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Initiation of coverage

**KRKO: BUY**

**Red Boilermaker: Justifying higher hopes**

**Stock data**

Shares Ords '000	213,258	Free float, %	20%
Shares Prefs '000	71,086	Free Float, \$ mn	28.8
Bid Ords, \$	0.50	12-m TP ords, \$	0.999
Offer Ords, \$	0.60	Upside, %	82%
Bid Prefs, \$	0.35	TP prefs, \$	0.699
Offer Prefs, \$	0.41	Upside, %	84%
M.Cap, \$ mn	144	Rating	BUY

**Financials**

	2010E	2011E
Revenue, \$ mn	226	272
EBITDA, \$ mn	31	46
CAPEX, \$ mn	13	24

**Market performance**

		1 month	6 months
Absolute	Ords	-18.03%	0.00%
Relative to RTSI	Ords	-13.09%	-22.26%
Price range, \$			
High	Ords	0.61	0.65
Low	Ords	0.5	0.48

- We are initiating analytical coverage of Krasny Kotelschik (Red Boilermaker), Russia's only domestic manufacturer of power boilers.

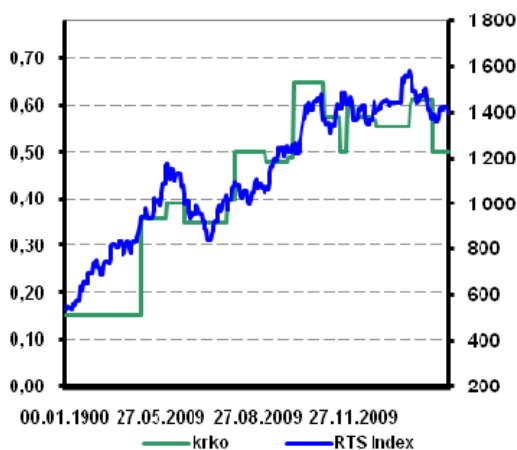
- The plant's development is inseparably connected with the prospects of the electrical energy industry, which represents the key source of demand for its products. In 2007-2008, Russian electric power plants met with an investment boom in connection with the fast growth in demand for electric power in the country, which was followed by a pause in project implementation due to the crisis. Now the situation in the industry has normalized, the decline in electric power consumption has ceased, and growth in demand for electric power in 4Q10, due to frost, exceeded that seen in 4Q06, which was also cold.

- Prime Minister Vladimir Putin recently remarked in an address to the strategic investors in power generating companies that they should fulfill their obligations; at the same time they are coming to accept the rules of the long-term capacity market. We believe these factors will catalyze the revitalization of investment in the electric power industry, and in turn guarantee an increase in the number of orders for Krasny Kotelschik.

- We have appraised the cash flows of Krasny Kotelschik through 2015 using a DCF model. In light of the results of this appraisal, we assign to its ordinary shares a **BUY** recommendation with a target price of \$0.999, assuming the share price will grow by 85%.

- Aside from the company's promising fundamentals, we also believe that it shows speculative potential, in that shareholders of Krasny Kotelschik could soon be able to trade their shares for those of its parent company, EMAlliance, prior to the IPO of the latter. In our opinion, the participation of Renova Group in the plant's share capital, although only indirect, indicates that this may be the case, and the group's participation may eliminate most incumbent risks for minority shareholders in the course of an eventual exchange.

