



Bamtonnelstroy

**Company
Note**

BUY

Upside: 38%
Target price: \$4,232

Tunnel construction

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Stock data

Ticker	btst	M.Cap, \$ mn	355.93
Shares Ords	98,688	Free float	N.A.
Shares Prefs	32,896	Free float, \$ mn	N.A.
Bid Ords, \$	3,075	Offer Ords, \$	3,300
Bid Prefs, \$	1,125	Offer Prefs, \$	1,390

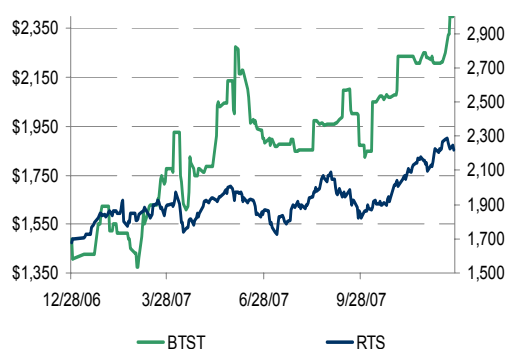
Market performance

		1 month	6 months
Absolute	Ords	31.44%	72.30%
Relative to RTSI	Ords	25.58%	50.77%
Price range, \$			
High	Ords	3,187.5	3,187.5
Low	Ords	2,425	1,825

Financials, 2007E

Revenue, \$ mn	335.4	P/S	1.01
EBITDA, \$ mn	49.4	EV/EBITDA	7.88
Net income, \$ mn	32.0	P/E	10.61
EBITDA margin, %	14.7%		
Net income, %	9.5%		

Bamtonnelstroy – Relative performance



Source: RTS, Sovlink

- OJSC Bamtonnelstroy is one of the leading companies in the tunnel construction sector. Its portfolio includes construction projects for railway, vehicle and diversion tunnels. The company has the most diversified portfolio of orders in its sector, which has a positive impact on their sustainability. Moreover, well-established relationships with customers such as Russian Railways, the Ministry of Transport and UES ensure that the company will be able to maintain its portfolio of attractive orders in the future.

- Key growth drivers of the company's business in future will consist of projects such as the reconstruction of the Baikal-Amur Mainline (BAM), transport infrastructure construction in the Krasnodar region, and participation in the investment programme of HydroWGC.

- The company has the largest profit margins in the industry: in 2006, its net operating margin approached 13%, and its net profit margin – 9%. Although its margin ratios dropped slightly in 2006, we believe that the company's position will improve over time and its projected net operating and net profit margins will rise to about 16% and 10.5%, respectively.

- The company has the most attractive market multipliers in its sector, including a P/E of 10.61; a P/S of 1.01 and EV/EBITDA of 7.88.

- We consider Bamtonnelstroy to be one of the best companies in its sector, and therefore, initiate coverage on it by issuing a **BUY** recommendation, with a target price of \$4,232 for its ordinary shares and \$1,541 for its privileged shares, which implies potential upside of 38% and 37% respectively, from current prices.



Introduction

OJSC Bamtonnelstroy is one of the largest Russian construction companies, which specialises in tunnel construction. Having started its operations in 1975 with the construction of the Baikal-Amur Mainline, the company has maintained its leading position in the industry for over 30 years. Taking into consideration the enormous potential of the road, bridge and tunnel construction market in Russia, we believe that the company will keep its leading role as a unique niche player.

Shareholder structure

OJSC Bamtonnelstroy is a closed-end company and does not release its quarterly reports, and has not revealed its shareholder structure. Market participants are aware that Transpromresource currently holds a controlling stake in the company. Transpromresource is allegedly affiliated with Severstal's principal shareholders; however, we believe that the MOST Construction Company (MOST CC) is the ultimate beneficial holder of Bamtonnelstroy.

Company activities

Since its foundation, Bamtonnelstroy's core activities have consisted of the construction of railway tunnels. As of today, the company has constructed over 20 tunnels for the East-Siberian, Far-Eastern, Zabaikal and Krasnoyarsk railways. It has also constructed a number of vehicle tunnels, and worked on hydroelectric power plants and subway systems.

