



INVESTMENT CAPITAL UKRAINE
INVESTMENT BANKING

Focus
Ukraine

Scope
Equity markets

Sector
Food & Agribusiness

Kernel

In search of a bottom



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2014**

READ FIRST THE DISCLOSURES SECTION FOR IMPORTANT DISCLOSURES AND
ANALYST CERTIFICATION

Country

Ukraine

Kernel

Sector

Food & Agribusiness

Recommendation

Neutral

Target price

PLN48

Upside

66%

Ticker in Bloomberg

KER PW

Key data on company's shares

Data as of 16 April 2014	
Current price (PLN)	29
3m ADT (US\$ 000)	2,626
52-week price range (PLN)	23 - 61
Mkt Cap (US\$m)	761
Enterprise value (US\$m)	1,784
Shares out (m)	79.7
Free float	61%
Exchange	Warsaw

Note: market exchange rate PLN3.06 per US\$.

Source: Company, Bloomberg

Key financial figures

(US\$m)	2013	2014E	2015F
Sales	2,797	2,493	2,152
Pro-forma EBITDA	273	223	259
Pro-forma Net profit	88	14	79
EPS (US\$)	1.10	0.17	0.99

Source: Company, ICU

Multiples

	LTM	2014E	2015F
EV/EBITDA	9.5	6.8	5.9
P/E	neg	54.7	9.3
EV/Sales	0.7	0.6	0.7

Source: Bloomberg, ICU

We are initiating coverage of Kernel, one of the high-ranked Ukrainian food producers. Once a growth leader and darling of investors, Kernel found itself in a difficult situation in recent years with profits dented by rising competition and weak grain prices. Shares that have significantly declined over the past year now offer a substantial upside to an estimated fair value of PLN48. However, the risk/reward profile still remains unfavorable given the escalation of Ukraine-Russia conflict combined with an uncertain outlook for fy 2015 and exuberant market expectations that weigh on the share price. Hence, we are Neutral on the stock and prefer to wait for a better entry point.

Some years ago, Kernel was a darling of investors who praised its break-neck growth and expansion strategy. During the years following its IPO in 2007, the company captured a quarter of the local oilseed crushing market, broke into the top five largest local grain exporters, and consolidated one of the largest land banks in Ukraine. Consequently, its EBITDA surged six-fold from US\$46m in fy 2007 to US\$301m in fy 2011 while its share price more than tripled.

Mounting challenges and strategic missteps derailed growth in recent years. In recent years, both the oilseed crushing and grain trading industries have seen increased competition that significantly squeezed profit margins. Furthermore, the high-cost venture into farming was misguided with results trailing well behind expectations. As a result, earnings began to slump and the share price fell into a downward spiral. As of now, the stock has lost over half of its value since Feb-13 when a clear downward trend was established.

Operations should soon stabilize but uncertainty over fy 2015 remains high. Kernel is set to deliver improved performance in 2H fy 2014 with the bulk of losses in farming behind and improved prospects in other divisions driven by the sharp hryvnia depreciation. Beyond that, we see modest recovery in FY2015 which, however, depends on a recovery in farming where the outlook remains vague due to uncertainty in selling prices and crop yields.

The Ukraine-Russia conflict is the major risk factor in the near term. The conflict has recently escalated into Eastern Ukraine and there are expectations that it will soon spread to Odessa and Kharkiv where Kernel has sizable operations. Fortunately, the conflict did not cause any disruption to Kernel's business thus far but it definitely hurts sentiment and dampens price appreciation.

We do not yet see an attractive risk/reward in the stock and look for a better entry point. In our view, current valuations are reasonably attractive with fair value in the range of PLN47-51, implying an upside of 63-77%. Nevertheless, the buy at the moment seems to be rather premature given i) the adverse geopolitical setting, ii) the vague outlook for fy 2015, and iii) exuberant market expectations. Hence, we would prefer to wait for a better entry point to play out the ultimate turnaround in operations.