KRKO – Relative performance



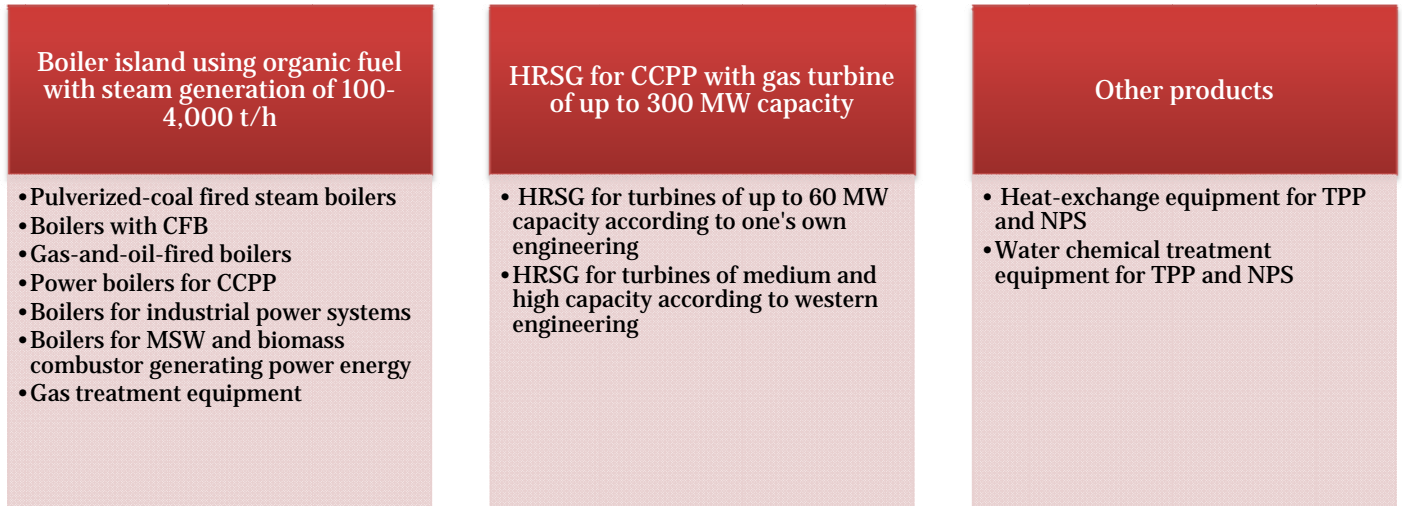
Source: Bloomberg



**About the company**

*Activities*

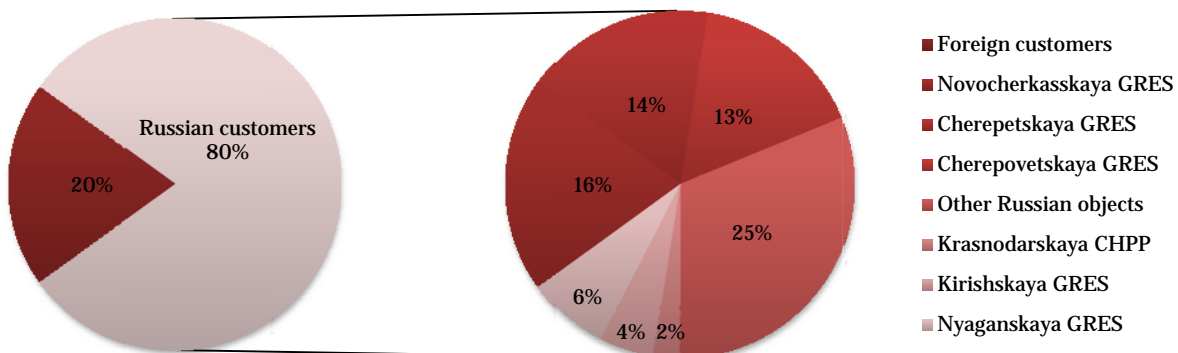
The plant manufactures power boilers for different kinds of electric power plants, including boilers with various capacities for condensation-type heat power plants and waste heat recovery boilers for combined-cycle plants. It also makes heat-exchange and auxiliary equipment. All of this forms a 'boiler island' of an electric power plant. The company's product line is shown below:



Source: EMAlliance

The company's primary sources of income are its sale of high and low capacity boilers, as well as spare parts for these, and waste heat recovery boilers. The sale of such equipment represents 75% of Kotelschik's sale volume.

Equipment manufactured by Kotelschik has been installed at over 80% of Russia's electric power plants. The plant's market share of current supplies to projects in Russia's electrical power industry amounts to 50.3% (for boilers for coal dust plants) and 35% (for waste heat recovery boilers). Its products are also supplied to Bulgaria, Vietnam, Greece, Israel, Iraq, Iran, India and other countries. Below, we have given a breakdown of the order portfolio:



Source: EMAlliance

The existing capacity of the plant is estimated at 6 GW, 2 GW of which is dedicated to waste heat recovery boilers, 2.5 GW is earmarked for boilers for coal dust plants, and 1.5 GW is used for boilers for oil-gas plants. The plant does not wish to manufacture all of its equipment using its own technology, so where appropriate, it cooperates with the leading world manufacturers. Notably, in 2008 a license for the production and sale of waste heat recovery boilers for gas-vapor plants was purchased. In 2008, the plant installed new equipment for the fitting of tubes used to manufacture waste heat recovery boilers for larger-capacity turbines.



