

### Motor Sich: The Great Outperformer

Being one of the most liquid yet inefficiently low priced Ukrainian stocks, Motor Sich is to publish its 3Q 2010 financials within the next two weeks. We expect the company's results to outperform market expectations which should point out the true value of the company. According to our estimates Motor Sich is to show revenues and EBITDA higher by 10-15% than the market consensus. Hence, we reiterate our BUY recommendation on the stock with 145% upside potential.

Motor Sich's 1H2010 financials outperformed market expectations. MSICH recorded a growth in net sales of 56% YoY in 1H2010, while EBITDA increased by 59% YoY. After data released almost all analysts were forced to increase their FY 2010 estimates, which in our view are still too conservative. MSICH's EBITDA margin increased by 0.7 p.p. to 31.2% in 1H2010. Sales growth was a result of the recovered Ukraine-Russian political relations and progressing interstate aero-projects, while increased margins showed the ability of MSICH to transfer inflation of costs onto the consumers.

We expect MSICH to post extra strong 3Q and 4Q financials and produce momentum for share price growth. According to our estimates, based on analysis of historical regularity of quarterly sales, relations between prepayments and reported sales, margins trends and operating leverage, MSICH will show record 3Q and 4Q financials and outperform market 2010 expectations by 10-15% (NRG FY2010 EBITDA and net income estimate: USD 189 mn and USD 121 mn vs. market consensus of USD 173 mn and USD 104 mn respectively).

#### Sales in 3Q and 4Q: historically higher than that of 1Q and 2Q

- The bulk part of MSICH's order book is formed in the beginning of each year (after adoption of the state budget by the Russian Federation and Russian state-owned companies), taking into account a production cycle of 6-9 months, the majority of the sales are reported closer to the end of each year. In the last five years, the second semiannual sales were higher than those of the first half on average by 65%, while average QoQ sales growth during each year was 31%. We conservatively expect the 2H2010 sales to be higher than 1H2010 one by 40%.
- Another sales growth indicator for the next 6-9 months is the amount of prepayments received by the Company. Figure 2 (next page) clearly demonstrates relations between prepayment/net sales ratio and future sales and indicates growth of sales in 2H2010.

#### Margins: economy of scale at its best

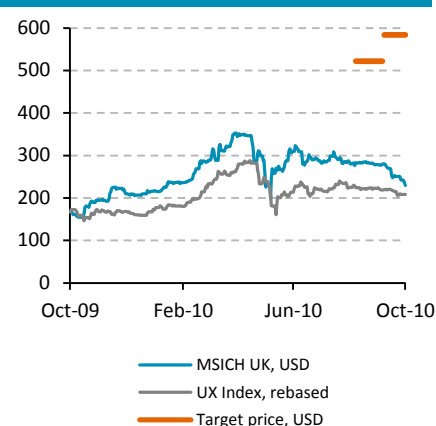
- MSICH, as every high-technology Company with diversified product mix, has high fixed costs, which results into high operating leverage. Thus, EBITDA and net income are changing by the higher magnitude than the change of the revenues. By analyzing MSICH's quarterly sales, one could find a clear trend: higher revenues resulting into higher margins (see Figure 4).
- SG&A costs/net sales ratio and OIBDA margin analysis both confirm economies of scale effect — while SG&A/net sales is falling, OIBDA margin is growing (Figure 3).

Valuation: Good 2H2010 financials would produce momentum for MSICH growth in the short-term, while fundamental undervaluation of the stock creates background for long-term growth. Motor Sich, one of the most profitable aerospace firms with great growth opportunities deserves a premium to its peers, but is trading with a substantial discount (2011E EV/EBITDA of 2.3 vs. global peers of 7.3). According to our DCF and Comparative valuation, the target price for the MSICH is USD 584, implying an upside of 145%.