Today, the company has an extensive portfolio of orders, with customers such as the Russian Railways, the Ministry of Transport, UES, and with regional and municipal authorities.

Facilities under construction:

Railway tunnels

- 1 A small tunnel in Novorossiysk
- 2 A large tunnel in Novorossiysk
- 3 Tunnel №1 on the North-Caucasus railway
- 4 Reconstruction of the Navaginsky tunnel
- 5 Reconstruction of the old Nanhchulsk tunnel
- 6 The Krolsky tunnel
- 7 The Mansky tunnel
- 8 The Korshunovsky tunnel
- 9 Reconstruction of the old Kiparisovsky tunnel

Road tunnels

- 10 The Shaumyansky tunnel

Hydroelectric power plants

- 11 The Zamagar HPS – a complex of water diversion tunnels
- 12 The shore spillway at the Sayano-Shushensk HPS
- 13 The construction of the rock-fill Bogouchan dam

Subway systems

- 14 The Krasnoyarsk subway

Industrial facilities

- 15 Runway at the airport in Ulan-Ude (in the Republic of Buryatia)
- 16 A building complex for the Poltavka (in the Omsk region) inter-regional offices
- 17 Cable gallery, Moscow

Source: Company data

The company possesses the most diversified order portfolio in its sector. Projects implemented by Bamtonnelstroy vary not only with respect to the types of facilities constructed, but also in their geographic distribution.



Source: Company data

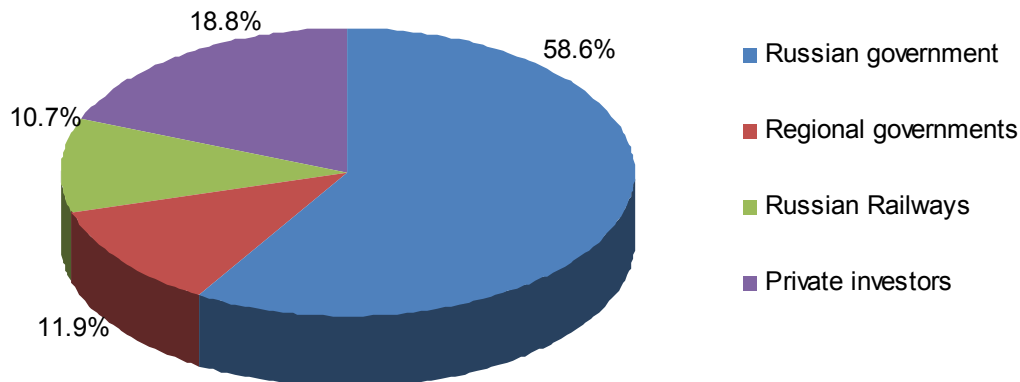
Prospects

We believe that the following programmes will be the key growth drivers for a highly specialised company such as Bamtonnelstroy:

1. In preparation for the Sochi Winter Olympic Games in 2014, the government plans to invest heavily in the development of the regional transport infrastructure. At the moment, it is difficult to assess the volume of orders the company might be given. However, we are confident that in the hilly terrain of the Krasnodar region, the regional transport infrastructure cannot be built without a company specialising in tunnel construction. Bamtonnelstroy is likely to receive orders for these projects since the company has well-established partnerships with the Russian Ministry of Transport and Russian Railways. In order to estimate the approximate amount that will be invested in the Olympic Games in Sochi, we have compared the investment made in preparation for the Beijing Olympic Games in 2008. According to rough estimates, the Chinese Government has spent around \$37-40 bn in preparing for the Games, out of which \$8 bn was used for the construction of new subway branches and other transport infrastructure facilities. According to previous statements of the Chinese Government, only \$10-12 bn should have been spent on the 2008 Olympic Games; however, the actual investment exceeded all expectations. At this stage, the Russian Government is planning to spend about \$12.2 bn in preparing for the 2014 Olympic Games. However, based on the escalation of actual investments compared to the planned investment amount as occurred in China, the actual investment amount may easily reach \$30 bn.
2. The “Railway Transport Development Strategy until 2030” provides for the construction of over 20 thousand km of new railways. The total investment required for the project exceeds RUR 4.2 trillion, of which RUR 2.4 trillion (58.6%) is to be invested by the Russian Government, RUR 502 bn (11.9%) by the regional governments; RUR 453 bn (10.7%) by the Russian Railways, and RUR 796 bn (18.8%) by private investors.



