Cement Producers: Cementing Recovery

	RTS ticker	Market bid-ask range, $	Market cap (mid), $m	EV/EBIT (2008)	Fair price, $	Up/down, %	Recommendation
Alfa Cement*	ALCE	9.00-100	452	3.0	**57**	5%	**HOLD**
Gornozavodskcement	GZCE	110-250	140	1.0	**152**	-15%	**SELL**
Iskitimcement	ISKC	50.0-990	50	1.0	**666**	28%	**HOLD**
Sibirsky Cement	SCEM	14.0-14.8	436	1.5	**19**	32%	**Spec BUY**
Ulyanovskcement com	ULCE	1.50-20	23	-6.1	**1.5**	-66%	**SELL**
Ulyanovskcement pref	ULCEP	0.300-1.00			**0.6**	-10%	**SELL**

* Including Volskcement and Schurovsky Cement

Note: prices as of 13.08.09

Source: RTS, RMG estimates

Investment Summary

We update our valuations of cement producers. We see Sibirsky Cement as most interesting among the companies, which we cover, thanks to its leading position on the cement market, modest corporate governance threats and possible sale of shares to a strategic investor or via IPO. Ulyanovskcement is the least attractive, in our view, due to possible mandatory buy-back of minority shares at an unfair price.

- ✓ Sale prices and volumes of Russian cement makers rose rapidly until mid-2008, when cement import duties were cancelled; in autumn cement production started to drop due to liquidity problems and freezing of many construction projects. There has been some revival in summer 2009 due to seasonal effects as well as gradual recovery of the overall economy.
- ✓ We think that price recovery will be very weak due to spare capacities and limited demand. As we are quite bearish on the ruble, we think that dollar prices for cement are unlikely to reach pre-crisis levels any time soon (we expect dollar prices to fluctuate near their current level, declining slightly in 2010 due to further ruble weakening).
- ✓ Generally, we see Sibirsky Cement as most interesting among covered companies, thanks to its strong market position (second largest producer in Russia), modest corporate governance threats, and possible future sale of a stake to strategic investor or via IPO. Our DCF model justifies a Speculative BUY recommendation.
- ✓ Ulyanovskcement is least attractive, in our view, due to possible mandatory buy-back of minority shares at unfair price. We recommend to SELL both commons and prefs.
- ✓ We also recommend to SELL shares of Gornozavodskcement, which is not currently included in any large holding, but may be included in such a holding in the future (as suggested by recent reports of raider action). Such inclusions are often accompanied by violation of minority rights.
- ✓ We have HOLD recommendations for Alfa Cement and Iskitimcement. Alfa Cement has good corporate governance (it is owned by Swiss Holcim), but its multiples are high and free float is very limited. Iskitimcement has average multiples and limited corporate governance threats, thanks to ownership of a blocking stake by government, but the situation could worsen if the government sells its stake to the controlling owner, RATM Holding.

RMG Research, August 14, 2009
Sergei Perminov (7 495) 258 6262
research@rmg.ru

Cement market

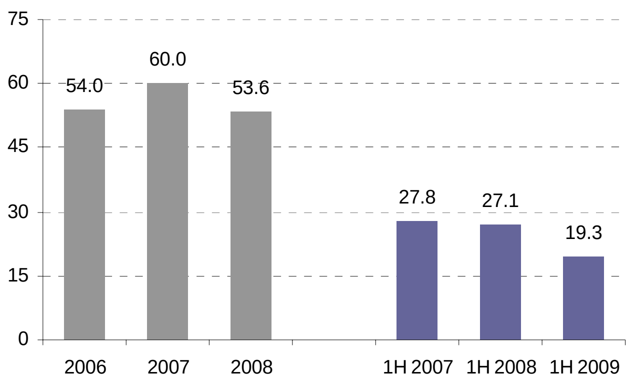
Prices and production volumes of Russian cement producers rose strongly until mid-2008, when removal of import duties constrained further growth of prices. Output started to fall last autumn as the financial crisis led to liquidity problems and freezing of many construction projects, and there was a particularly sharp output decline in the first half of this year.

Cement production bottomed in spring 2009, but recovery is likely to be slow

We think that cement production touched bottom in spring 2009 and there has been some recovery this summer, due to seasonal effects as well as gradual recovery of the overall economy. However, we do not expect a strong upturn on the cement market, since real estate demand (and construction volumes) are constrained by high interest rates and limited decline of prices for real estate.

