

MOTOR SICH: IN THE TAX HAVEN

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TP UPGRADE ON 10-YEAR TAX BREAK

The Tax Code foresees income tax breaks for Motor Sich till 2020, which will stimulate the company to reduce its debt and spend more funds on working capital, CapEX and R&D, improving the competitiveness of its products. The news is POSITIVE for Motor Sich, and we reiterate our BUY rating on its stock and increase the target price by 14% to \$632.

Tax Code stimulates CapEX and R&D. 95% of Motor Sich's revenues in 2010 are related to aircraft engineering, which allows the company to have a full benefit of the tax break. The tax cuts will impact Motor Sich directly by saving funds for CapEX as well as indirectly through Antonov and Kharkiv Aviation Plant, which are currently constrained by the lack of working capital.

Motor Sich can undertake new projects. Free CapEX can push the company toward realization of its standby projects, such as 5th generation engines and helicopter manufacturing. Motor Sich amended its statute last March to allow helicopter production and considers an idea of a new Ukrainian medium helicopter for 9-12 passengers.

Tax cuts will limit dividend payments. Dividend payouts do not belong to the list of eligible uses of the funds freed by the tax cuts, so dividend payments are likely to be kept at a minimum, which is negative for shareholders. However, we believe the expected capital gains in the short run to outweigh any dividend yield losses.

Cash flows to grow on lower effective tax rate. Lower terminal tax rate of 16%, set by the Tax Code, will give an extra boost to the terminal value. In addition, in the long run, extra CapEX and R&D will increase the competitiveness of the company's engines, driving up the profit from operations both through larger sales and bigger margins in the long-run.

Tax code changes boost Motor Sich value by 14%. Based on our DCF model, Motor Sich is valued at \$630. Currently the shares trade at 1.3x sales, 4.3x EBITDA, and 6.3x earnings, implying a \$634 fair value. Our target price of \$632, based on a combination of DCF and relative valuation, implies a 69% upside from the current level.

Recommendation	BUY
Upside	69%
12m target (from \$554)	\$632
Current price	\$373

Ticker UX	MSICH
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Shares Outstanding, mln	2.078
Enterprise value, \$ mln	801
Market capitalization, \$ mln	775

52-week performance, %	59%
52-week high/low, \$	373/200
Change from high/low, %	0%/87%
1M Change	23.4%
3M Change	24.9%
Avg Daily Turnover 3M, \$ mln	0.89
Free float, \$ mln	186

Ownership Structure:

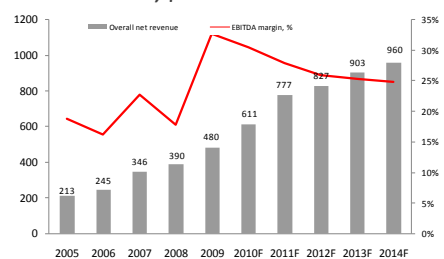
Management	76%
Free float, %	24%

* price as of December 10, 2010

Stock price trend, YTD



Sales Forecast, \$ mln



Sources: Bloomberg, company data and Art Capital estimates

Financials and multipliers, \$ mln

	Net Revenue	Net EBITDA	Net Income	EBITDA margin	Net income margin	EV/S	EV/EBITDA	P/E
2009	480	157	95	32.7%	19.8%	1.7	5.2	8.1
2010E	611	186	121	30.5%	19.8%	1.3	4.4	6.4
2011E	777	217	196	28.0%	25.2%	1.0	3.5	4.0
2012E	827	214	195	25.9%	23.6%	0.9	3.4	4.0

Source: ART CAPITAL Research

OPERATIONAL OUTLOOK CHANGES

Tax Code will prompt Motor Sich to internalize net income

Since dividend payouts are not an eligible use of the funds freed by the tax cuts introduced in the Tax Code, Motor Sich will increase its CapEX, R&D and working capital and lower debt to make full use of the tax cuts.