Investment for the construction of new railways



In addition to the construction of new railways, the strategy consists of upgrading the existing infrastructure, and, in particular, important facilities such as BAM. Together with the Trans-Siberian railway, BAM holds an important position in the railway system and is the second railway line, providing Russia with access to the Pacific Ocean. Today, the infrastructure in this area is riddled with problems, with the Kuznetsovsky tunnel providing the biggest difficulty. The construction of new terminals by private companies at the Vanino seaport and the Sovetskaya Gavan in the Far East depend heavily on the upgrading of these facilities. The low throughput (12 mn tonnes p.a.) of the Kuznetsovsky tunnel does not allow sufficient cargo turnover to pass through to Sovetskaya Gavan. After widening the tunnel, the cargo turnover is expected to jump to 37 mn tons p.a. and to 50 bn tons p.a. by 2014, upon implementation of the full BAM upgrading programme. RUR 50 mn are required to implement this project; Russian Railways will receive RUR 12 bn from the government's investment fund and it will raise the remaining portion through its own means. Given the fact that Bamtonnelstroy has a long-standing record of cooperation with Russian Railways and taking into consideration the construction projects completed by the company, we feel that Bamtonnelstroy is well placed to win the tender for this project.

3. As Bamtonnelstroy specialises not only in the construction of railway and vehicle tunnels, but also has extensive experience in the construction of water diversion tunnels for hydro power plants, it is also well-placed for participation in HydroWGC's investment programme. HydroWGC, a specialised energy holding, was spun off during UES' restructuring process. It integrated all the water assets of UES' energy generation unit. As hydro power stations can generate electricity at cheaper prices – prices that are twice as cheap as electricity generated via nuclear power plants and 5 times cheaper than via GRES – the government decided to develop this segment. Based on this decision, the HydroWGC investment programme was developed, in which almost RUR 330 bn will be invested from 2006 to 2010.



Investment demand, RUR bn

No.	Description	2006	2007E	2008E	2009E	2010E	2006-2010E
I	Technical development and Reconstruction	6,194	8,170	10,368	9,173	7,712	41,617
II	Additional construction	19,002	33,512	39,445	27,851	10,631	130,440
III	Start-ups (not operational) until 2010	768	6,418	12,967	27,692	49,571	97,416
IV	New construction	1,777	8,326	12,344	16,147	16,130	54,724
V	Other	1,181	113	115	157	170	1,736
	Reserves	30	2,950				2,980
	Total	28,952	59,489	75,239	81,020	84,213	328,914
	Displacement of the Izvestkovaya-Chegdomyn railway located at the flooding area of the water reservoir at the Bureiskaya HPS (part of HydroWGC)		957				957
	Total with displacement of the railway	28,952	60,446	75,239	81,020	84,213	329,871

Source: HydroWGC

In our opinion, Bamtonnelstroy has every chance to win the tender for the construction of water diversion tunnels for the new hydro power plants. Taking into account the fact that the value of the diversion tunnels ranges from 10% to 60% of the value of a hydro power plant (depending on the length of the tunnel), we assume that tunnel construction companies will receive significant amounts of funds under the investment programme. Regarding the funds to be spent on new construction, companies engaged in tunnel construction will receive orders ranging from at least RUR 6 to 30 bn.

Financials

Analysis of the company's financials shows that it has made steady progress and increased its turnover from \$89 mn in 2002 to \$305 mn in 2006. Thus, over the past 5 years, its revenues have, on average, grown at about 28% p.a. Its steadily rising revenues are an indication that the company has a systematic approach in developing its business and has built up its order portfolio gradually. However, production costs and other operating expenses grew even faster, which resulted in a lower CAGR – with respect to operating profit growth – of about 17.5%.

