Kuibyshev Azot: Dominant on a Growing Market

Investment Summary

We reinitiate coverage of Kuibyshev Azot, #1 domestic producer of caprolactam and derivatives, with a BUY rating. Combination of defensive nitrogen production with output of organics, increasing exposure to higher margin petrochemical markets, good location and up-to-date units are strong arguments in favor.

- ✓ Kuibyshev Azot (KuAz) is the biggest Russian producer of caprolactam and derivatives, and also makes ammonia and nitrogen fertilizers (about 38% of company revenues). The company generates 74% of its revenues from exports, taking advantage of lower cost inputs in Russia.
- ✓ Caprolactam is widely used for production of polyamide plastics and fibers, and company strategy is to make and sell more of these outputs in order to achieve higher margins. Creation of a Chinese subsidiary for polyamide production is an important step, as is acquisition of the biggest domestic producer of chemical fibers.
- ✓ Reliance on natural gas and benzene inputs exposes KuAz to price volatility for these commodities, but relatively low domestic prices for both inputs and modern processing facilities give competitive advantages.
- ✓ The main site in Togliatti (Samara region) is close to key suppliers, and KuAz has a stake in Togliatti port as well as its own fleet of railcars and trucks.
- ✓ We believe that the company is owned by management. Dividends have been low, but will be higher this year, and we are optimistic that the upward trend will continue. Publication of IFRS financials is pleasing and is a rarity among second-tier Russian petrochemicals.
- ✓ Net debt-to-EBITDA ratio was 3.5x at the end of 2009. We expect increasing liquidity and market recovery to lower the ratio to 2.0x by the end of 2011. Interest rates are also improving.
- ✓ Key advantages are combination of defensive nitrogen production with output of organics, and increasing exposure to high marginal petrochemical markets by processing of caprolactam into derivatives. Good location and own transportation facilities as well as up-to-date units add to competitiveness and cost control.
- ✓ We valued Kuibyshev Azot by DCF and multiples using 75-25 weights and found the stocks to be undervalued. We recommend to BUY both common and preferred shares of Kuibyshev Azot with target prices of $1.7 and $1.1 per share, respectively.

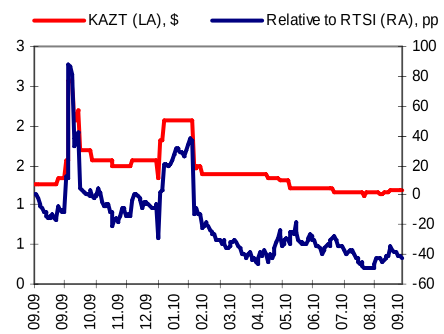
KAZT **BUY $1.7 ▲54%**
KAZTP **BUY $1.1 ▲57%**

Current market cap, $m	213.8
EV, $m	472.4
Estimated free-float, %	n/a
Common shares	
- ticker (RTS)	KAZT
- number*, m	192.92
- bid-ask range, $	1.00-1.20
- fair price, $	1.70
- up/down, %	54%
- previous fair price, $	U/R
Preferred shares	
- ticker (RTS)	KAZTP
- number, m	2.24
- bid-ask range, $	0.615-0.809
- fair price, $	1.10
- up/down, %	57%
- previous fair price, $	U/R
Other stock exchanges	
LSE	N/L
NYSE	N/L

* excluding treasury shares

IFRS, $m	08	09	10E	11E
Revenues	794	539	636	681
EBITDA	170	74	79	114
- margin, %	21%	14%	12%	17%
Op. income	129	39	46	82
Net income	70	9	23	51
- margin, %	9%	2%	4%	8%
EPS, $	0.36	0.05	0.12	0.27

	08	09	10E	11E
EV/S	0.59	0.88	0.74	0.69
EV/EBITDA	2.79	6.42	5.96	4.15
P/E	3.06	23.18	9.15	4.16



RMG Research, September 10, 2010
Constantin Yuminov (7 495) 258 6262
research@rmg.ru

Company description

Production and sales profile

KuAz is the largest Russian producer of caprolactam and derivatives

Kuibyshev Azot (KuAz) is the largest Russian producer of caprolactam (55% of national output) and its derivative, nylon-6 (or polyamide-6, PA6). Caprolactam is obtained from the oil refining fraction, benzene, or from phenol, and its main use is for production of polyamide, a plastic with numerous uses in manufacture of industrial and consumer goods.