Share price performance

Trailing 12 months



Source: Bloomberg, ICU

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Investment thesis

Kernel was once a darling of investors and a highly praised success story. In the years following its IPO in 2007, the company managed to become a preeminent force in the oilseed crushing and grain export industries in Ukraine while its EBITDA surged six-fold from US\$46m in fy 2007 to US\$301m in fy 2011, boosted by persistently high soft commodity prices. As a result, KER shares, priced at PLN24 at the IPO, more than tripled to their peak in Feb-11 when they were trading in the low- to mid-80s.

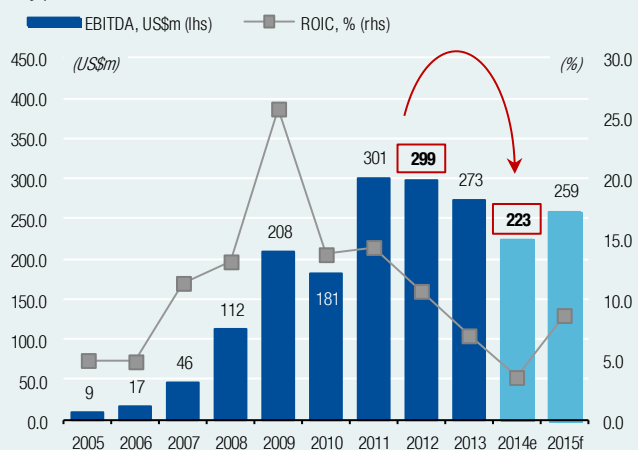
Chart 1. Kernel plunged to its IPO price as growth reversed in fy 2013

KER share price performance since IPO, PLN/sh



Source: Bloomberg.

Key performance indicators



Unfortunately, every growth story comes to an end, and Kernel was no exception. Over the past two years, a confluence of challenges and strategic missteps derailed growth and reversed some of the achievements of the previous years. There was significant margin deterioration in grain trading and oilseed crushing operations due to increased local competition. Meanwhile, the farming business, which consumed nearly US\$400m in investments since 2008, failed to perform up to expectations and became a real drag after the recent collapse in grain prices. Earnings suffered as a result, with EBITDA slated to drop to below US\$250m in fy 2014 and ROIC possibly down to below 4%.

Deteriorating fundamentals caused the share price to decline significantly. Since Feb-13, KER stock has lost over half of its value and is now trading in the high-20s compared to the high-60s seen early last year. Early Mar-14 marked a local trough when shares briefly dipped below PLN23 amidst a sell-off triggered by a possible Russian invasion of mainland Ukraine. Shares recovered to the high-20s, where they stand now, when the invasion threat dissipated.

In our view, current valuations are reasonably attractive and offer a fair margin of safety to investors. NAV, DCF and mid-cycle methods indicate a fair value range of PLN47-51 with an estimated return of 63-77%. Admittedly, there is an upside to these estimates if the restructuring in the farming business is successful. If this occurs, we can easily imagine valuations in the PLN60-70 range. Otherwise, if the farming segment fails, the price target will still hold firmly above PLN40, sufficiently above the current price. We establish the price target at PLN48, equal to the net asset value per share.

Despite the compelling valuation, a buy recommendation at the moment is premature. The deteriorating conflict between Ukraine and Russia will probably hamper any significant share price appreciation in the near-term despite the improved operational outlook for 2H fy 2014. Furthermore, uncertainty prevails over the performance of the farming segment in fy 2015 which will hardly dissipate before Sep-Oct when we get a better feel of yields and selling prices. The major risk is that we may witness a stagnant share price for another year if the farming segment fails yet again. Of course, current uncertainty does not prevent short-term trades on the long side if good opportunities emerge over the next several weeks driven by a recurring escalation of the ongoing conflict.

The current conflict between Ukraine and Russia is the major risk factor in the near term. The conflict that started with annexation of Crimea in early Mar recently escalated into Eastern Ukraine where insurgents backed by Russian forces captured a number of cities from authorities. Fortunately, the conflict did not cause any disruption to Kernel's operations thus far, but this may change if insurgents and government forces clash over Odessa or Kharkiv, where Kernel has sizable operations. These events are widely expected to occur during the next few weeks and we would seek to take advantage of any short-term buying opportunities that might present themselves.