Table 1: Summary of key changes

Forecast	Old value	New value	Change	% change
Net revenue 2011	789	777	-12	-1%
EBITDA 2011	229	217	-12	-5%
Net income 2011	153	196	43	28%
EBITDA margin 2011	29,0%	28,0%	-1 p.p.	
NI margin 2011	19,4%	25,2%	6 p.p.	
CapEX 2011-15	262	327	65	25%
Average WC/Sales	43,3%	48,8%	6 p.p.	
Leverage 2015	5%	2%	-3 p.p.	
Average CF 2011-15	93	109	16	17%
Terminal value	542	649	107	20%
DCF	539	630	90,7	17%
RV	569	634	65	11%
Target	554	632	77,9	14%

Source: ART CAPITAL Research

Midterm revenue forecast increased on sales to Russia and China

We applied several changes to our operational model since our August report to reflect recent developments in the aviation engine industry:

- ▲ We increased sales of AI-222-25F to China due to an anticipated contract to supply 60-100 engines in the next two years, which exceeded our forecasts.
- ▲ We raised An-148 sales forecast by 10 units starting 2015 due to better access to working capital, joint-venture with Russia, and Iran's upgraded production plans.
- ▲ At the same time, we lowered the share of An-148 to be equipped with Motor Sich engines from 70% to 60%, which could be viewed as an increase in probability of success of Russian lobbyists. Russia provides Antonov with VTB loans and can manipulate the demand for An-148 by Russian airlines, which gives it a stronger position in determining which engines should be equipped on An-148.
- ▲ Increased midterm sales of Yak-130 since the jet was selected as Russia's official training unit and a demand for 500 units is expected before 2040.
- ▲ Delayed expected launch of Russian full-scale helicopter engine production on continued changes in the proposed placement of the production.