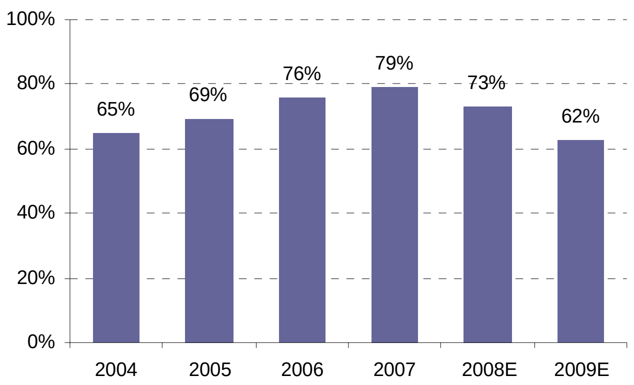
Our forecast may prove too pessimistic if oil prices, capital flows and the overall Russian economy perform better than we expect (some experts are predicting average oil prices of $80-90 in 2010-2011).

Russian cement production (million tonnes)



Source: Russian Statistics Service, RMG estimates

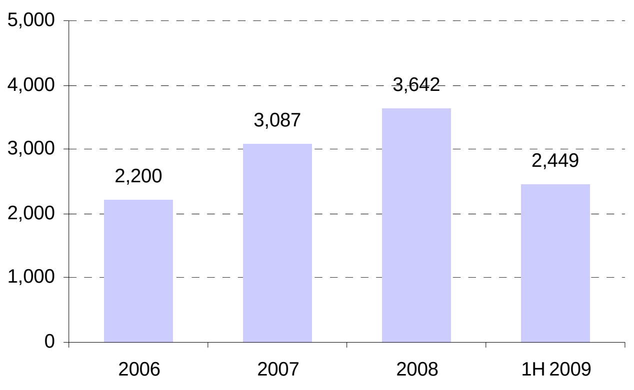
Capacity utilization (%)



Source: Russian Statistics Service, RMG estimates

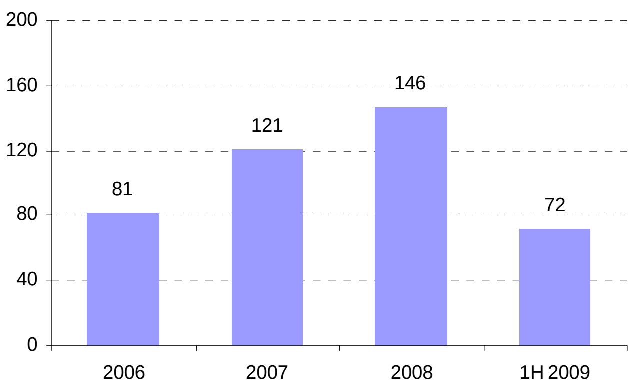
Rapid decline of prices for cement in 1H 2009 were magnified in dollar terms by the weaker ruble.

Average cement prices (rubles per tonne)



Source: Moscow Stock Exchange, RMG estimates

Average cement prices (dollars per tonne)