Geopolitical issues currently overshadow the improved operational outlook for 2H fy 2014, but the latter may come to the fore if tensions recede at some point. Kernel has already booked a bulk of the losses in farming during 2Q14 which removes much of the risk ahead. Meanwhile, Kernel's oilseed crushing and grain trading divisions are set to benefit from significant arbitrage opportunities created by temporary dislocations between export and farm-gate prices that occurred during Feb-Mar due to the sharp hryvnia depreciation. As such, 3Q should see higher profits with significant spillover into 4Q. The 3Q14 results are expected on 30 May and could support the share price if the geopolitical issue corrects itself.

Meanwhile, the outlook beyond July is uncertain and will depend on many factors, including i) the US corn crop results, ii) Ukraine's corn and sunflower seed crop results, and iii) the corn and soybean yields achieved by the new head of farming. Sufficient clarity should not be expected before Sep-Oct when crop harvesting gets underway and yield prospects become more certain.

Our baseline assumption is that fy 2015 will be tough with a modest recovery compared to fy 2014. While the outlook for grain and oilseed crushing operations is subject to modest variation, farming still remains highly uncertain. Based on consensus estimates, the market appears to expect a sharp recovery in farming profits in fy 2015. However, we remain cautious because of high risks related to the selling prices and yield progress. We project fy 2015 EBITDA of US\$259m versus the consensus estimate of US\$360m, which is highly vulnerable to downside risks.

The vague outlook for fy 2015 and exuberant market expectations do not facilitate positive price action. Hence, **we would prefer to wait for an entry point with a more favorable risk/reward profile** to capitalize on the ultimate recovery in farming.

Table 1. Kernel. Valuation summary

	Price			Upside	Horizon	Rating		
	PT new	PT old	Current			New	Old	Action
US\$/share	15.8	n/a	9.5	66%	Dec-15	Neutral	n/a	Initiate
PLN/share	48	n/a	29					

Sources: ICU

Valuation

We establish a Dec-15 price target for Kernel at PLN48 based on a 1.0x P/NAV estimate. While normally we use a forward EV/EBITDA metric for the purpose of valuation, the ongoing cyclical slump in earnings induced by recent plunge in grain prices is hampering the use of earnings multiples. With the outlook on mid-cycle earnings still somewhat vague in light of continued structural pressures in the oilseed crushing business and numerous challenges in the farming segment, we feel more comfortable with a conservative P/NAV approach for the time being. Meanwhile, the valuation based on an estimated mid-cycle EBITDA range of US\$250-350m and an average historical EV/EBITDA multiple of 7.0x yields a price target range of PLN38-64, corresponding to PLN51 at the mid-point. The result is similar to the one produced by the P/NAV method giving additional support to the established price target.

Table 2. Kernel valuation range

	(PLN/sh)
NAV	48
Mid-cycle valuation	51
Relative valuation	42
DCF	47

Sources: ICU

Besides the P/NAV and mid-cycle valuation, we also considered other valuation methods that, admittedly, produced lower PT values. In particular, DCF returned a fair value range of PLN32-48 using WACC of 10-16% while relative valuation based on the forward EV/EBITDA metric implied a PT range of PLN41-43. In the latter case, the low numbers are fully explained by cyclically depressed earnings.

We set the price target horizon to Dec-15 because of the high uncertainty over farming result in fy 2015.

Below we provide detailed calculations and discuss major assumptions behind each valuation method as well as particular results obtained.

NAV valuation

We estimate the net value of Kernel's assets at PLN48/sh which corresponds to US\$1,291m for all equity. The number largely falls in line with the 2Q14 reported book value of US\$1,292m (US\$1,304m less non-controlling interest of US\$12m). To arrive at our NAV estimate, we made adjustments to certain assets, primarily PP&E and intangibles, while leaving all liabilities untouched. Fixed assets were split into groups corresponding to the main business segments and evaluated individually. The same goes for intangible assets that are mostly comprised of land lease rights and trademarks. Our key assumptions are as follows.