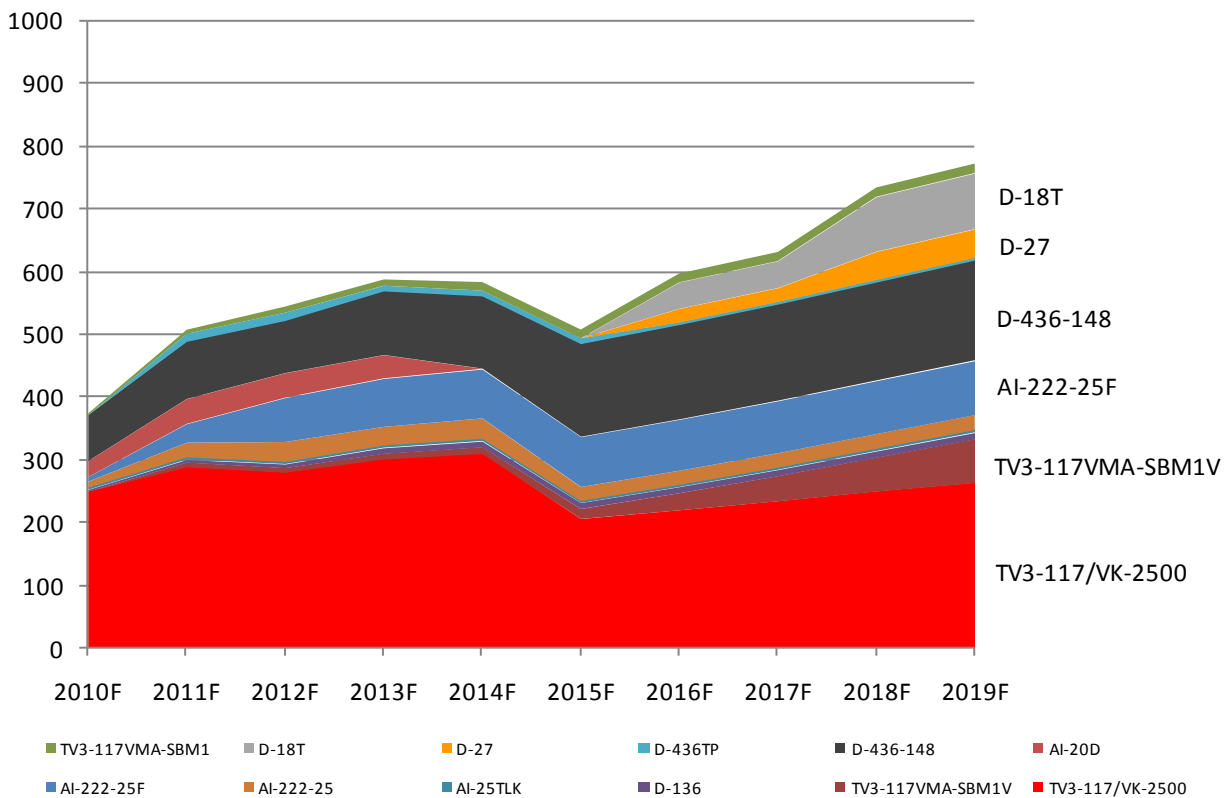
OPERATIONAL OUTLOOK CHANGES

Long-term revenues scaled down on weak prospects of An-70/An-124

We scaled down the An-70 and An-124 portion of the revenues compared to our August report. Ukrainian Ministry of Defense is going to delay the expenditure of An-70 till 2013-14 and is not going to buy any of these airplanes till 2020. Russian Ministry of Defense is still interested in the aircraft, and we expect the production to be launched in 2016.

An-124 production is expected to start in 2016 as well as strong demand for this airplane by Russia, Ukraine and NATO persists. We anticipate 9% of Motor Sich's revenues in 2016-2019 to be generated by sales of D-27 and D-18 engines for An-70 and An-124 respectively.

Figure 1: Revenue distribution, \$ mln, 2010-2019



Source: Company data, ART CAPITAL Research

DCF VALUATION

DCF analysis implies a fair value of \$630

Using our cash flow forecast, we constructed a DCF model spanning 2010-19. We keep the terminal growth rate at 3%, and use 16% as the tax rate for terminal value calculation.

Table 2: DCF valuation, \$ mln

	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F
Net Sales	611	777	827	903	960	855	961	1 000	1 123	1 187
EBIT	171	202	199	212	221	192	211	220	247	261
Aftertax EBIT	128	202	199	212	221	192	211	220	247	261
Depreciation & amortization	15	15	16	16	17	19	20	22	24	25
CapEx	36	47	56	64	74	85	88	92	97	102
Change in working capital	70	72	62	60	38	7	4	6	-2	2
FCF	38	99	96	104	126	119	139	144	176	183
WACC	16,0%	15,9%	15,8%	15,6%	15,4%	15,3%	15,1%	14,9%	14,6%	14,6%
DVCF	0	99	83	78	82	67	69	62	68	62
Sum of DVCF	670									48,1%
Perpetuity growth rate	3,0%									Net debt
Terminal value	649									Equity value
Enterprise value	1 350									Implied exit EBITDA mult
										7,3
										12m fair value, \$
										630

	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F
Risk Free Rate	7,5%	7,3%	7,2%	7,0%	6,8%	6,7%	6,5%	6,3%	6,0%	6,0%
Market Risk Premium	6,0%	6,0%	6,0%	6,0%	6,0%	6,0%	6,0%	6,0%	6,0%	6,0%
Company Specific Risk	3,0%	3,0%	3,0%	3,0%	3,0%	3,0%	3,0%	3,0%	3,0%	3,0%
Cost of Equity	16,5%	16,3%	16,2%	16,0%	15,8%	15,7%	15,5%	15,3%	15,0%	15,0%
Cost of ST debt	9,5%	9,3%	9,2%	8,5%	8,3%	8,2%	8,0%	7,3%	7,0%	7,0%
Share of ST debt	72,1%	83,4%	96,3%	93,0%	96,2%	97,7%	98,6%	98,4%	98,6%	96,9%
Cost of LT debt	10,5%	10,3%	10,2%	10,0%	9,8%	9,7%	9,5%	9,3%	9,0%	9,0%
Share of LT debt	27,9%	16,6%	3,7%	7,0%	3,8%	2,3%	1,4%	1,6%	1,4%	3,1%
Cost of Debt (pre tax)	9,8%	9,4%	9,2%	8,6%	8,3%	8,2%	8,0%	7,3%	7,0%	7,1%
Marginal Tax Rate	25,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%
Cost of Debt (after tax)	7,3%	9,4%	9,2%	8,6%	8,3%	8,2%	8,0%	7,3%	7,0%	7,1%
Leverage	5,0%	5,0%	5,0%	5,0%	5,0%	5,0%	5,0%	5,0%	5,0%	5,0%
WACC	16,0%	15,9%	15,8%	15,6%	15,4%	15,3%	15,1%	14,9%	14,6%	14,6%

Source: Company data, ART CAPITAL Research

The DCF fair value shows higher sensitivity to WACC than to perpetuity growth rate supporting our choice of the latter.