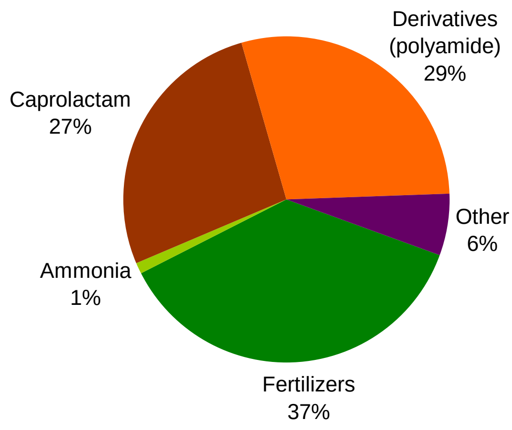
Modernization and expansion has increased total caprolactam capacity to 190 000 tonnes per annum from 60 000 tonnes in 1990 and 120 000 tonnes in 2004, making KuAz the eighth largest producer in the world.

KuAz also makes and sells large quantities of ammonia and nitrogen fertilizers.

3/4 of sales are exports

The company generates 74% of its revenues from exports, taking advantage of lower cost inputs in Russia (natural gas for ammonia and benzene for caprolactam), and much higher prices for outputs abroad than on the domestic market.

Kuibyshev Azot sales structure in 2009



Source: Company data

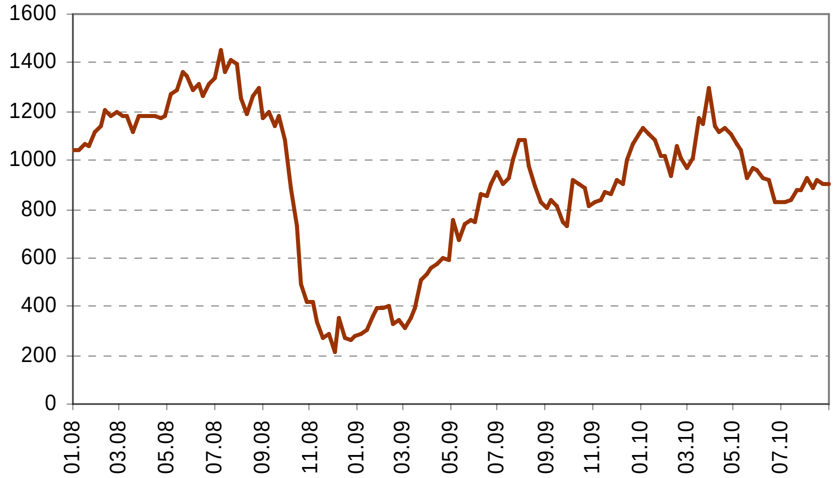
Cost risks and advantages

KuAz benefits from low Russian prices for its inputs

Kuibyshev Azot's reliance on natural gas and benzene inputs gives it large exposure to price volatility on hydrocarbon and petroleum product markets.

There have been several benzene price spikes on the international market in the past (see diagram below), mainly tracking oil price trends, but also determined by capacity deficits and strong demand for benzene. However, prices inside Russia are lower due to exclusion of export duties and lower transportation costs. The company buys its benzene inputs from the Lukoil petrochemical subsidiary, Lukoil-Neftekhim.

Global benzene prices, $ per tonne FOB Rotterdam



Source: Bloomberg

...and cost risk is spread over gas and benzene

The company's ammonia and fertilizer business is vulnerable to gradual increase of natural gas prices for industrial consumers in Russia. But local prices are still much lower than both international gas spot-prices and export netback prices of Gazprom, giving KuAz strong competitive advantage in comparison with producers in Europe and in CIS countries outside Russia. Despite declarations by Gazprom and the Russian government, we do not expect domestic gas prices to draw level with export netback before 2016.

KuAz is also at an advantage since its ammonia unit is among the most efficient by gas consumption among domestic nitrogen producers: it uses about 1080 cm of natural gas per tonne of ammonia, roughly as efficient as facilities of Acron.