Oilseed crushing. The replacement cost of high-profile oilseed crushing plants is assumed at US\$200 per tonne of annual crushing capacity, which stands in between the reported cost of recently completed projects (Creativ, Gradoliya, Delta Wilmar) at US\$170-180/t and the alleged cost of Kernel's greenfield project in Russia at US\$250/t. US\$200/t

estimate was applied to Bandurka and BSI, while other facilities were valued at a varied discount depending on their age profile and technical condition. The worst among them (Russian assets) were ascribed US\$75/t price tag which is equivalent to the price received for Nevinnomyssk plant (US\$10m consideration for 138 kt of nominal capacity).

Export terminals. The replacement cost of export loading terminals is estimated at US\$30 per tonne of annual throughput capacity which sits at the low end of the cost range for the new projects (US\$30-40/t). There are some aspects that put Kernel's facilities behind new projects in terms of operational efficiency which justifies our conservative stance. Meanwhile, Kernel's 50% stake in the Taman JV is valued separately and is set equal to its current book value of US\$98m which, in our view, reasonably reflects the possible selling price of the stake in a potential deal with the JV partner Glencore.

Grain elevators. Grain elevators are comprised of three distinct groups that are valued separately. Modern elevators are ascribed a value of US\$180 per tonne of storage, equal to the average construction cost implied by Kernel's recent storage projects. Aged vertical silos get a price of US\$80/t, while flat storage is priced at US\$40/t.

Farmland. We value the farmland lease rights at US\$300/ha, which is obviously a conservative estimate. Their current market price is some US\$400/t, while they were worth as much as US\$600/ha as recently as last summer. However, the market is thin at present with very few buyers around amidst the massive drop in farm profits. If this situation persists for another season, and it looks like it will, the farmland prices should fall further – possibly to US\$300/t.

Farming equipment. We also made some adjustments to the book value of farming structures and equipment. While we preserved the value of agricultural machinery and equipment as it was reported, we cut the value of structures and non-farming equipment by half to be conservative since those are the areas where much unjustified revaluation typically happens upon acquisitions.

Current assets. The book value of a portion of the current assets was adjusted to better reflect the inherent risks. Taxes recoverable and prepaid, mostly comprised of the accrued VAT refund, are discounted by 39%. This discount reflects the loss due to sharp hryvnia depreciation along with an appropriate discount on VAT bonds that are supposed to be issued by the government to cover its VAT liabilities to the companies. Additionally, the book value of assets held for sale, which is comprised of sugar plants, is reduced by a third given the loss incurred on a recent disposal of the Orzhytsia sugar plant.

Table 3. Kernel. Pro-forma NAV and valuation

Pro-forma NAV		Reported	Adjustment		Pro forma
Fixed assets	US\$m	740	(+) 232	31%	972
Intangible assets	US\$m	305	(-) 164	-54%	141
Other long-term assets	US\$m	166	-	0%	166
Net working capital	US\$m	1,132	(-) 101	-9%	1,030
Cash	US\$m	40	-	0%	40
Fair value of assets	US\$m	2,383	(-) 33	-1%	2,349
(-)					
Loans and borrowings	US\$m	1,051	-	0%	1,051
Other long-term liabilities	US\$m	27	-	0%	27
Fair value of liabilities	US\$m	1,078	-	0%	1,078
(-)					
Non-controlling interest	US\$m	12	-	0%	12
Net asset value	US\$m	1,292	(-) 33	-3%	1,259
Shares out	mn	79.7			
Net asset value	\$/sh	16.2			15.8
PLN / USD exchange rate	x	3.06			
Net asset value	PLN/sh	50			48