*Ownership structure*

Krasny Kotelschik is part of EMAlliance, a power plant machine-building conglomerate which aspires to implement projects for the turnkey construction of 'boiler islands', which, in addition to supplying equipment, provides engineering services to the power generation industry. EMAlliance owns a 59.12% stake in the company's authorized capital, including 70.84% of its ordinary shares. In turn, 100% of EMAlliance is owned by Auburn Investments, the main beneficiary of which is Evgeniy Tugolukov, an entrepreneur.

Until recently, Prosperity Capital Management was the second largest shareholder of Kotelschik after the conglomerate. According to estimates published in the media, it owned about 8% of shares (according to information provided by EMAlliance's management, about 15% of the company's shares were owned by two funds). However, it was made known by Interfax early in the year that Roinco Enterprises Ltd, an offshore company (which owns 10.1% of ordinary shares), became a minority shareholder of the plant instead of Prosperity, and that it had proposed that a representative of Renova Group sit on the company's Board of Directors. Renova has already cooperated with EMAlliance for three years in the sphere of power-plant engineering through REMCO, a company that is comprised of ZiO Podolsk (which manufactures steam-gas generators for nuclear power plant) and IK Ziomar. The principal shareholder of EMAlliance recently sold its share in the Joint Venture to Renova.

*Mutual relations inside the group*

Kotelschik is responsible for most of the group's construction projects, while EMAlliance handles engineering. Engineering is the more profitable business: according to an estimate made by the holding, profitability may reach 50%, whereas for equipment manufacturing the limit of profitability is 15%. Contracts with customers are signed with EMAlliance, which afterwards assigns work to Kotelschik as a subcontractor.

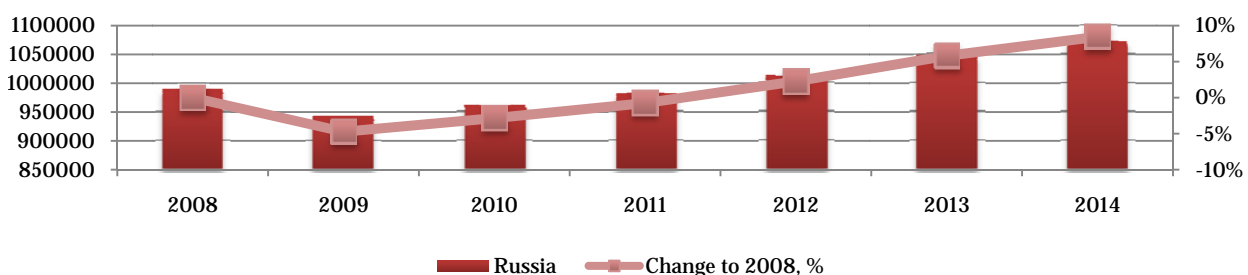
According to estimates made by EMAlliance, Krasny Kotelschik handled about 60% of its 2008 IFRS consolidated sale proceeds, while engineering handled about 40%. It should be noted, however, that part of the income from engineering is included in the plant's sale proceeds.

*The prospects*

The plant's development is inseparably connected with the prospects of the electrical energy industry, which purchases the bulk of its products. In 2007-2008, Russian electric power plants experienced an investment boom in connection with the fast growth in demand for electric power in the country; however, this was followed by a pause in project implementation because of the crisis. Now the situation in the industry has normalized, and the decline in electric power consumption has ceased. Due to the cold weather, the growth in demand for electric power in 4Q09 even exceeded the demand seen in 4Q06, which was also especially cold.

According to forecasts prepared by 'System Operator', a dispatching organization in the industry, electric power consumption, starting in 2010, will grow by approximately 2% per annum. The organization expects consumption to reach its pre-crisis annual volume (which exceeded 1 trillion kWh) by 2012.