Source: Moscow Stock Exchange, RMG estimates

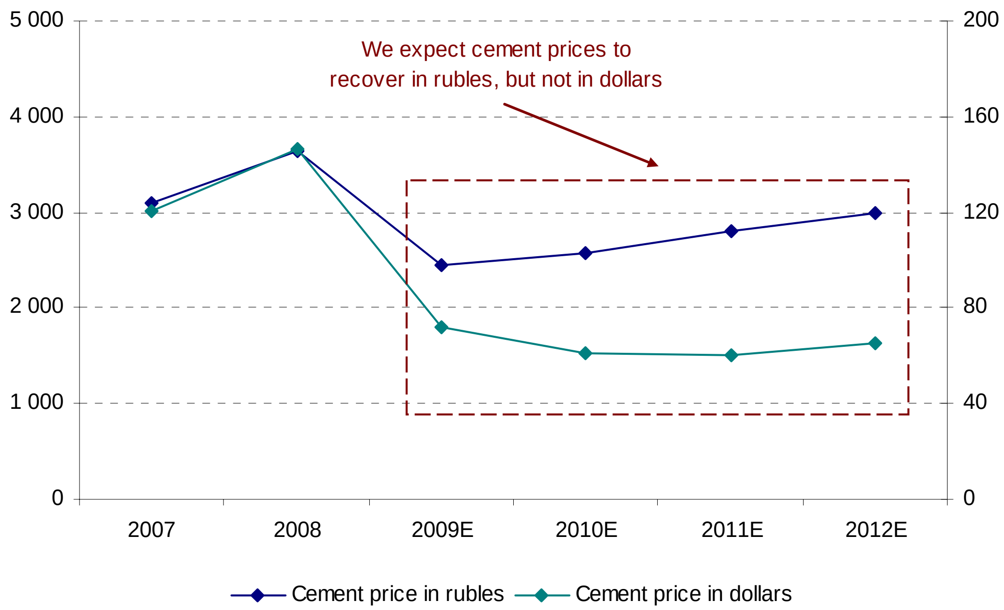
Spare capacities are likely to constrain price growth

Prices for cement will also be dependent on levels of cement production capacity, and they are difficult to predict (data for 2008 are not yet available). Only a modest part of the investment plans made in 2007-2008 are now likely to be realized, but we expect that cement production capacity will increase somewhat in 2009-2010.

In dollar terms, we expect cement prices to fluctuate near current levels

Taken together, the factors above suggest that price growth will be very limited. Since we are bearish on the ruble, we doubt that cement prices in dollars will reach pre-crisis levels anytime soon. We expect cement prices in dollars to fluctuate around their current level, slightly declining in 2010 due to further decline of the Russian currency.

Average cement prices per tonne



Source: Moscow Stock Exchange, RMG estimates

Sibirsky Cement

Sibirsky Cement is the second-largest cement producer in Russia

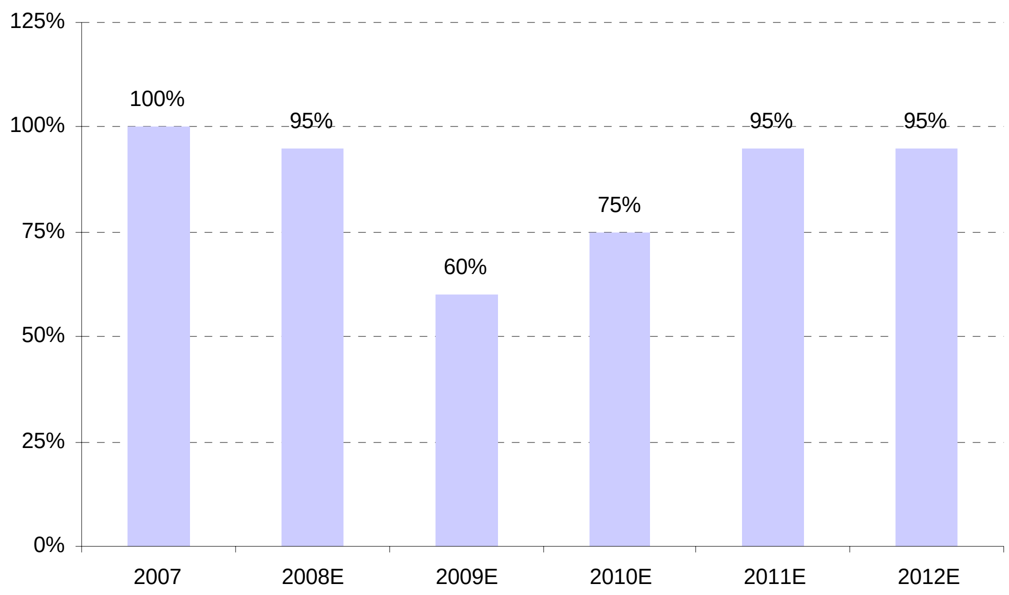
Sibirsky Cement is the second-largest cement producer in Russia. It has seven construction material plants, mainly producing cement. All of the plants are located in Siberia, and the company is headquartered in Kemerovo. The company is owned by management. We estimate free float at about 10%.

The company has been hard hit by fall in demand. Cement production was down by 47% in 5M 2009 and we expect 40% decline in the whole of the year.

