

Corporate Bonds

Kuzbassrazrezugol



Sector: Metals & mining

11 April 2008

Recommendation (3 month horizon)
SELL*

*on spread basis

Rating
Moody's: B3 (stable)

Credit picture*

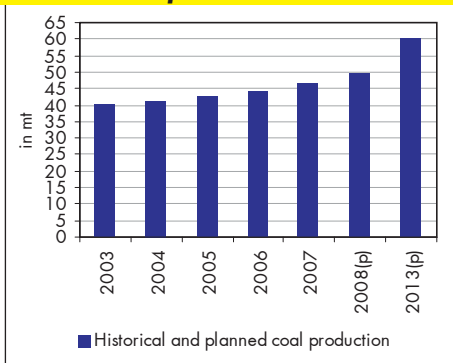
Fundamental situation	-
Valuation	-
Technical picture	-
Event risk	=
Newsflow	=
Total	-

*+... credit positive, -... credit negative,

=... credit neutral

Source: Raiffeisen RESEARCH

KRU's coal production



Source: Company data

Kuzbassrazrezugol (KRU) is Russia's second leading hard coal producer and had a total coal output of 46.3 million tonnes (mt) in 2007, including 5 mt of coking coal. In 2007 KRU exported approx. 46% of its output (which is approx. 25% of the Russia's total coal exports), mainly to Europe and South East Asia. KRU operates 17 coal fields with 11 open pit mines, all concentrated in the Kemerovo region of Russia (the Kuzbass Basin). The company's coal production is supported by its developed facilities including washing plants, processing complexes and transportation infrastructure. KRU reports 2,300 mt of proven and probable coal reserves which implies a reserve life of approx. 50 years. The company is controlled by private individuals and managed by UGMK-Holding, beneficially owned by its president, Russian businessman Iskander Makhmudov.

Credit positive factors

KRU has strong positions in the domestic coal market and several different coal production lines (coking coal, steam coal and sized coal). We expect KRU to benefit additionally from domestic sales over the medium term in light of the liberalisation of domestic gas prices and the government's preference towards coal-fuelled energy plants. We consider KRU's intention to invest in transport infrastructure and the modernisation of assets to be a positive step. The acquisition of 300 railroad cars planned in 2008 could partially protect KRU from Russian Railways' aggressive tariff policy. New coal preparation facilities are expected to be ready by the end of 2008, which is a significant step towards higher cost-efficiency and the production of higher quality coal with lower ash content. We also note that KRU is less subject to state regulations concerning labour safety because open-pit mining has a lower risk of accidents. KRU also benefits from the diversified export sales provided by the exclusive non-consolidated distributor Krutrade AG, which in turn is a strategic partner of Glencore. However, the lack of transparency for transfer pricing between KRU and Krutrade negatively impacts KRU's financial performance in our opinion. Krutrade enjoys much higher profitability than KRU.

Risk factors

KRU's business is generally subject to the same set of risks as its closest peer Rapsadskaya (geographical concentration of assets, dependence on volatile market prices, increasing transportation costs and relatively small base of major customers). Additionally, KRU is one of the more highly leveraged corporations in the Russian market (Net debt/EBITDA ca. 5.2x at the end of 2006), with a negative free cash flow (FCF) trend due to aggressive CAPEX. Although KRU's suppliers are diversified among energy and heating sector companies, we want to point out that contracting with municipals usually entails payment delays and higher accounts receivable (trade receivables of ca. 6% of total assets compared to ca. 1% for Rapsadskaya). This could negatively impact the solvency of the company.

Rating

Kuzbassrazrezugol only has a sub-investment grade rating of B3 (stable) from Moody's. According to the rating agency, a significant improvement of KRU's

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Financial figures

in RUR mn	2004	2005	2006
Revenue	15,768	22,096	27,666
Revenue growth (y-o-y)	n.a.	40%	25%
EBITDA	736	2,236	3,161
EBIT	-1,925	-590	572
Net loss	-1,787	-1,321	-244
Cash from operating activities	950	1,413	2,346
Cash from investing activities	-1,162	-2,600	-11,015
Cash from financing activities	320	1,101	9,015
Free cash flow (FCF)	427	-1,389	-3,166
Cash and equivalents	115	281	374
Net debt	7,421	7,966	16,575
EBITDA margin	5%	10%	11%
EBITDA interest coverage ratio	1.4 x	2.4 x	3.9 x
Net debt/EBITDA	10.1 x	3.6 x	5.2 x

Source: Company data, Raiffeisen RESEARCH

financial performance and credit metrics would be required for a rating upgrade. We expect KRU's rating to remain unchanged over the next six months mainly due to favourable coal prices. The 2007 annual report is scheduled to be published in May 2008 but we do not expect considerable positive shifts in KRU's credit quality.