Sources: ICU

Relative valuation

Relative valuation implies a price target range of PLN41-43 but the relevance of those estimates is rather low. Valuation is based on a forward EV/EBITDA metric that we traditionally apply to Ukrainian companies. To establish the target range we utilize fy 2015 EV/EBITDA multiples of 7.7x and 9.0x corresponding to current valuations of two main groups of comparables - grain traders and oilseed crushers. Those are adjusted downwards by 8% and 19%, respectively, to account for prevailing historical discounts. We eventually arrive at target multiples of 7.1x and 7.3x, which applied to our fy 2015 EBITDA estimate of US\$259m and the fy 2014 season average net debt of US\$765m give us a price target range of PLN41-43. However, the weak historical correlation between Kernel and most of its peers makes these estimates rather irrelevant for the valuation of Kernel stock and hardly suitable for making any meaningful investment conclusions.

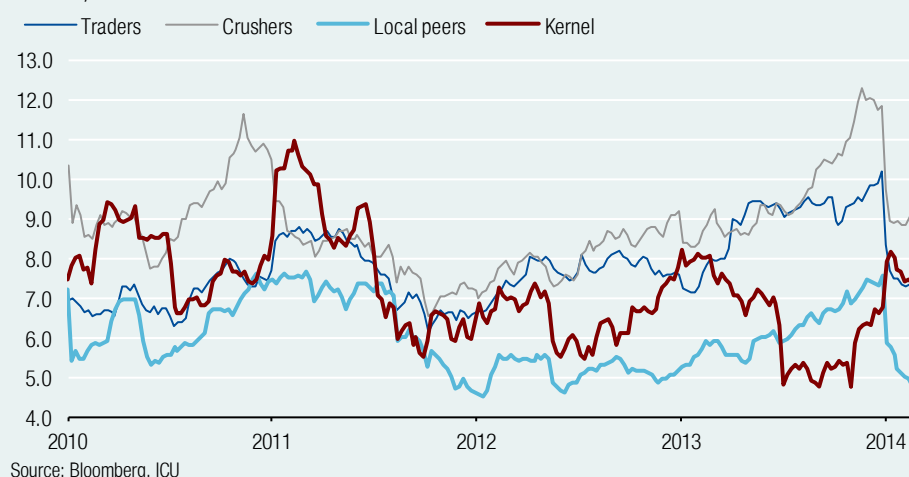
When undertaking the relative valuation of Kernel, we have split feasible peers into four distinct groups, depending on their principal areas of operation and geographic location. The first group consists of established Ukrainian food producers (MHP and Astarta) with a solid track record and trading history extending to the pre-GFC period. Meanwhile, the rest of the comps come from other geographies and have limited exposure to Ukraine where Kernel principally operates. Grain traders, including such global giants as ADM and Bunge, comprise the second group. The largest group consists of oilseed crushers, predominantly from among ASEAN palm oil producers. A group of focused farmland operators from Latin America forms the fourth peer group.

None of the aforementioned peer groups, however, exhibits a sufficient degree of correlation with Kernel, except for local comps that mostly tend to follow Kernel. If we trace the moves in the forward EV/EBITDA multiple back to 2010, we would see that KER rarely follows the trajectory of foreign peers and at times their ways diverge rather dramatically. This fact is confirmed by statistical analysis which reveals that Kernel is weakly correlated

to its peers outside of Ukraine if compared on either fwd EV/EBITDA or share price dynamics. Weak historical correlation essentially tells us that comps are largely irrelevant for the valuation of Kernel on short time frames and might only be used as a reference over sufficiently long horizons.

Chart 2. Kernel oftentimes diverges from global industry peers

Kernel vs peers on EV/EBITDA basis



Although local food producers perform much better as comps, they usually trail Kernel's dynamics which largely prevents their use for valuation purposes. Normally, the broad market uses Kernel as a benchmark for local peers due to Kernel's superior standing among investors. There are several aspects that make Kernel stock more appealing. Unlike local peers, it is part of two major stock indices (WIG20 and MSCI EM) which provides a large shareholder base and high liquidity to its shares. Its float is also much higher at 61% vs 34% of MHP and 37% of Astarta. Besides, Kernel is listed on the main market of the WSE in contrast to MHP which is listed on the AIM. Meanwhile, compared to Astarta, Kernel's market cap is 2-3x higher, which makes the company much more interesting to investors.