The fact that the company makes both organics (caprolactam & derivatives) and ammonia/urea gives it extra protection against price shocks, since probability of simultaneous price spikes for benzene and natural gas is limited.

Expanding value-added outputs

Value-added outputs are increasingly large

The key strategic priority for KuAz is to reduce its exposure to price volatility on the international market for caprolactam and to raise margins by increasing capacity for processing caprolactam into polyamide. Demand for engineering plastics (the main use of polyamide) is increasing by up to 20% a year in China and by 6-8% per year globally.

The company only launched polyamide production in 2003 and now produces up to 100 000 tonnes annually, having the largest capacity in Russia and one of the largest in the world. The second biggest domestic producer of polyamide (and #1 producer of chemical fibers), Kurskkhimvolokno, was acquired by KuAz in 2007, so its overall share of domestic production is now about 90%.

Fiber and tire cord production is now a valuable part of the KuAz business. These outputs are sold mainly to domestic tire makers.

Location, Chinese subsidiary

The company's main site at Togliatti (Samara region) is close to main suppliers of inputs. KuAz also owns transportation assets (a stake in Togliatti port, and a fleet of railcars and trucks), reducing transportation expenses and giving logistical advantages.

KuAz also has the advantage of local presence in China: its Shanghai subsidiary, Kuibyshev Azot Engineering Plastics, produces high-quality polyamide for the Chinese electronics, packaging and auto industries.

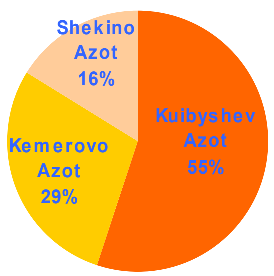
Caprolactam (polyamide) market

Caprolactam and polyamide demand is recovering strongly

Global demand for caprolactam recovered to 4mt in 2009, following significant fall at the end of 2008. Buyers, particularly in Asia, destocked as prices tumbled in late 2008 and early 2009, but hurried back to the market from 2Q 2009 as the tide began to turn, so that demand remained strong even in the traditionally quiet summer season. Trends in demand for polyamide plastics have been similar. Preliminary 1H 2010 results show further strong recovery of consumption and we expect the trend to continue in 2011.

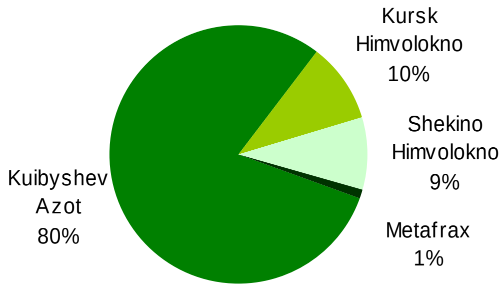
Main Russian caprolactam producers – Kuibyshev Azot, Kemerovo Azot (owned by the Gazprom subsidiary, Sibur) and Shekino Azot – export about 60% of their output, mainly to China. Chinese buyers prefer to purchase caprolactam from Russia and Japan, as neither of these countries is included in an ongoing caprolactam anti-dumping investigation by the Chinese government.

Domestic producers of caprolactam, 2009



Source: Company data, RMG estimates

Domestic producers of polyamide, 2009



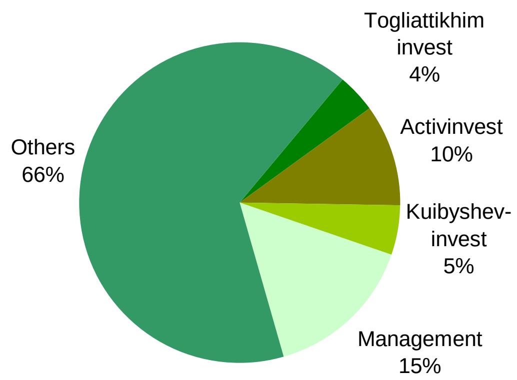
Source: Company data, RMG estimates

Shareholder structure and corporate governance

We believe that the company is owned by its management

We believe that Kuibyshev Azot is controlled by its management: executive members of the BoD own about 15.3% of charter capital, while 19.1% is owned by three subsidiaries – Togliattikhiminvest (3.84%), Activinvest (10.26%) and Kuibyshev-Invest (5.01%). It is not clear how much of remaining 65% is dispersed among minorities, but we doubt that all of these shares are free-float.