## BUY

UX	MSICH
Bloomberg	MSICH UK Equity
Target price, USD	584.1
Current price, USD	238.0
Upside, %	145%

#### Market data



#### Stock information

Market price, USD	238
Shares outstanding, mn	2.08
Market cap, USD mn	495
EV, USD mn	528
Free float, USD mn	119
Price 12M Lo/Hi, USD	155/353
Change from 12M Lo/Hi	81%/-21%

#### Ownership structure

Management	76%
Free float	24%

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#### Key indicators

Year	Net sales, USD mn	EBITDA, USD mn	Net income, USD mn	EBITDA margin	Net margin	P/E	EV/Sales	EV/EBITDA	Net debt, USD mn	Debt / Equity	Net debt / EBITDA
2008	391	33	0.7	8.5%	0.2%	673.0	1.4	15.8	76.4	0.36	2.6
2009	463	148	91	32.0%	32.0%	5.4	1.1	3.6	58.6	0.26	0.4
2010E	600	188	121	31.4%	20.2%	4.1	0.9	2.8	23.2	0.19	0.2
2011F	706	227	148	32.2%	21.0%	3.3	0.7	2.3	(71.5)	0.14	neg.
2012F	800	250	164	31.3%	20.5%	3.0	0.7	2.1	(175.8)	0.12	neg.

As seen from Figure 1, MSICH's quarterly net sales are growing by 31% QoQ during each year on average during the last five years. The reason — the bulk part of the order book is formed at the beginning of the year (after Russian state budget adopted); production cycle of aviation engine lasts for 6-9 month. Thus, the bulk part of sales are reported in the 3Q and 4Q quarters.

**Figure 1. MSICH quarterly net sales, EBITDA and compound quarterly growth rate**

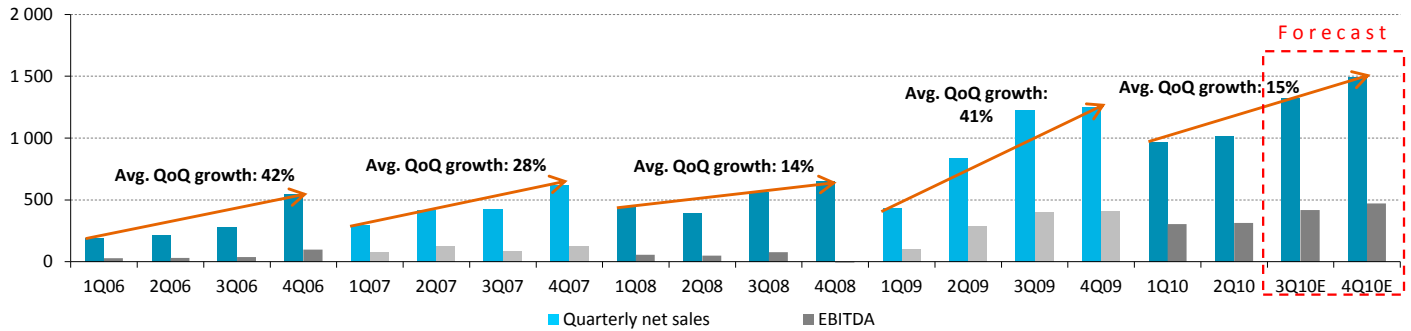
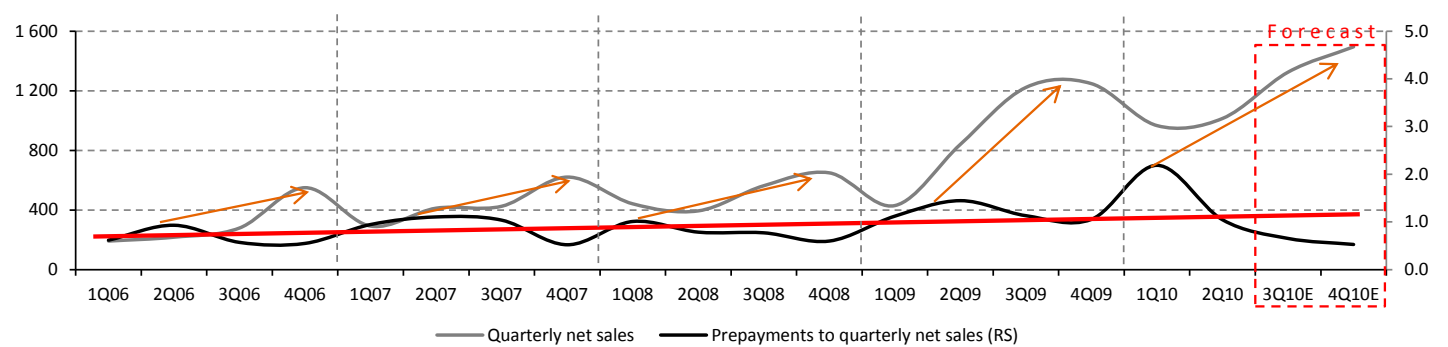


Figure 2 represents the relationship between prepayments the Company receives and the reported quarterly sales. As seen from the figure below, after the prepayment to sales ratio exceeds the red line, the quarterly sales witness a burst of growth. Taking into account strong growth of the ratio in the 1H2010, one could expect the following growth in quarterly sales.