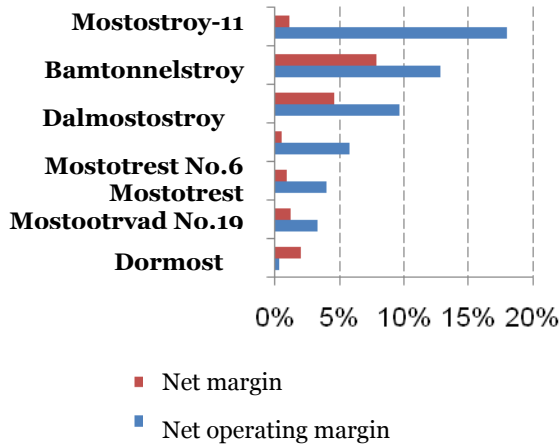
\$ mn	2002	2003	2004	2005	2006	CAGR 2002-2006
Revenues	89.0	185.4	201.2	210.3	304.9	27.93%
Production costs	71.5	152.8	163.4	166.4	248.4	28.27%
Operating profit	17.4	32.7	37.8	43.9	39.0	17.46%
Profit before tax	18.9	30.9	41.1	35.3	31.8	10.95%
Net profit	17.6	25.4	34.4	25.4	26.5	8.58%

Source: Company data, SOVLINK estimates

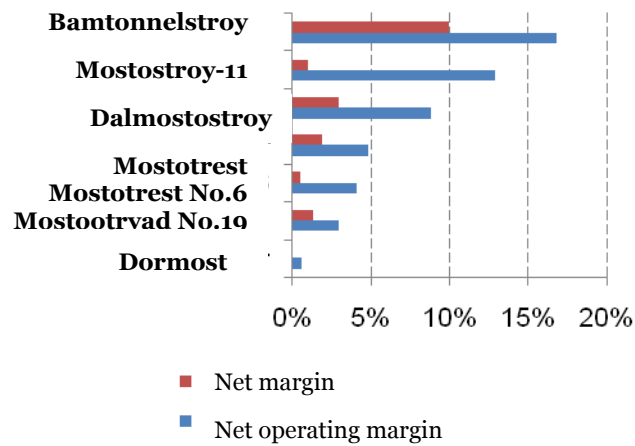
We note that Bamtonnelstroy has the best profitability ratios amongst companies in the road construction industry. Strong relationships with key customers and the unique technologies employed by the company have enabled it to develop a diversified and highly profitable portfolio of orders.



Profit margins, 2006



Profit margins, 2007E

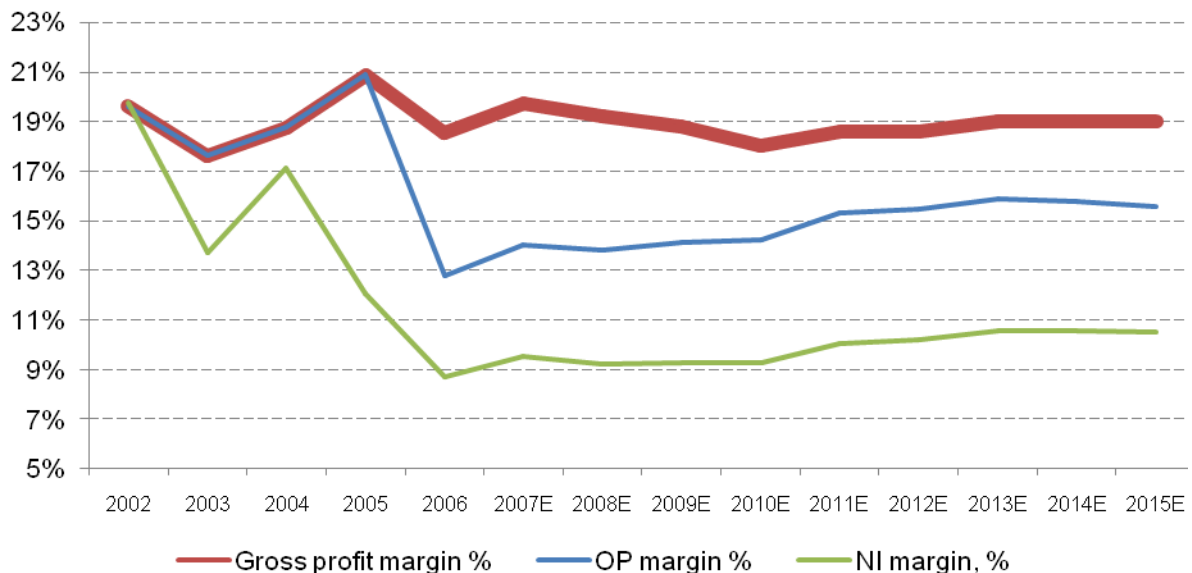


Source: Company data, SOVLINK estimates

Over the past few years, there was a decline in the company’s operating margins because of sharply rising prices for building materials, combined with weak management of administrative and business expenses. This gradually led to a decline in its profitability ratios.