We expect that output levels will start to recover in 2H 2009 and approach 2007 levels in 2011-2012.

The main attraction of Sibirsky Cement share is possibility of an ownership change or IPO in the near or medium term. News media reported a few months ago that Mitsubishi Heavy Industries may buy a 25% stake in the company. Also, Sibirsky Cement said before the crisis that it plans to carry out an IPO.

Cement production by Sibirsky Cement (% of 2007 level)



Source: RMG estimates

We see the stock as a bet on an M&A deal or IPO

Purchase of a stake by Mitsubishi Heavy Industries would have strong positive effect on the share price, due to increased transparency and access to financing. Also there is the possibility of an offer to minorities (if the stake purchased by Mitsubishi turns out to be in excess of 30%).

An IPO would also boost the share price due to much improved liquidity.

We reflect the prospects for strategic sale or a share placement in our valuation (see Appendix 1) by giving Sibirsky Cement zero additional discount (risk premium) instead of 6%, which is suggested by current market liquidity.

The zero discount justifies a BUY recommendation for company shares. With 6% discount the company would only deserve a HOLD recommendation (due to our bearish view on the ruble, as shown in the "Sensitivity analysis" table in Appendix 1).

Alfa Cement

Alfa Cement has two plants and is owned by Swiss Holcim

Alfa Cement is a holding company owning 2 cement plants, Volskcement and Schurovsky Cement. Alfa Cement is owned by Holcim, a large Swiss cement company, and currently has no connection with Alfa Group (it was sold by Alfa Group several years ago).

Volskcement is located in Saratov Region and has annual capacity of about 3 million tonnes of cement.

Schurovsky Cement is located in Kolomna (Moscow Region) and has annual capacity of about 1.8 million tonnes.

Gornozavodskcement

Gornozavodsk is an independent cement producer

Gornozavodsk is a stand-alone cement plant, owned by its management and located in Perm Region.

Annual capacity is about 2 million tonnes of cement.

There has been an attempt by raiders to seize control over the company

Kommersant newspaper reported in July this year that corporate raiders, possibly affiliated with Millhouse Capital (the investment vehicle of Roman Abramovich), have recently attempted to win control of Gornozavodskcement by exploiting weak points in its corporate structure.

There has been no further news about this situation, but we recommend caution, since an ownership struggle or ownership change via raiding are likely to be very negative for minorities.

Iskitimcement

Iskitimcement is owned by RATM Holding, a blocking stake belongs to government

Iskitimcement is a cement plant, located in Novosibirsk Region, with annual capacity of about 2 million tonnes of cement. The company is owned by RATM Holding, a large cement production holding.

A blocking stake is owned by government. According to RBC Daily newspaper, about 2% is owned by Prosperity Capital Management.

The government stake protects minorities…

Earlier this year RATM Holding planned to carry out a share issue, which would have diluted stakes of other shareholders in Iskitimcement, but the action was cancelled. According to RBC Daily newspaper, the dilution was prevented when government shareholders intervened. The example shows once again that partial ownership by government is a large advantage for third-tier stocks.

… unless it is sold

However, it has also been reported the government wants to sell its stake. If it sells to an investor unrelated to RATM Holding, this is likely to be positive for market quotes. If it sells the stake to RATM Holding, minorities will become even more vulnerable.

Investment in the stock therefore depends on assessment of whether RATM Holding is prepared to (and can afford to) buy the government stake. Pricing of the stake is unknown.

Ulyanovskcement

Ulyanovskcement is owned by Eurocement…

Ulyanovskcement is located in Ulyanovsk Region and is owned by Eurocement, the largest cement producer in Russia.

Its annual capacity is about 2.4 million tonnes of cement.

…which has a tradition of hostility to minorities

Eurocement has a tradition of hostility to minorities. In 2007 it carried out a mandatory buy-back of 2% of its shares from the market at a price far below market levels. We therefore recommend much caution with shares of Ulyanovskcement due to possible corporate governance threats.

We also note that free float is very limited, so there is a threat of mandatory buy-back of minority shares at an unfair price when Eurocement consolidates 95% of company shares.