**Figure 2. MSICH's prepayments to quarterly sales ratio and actual quarterly net sales**



SG&A costs are tending to decline relatively to sales while OIBDA margin is growing: economies of scale in play

**Figure 3. SG&A costs to sales and OIBDA margin trend**

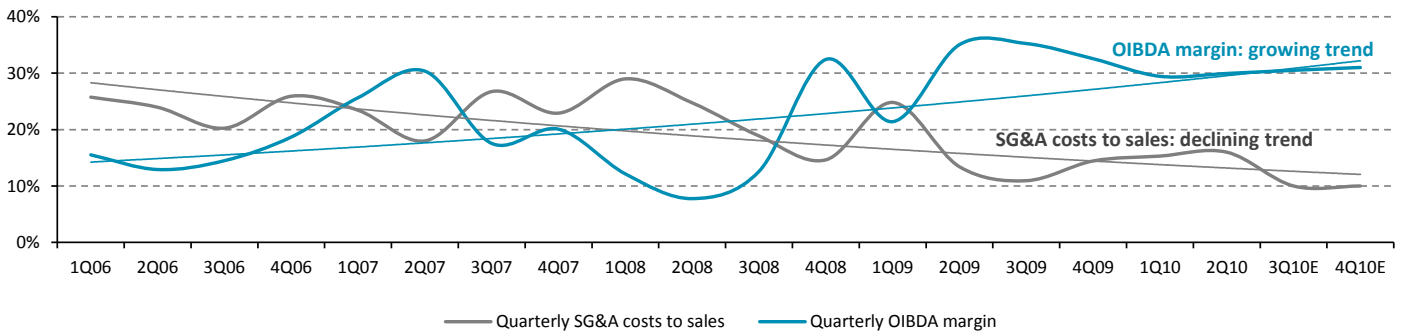


Figure 4 represents the relationship of the quarterly net sales and OIBDA margin

**Figure 4. Effect of scale in play: MSICH quarterly net sales and OIBDA margin (2006-1H2010)**

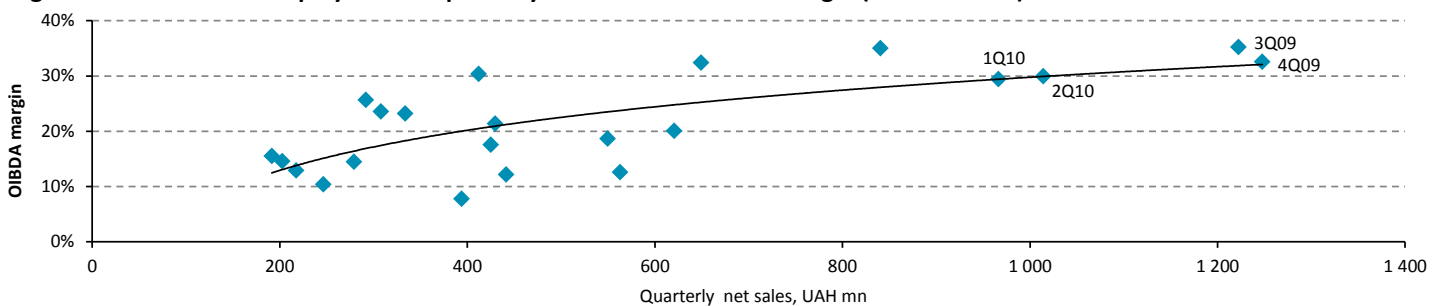


Figure 5. Comparative valuation

	Share Price, USD	MCap, USD mln	EV, USD mln	EV/S		EV/EBITDA		P/E		EBITDA margin	
				2010E	2011F	2010E	2011F	2010E	2011F	2010E	2011F
<b>MSICH</b>	<b>238.0</b>	<b>495</b>	<b>528</b>	<b>0.9</b>	<b>0.7</b>	<b>2.8</b>	<b>2.3</b>	<b>4.1</b>	<b>3.3</b>	<b>31.4%</b>	<b>32.2%</b>
<b>Global peers</b>											
MTU AERO ENGINES HOLDING AG	58.0	3 016	3 174	0.8	0.8	5.8	5.3	13.1	11.1	14.2%	14.6%
VECTOR AEROSPACE CORP	6.8	314	356	0.7	0.7	5.9	5.2	9.4	7.5	11.9%	12.6%
BOMBARDIER INC 'B'	5.0	8 768	11 037	0.6	0.6	6.8	7.5	11.7	13.6	8.4%	8.2%
BAE SYSTEMS PLC	5.9	19 953	21 582	0.6	0.6	5.0	5.0	8.4	8.4	11.8%	12.0%
UNITED TECHNOLOGIES CORP	74.6	69 290	77 340	1.4	1.4	8.7	8.1	15.8	14.2	16.3%	16.7%
BOEING CO	70.8	51 825	54 841	0.9	0.8	8.1	7.3	17.8	14.6	10.4%	10.5%
LOCKHEED MARTIN CORP	70.0	25 371	26 791	0.6	0.6	5.2	5.4	9.6	9.7	11.1%	10.4%
MEGGITT PLC	4.8	3 350	4 628	2.5	2.4	8.3	7.6	11.8	10.5	30.2%	31.2%
SAFRAN SA	28.0	11 696	11 188	0.7	0.7	6.0	5.0	16.4	12.0	12.4%	13.8%