Kuibyshev Azot shareholders

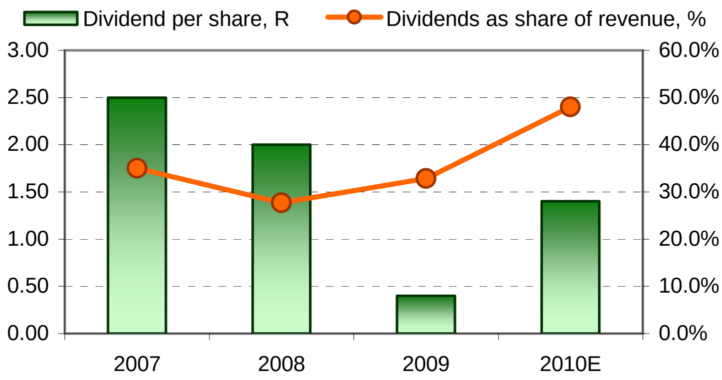


Source: Company data

Dividends are low, but improving

Kuibyshev Azot traditionally pays low dividends, which are equal for commons and prefs. The company also has a practice of interim dividends, which reduces attractiveness. Total payouts are 30-35% of IFRS net income, but we expect this share to increase in 2010 and coming years: the company has paid R0.8 per share as interim dividends for 1H 2010, and we conservatively estimate additional payments for 2H 2010 at R0.6 per share, which will represent a total payout equal to 48% net income.

Dividend payments



Source: Company data

Publication of financial results under IFRS is a additional plus, and is a rarity among second-tier Russian petrochemicals.

Debt position

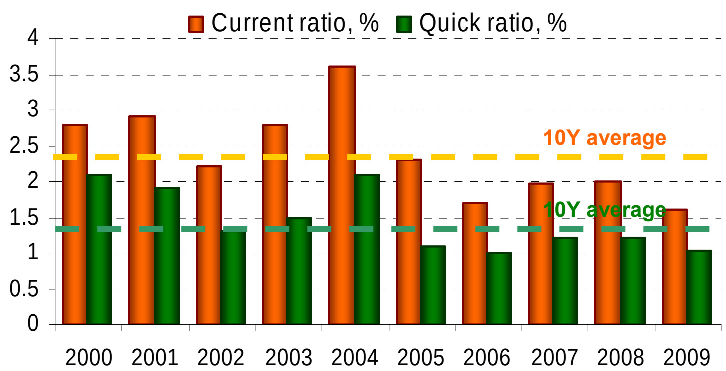
The company has a good credit history

In March 2006 Kuibyshev Azot Invest, a special-purpose vehicle of Kuibyshev Azot, placed a second bond issue with value of R2b (about $72m) and maturity date in 2011. Part of the cash was used to repay a preceding $20m bond issue and the rest was used for capex. The bonds have 8.8% coupon. The company kept payments on bonds current in 2009, despite the difficult climate, and positive bond history has enabled cheaper financing.

Liquidity ratios are strong

Liquidity ratios have traditionally been strong: the average 10-year current ratio is 2.4x, while average quick ratio is 1.4x. Despite expected deterioration of debt position in 2009 (current ratio fell from 2.0x in 2008 to 1.6x in 2009, while quick ratio dropped from 1.2x to 1.0x), we expect a return to the historical trend in the near term.