Table 4. Shareholder appeal of Ukraine's major food producers

	Kernel	MHP	Astarta
Major index participation	WIG20, MSCI EM		
Float	61%	34%	37%
Shareholder base	Wide	Narrow	Narrow
12m ADT (US\$ 000)	2,631	1,706	215
Frequency of trades	High	Low	Low

Sources: Companies, Bloomberg, ICU

Kernel typically trades at significant premium to local food peers. In the period since 2010, it averaged 15% and 25% to MHP and Astarta, respectively, while surging to 40-60% at times. Currently, the spread is considerably higher than normal (premiums of 33% to MHP and 52% to Astarta based on a fy 2014 EV/EBITDA metric). In our view, the reason is that Kernel has already undergone a major earnings downgrade resulting from the recent drop in grain prices and a concomitant sharp guidance revision which is still something to be factored into consensus estimates for MHP and Astarta, both of which also have large exposure to grain prices but were cautious with their guidance.

See Appendices for the detailed peer analysis.

Mid-cycle valuation

Over the past four years, Kernel has been trading at an average EV/EBITDA multiple of 7.0x with shares swinging in the range of 5.7-8.3x for most of the time (3/4). This is below the average historical multiples of global soft commodity traders (7.6x) and palm oil producers (8.7x) but above those of major local food peers MHP (6.1x) and Astarta (5.6x).

Chart 3. Kernel tends to trade at about 7.0x EV/EBITDA

Kernel's fwd EV/EBITDA band



Table 5. Kernel normally trades at a discount to global industry peers and with premium to local food producers

4yr avg forward multiples

	Kernel	Local peers		Industry peers	
		MHP	Astarta	Traders	Crushers
EV / EBITDA	7.01	6.08	5.62	7.65	8.65
St. dev.	1.31	0.82	1.07	0.94	1.15
Avg discount		-15.3%	-24.7%	8.4%	19.0%

Sources: Bloomberg, ICU

If we apply a 4yr avg multiple of 7.0x to our mid-point projection of US\$300m for mid-cycle EBITDA and fy 2014 average-season net debt of US\$765m, we arrive at a price target of PLN51, which is generally in line with figure produced by NAV valuation. Meanwhile, the possible mid-cycle EBITDA range of US\$250-350m suggests that the price target can vary from PLN38 to PLN64 depending on future developments in farming and other segments.

Table 6. Kernel: Mid-cycle valuation

Hist avg EV/EBITDA multiple	x	7.0
Mid-cycle EBITDA (est)	US\$m	300
Enterprise value	US\$m	2,100
Net debt	US\$m	(765)
Implied Mkt Cap	US\$m	1,335
Shares out	mn	79.7
Price target	US\$/sh	16.8
US\$/PLN exchange rate	x	3.06
Price target	PLN/sh	51

DCF valuation

Our DCF model yields a fair value of PLN47.

Main assumptions:

- Explicit forecast period covers five years between 2014 and 2018.
- Our forecast cash flows are based on existing assets. The only expansion that we account for is the ongoing development of ZTK Taman that will raise its throughput capacity from 3 mt to 5 mt and is scheduled for completion in Aug-14. We assume that incremental capacity will start contributing in FY15.
- We employ a WACC of 10% based on the 7% after-tax cost of debt and a 13% cost of equity. We are fully aware that this figure looks somewhat low against market practice which typically employs cost of capital in excess of 16% when valuing Ukrainian companies. However, there are strong reasons to treat Kernel differently. Aside from the fact that its production assets are located in Ukraine, there are no other major links to the domestic economy. Kernel pursues an export-focused business model receiving the bulk of revenue in hard currency and mostly works with major European banks and their local subsidiaries to cover its funding needs. As such, the company has limited exposure to local currency while its borrowing costs (7-8%) stand significantly below local interest rates which, in our view, fully justify lower WACC. Nevertheless, if we were to raise WACC to the more familiar 16% mark all else remaining constant, we would get a fair value of PLN32.
- We utilize the multiple-based approach to arrive at a terminal value. We assume an EV/EBITDA multiple of 7.0x, in line with the historical average, and EBITDA of US\$303m in the terminal year (fy 2018).
- We employ year-average net debt to account for heavy seasonal patterns in operations. Normally for Kernel, the debt load peaks towards the middle of the fiscal year when large sunflower seed inventory is accumulated to be gradually worked down towards the year-end.
- We assume US\$60-80m for annual maintenance capex for the explicit forecast period.