ZODIAC AEROSPACE	66.9	3 735	4 616	1.5	1.3	11.5	8.8	19.5	13.9	13.5%	15.0%
SICHUAN CHENGFA AERO-SCIEN-A	3.4	451	523	2.6	2.7	15.9	14.1	n.a.	n.a.	16.3%	19.3%
<b>Global peers, median</b>				<b>0.8</b>	<b>0.8</b>	<b>6.8</b>	<b>7.3</b>	<b>12.4</b>	<b>11.5</b>	<b>12.4%</b>	<b>13.8%</b>
				<b>2010E</b>	<b>2011F</b>	<b>2010E</b>	<b>2011F</b>	<b>2010E</b>	<b>2011F</b>		
<b>Upside</b>				-7%	2%	153%	227%	204%	246%		
<b>Fair price, USD</b>				222	244	601	779	723	824		
<b>Weights</b>				<b>16.7%</b>	<b>16.7%</b>	<b>16.7%</b>	<b>16.7%</b>	<b>16.7%</b>	<b>16.7%</b>		
<b>Fair price, USD</b>			<b>565.4</b>								
<b>Current price, USD</b>			<b>238.0</b>								
<b>Upside</b>			<b>137.6%</b>								

Figure 6. DCF model

USD mln	2010E	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F
<b>FCF to Firm</b>	<b>65</b>	<b>108</b>	<b>128</b>	<b>135</b>	<b>143</b>	<b>188</b>	<b>216</b>	<b>230</b>	<b>258</b>
<i>EBIT</i>	172	209	229	257	313	338	350	350	348
<i>Income tax rate</i>	25%	25%	25%	25%	25%	25%	25%	25%	25%
- Tax	(40)	(49)	(55)	(61)	(75)	(81)	(84)	(84)	(83)
+ Depreciation	16	19	21	24	28	32	36	41	46
- CapEx	(29)	(33)	(38)	(45)	(52)	(61)	(66)	(71)	(46)
- WC need	(55)	(37)	(30)	(40)	(70)	(40)	(20)	(6)	(6)
<b>WACC</b>	<b>14.6%</b>	<b>14.8%</b>	<b>14.8%</b>	<b>14.8%</b>	<b>14.8%</b>	<b>14.8%</b>	<b>14.4%</b>	<b>14.5%</b>	<b>14.5%</b>
<i>Discount factor</i>	0.87	0.76	0.66	0.58	0.50	0.44	0.38	0.33	0.29
<b>FCFF Discounted</b>	<b>56</b>	<b>82</b>	<b>85</b>	<b>78</b>	<b>72</b>	<b>82</b>	<b>83</b>	<b>77</b>	<b>75</b>