Kuibyshev Azot liquidity position

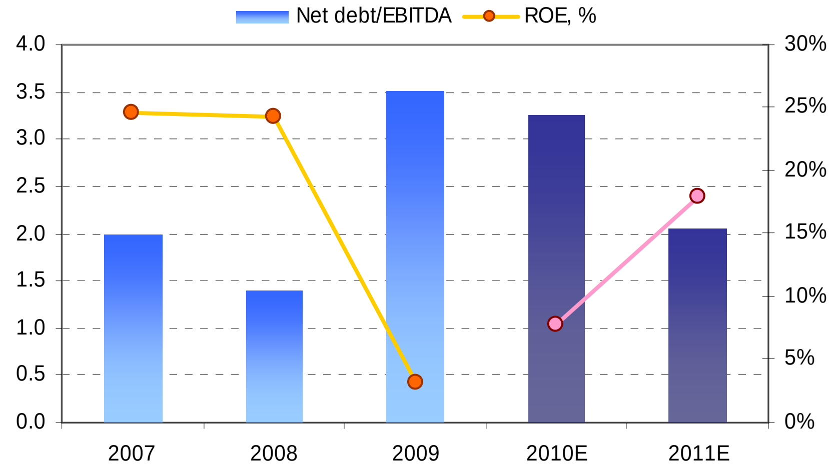


Source: Company data, RMG estimates

Debt levels appear to be declining

Total debt under IFRS at the start of 2010 was nearly $316m, of which 60% was short-term, and net debt was $259m (9% higher y-o-y), giving net debt-to-EBITDA (2009) ratio of 3.5x. We believe that increasing liquidity and market recovery will enable further reduction of interest rates and debt levels. We expect decline of net debt-to-EBITDA to 2.0x by the end of 2011 (see below).

Kuibyshev Azot debt position



Source: Company data, RMG estimates

Valuation principles

We valued Kuibyshev Azot by DCF and multiples. Our key assumptions for the model are as follows:

- The company will continue to increase volumes of caprolactam processing, boosting EBITDA margin;
- Strong export exposure, mainly to Chinese and South-East Asian markets, will support sales price of polyamide and nitrogens, while import substitution for fibers and yarns supports strong position on the domestic market;
- The company will continue to reduce consumption of raw materials per tonne of output (in both organic and nitrogen divisions) by upgrading production facilities;
- Company margins will increase after 2010 due to slower increase of raw material prices (based on our oil price forecast);

KuAz looks undervalued in comparison with peer groups (caprolactam producers and nitrogen fertilizers). We valued the company using EV/S, EV/EBITDA and MC/BV multiples. We found upside potential, even applying conservative discount of 20%.

Kuibyshev Azot income statement, $m

	2008	2009	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Total revenue	**794**	**539**	**636**	**681**	**736**	**789**	**846**	**914**	**980**
Raw materials	395	251	296	296	313	331	351	373	374
Energy	71	61	78	87	87	86	90	92	97
Transportation	61	63	71	70	74	80	86	93	100
Wages	59	51	59	59	65	72	81	90	99
Depreciation	41	35	34	32	34	36	39	41	44
Others	-3	4	14	14	15	16	17	18	18
G&A	42	36	39	42	45	48	52	56	60
Operating income	**129**	**39**	**46**	**82**	**103**	**119**	**131**	**152**	**188**
Operating margin, %	16%	7%	7%	12%	14%	15%	15%	17%	19%
EBITDA	**170**	**74**	**79**	**114**	**137**	**155**	**170**	**193**	**232**
EBITDA margin, %	21%	14%	12%	17%	19%	20%	20%	21%	24%
Net income	**70**	**9**	**23**	**51**	**65**	**75**	**82**	**121**	**150**
Net margin, %	8.8%	2%	4%	8%	9%	9%	10%	13%	15%

Source: Company data, RMG estimates

FCFF calculation, $m

	2008	2009	2010E	2011E	2012E	2013E	2014E	2015E	2016E
EBIT	129	39	46	82	103	119	131	152	188
Non-operating expenses	33	26	13	14	17	20	22	0	0
Income tax	26	1	9	16	21	24	26	30	38
Minority interest	0	2	0	0	0	0	0	1	1
Capex	116	36	43	46	50	53	57	62	66
Change in WC	-30	28	-9	10	12	11	12	14	13
Depreciation	41	35	34	32	34	36	39	41	44
FCFF	24	-21	23	28	38	47	53	87	115
Discounted FCFF			**23**	**25**	**29**	**32**	**32**	**46**	**53**

Source: Company data, RMG estimates

WACC calculation

Cost of debt	**10.4%**
Beta leveraged	1.82
Risk free rate	7.0%
Standard risk premium	5.0%
Specific company premium	4.0%
Cost of equity	**20.1%**
Share of debt, %	52.3%
Share of equity, %	47.7%
WACC	**15.0%**