In the near future, we forecast stabilisation of the company’s gross profit margin at 18-19%. We also assume that reduction of other operating costs will enable the company to increase its operating margin from 14% to 16%, and its net interest margin from 9.5% to 10.5%.

Margin trends



Source: Company data, SOVLINK estimates



Valuation

We have estimated the company's fair value, based on our DCF model – obtaining a fair value \$4,232 for its ordinary shares and \$1,541 for its preferred shares.

We made the following assumptions in our DCF model:

1. We assume that, given the "Railway Transport Development Strategy until 2030" and plans for the reconstruction of tunnels in the Krasnodar region near Sochi, the company will expand its activities, which will result in the growth of its revenues. According to our forecasts, revenue growth rates will jump from 10% in 2007 to 35% in 2010; although in future the growth rate will slow down to a terminal value of 3% by 2015.

	2005	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Sales, \$ mn	210.3	304.9	335.4	385.7	482.1	650.8	813.5	935.5	1,029.1	1,080.5	1,113.0

Source: Company data, SOVLINK estimates

2. In 2006, rising raw material prices resulted in a drop in the company's operating income margin from 20.88% in 2005 to 12.79% in 2006. We anticipate the margin to be much lower in the next few years. Nevertheless, long-standing partnerships with suppliers and new projects with high returns will allow the company to increase its margin to 17%.

\$ mn	2005	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Operating profit	43.9	39.0	47.0	53.3	68.0	92.5	124.4	144.7	163.6	170.5	173.5
OP margin, %	20.88	12.79	14.02	13.82	14.10	14.21	15.29	15.47	15.89	15.78	15.59

Source: Company data, SOVLINK estimates

3. According to the company's data, its preferred shares account for 10% of its net profits. Therefore, when calculating free cash flow, we adjusted our net profit estimates by deducting the dividends paid on preferred shares.

Net income adjustment, \$ mn	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
NI	32.0	35.6	44.7	60.2	81.8	95.6	108.9	114.4	116.7
Preferred share dividends	3.2	3.6	4.5	6.0	8.2	9.6	10.9	11.4	11.7
Adjusted NI	28.8	32.0	40.2	54.2	73.6	86.1	98.0	102.9	105.1

Source: SOVLINK estimates



4. We note that the company's liabilities have gradually decreased from 77.05% in 2002 to 43.65% in 2006. We expect that this trend will continue, and liabilities as a proportion of the company's equity will come down to 31.76% by 2015, (although, in absolute terms, it will have grown significantly.)

\$ mn	2002	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Non-current liabilities	0.00	37.24	34.99	43.74	59.05	81.75	97.86	87.65	85.70	85.28	73.97
Current liabilities	58.17	51.25	60.85	69.98	89.25	145.97	187.03	196.86	219.57	214.38	197.12
Total liabilities	58.17	88.49	95.84	113.72	148.30	227.72	284.89	284.51	305.27	299.66	271.10
Total liabilities and Equity	75.49	202.74	232.49	275.28	345.63	473.22	591.75	663.09	749.19	812.21	853.70
Liabilities as a % of equity	77.05	43.65	41.22	41.31	42.91	48.12	48.14	42.91	40.75	36.89	31.76