WACC to perpetuity	14.5%
<b>Sum of FCF</b>	<b>690</b>
Terminal growth rate	1.5%
Terminal value	1 987
<b>NPV of TV</b>	<b>580</b>
TV contribution to EV	46%
<b>EV</b>	<b>1 270</b>
Less Net Debt	<b>34</b>
<b>Equity value</b>	<b>1 237</b>
<b>Current Mcap</b>	<b>488</b>
<b>Fair share price, USD</b>	<b>602.8</b>
<b>Current price, USD</b>	<b>238.0</b>
<b>Upside</b>	<b>153.3%</b>

		Sensitivity analysis				
		Terminal growth rate				
USD per share		0.5%	1.0%	1.5%	2.0%	2.5%
WACC to perpetuity	13.0%	614.1	626.3	639.7	654.2	670.1
	13.5%	602.8	614.1	626.3	639.7	654.2
	14.0%	592.3	602.8	614.1	626.4	639.7
	14.5%	582.6	592.3	<b>602.8</b>	614.1	626.4
	15.0%	573.5	582.6	592.3	602.8	614.1
	15.5%	565.1	573.5	582.6	592.3	602.8
	16.0%	557.2	565.1	573.5	582.6	592.3

Figure 7. WACC calculation

	2010E	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F
<b>WACC</b>	<b>14.6%</b>	<b>14.8%</b>	<b>14.8%</b>	<b>14.8%</b>	<b>14.8%</b>	<b>14.8%</b>	<b>14.4%</b>	<b>14.5%</b>	<b>14.5%</b>
<b>Cost of Equity</b>	<b>15.5%</b>	<b>15.5%</b>	<b>15.5%</b>	<b>15.5%</b>	<b>15.5%</b>	<b>15.5%</b>	<b>15.0%</b>	<b>15.0%</b>	<b>15.0%</b>
Ukraine 5Y yield	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	6.5%	6.5%	6.5%
Equity risk	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Currency risk	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Company specific risk	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%
<b>Equity/(Debt+Equity)</b>	<b>83.7%</b>	<b>87.5%</b>	<b>89.0%</b>	<b>89.8%</b>	<b>90.0%</b>	<b>90.9%</b>	<b>91.8%</b>	<b>92.7%</b>	<b>93.3%</b>
<b>After tax cost of debt</b>	<b>10.0%</b>	<b>9.6%</b>	<b>9.0%</b>	<b>8.6%</b>	<b>8.3%</b>	<b>7.9%</b>	<b>7.7%</b>	<b>7.6%</b>	<b>7.5%</b>
Pre-tax cost of debt	13.3%	12.8%	12.0%	11.5%	11.0%	10.5%	10.3%	10.1%	10.0%
Tax rate	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%
<b>Debt/(Debt+Equity)</b>	<b>16.3%</b>	<b>12.5%</b>	<b>11.0%</b>	<b>10.2%</b>	<b>10.0%</b>	<b>9.1%</b>	<b>8.2%</b>	<b>7.3%</b>	<b>6.7%</b>