**Electricity consumption, mn kWh**



Source: SO-CDU UES



EMAlliance, inclusive of Kotelschik, secured orders with the lion's share of power generation projects started during the economic crisis, having managed in stagnant 2009 to build up the portfolio of orders by 17%, to 41 billion rubles. The contracts, which have already been concluded, permit the group to expect 22 billion rubles in sale proceeds in 2010, representing a twofold growth in its sales volume.

The long-term capacity market's acceptance of new guidelines which guarantee a return on investments, as well as the close attention of Russian authorities to progress in the implementation of investment programs made by heat generation companies, may catalyze the revitalization of the investment process in the electric power industry. On 24 February, Prime Minister Vladimir Putin stated: "The right to use the benefits of the long-term capacity market is deserved only by companies which completely fulfill their obligations to the state, and invest money in the construction of new objects, in modernization, and in security protection", in the course of a meeting on issues which are important for the industry.

Kotelschik's own investment program will allow it to keep up with the growing needs of its key customers, and presupposes the buildup of the plant's capacity to its previous amount (10 hW). The program, which was approved in 2008 is set to last four years and has been appraised as being worth 1.7 billion rubles.

### *EMAlliance's upcoming IPO*

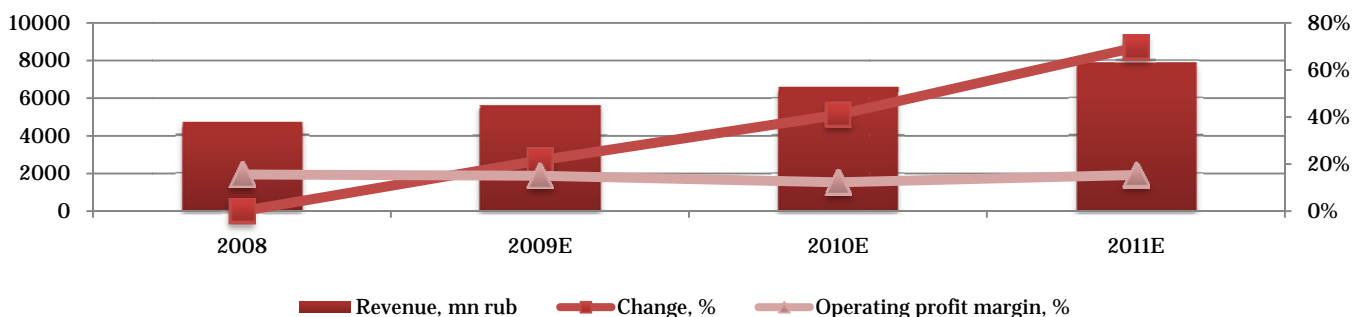
Certain changes may take place in the corporate life of Kotelschik. In 1Q10, EMAlliance, its parent company, announced a plan to conduct an IPO and list its shares with the RTS. The maximum volume of shares being offered to the public is 25%; in actuality the company expects to place about 10%.

EMAlliance's offering, which will draw on the liquidity of Kotelschik's shares, seems to create substantial risks for the minority shareholders of the manufacturing enterprise, especially considering the possibility that the parent company will allocate itself the cash flows of the holding company. However, in our opinion, the recent change in the composition of Kotelschik's minority shareholders will partially eliminate those risks and may increase the probability of an eventual conversion of the plant's shares into those of EMAlliance, notwithstanding even the fact that in recent public comments, the management of EMAlliance has denied such plans.

### **Valuation**

We've appraised the cash flows of Krasny Kotelschik through 2015. We based our appraisal on the financial results and forecasts of EMAlliance that were submitted by the management when it met with investors with regards to the forthcoming allocation, and on the historical dynamics of certain characteristics of the plant.

**Revenue and profit margin**



Source: company's data, Sovlink's estimates

We expect growth in the coming years of the operational profits from the current average of 15% to 19%, on account of cash inflow from the maintenance of equipment installed in previous years, and due to its improving cost margin, as costs are growing at a more moderate rate than sales (see Appendix 1 for details).

We also took into consideration the increase in output, corresponding to additions to the capacity of Kotelschik and investments intended for that.