Valuation and technical situation

Spreads on KRU's Eurobond have recently tightened compared to its closest peers in the Russian metals and mining sector. The spread between KRU's 2010 bond and Raspadskaya's 2012 bond has reached a five-month low of approximately 140 bp. Recent observations (calculated in steps where n=50 days) indicate that the beta levels are above 1, which means the bond is currently volatile compared to the JP Morgan RUBI Other Index.

Outlook and recommendation

In our opinion, KRU continues to lack transparency and remains unfavourable for investors. The recently announced investment programme for 2008 (around RUR 15.1 bn) is almost two times more than the estimated level of investment in 2007. However, KRU's intention to become a vertically integrated company with its own power plants and to increase coal concentrate production to 80% by 2012 could positively impact KRU's profitability in the long run. Because we expect the negative technical trend to continue on the Russian Eurobond market, we currently prefer stronger credits from the Russian high yield segment, such as Raspadskaya. Moreover, KRU's bond looks expensive compared to peers after the recent market rally. Notwithstanding the fact that KRU's bondholders benefit from an unconditional and irrevocable guarantee from Krutrade AG, we recommend to **sell** the KUZBAS 9% 2010 bond on a three-month horizon. From a relative value point of view, we recommend to **underweight** the bond position against the RUBI Other Index.

ISIN	Name	Coupon in %	Maturity	Amount outstanding*	Yield in %	ASW in bp	Rating
XS0310261309	KUZBAS	9.000%	12.07.2010	200	8.988	620	B3/-

* in USD mn

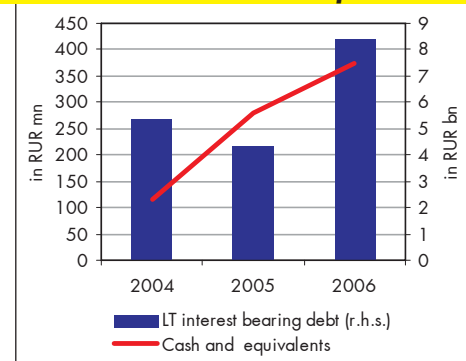
Source: Bloomberg

Krutrade AG - financial figures

in USD mn	2005	2006
Revenue	1,610	1,393
EBITDA	404	199
EBIT	398	186
Net income	356	183
Cash from operat. act.	356	96
Free cash flow	266	84
Cash and equivalents	82	32
Net debt	169	-9
EBITDA margin	25%	14%
EBIT int. cov.	23 x	24 x
Net debt/EBITDA	0.4 x	0.0 x

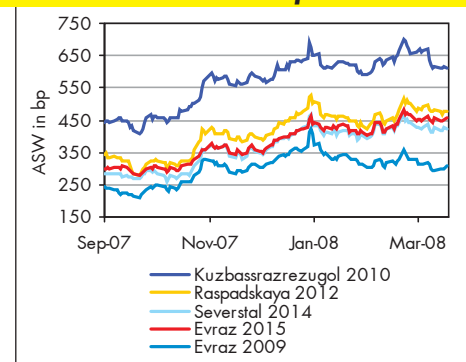
Source: Company data, Raiffeisen RESEARCH

LT debt vs. cash and equivalents



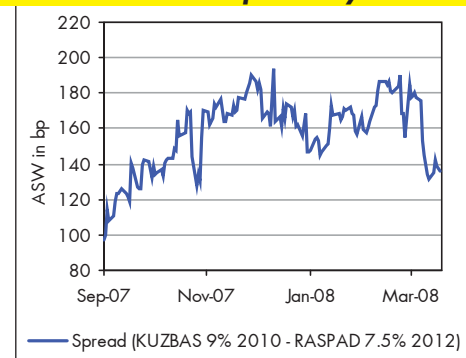
Source: Company data, Raiffeisen RESEARCH

KUZBAS vs. closest peers



Source: Bloomberg

KUZBAS vs. Raspadskaya



Source: Bloomberg, Raiffeisen RESEARCH



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Kuzbassrazrezugol Acknowledgements

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