Figure 8. Balance sheet

USD mln	2006	2007	2008	2009	2010E	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F
<b>Total Assets</b>	<b>449</b>	<b>577</b>	<b>444</b>	<b>529</b>	<b>691</b>	<b>870</b>	<b>1 072</b>	<b>1 307</b>	<b>1 615</b>	<b>1 909</b>	<b>2 190</b>	<b>2 452</b>	<b>2 715</b>
<b>Non-current Assets</b>	<b>207</b>	<b>230</b>	<b>156</b>	<b>176</b>	<b>203</b>	<b>221</b>	<b>242</b>	<b>268</b>	<b>298</b>	<b>335</b>	<b>371</b>	<b>409</b>	<b>382</b>
PPE	142	156	106	116	128	142	160	180	205	235	264	294	294
CIP	27	27	18	27	31	34	38	43	49	56	63	71	44
LT Investments on equity basis	37	45	29	31	42	42	42	42	42	42	42	42	42
Other NCA	2	3	3	2	2	2	2	2	2	2	2	2	2
<b>Current Assets</b>	<b>241</b>	<b>348</b>	<b>288</b>	<b>353</b>	<b>488</b>	<b>650</b>	<b>829</b>	<b>1 040</b>	<b>1 317</b>	<b>1 574</b>	<b>1 818</b>	<b>2 043</b>	<b>2 332</b>
Accounts Receivable	64	98	84	119	150	177	200	233	288	320	338	344	351
Inventories	164	228	191	199	276	318	360	420	518	576	608	620	632
Cash & Equivalents	11	17	6	24	62	155	269	387	511	678	872	1 079	1 349
Other CA	2	5	7	11	0	0	0	0	0	0	0	0	0
<b>Total Liabilities &amp; Equity</b>	<b>449</b>	<b>577</b>	<b>444</b>	<b>529</b>	<b>691</b>	<b>870</b>	<b>1 072</b>	<b>1 307</b>	<b>1 615</b>	<b>1 909</b>	<b>2 190</b>	<b>2 452</b>	<b>2 715</b>
<b>Total Liabilities</b>	<b>173</b>	<b>223</b>	<b>218</b>	<b>209</b>	<b>251</b>	<b>283</b>	<b>320</b>	<b>372</b>	<b>454</b>	<b>504</b>	<b>534</b>	<b>545</b>	<b>558</b>
<b>Long-Term Liabilities</b>	<b>12</b>	<b>21</b>	<b>16</b>	<b>30</b>	<b>30</b>	<b>30</b>	<b>31</b>	<b>30</b>	<b>30</b>	<b>30</b>	<b>30</b>	<b>30</b>	<b>30</b>
Long-Term Debt	0	4	9	15	13	13	13	13	13	13	13	13	13
Other Long-Term Liabilities	12	17	8	16	17	17	18	17	17	17	17	17	17
<b>Short-Term Liabilities</b>	<b>161</b>	<b>202</b>	<b>201</b>	<b>179</b>	<b>221</b>	<b>252</b>	<b>289</b>	<b>341</b>	<b>424</b>	<b>474</b>	<b>504</b>	<b>515</b>	<b>528</b>
Accounts Payable	31	42	32	12	21	28	32	37	46	51	54	55	56
Accrued Expenses	66	88	95	99	128	153	177	211	263	295	314	322	331
Short-Term Debt	64	71	74	68	72	71	80	93	115	128	135	138	140
<b>Equity</b>	<b>276</b>	<b>354</b>	<b>226</b>	<b>320</b>	<b>439</b>	<b>588</b>	<b>752</b>	<b>936</b>	<b>1 161</b>	<b>1 404</b>	<b>1 656</b>	<b>1 907</b>	<b>2 156</b>
Share Capital	53	55	35	35	34	34	34	34	34	34	34	34	34
Additional Paid-in Capital	127	163	104	104	104	104	104	104	104	104	104	104	104
Retained Earnings and Reserves	96	137	88	181	301	450	613	798	1 023	1 266	1 517	1 769	2 018
<b>Total Debt</b>	<b>64</b>	<b>75</b>	<b>83</b>	<b>82</b>	<b>85</b>	<b>84</b>	<b>93</b>	<b>107</b>	<b>128</b>	<b>141</b>	<b>148</b>	<b>151</b>	<b>154</b>
<b>Net Debt</b>	<b>53</b>	<b>58</b>	<b>76</b>	<b>59</b>	<b>23</b>	<b>(72)</b>	<b>(176)</b>	<b>(280)</b>	<b>(383)</b>	<b>(536)</b>	<b>(724)</b>	<b>(928)</b>	<b>(1 195)</b>
Debt-to-Equity Ratio	0.23	0.21	0.36	0.26	0.19	0.14	0.12	0.11	0.11	0.10	0.09	0.08	0.07
Total debt/EBITDA	1.54	0.85	2.97	0.55	0.44	0.37	0.35	0.36	0.34	0.36	0.38	0.38	0.39
Net debt/EBITDA	1.21	0.68	2.59	0.45	0.22	neg.	neg.	neg.	neg.	neg.	neg.	neg.	neg.
Current Ratio	1.50	1.72	1.43	1.98	2.21	2.57	2.87	3.05	3.11	3.32	3.61	3.97	4.42
Quick Ratio	0.46	0.57	0.45	0.80	0.96	1.32	1.62	1.82	1.89	2.10	2.40	2.76	3.22