<b>DCF SUMMARY, mn rub</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
Revenues	6,560.3	7,894.8	10,059.3	10,928.6	11,942.4	12,718.6
COGS	4,787.3	5,593.6	7,116.9	7,636.4	8,170.9	8,702.0
Gross profit	1,773.0	2,301.3	2,942.5	3,292.2	3,771.4	4,016.6
Distribution expences	-314.9	-339.5	-432.6	-415.3	-453.8	-483.3
Administrative expences	-656.0	-750.0	-905.3	-983.6	-1,074.8	-1,144.7
EBITDA	897.9	1,323.7	1,746.9	2,046.1	2,406.2	2,562.6
Amortization&depreciation	95.7	111.9	142.3	152.7	163.4	174.0
Interest payments	-315.7	-355.2	-373.7	-362.6	-377.0	-449.3
PBT	486.4	856.6	1,230.9	1,530.7	1,865.8	1,939.3
Net profit	389.1	685.3	984.7	1,224.6	1,492.6	1,551.5
EBITDA margin, %	14%	17%	17%	19%	20%	20%
Net profit margin, %	6%	9%	10%	11%	12%	12%
<b>FCFF</b>						
EBIT	802.1	1,211.8	1,604.6	1,893.3	2,242.8	2,388.6
Taxes	-97.3	-171.3	-246.2	-306.1	-373.2	-387.9
Depreciation	95.7	111.9	142.3	152.7	163.4	174.0
Change in NWC	-127.8	-148.3	-182.9	-191.7	-201.6	-207.0
Capex	-450.0	-450.0	-450.0	-50.0	-50.0	-50.0
FCFF	222.8	554.0	867.8	1,498.2	1,781.5	1,917.7
FCFF discounted	188.8	469.5	623.3	911.8	918.9	838.3

Target Price (2010 year end):

WACC	18%
Terminal growth	3%
NPV of forecasted years, mn rub	3,761.7
NPV of terminal value, mn rub	5,756
Fair EV, mn rub	9,518
Net debt, mn rub	1,637
Fair Mcap, mn rub	7,881
Shares outstanding, ords	213,258,000
Shares outstanding, prefs	71,086,000
Target price ords, rub	29.96
Target price prefs, rub	20.97

WACC calculation :

<b>WACC decompression</b>	
Tax rate	20%
Cost of equity	20%
Cost of debt	15.00%
D/EV	28.3%
E/EV	71.7%
WACC	18%
<b>Cost of equity decompression</b>	
Risk free	5.4%
beta unlevered	1.2
beta levered	1.47
Russian Equity Risk Premium	8.0%
Company risk premium	11.7%
Spread of russian eurobonds to russian ruble bonds	3.03%
Cost of equity	20%



We also executed an analysis of Krasny Kotelschik, where we compared it with similar foreign and Russian companies using a standard set of multipliers, our appraisals of the plant's financial indicators and consensus forecasts issued by Bloomberg. This analysis demonstrates that the plant is significantly undervalued in comparison with similar companies in the developing countries.

<b>Emerging countries</b>	<b>Country</b>	<b>EV/S 10E</b>	<b>EV/EBITDA 10E</b>	<b>P/E 10E</b>	<b>EV/S 11E</b>	<b>EV/EBITDA 11E</b>	<b>P/E 11E</b>
Doosan Heavy Industries	South Korea	1.6	18.6	32	1.4	14.2	17.8
Bharat Heavy Electricals	India	3.4	18.4	28	2.7	14.2	22.2
Shanghai Electric Group	China	1.7	20.2	42	1.6	17.9	37.3
		<b>2</b>	<b>19</b>	<b>34</b>	<b>2</b>	<b>15</b>	<b>26</b>
<b>Developed countries</b>							
Mitsubishi Heavy Industries	Japan	0.8	11.5	94	0.8	10.5	45.3
Siemens AG	Germany	0.9	7.8	16	0.9	6.9	13.1
Foster Wheeler AG	United States	0.5	5.1	10	0.4	4.7	8.7
		<b>0.8</b>	<b>8.2</b>	<b>39.8</b>	<b>0.7</b>	<b>7.4</b>	<b>22.4</b>
<b>Russia</b>							
Power Machines	Russia	<b>1.0</b>	<b>5.1</b>	<b>12</b>	<b>0.9</b>	<b>4.6</b>	<b>8.1</b>
<b>Krasny Kotelschik</b>	Russia	<b>0.9</b>	<b>6.5</b>	<b>11</b>	<b>0.7</b>	<b>4.4</b>	<b>6.1</b>
Discount to peers from emerging markets		-60.2%	-66.0%	-68.4%	-61.1%	-71.5%	-76.3%
Discount to peers from developed countries		17.1%	-20.6%	-73.1%	0.6%	-40.5%	-72.7%
Discount to Russian peer		-7%	28%	-11%	-15%	-4%	-25%