DCF sensitivity

Discount rate	Perpetuity growth rate				
	1,0%	2,0%	3,0%	4,0%	5,0%
-2,0%	692	729	774	829	899
-1,0%	630	660	695	737	789
0,0%	579	602	630	662	702
1,0%	534	554	576	602	632
2,0%	496	512	530	551	575

RELATIVE VALUATION

Relative valuation confirms the DCF analysis

Relative valuation of Motor Sich shows a 70% upside to the fair value of \$634. Since August, Russian peers increased capitalization by 70% on expectations of IPO and improved outlook. Their P/E gained only 10% though due to higher earnings forecasts. The valuation of foreign peers increased by 20% on stronger global aircraft production outlook.

Table 3: Relative valuation, \$ mln

Company	Country	Mcap	EV/S		EV/EBITDA		P/E	
			2011E	2012F	2011E	2012F	2011E	2012F
Dassault Aviation	France	7 993	1,1	1,1	6,6	7,2	16,1	15,3
General Dynamics	United States	26 023	0,7	0,7	5,5	5,0	9,7	9,2
Rolls-Royce Group	Britain	18 928	1,0	0,9	7,7	6,9	14,8	13,1
Saab AB-B	Sweden	1 919	0,5	0,5	3,8	3,4	11,0	9,9
Safran SA	France	13 850	1,0	0,9	7,1	5,9	14,9	12,2
Textron Inc	United States	6 347	0,7	0,6	7,2	4,6	16,5	10,6
Boeing Company	United States	47 397	0,8	0,7	7,6	6,4	14,0	11,7
United Tech Corporation	United States	71 684	1,3	1,2	7,9	7,2	14,9	13,3
Bombardier Inc	Canada	7 962	0,5	0,5	6,6	5,6	12,7	10,5
Developed market peers			0,8	0,7	7,1	5,9	14,8	11,7
Kazan Helicopters	Russia	601,0	0,8	0,8	3,6	3,4	5,0	4,0
Ulan-Ude Aviation Plant	Russia	473,3	0,8	0,8	3,7	2,8	6,4	4,6
Russian market peers		537,1	0,8	0,8	3,6	3,1	5,7	4,3
Motor Sich		817	1,0	0,9	3,5	3,4	4,0	4,0

	EV/S		EV/EBITDA		P/E	
	2010E	2011F	2010E	2011F	2010E	2011F
Fair value by multiple metric	324	323	678	589	1 226	976
Upside (downside)	-13%	-13%	82%	58%	229%	162%

RV Fair value	634
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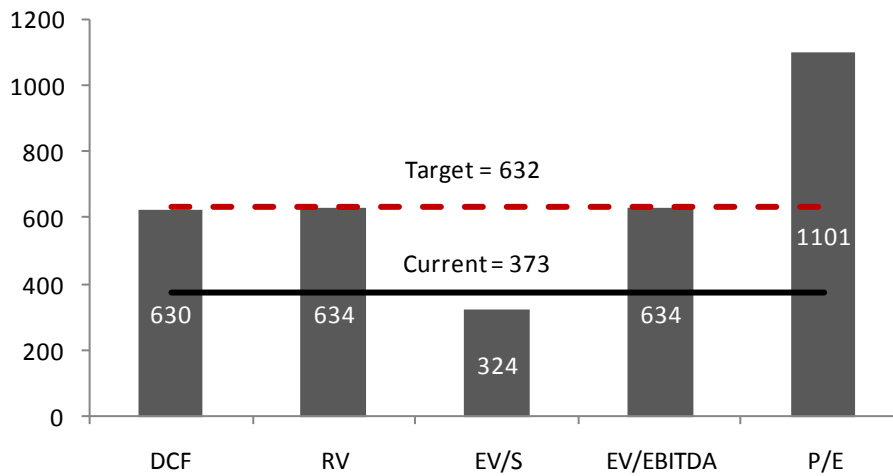
Source: Company data, ART CAPITAL Research