Table 7. Kernel. WACC decomposition

Decomposition process	Unit	Value
Risk-free rate	%	8.0%
Corporate risk premium	%	2.3%
Company specific risk premium	%	-2.3%
Pre tax cost of debt	%	8.0%
Income tax rate	%	18.0%
After tax cost of debt	%	6.6%
Equity risk premium	%	5.0%
Cost of equity	%	13.0%
D/E	x	0.70
Weight of equity	%	59.0%
WACC	%	10.4%

Table 8. Kernel. DCF valuation

		2014	2015	2016	2017	2018
EBIT	US\$m	90	186	219	234	246
Tax	US\$m	(40)	(21)	(22)	(24)	(25)
D&A	US\$m	92	85	81	78	76
Δ Working capital	US\$m	42	233	(9)	(11)	(11)
Capex	US\$m	(146)	(65)	(67)	(69)	(71)
Unleveraged free cash flow	US\$m	37	418	203	208	214
WACC	%	10.4%	10.4%	10.4%	10.4%	10.4%
Discounted FCF	US\$m	33	343	151	140	131
Sum of discounted FCF	US\$m	799				
Terminal EBITDA	US\$m	303				
Terminal EBITDA multiple	x	7.00				
Terminal value	US\$m	2,121				
Terminal WACC	%	10.4%				
Discounted terminal value	US\$m	1,295				
EV	US\$m	2,094				
(-) Net debt	US\$m	(851)				
(-) Minorities	US\$m	(12)				
Fair equity value	US\$m	1,231				
Shares out	mn	79.7				
Fair equity value	US\$/sh	15.4				
PLN / USD exchange rate	x	3.06				
Fair equity value	PLN/sh	47				

Table 9. Fair value sensitivity

		Terminal EBITDA multiple						
		5.00	5.50	6.00	6.50	7.00	7.50	8.00
WACC	16%	21	24	27	29	32	35	38
	15%	23	26	29	32	34	37	40
	14%	25	28	31	34	37	40	43
	13%	27	30	33	36	40	43	46
	12%	29	33	36	39	42	46	49
	11%	32	35	38	42	45	49	52
	10%	34	38	41	45	48	52	56

Short description

Kernel is a large agribusiness player with US\$2.8bn of sales and is focused on the rapidly developing Black Sea region. Its interests span vegetable oil, grain handling, and crop farming. The company's assets are located mostly in Ukraine where Kernel operates seven oilseed crushing plants, about 40 grain elevators, two port facilities and has 400k ha of farmland under lease. Besides, it has some outposts in Russia, namely two crushing plants and 50% in the JV running the Taman grain terminal. In Ukraine, Kernel occupies leading positions in each of its main business areas – 1st in vegetable oil production, 1st in grain storage and 2nd by the size of the land bank.

Kernel's earnings profile reflects a combination of relatively stable profit stream from oilseed crushing business and grain infrastructure and widely fluctuating returns from farming operations mostly driven by volatile global grain prices. Historically, oilseed crushing operations have been the largest earnings contributor, accounting for a 65% share of the consolidated EBITDA in FY13, followed by grain handling (19%) and farming (16%).

Kernel has been operating since the mid-1990s and over the span of 20 years has evolved into a major agricultural player in Ukraine and the entire Black Sea region. M&A is central to Kernel's expansion strategy with 12 large deals closed since 2006, earning the company the status of being the largest industry consolidator in Ukraine. Altogether, the Group has spent nearly US\$750m on its acquisitions over the past decade.

