lead to improved margins for the company.

4) Nizhegorodoblgaz owns only 11% of the total length of low-pressure pipelines (2,000 km of the total 17,000 km). 34% is owned by Gazpromregiongaz, 51% by the regional authorities, and another 3% by various companies and individuals. It means that most of the pipelines which Nizhegorodoblgaz operates are leased.

5) According to Nizhegorodoblgaz' CEO, Verhovodov, gas transportation could be a fairly profitable business. The company's recent sale of non-core assets and optimisation of business processes indicate that Verhovodov is preparing the company for division. Gas transportation, gas distribution and the repair of gas pipelines will be divided into separate business units.

We also obtained some financial forecasts for 2007: incorporating them into our model, we reiterate our **BUY** recommendation with a new target price of $4.6 per ordinary share, with upside of 56%.

New information on Nizhegorodoblgaz' business.

Nizhegorodoblgaz' main business is gas transportation – accounting for 85% of the company's revenues. The company receives transportation tariffs regulated by the Federal Tariff Agency (FST) based on a cost-plus method. This tariff amounted to 181 roubles per 1,000 cubic metres last year. The transport price, including an investment surcharge of 10%, is to increase by 20% in 2007 to 218 roubles, which — in our opinion — should lead to higher revenues, net profit and EBITDA margin.

Nizhegorodoblgaz operates more than 17,000 kilometres of low-pressure pipes, but owns only 2,000 kilometres of this pipeline.

Ownership structure of the low-pressure pipelines in the Nizhegorodskaya region

	Length, km	% of total length
Nizhegorodoblgaz	2,000	11%
Regional authorities	9,000	51%
Regiongazholding	6,000	34%
Other (companies and individuals)	560	3%

Company data

Despite the fact that Nizhegorodoblgaz owns only 2,000 km of low-pressure pipelines, nonetheless it operates most of the pipeline network. The company leases 9,000 km of pipelines owned by the regional authorities. We note that lease payments are quite insignificant – 500 roubles per km per year. 6000 km of pipelines are owned by Gazprom through Regiongazholding, another 560 kilometres don't have a specific owner. Nizhegorodoblgaz has specific agreements on the use and technical service of these 6,560 km of pipelines.

We stress that Nizhegorodoblgaz' management team led by CEO Feliks Verhovodov is implementing measures aimed at optimising the company's business processes. The most obvious improvements are:

1) All subsidiaries now use a single bank account.
2) The system of collecting payments from consumers has been optimised.
3) Several non-core assets, such as the liquid gas distribution business, were sold.
4) Management has launched a cost normalisation system.

Nizhegorodoblgaz' level of consumer payments collection is 99%. This is explained by the high proportion (83%) of large industrial companies amongst its clients. One of the largest gas consumers in the district – the GAZ automobile plant – is not supplied by Nizhegorodoblgaz, but directly from arterial gas pipelines owned by Gazprom. However, Nizhegorodoblgaz' management expects that in two years' time it will supply GAZ. Gas distribution in the Nizhegorodskaya region amounted to slightly over 8 bn cubic metres in 2006. Distribution to GAZ would add another 1 bn cubic metres.

Management expects that tariff growth rate will slow down from the existing rate of over 20% to approximately 10%-12% by 2010. The current gas transportation tariff is calculated according to a cost-plus method and is approved by the FST. Costs considered in determining the tariff include:

1) Labour costs
2) Operating expenses
3) Administrative expenses
4) Depreciation

5) Capital expenditures
6) Repair costs

We note that the transport tariff also includes a so-called investment surcharge, which allows Nizhegorodoblgaz to finance part of its capex expenditures. The investment surcharge is included in the transportation tariff only for industrial consumers, but not for individual consumers. This is extremely important for Nizhegorodoblgaz as 83% of its clients are industrial consumers. As a result, the company benefits to a greater degree than other oblgazes which have a greater proportion of individual consumers.

Changes in valuation

We have changed some details in our valuation method for Nizhegorodoblgaz.

1. We assume that GAZ' plants will start using gas supplies from Nizhegorodoblgaz from 2009, thereby adding 1 bn cubic metres of gas supplied by the company.
2. We assume that the gas tariff will be increased by 20% in 2007. We expect a gradual slowdown of the tariff growth rate to 10% by 2011, as estimated by the company's management.
3. We changed our forecasts for future EBITDA and NI margins. Our expectations are that between 2007-10, these margins will remain below the margins achieved in 2006. This is mainly due to the extremely high (25%) gas transportation tariff growth rate in 2006. Nevertheless, due to the company's cost-saving and optimization programmes, we expect that the EBITDA and NI margins will overcome the levels of 2006 year by 2011 year.
4. Currently, our valuation is based exclusively on the DCF model. As the oblgazes' cash flows and margins are stable and predictable, this results in the DCF valuation becoming the most appropriate way to value them. Foreign gas transportation companies are usually more diversified and often also sell gas in addition to gas transportation. Moreover, for foreign companies the gas transportation tariff is not regulated based on a cost plus method. Consequently, we consider the comparative method to be inadequate for valuing Russian oblgazes.
5. We lowered the discount rate applied to Nizhegorodoblgaz's cash flows to 18% from 20% as the company's business has become more transparent to us after our meeting with management.