VALUATION SUMMARY

Motor Sich stock has a 69% upside in the next 12 months

Despite a 76% rebound YTD, Motor Sich stock remains undervalued based on our DCF and relative valuation. Below we show the summary of our valuations in US dollars.

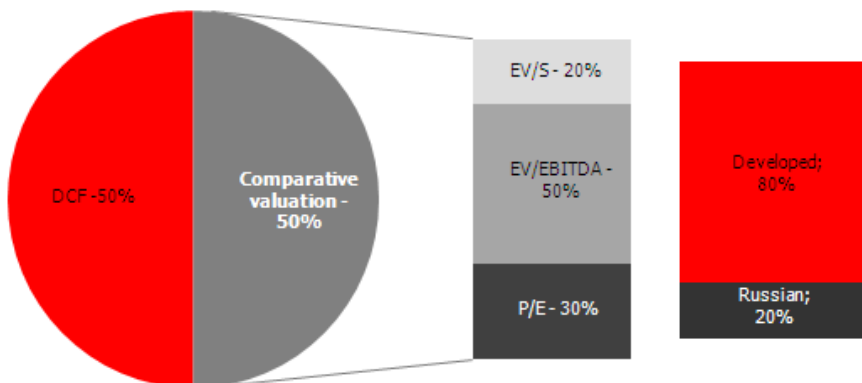
Figure 2: Valuation Summary, \$



Source: ART CAPITAL Research

The resulting 12-month target price for Motor Sich stock, based on 50% DCF and 50% relative valuation, is \$632, which implies a 69% upside from the current levels.

Figure 3: Target-price weighting



APPENDIX: FINANCIALS

Income statement, \$ mn

	2008	2009	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F
Net Sales	389	480	611	777	827	903	960	855	961	1 000	1 123	1 187
Cost of goods sold	250	274	348	459	505	555	595	534	606	630	708	748
Gross profit	138	206	263	319	323	348	365	321	356	370	416	439
EBITDA	69	157	186	217	214	229	238	211	232	242	271	287
Depreciation & amortization	20	15	15	15	16	16	17	19	20	22	24	25
EBIT	49	142	171	202	199	212	221	192	211	220	247	261
Financial expenses	10	11	10	6	4	2	2	2	2	2	2	2
Pretax Income	3	128	162	196	195	210	219	191	210	218	245	259
Income taxes	2	33	40	0	0	0	0	0	0	0	0	0
Net income/loss	1	95	121	196	195	210	219	191	210	218	245	259

Balance sheet, \$ mn

	2008	2009	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F
Cash and cash equivalents	21	37	33	46	63	81	97	133	140	144	162	167
Accounts receivable	72	106	141	178	258	250	319	342	359	371	389	401
Inventories	198	199	271	327	356	443	442	465	489	494	507	524
Other current assets	7	11	23	23	21	32	27	9	10	21	22	22
Total current assets	298	352	467	573	698	806	885	950	999	1 030	1 080	1 114
Construction in progress	19	27	31	37	44	52	61	71	80	90	99	109
Net property and equipment	110	115	132	157	191	231	278	334	392	453	517	583
Non-tangible assets	0	0	0	0	0	0	1	1	1	1	1	1
Financial investments	31	32	43	48	52	58	63	70	77	84	93	102
Other non-current assets	1	1	0	0	0	0	0	0	0	0	0	0
Total non-current assets	161	175	206	242	287	340	403	476	550	628	710	795
Deferred expenses	0	0	0	0	0	0	0	0	0	0	0	0
Total assets	460	527	674	815	985	1 146	1 288	1 425	1 549	1 658	1 790	1 909
Short-term debt	77	67	54	32	25	14	15	16	18	19	21	22
Accounts payable	33	12	21	24	30	30	30	32	36	38	42	45
Accrued expenses	97	97	122	122	144	155	169	183	205	217	238	254
Other current liabilities	2	2	17	36	53	73	83	90	101	107	117	125
Total current liabilities	209	179	215	214	253	271	297	320	360	382	418	446
Long-term debt	9	14	21	6	1	1	1	0	0	0	0	1
Other long-term liabilities	7	15	15	15	15	15	15	15	15	15	15	15
Deferred income	0	0	0	0	0	0	0	0	0	0	0	0
Shareholders' equity	234	319	423	579	716	859	975	1 089	1 173	1 261	1 356	1 447
Total liabilities and equity	460	527	674	815	985	1 146	1 288	1 425	1 549	1 658	1 790	1 909