Source: Company data, SOVLINK estimates

5. When discounting future cash flows, we applied the following beta values:

	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Risk free rate	6.10%	6.10%	6.10%	6.10%	6.10%	6.10%	6.10%	6.10%	6.10%
Russian Market Premium	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
Debt/Equity	47.47%	48.34%	51.69%	55.43%	53.03%	46.06%	40.34%	33.19%	28.06%
Beta levered	1.01	1.02	1.04	1.06	1.05	1.00	0.96	0.91	0.88
Cost of Equity	16.20%	16.26%	16.49%	16.75%	16.58%	16.11%	15.71%	15.22%	14.87%
Cost of Debt	11.34%	10.97%	10.60%	10.23%	9.86%	9.49%	9.12%	8.75%	8.38%
Share of Equity	58.78%	58.69%	57.09%	51.88%	51.86%	57.09%	59.25%	63.11%	68.24%
Share of Liabilities	41.22%	41.31%	42.91%	48.12%	48.14%	42.91%	40.75%	36.89%	31.76%
WACC	13.08%	12.99%	12.87%	12.43%	12.21%	12.29%	12.14%	12.06%	12.17%

Source: SOVLINK estimates



6. In order to determine the price of the preferred shares, we applied the average historical discount rate of 63.6%.



Source: RTS data, SOVLINK estimates

DCF model

\$ mn	2005	2006	2007E	2008 E	2009 E	2010E	2011E	2012E	2013E	2014E	2015E
Sales	210.3	304.9	335.4	385.7	482.1	650.8	813.5	935.5	1,029.1	1,080.5	1,113.0
COGS	166.4	248.4	269.3	311.6	391.4	533.7	662.2	761.5	833.6	875.2	901.5
Gross profit	43.9	56.5	66.1	74.0	90.6	117.1	151.3	174.0	195.5	205.3	211.5
Operational expenses	0.0	17.5	19.1	20.8	22.6	24.7	26.9	29.3	32.0	34.8	38.0
Operational profit	43.9	39.0	47.0	53.3	68.0	92.5	124.4	144.7	163.6	170.5	173.5
EBITDA	46.0	41.2	49.4	59.0	78.4	109.6	146.4	170.5	191.6	198.8	200.3
EBT	35.3	31.8	42.1	46.8	58.8	79.3	107.6	125.8	143.3	150.5	153.6
Tax	9.9	5.3	10.1	11.2	14.1	19.0	25.8	30.2	34.4	36.1	36.9
Net income	25.4	26.5	32.0	35.6	44.7	60.2	81.8	95.6	108.9	114.4	116.7
EBITDA margin, %	21.9%	13.5%	14.7%	15.3%	16.3%	16.8%	18.0%	18.2%	18.6%	18.4%	18.0%
EBT margin, %	16.8%	10.4%	12.6%	12.1%	12.2%	12.2%	13.2%	13.4%	13.9%	13.9%	13.8%
NI margin, %	12.1%	8.7%	9.5%	9.2%	9.3%	9.3%	10.1%	10.2%	10.6%	10.6%	10.5%

Source: Company data, SOVLINK estimates



DCF summary, \$ mn	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Adjusted NI	28.8	32.0	40.2	54.2	73.6	86.1	98.0	102.9	105.1
Amortisation & Depreciation	2.4	5.7	10.4	17.2	21.9	25.8	28.0	28.3	26.8
Changes in working capital	23.8	27.1	38.3	68.7	68.4	18.2	37.1	21.6	13.0
CAPEX	16.8	27.0	43.4	39.0	40.7	37.4	30.9	21.6	11.1
FCFF	-9.4	-16.4	-31.1	-36.4	-13.6	56.2	58.0	88.0	107.7

Source: SOVLINK estimates

Terminal growth rate	3%
Sum of NPV, \$ mn	54.6
Terminal value, \$ mn	412.7
Fair EV, \$ mn	467.3
Net Debt, \$ mn	49.7
Fair Mcap, \$ mn	417.7
Ordinary shares	98,688
Preferred shares	32,896
Discount of preffs	63.6%
Price of ordinary shares, \$	3,075
Price of preferred shares, \$	1,100
Target price of ordinary shares, \$	4,232
Target price of preferred shares, \$	1,541
Upside of ordinary shares	38%
Upside of preferred shares	37%

Source: Company data, SOVLINK estimates

Based on our DCF model, we obtained a target price of \$4,232 per ordinary share of the company and \$1,541 per preferred share, which imply potential upside of 38% and 37% respectively, from current prices. We, therefore initiate coverage on Bamtonnelstroy by issuing a **BUY** recommendation on both the company's ordinary and preference shares.



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:	Target price at or below current price levels

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