Sergei Perminov (7 495) 258 6262
research@rmg.ru

Valuation and recommendations

We make a DCF model for Sibirsky

We created a DCF model for Sibirsky Cement, which is the largest company considered in this Report (see Appendix 1). We use 0% additional risk premium instead of 6%, suggested by current liquidity, in order to reflect probable improvement of liquidity in future (see above). This tends to make our valuation more optimistic, but we do not view it as over-optimistic, since we use bearish assumptions about the ruble/dollar exchange rate.

We use multiples valuation for other companies

Other companies were valued using a target multiple approach. We take fair EV/S for Sibirsky Cement for 2008, based on our DCF estimates, and then apply discount or premium to reflect specific features of each company (see Appendix 2).

We see Sibirskiy Cement as the most attractive…

Generally, we see Sibirsky Cement as the most attractive asset, thanks to its strong market position, modest corporate governance threats and possible future sale of shares to a strategic investor or via an IPO. We give a Speculative BUY recommendation for the stock.

… and Ulyanovskcement as the least attractive

Ulyanovskcement is the least attractive company, in our view, due to possible mandatory buy-back of minority shares at an unfair price. We recommend to SELL both commons and prefs of the company.

We also give a SELL recommendation to Gornozavodskcement. The company is not included in any large holding at present, and we think that such inclusion may happen in the future (this may be the purpose of the raiding activities, described above). Past examples show that minority rights tend to be violated when large holdings take control of cement producers.

We give HOLD recommendations for the other companies. Alfa Cement has good corporate governance (it is owned by Swiss Holcim), but its multiples are high and free float is very limited. Iskitimcement has average multiples and some assurances on corporate governance (thanks to government ownership of a blocking stake), but the situation could worsen if government sells its stake to the controlling owner, RATM Holding.

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Appendix 1: Valuation of Sibirsky Cement

WACC

Risk-free rate	8.5%
Equity risk premium	5.0%
Beta	1.30
Additional equity risk premium	0.0%
Cost of equity	**15.0%**
Cost of debt	18.0%
Debt-to-equity ratio	6.7%
Income tax rate	24.0%
WACC	**14.9%**

Source: RMG estimates

DCF model of Sibirsky Cement ($m)

	2007	2008E	2009E	2010E	2011E	2012E	Continuity
Revenue	569	656	203	217	271	293	
Operating costs	321	349	189	198	223	194	
Operating income	**247**	**307**	**14**	**19**	**48**	**99**	
- operating margin	*43%*	*47%*	*7%*	*9%*	*18%*	*34%*	
Income tax	62	77	3	4	10	20	
- effective tax rate (on operating income)	*25%*	*25%*	*20%*	*20%*	*20%*	*20%*	
NOPLAT	**185**	**230**	**11**	**15**	**38**	**79**	
Net non-operating expenses	-2	0	0	0	0	0	
Change of non-cash working capital	42	56	-22	-1	21	-1	
Net capex	52	78	0	0	0	0	
FCFF	**93**	**96**	**33**	**16**	**17**	**81**	
Terminal growth (%)							3%
WACC			14.9%	14.9%	14.9%	14.9%	14.9%
Terminal value							**858**
Discount factor			1.00	0.87	0.76	0.66	0.57
Discounted FCFF / terminal value			**33**	**14**	**13**	**53**	**492**
Fair EV			**604**				
Net debt	126	30					
Fair value of equity			**574**				
Number of shares (m)			30				
Fair price ($)			**19**				
Upside / downside (%)			**32%**				

Source: Company data, RMG estimates

Sensitivity analysis (fair price per share in $)

Terminal exchange rate	Additional risk premium, %	
	0.00%	6.00%
R45 per dollar	19	11
R35 per dollar	24	14

Source: RMG estimates

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research@rmg.ru

Appendix 2: Valuation of other companies

Valuation of Alfa Cement, Gornozavodskcement, Iskitimcement and Ulyanovskcement

Company	Basic EV/S (2008)	Premium / discount	Target EV/S (2008)	Target price ($)	Upside (%)
Alfa Cement*	0.9	25%	1.2	57	5%
Gornozavodskcement	0.9	-60%	0.4	152	-15%
Iskitimcement	0.9	-50%	0.5	666	28%
Ulyanovskcement com	0.9	-70%	0.3	1.5	-67%
Ulyanovskcement pref				0.6	-10%

* Including Volskcement and Schurovsky Cement

Source: Company data, RMG estimates

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