Source: Company data, RMG estimates

DCF results

Terminal growth rate, %	2.5%
Terminal EBIT margin, %	15%
Terminal value, $m	962
PV of terminal value, $m	361
Discounted value for 2010-2016, $m	229
Fair EV, $m	590
Net debt, $m	259
Fair MC, $m	331
Number of common shares, m	193
Number of preferred shares, m	2
Fair price per common share, $	**1.71**
Fair price per preferred share, $	**1.11**

Source: Company data, RMG estimates

Sensitivity analysis (fair price in $)

Terminal growth rate, %	WACC, %						
	13.5%	14.0%	14.5%	**15.0%**	15.5%	16.0%	16.5%
1.5%	2.01	1.85	1.70	1.56	1.43	1.31	1.20
2.0%	2.11	1.94	1.78	1.63	1.50	1.37	1.26
2.5%	2.22	2.04	1.87	1.71	1.57	1.44	1.32
3.0%	2.35	2.15	1.96	1.80	1.65	1.51	1.38
3.5%	2.48	2.27	2.07	1.89	1.73	1.58	1.45

Source: RMG estimates

Constantin Yuminov (7 495) 258 6262
research@rmg.ru

Comparative multiples, 2010E

	Country	MCap, $m	EV / S	EV / EBITDA	P / E	MC / BV	EBITDA margin	Net margin
Nitrogen peers								
YARA INTERNATIONAL ASA	NORWAY	12 048	1.4	9.0	14.7	2.3	15%	8%
CF INDUSTRIES HOLDINGS INC	US	6 575	2.2	7.0	14.7	1.6	32%	12%
CHINA BLUECHEMICAL LTD - H	CHINA	2 999	2.7	7.0	15.6	1.9	38%	19%
AGRIUM INC	CANADA	11 142	1.2	8.8	15.1	2.2	14%	7%
Median			**1.8**	**7.9**	**14.9**	**2.0**	**24%**	**10%**
Caprolactam & derivatives peers								
CHINA PETROCHEMICAL DEV CORP	TAIWAN	1 087	1.0	7.4	8.2	1.4	14%	11%
CAPRO CORPORATION	S. KOREA	529	0.8	4.8	6.7	4.1	17%	10%
UBE INDUSTRIES LTD	JAPAN	2 163	0.9	7.8	25.2	1.0	11%	1%
FORMOSA CHEMICALS & FIBRE	TAIWAN	12 614	1.5	12.2	10.6	1.8	12%	14%
Median			**1.0**	**7.6**	**9.4**	**1.6**	**13%**	**11%**
Kuibyshev Azot	**Russia**	**212**	**0.7**	**6.0**	**9.2**	**0.7**	**12%**	**4%**
Premium / discount to:								
Nitrogen peers			**-59%**	**-25%**	**-39%**	**-65%**		
Caprolactam & derivatives peers			**-22%**	**-22%**	**-3%**	**-56%**		

Source: Bloomberg, RMG estimates

Kuibyshev Azot multiples valuation

	EV / S	EV / EBITDA	MC / BV
Median for peers	1.3	7.6	1.8
Applied premium/discount, %	-20%	-20%	-20%
Implied multiples for valuation	1.0	6.1	1.5
MCap based on multiples, $m	394	224	441
Weight, %	20%	60%	20%
Weighted fair market cap, $m		302	
# of common shares		192.92	
# of preferred shares		2.24	
Discount, %		35%	
Fair price per common share, $		**1.56**	
Fair price per preferred share, $		**1.01**	

Source: RMG estimates

Final valuation

	DCF	Comparative
Fair price per common share, $	1.71	1.56
Weight in final fair price, %	75%	25%
Final fair price per common share, $	**1.7**	
Pref discount, $	35%	
Final fair price per preferred share, $	**1.1**	

Source: RMG estimates

Final recommendation

We recommend both commons and prefs as BUY with targets of $1.7 and $1.1

We valued Kuibyshev Azot by DCF and multiples using 75-25% weights and found the stocks to be undervalued. We recommend to BUY both common and preferred shares of Kuibyshev Azot with target prices of $1.7 and $1.1 per share, respectively.

Key drivers are combination of defensive nitrogen production and production of organics, as well as increasing exposure to higher margin markets by processing of more caprolactam into derivatives. Good location and own transportation facilities as well as up-to-date units add optimism regarding competitiveness and cost control.

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