Source: Bloomberg, Sovlink's estimates

We didn't use a comparative appraisal to determine the fair value of Kotelschik's share value, preferring a DCF model.

Thus, following the results of our analysis, we assign the shares of Krasny Kotelschik a **BUY** recommendation.



## Appendix 1

### Income statement:

<i>mn rub</i>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
Revenue	6,560.3	7,894.8	10,059.3	10,928.6	11,942.4	12,718.6
Cost of sales	4,787.3	5,593.6	7,116.9	7,636.4	8,170.9	8,702.0
Gross profit	1,773.0	2,301.3	2,942.5	3,292.2	3,771.4	4,016.6
	27%	29%	29%	30%	32%	32%
Distribution expenses	-314.9	-339.5	-432.6	-415.3	-453.8	-483.3
Administrative expenses	-656.0	-750.0	-905.3	-983.6	-1,074.8	-1,144.7
<i>Total operation expenses</i>	-970.9	-1,089.5	-1,337.9	-1,398.9	-1,528.6	-1,628.0
	15.9%	12.2%	22.8%	4.6%	9.3%	6.5%
Operating income	802.1	1,211.8	1,604.6	1,893.3	2,242.8	2,388.6
	12%	15%	16%	17%	19%	19%
Amortization & Depreciation	95.7	111.9	142.3	152.7	163.4	174.0
EBITDA	897.9	1,323.7	1,746.9	2,046.1	2,406.2	2,562.6
	14%	17%	17%	19%	20%	20%
Interest net	-315.7	-355.2	-373.7	-362.6	-377.0	-449.3
PBT	486.4	856.6	1,230.9	1,530.7	1,865.8	1,939.3
Income tax	-97.3	-171.3	-246.2	-306.1	-373.2	-387.9
Net income	389.1	685.3	984.7	1,224.6	1,492.6	1,551.5

Source: Company data, Sovlink estimates

### Balance sheet:

<i>mn rub</i>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
<b>Assets</b>						
PPE & investments	671.8	731.2	873.3	873.3	873.3	873.3
<i>current assets:</i>						
Inventories	2,755	2,911	3,105	3,309	3,522	3,744
<b>Trade &amp; other receivables</b>	2,438	2,561	2,712	2,869	3,034	3,202
Other current assets	41.8	41.8	41.8	41.8	41.8	41.8
Cash & equivalents	813	1,601	2,437	3,437	4,856	6,741
<b>Total assets</b>	<b>6,790</b>	<b>7,917</b>	<b>9,240</b>	<b>10,601</b>	<b>12,398</b>	<b>14,673</b>
<b>Liabilities</b>						
Borrowings	1690	1972	2104	2025	2128	2644
Other long-term liabilities	65.6	78.9	100.6	109.3	119.4	127.2
Deffered tax	96.2	111.5	134.2	171.0	185.8	203.0
<i>current liabilities:</i>						
Borrowings	565	565	565	565	565	565
<b>Trade and other payables</b>	2,193	2,324	2,486	2,656	2,832	3,015
Provisions	67.4	67.4	67.4	67.4	67.4	67.4
<b>Total liabilities</b>	<b>4,677</b>	<b>5,119</b>	<b>5,457</b>	<b>5,593</b>	<b>5,898</b>	<b>6,621</b>
<b>Equity</b>						
Issued capital	284	284	284	284	284	284
Additional paid-in capital	160	160	160	160	160	160
Translation reserve	43	43	43	43	43	43
Retained earnings	1,626	2,311	3,296	4,521	6,013	7,565
Minority interest						
<b>Total equity</b>	<b>2,113</b>	<b>2,798</b>	<b>3,783</b>	<b>5,008</b>	<b>6,500</b>	<b>8,052</b>
<b>Total liabilities &amp; equity</b>	<b>6,790</b>	<b>7,917</b>	<b>9,240</b>	<b>10,601</b>	<b>12,398</b>	<b>14,673</b>