Figure 9. Income statement

USD mln	2006	2007	2008	2009	2010E	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F
<b>Gross Revenues</b>	<b>254</b>	<b>358</b>	<b>406</b>	<b>476</b>	<b>613</b>	<b>726</b>	<b>822</b>	<b>959</b>	<b>1 183</b>	<b>1 315</b>	<b>1 388</b>	<b>1 414</b>	<b>1 442</b>
VAT & other deductions	(8)	(10)	(14)	(12)	(13)	(20)	(22)	(25)	(31)	(34)	(36)	(37)	(37)
<b>Net Sales</b>	<b>246</b>	<b>348</b>	<b>391</b>	<b>463</b>	<b>600</b>	<b>706</b>	<b>800</b>	<b>933</b>	<b>1 152</b>	<b>1 281</b>	<b>1 352</b>	<b>1 377</b>	<b>1 405</b>
COGS	(151)	(196)	(252)	(265)	(337)	(404)	(465)	(554)	(691)	(776)	(827)	(848)	(872)
<b>Gross Profit</b>	<b>94</b>	<b>152</b>	<b>139</b>	<b>199</b>	<b>263</b>	<b>302</b>	<b>335</b>	<b>379</b>	<b>461</b>	<b>505</b>	<b>525</b>	<b>529</b>	<b>532</b>
General and Administrative Costs	(35)	(52)	(53)	(38)	(48)	(57)	(64)	(75)	(91)	(99)	(103)	(103)	(104)
Selling and Marketing	(24)	(27)	(29)	(28)	(34)	(38)	(43)	(50)	(61)	(68)	(67)	(68)	(69)
Other Profits	155	183	264	307	183	233	268	322	403	448	473	482	492
Other Expenditures	(168)	(195)	(273)	(303)	(195)	(234)	(270)	(321)	(401)	(450)	(480)	(492)	(506)
<b>Operating Profit</b>	<b>22</b>	<b>60</b>	<b>49</b>	<b>137</b>	<b>169</b>	<b>206</b>	<b>227</b>	<b>255</b>	<b>311</b>	<b>336</b>	<b>347</b>	<b>347</b>	<b>345</b>
OIBDA	40	79	70	152	185	225	248	279	339	368	384	388	391
Financial & other income (loss)	(1)	3	(36)	(3)	3	3	3	3	3	3	3	3	3
<b>EBITDA</b>	<b>39</b>	<b>82</b>	<b>33</b>	<b>148</b>	<b>189</b>	<b>227</b>	<b>250</b>	<b>281</b>	<b>341</b>	<b>370</b>	<b>386</b>	<b>391</b>	<b>393</b>
Depreciation	(18)	(19)	(20)	(15)	(16)	(19)	(21)	(24)	(28)	(32)	(36)	(41)	(46)
<b>EBIT</b>	<b>21</b>	<b>63</b>	<b>13</b>	<b>134</b>	<b>172</b>	<b>209</b>	<b>229</b>	<b>257</b>	<b>313</b>	<b>338</b>	<b>350</b>	<b>350</b>	<b>348</b>
Interest Expense	(7)	(37)	(53)	(84)	(89)	(87)	(85)	(92)	(103)	(113)	(119)	(121)	(122)
<b>EBT</b>	<b>14</b>	<b>56</b>	<b>3</b>	<b>123</b>	<b>161</b>	<b>198</b>	<b>219</b>	<b>246</b>	<b>301</b>	<b>324</b>	<b>335</b>	<b>335</b>	<b>333</b>
Income Tax	(6)	(15)	(2)	(32)	(40)	(49)	(55)	(61)	(75)	(81)	(84)	(84)	(83)
<b>Net Income</b>	<b>7</b>	<b>41</b>	<b>1</b>	<b>92</b>	<b>121</b>	<b>148</b>	<b>164</b>	<b>184</b>	<b>225</b>	<b>243</b>	<b>251</b>	<b>251</b>	<b>249</b>
<b>Margins</b>													
Gross	38.4%	43.7%	35.6%	42.9%	43.8%	42.8%	41.9%	40.6%	40.0%	39.4%	38.8%	38.4%	37.9%
EBITDA	15.9%	23.6%	8.5%	32.0%	31.4%	32.2%	31.3%	30.2%	29.6%	28.9%	28.6%	28.4%	28.0%
Net	3.0%	11.8%	0.2%	19.8%	20.2%	21.0%	20.5%	19.7%	19.6%	19.0%	18.6%	18.2%	17.8%

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