APPENDIX: DISCLOSURES

Analyst certification

The research analyst(s) identified as the author(s) on the cover of this report hereby certifies that 1) the views expressed in this research report accurately reflect his or her personal views about the subject securities and issuers and 2) no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.

Investment Rating Assessment Principle

An investment rating reflects expectations of ART CAPITAL analysts concerning the future growth of the value of the issuer's shares as follows:

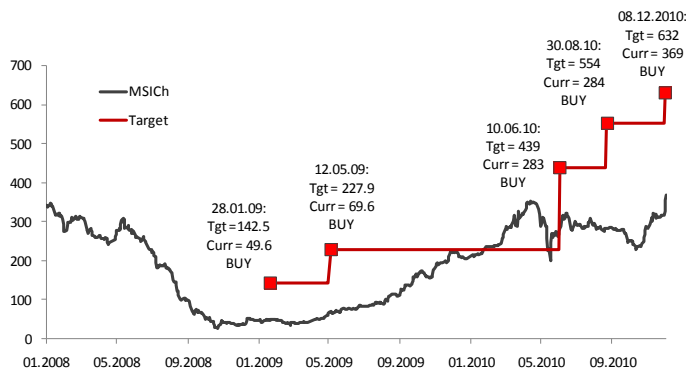
Recommendation	Upside
BUY	>20%
HOLD	5%-20%
SELL	<5%

We recommend selling stock with a positive expected return up to 5%, since there are deposits and bonds with an effective internal yield up to 10%. The expected upside potential may vary depending on price movements and market volatility. Such oscillations are possible and will result in the change of recommendations for the stocks under consideration. In addition, we use a recommendation called **SPECULATIVE PURCHASE** given to high-risk issuers with an upside warranting a BUY rating. High-risk factors include a possibility of a sudden deterioration of the issuer's financial state, significant discrepancy between different estimation methods of the issuer's value and low expertise rating determined by the analyst in charge.

ART CAPITAL Recommendation Distribution, as of December 14, 2010

Coverage	BUY	HOLD	SELL	Under review	Suspended	Non-rated
75	21	5	1	8	3	39
% of total	28%	7%	1%	11%	4%	52%

Rating and Target Price History



Analyst recommendations

Ticker	Company	Industry	Recommendation	Upside
SUNI	SUN InBev Ukraine	Brewers	BUY	165%
SNEM	Nasosenergomash	Heavy Electrical Equipment	BUY	91%
LUAZ	Bohdan Motors	Automobile Manufacturers	BUY	86%
MSICH	Motor Sich	Aircraft Engines	BUY	69%
SLAV	Slavutich Brewery	Brewers	BUY	38%
KVBZ	Kryukiv Wagon	Railcar Engineering	BUY	30%
SVGZ	Stakhaniv Wagon	Railcar Engineering	HOLD	18%
AVTO	Ukravto	Automobile Manufacturers	HOLD	10%
MZVM	Mariupol Heavy Machinery	Railcar Engineering	SELL	8%
SMASH	Sumy Frunze	Heavy Electrical Equipment	SELL	-56%
KRAZ	Avtokraz	Automobile Manufacturers	Under review	
LTPL	Luganskteplovoz	Railcar Engineering	Under review	
ZATR	Zaporozhtransformator	Heavy Electrical Equipment	Under review	

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