Source: Company data, Sovlink estimates



Cash flow statement:

<i>rub mn</i>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
Net income	389.1	685.3	984.7	1,224.6	1,492.6	1,551.5
Depreciation & Amortization	95.7	111.9	142.3	152.7	163.4	174.0
Interest expense	315.7	355.2	373.7	362.6	377.0	449.3
Net interest	315.7	355.2	373.7	362.6	377.0	449.3
Penalty provision	0.0	0.0	0.0	0.0	0.0	0.0
Income tax	97.3	171.3	246.2	306.1	373.2	387.9
Unrealised foreign exchange gain	0.0	0.0	0.0	0.0	0.0	0.0
<b>Operating profit before change in WC&amp;P</b>	<b>1,213.6</b>	<b>1,678.9</b>	<b>2,120.6</b>	<b>2,408.7</b>	<b>2,783.3</b>	<b>3,011.9</b>
Increase/ decrease in inventories	-136.4	-156.1	-194.3	-203.9	-213.3	-221.9
Increase/ decrease in trade and other receivables	-106.3	-123.2	-150.9	-157.4	-164.8	-167.9
Increase/ decrease in trade and other payables	114.9	130.9	162.3	169.5	176.5	182.7
<b>Cash flow from operations before taxes and interest</b>	<b>1,085.8</b>	<b>1,530.5</b>	<b>1,937.7</b>	<b>2,216.9</b>	<b>2,581.7</b>	<b>2,804.9</b>
Interest paid	-315.7	-355.2	-373.7	-362.6	-377.0	-449.3
Income tax paid	-97.3	-171.3	-246.2	-306.1	-373.2	-387.9
<b>Cash flow from operating activity</b>	<b>672.8</b>	<b>1,004.0</b>	<b>1,317.8</b>	<b>1,548.2</b>	<b>1,831.5</b>	<b>1,967.7</b>
Acquisition of PPE and Intangibles	-450.0	-450.0	-450.0	-50.0	-50.0	-50.0
Total capital investment	-450.0	-450.0	-450.0	-50.0	-50.0	-50.0
<b>Cash flow from investing activities</b>	<b>-450.0</b>	<b>-450.0</b>	<b>-450.0</b>	<b>-50.0</b>	<b>-50.0</b>	<b>-50.0</b>
Net proceeds from borrowings	565.0	282.0	132.0	-79.0	103.0	516.0
Proceeds from borrowings	565.0	282.0	132.0	0.0	103.0	516.0
Repayments from borrowings	0.0	0.0	0.0	-79.0	0.0	0.0
Proceeds from issuance of ordinary shares	0.0	0.0	0.0	0.0	0.0	0.0
<b>Cash flows from financing activities</b>	<b>565.0</b>	<b>282.0</b>	<b>132.0</b>	<b>-79.0</b>	<b>103.0</b>	<b>516.0</b>
Net increase in cash and cash equivalents	787.8	836.0	999.8	1,419.2	1,884.5	2,433.7
Cash and cash equivalents at the beginning of year	813.4	1,601.2	2,437.2	3,437.0	4,856.2	6,740.7
Effect of exchange rate fluctuations						
<b>Cash and cash equivalents at the end of year</b>	<b>1,601.2</b>	<b>2,437.2</b>	<b>3,437.0</b>	<b>4,856.2</b>	<b>6,740.7</b>	<b>9,174.4</b>

Source: Company data, Sovlink estimates



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## STOCK RATING POLICY

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<b>STRONG BUY:</b>	Upside over 25%; confidence level – high / upside over 100%; confidence level - low
<b>BUY:</b>	Upside between 15 and 25%; confidence level – high / upside between 25% and 100%; confidence level – low
<b>HOLD:</b>	Upside of less than 15%; confidence level – high / upside of less than 25%; confidence level – low
<b>SELL:</b>	Target price at or below current price levels

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