



Severstal-Auto

Flash
Note

BUY

Upside: 16%
Target Price: \$56

A glance into the future

Analyst: Igor Kraevsky
kraevsky@sovlink.ru

- Several days ago, Severstal-Auto's management met with analysts in order to present the company's 1H07 IFRS results. The company has significantly improved its financial indicators in comparison with its 1H06 results, which is an encouraging sign for investors. However, in our opinion, the highlight of the meeting concerned information about the company's long term strategy.
- The automotive sector has grown significantly during the past few years. During 2006, Russian consumers spent approximately \$19 bn on new foreign cars – \$7 bn more than in 2005. According to our estimates, the new foreign car market in Russia will be worth about \$36 bn by 2010. The dynamic growth of the Russian automotive market has attracted global automobile manufacturers such as Toyota, Volkswagen, Peugeot (PSA) and others to enter the Russian market. For example, Toyota has started the construction of a plant near Saint-Petersburg with an annual production capacity of 50 thousand units, which will be increased to 200,000 units; Volkswagen will build a plant with an annual production capacity of 150,000 units in the Kaluga region; and other international manufacturers have also announced or started constructing production plants in Russia. With the entrance of an increasing number of international manufacturers, the competition in the Russian passenger car market will increase; and despite the existing partnerships with foreign manufacturers (especially from Asian companies) that had already arrived on the Russian market, Russian producers are apprehensive of the new competition they will face.
- Severstal-Auto's management has analysed the market and has decided to diversify its business by developing its own vehicle components production facilities and providing maintenance service facilities to its clients.
- The company's joint ventures with Isuzu and Fiat have played a key role in implementing the company's diversification policy. The joint venture with Isuzu will lead to the production of the full model range of Isuzu commercial vehicles from LCVs to HDTs and the joint venture with Fiat will lead to the production of passenger vehicles. (In our previous reports, we already wrote about the joint venture with Isuzu.) The joint venture with Fiat will become the official distributor of all Fiat models in Russia. Initially, the Fiat Linea will be produced under the joint venture, and subsequently other models will also be produced at its facilities and jointly marketed. Management declined to give any production details, but promised to disclose all project-related information early next year. We expect the joint venture's facilities will have an annual production capacity of 50,000 units, will be constructed jointly by Fiat and Severstal-Auto, and will be 50% owned by Severstal-Auto (so only 50% of the JV's revenues will be included in Severstal-Auto's financials). The company decided to form the joint venture in order to diversify the risks associated with the promotion of the Fiat brand in Russia. Clearly, in order to compete with the increasing number of foreign automobile manufacturers entering the Russian market, the launch of the advertising campaign for marketing the Fiat brand will result in significantly higher distribution costs.
- Currently, auto component sales generate 12% of the company's revenues. Having foreseen the danger posed by the entrance of large international automobile producers, Severstal-Auto decided to expand its automobile component production division. This usually requires a long time period to implement: during the initial phase, the company will concentrate on increasing the proportion of components produced (locally by the company) for its own vehicles. This will be followed by the construction of a vertically integrated full cycle production facility, which will enable the company to produce and supply auto components to third party producers as well. Currently, the company is using the sale of high quality auto components produced by Asian companies to develop its "Dvoynoy resurs" ("Doubled life") brand. However, once the company's own production facilities are completed, the company plans to start selling its own auto components under this brand. In addition to developing its automobile component production facilities, Severstal-Auto plans to build production facilities for automobile body parts for the Fiat Ducato at its plant in Elabuga. This project requires an investment of 20 mn euros and will be developed in cooperation with another foreign company.
- *Conclusion:* Severstal-Auto is developing facilities to produce auto components, with the intention of eventually dominating this rapidly growing market sector. We will inform investors about further developments in the implementation of the company's strategy. We believe that the company, in the near future, is likely to dominate the automobile component production market in Russia.
- We consider that the company is fundamentally undervalued, so we reiterate our **BUY** recommendation on Severstal-Auto, with a target price of \$56 per ordinary share, implying potential upside of 16% from the current price of \$48.5.



STOCK RATING POLICY

STRONG BUY:	Upside over 25%; confidence level – high / upside over 100%; confidence level - low
BUY:	Upside between 15 and 25%; confidence level – high / upside between 25% and 100%; confidence level – low
HOLD:	Upside of less than 15%; confidence level – high / upside of less than 25%; confidence level – low
SELL:	Fair value 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

©2007 Sovlink LLC. The information in the enclosed Report (the "Information") is not an advertisement for any security or particular issuer and should not be interpreted as such. The Information is intended solely for the personal use of Sovlink LLC's clients or other parties pre-agreed to with Sovlink LLC. The Information is not intended for use by citizens of the USA or legal entities registered in the USA. Nothing contained in the Information is, or should be interpreted as being information intended for an undetermined audience.

The Information is exclusively of an informational/analytical nature, and should not be interpreted as a recommendation to take any particular investment action. The Information should not be relied upon as a justification for the execution of any transactions, and should not be referred to as such. Sovlink LLC takes no responsibility for any actions taken on the basis of the Information. The enclosed Report does not contain an offer or an invitation to make an offer to buy or sell any securities or any options, futures or other derivatives related to such securities.

This Report does not have regard to any specific investment objectives, financial situation and the particular needs of any specific person who may receive this Information. Investors should seek financial advice regarding the appropriateness of investing in any securities mentioned and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities, if any, may fluctuate and that each security's price or value may rise or fall. Accordingly, investors may earn less than originally invested. Past performance is not necessarily a guide for future performance. Foreign currency exchange rates may adversely affect the value, price or income of any security mentioned in the Report. Please bear in mind that investment activity in emerging markets is very risky, and investors should conduct their own due-diligence prior to making an investment decision.

The individual(s) responsible for the preparation of this Report (the Author(s)), or Sovlink LLC may hold short-and long-term positions in any of the securities mentioned in the Report, and may take part in investment activities with companies mentioned in the Report.

In preparing this Report, the Author(s) assumed that the issuers mentioned in the Report disclose information in the amount and under the procedure stipulated by the securities legislation of the Russian Federation for issuers who publicly place securities.

This Report and the Information is based exclusively on publicly-available information, which is deemed to be reliable, however Sovlink LLC makes no representation that this Information is accurate or comprehensive, and it should not be relied upon as such. Sovlink LLC makes no representation that this Report has been released to all readers simultaneously, nor that Sovlink LLC will update this material on a regular basis, or that it will correct inaccuracies contained in this Report.