DCF model, $ mn

	2005	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Gas transportation volume, bn cubic metres	8.0	8.2	8.2	8.2	9.2	9.2	9.2	9.2	9.2	9.2	9.2
Tariff, roubles per 1,000 cubic metres	145	181	218	250	280	314	345	380	418	459	505
Revenues from transportation of gas	42.2	50.5	68.6	78.9	99.1	111.0	122.1	134.3	147.8	162.5	178.8
Revenues from sales of LPG	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Revenues from technical services and repairs	7.8	12.6	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Revenues	50.0	63.1	78.6	88.9	109.1	121.0	132.1	144.3	157.8	172.5	188.8
COGS	33.0	39.9	48.7	55.1	67.7	75.0	80.6	88.0	96.2	103.5	113.3
Gross profit	17	23.2	29.9	33.8	41.5	46.0	51.5	56.3	61.5	69.0	75.5
Gross profit margin, %		37%	38%	38%	38%	38%	39%	39%	39%	40%	40%
Depreciation	1.5	1.6	2.3	2.6	2.7	3.0	3.3	3.6	3.9	4.3	4.3
Cash flow from non-operating activities	6.0	6.4	9.4	10.7	13.1	14.5	15.9	16.6	17.4	18.1	18.9
EBITDA margin	12.5	18.4	22.7	25.7	31.1	34.5	39.0	43.3	48.1	55.2	61.0
EBITDA margin, %	24.9%	29.2%	28.9%	28.9%	28.5%	28.5%	29.5%	30.0%	30.5%	32.0%	32.3%
Interest payment	0.3	0.0	0.8	0.9	1.1	1.0	1.1	1.2	1.3	1.4	1.5
Depreciation	1.5	1.6	2.3	2.6	2.7	3.0	3.3	3.6	3.9	4.3	4.3
EBT	10.7	16.8	19.6	22.2	27.3	30.5	34.6	38.5	42.9	49.5	55.1
NI	7.5	11.1	13.8	15.6	19.1	21.3	24.2	27.0	30.0	34.7	38.6
NI margin, %	14.9%	17.6%	17.5%	17.5%	17.5%	17.6%	18.3%	18.7%	19.0%	20.1%	20.4%

$ mn	2005	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Revenues	50.0	63.1	78.6	88.9	109.1	121.0	132.1	144.3	157.8	172.5	188.8
Gross profit	17.0	23.2	29.9	33.8	41.5	46.0	51.5	56.3	61.5	69.0	75.5
non-COGS	6.0	6.4	9.4	10.7	13.1	14.5	15.9	16.6	17.4	18.1	18.9
EBITDA	12.5	18.4	22.7	25.7	31.1	34.5	39.0	43.3	48.1	55.2	61.0
Amortisation & depreciation	1.5	1.6	2.3	2.6	2.7	3.0	3.3	3.6	3.9	4.3	4.3
EBIT	11.0	16.8	20.4	23.1	28.4	31.5	35.7	39.7	44.2	50.9	56.6
Interest payments	0.3	0.0	0.8	0.9	1.1	1.0	1.1	1.2	1.3	1.4	1.5
Net profit	7.5	11.1	13.8	15.6	19.1	21.3	24.2	27.0	30.0	34.7	38.6
EBITDA margin, %	24.9%	29.2%	28.9%	28.9%	28.5%	28.5%	29.5%	30.0%	30.5%	32.0%	32.3%
Net profit margin, %	14.9%	17.6%	17.5%	17.5%	17.5%	17.6%	18.3%	18.7%	19.0%	20.1%	20.4%
NI	7.5	11.1	13.8	15.6	19.1	21.3	24.2	27.0	30.0	34.7	38.6
Amortization & Depreciation	1.5	1.6	2.3	2.6	2.7	3.0	3.3	3.6	3.9	4.3	4.3
Capex	4.4	5.6	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8
FCFF			10.3	12.4	16.1	18.6	21.8	24.8	28.2	33.2	37.2
FCFF discounted			7.4	7.5	8.3	8.1	8.1	7.8	7.5	7.5	7.1

Source: Company data, Sovlink estimates

WACC	18%
Terminal growth rate	3%
NPV of forecast years	75.3
NPV of Terminal Value	48.8
Fair EV, US$ mn	124.0
Net Debt, US$ mn	-3.6
Fair M.Cap, US$ mn	127.6
Target price, $	4.6

Source: Company data, Sovlink estimates

As a result of these modifications, we obtained a new target price of $4.6 per ordinary share, which implies 56% upside from the last mid-market price. We retain a positive outlook on the company and reiterate our **BUY** recommendation.

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

SOVLINK LLC
Tel.: +7 495 967 1300
Fax: +7 495 967 1311

Kremlin Embankment 1, building 2,
Moscow 119019, Russia
www.sovlink.ru
research@sovlink.ru

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