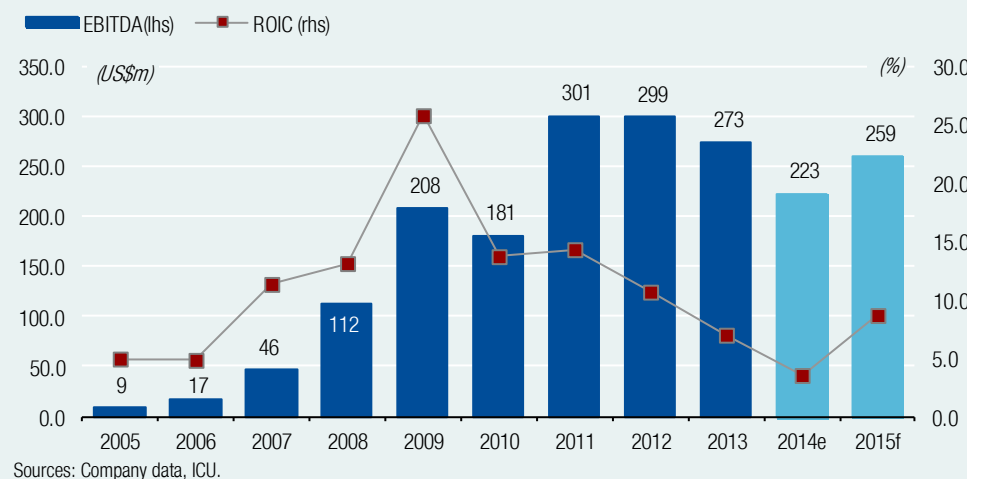
Current situation and outlook

Kernel shareholders had few reasons to celebrate as of late. After years of fast profit growth, which looked like it would never end, the company eventually ran into a host of obstacles. First, they lost a bulk of third-party volumes at their grain export terminal which they were unable to replace with volumes of their own. After that, their grain trading operations faced a massive margin squeeze driven by a change in tax policy. Worse, their cornerstone oilseed crushing business experienced significant profit erosion due to mounting local competition. And finally, their young farming venture was slapped by a massive collapse in grain prices.

Momentum was lost in fy 2012 when successive external shocks began to batter various parts of the business. Before 2012, everything looked steadily promising. During the preceding four years, EBITDA soared by a factor of six from US\$46m in fy 2007 to US\$301m in fy 2011, driven by generally successful expansion efforts and favorable price dynamics across the soft commodities universe. Then, in a matter of two years, all business units faced significant challenges, one by one, until pressure was felt all across the board. Even though Kernel had thrown almost US\$360m on acquisitions since 2011, there was no material impact on results which have been in steady decline. In fy 2013, consolidated EBITDA decreased to US\$273m and might shrink to some US\$223m this year. ROIC trajectory was even more telling, showing a twofold contraction from 14% in fy 2011 to just 7% in fy 2013.

Chart 4. Kernel lost momentum in fy 2012 with a slump from fy 2013 onwards

Key performance indicators



Currently, the most challenged divisions are the farming and crushing businesses. This year, they might suffer from a combined EBITDA squeeze as high as US\$115m. Meanwhile, grain operations should finally enjoy significant relief after two disappointing years thereby offsetting some of the pressure in the other two segments. We expect fy 2014 EBITDA to be down by US\$50m y/y to US\$223m.

Table 10. Farming and oilseed crushing weigh on results in fy 2014
EBITDA dynamics by segments (US\$m)

	2013	Δ	2014	Δ	2015
Bulk sunflower oil	173	(35)	138	20	158
Bottled sunflower oil	26	6	32	(10)	22
Oilseed crushing	199	(29)	170	10	180
Grain	13	33	46	(3)	43
Export terminals	27	6	33	(5)	28
Silo services	19	26	45	(16)	29
Grain handling and marketing	59	65	124	(24)	100
Farming	50	(86)	(35)	47	12
Sugar	(1)	1	(0)	0	-
Other	(34)	(2)	(36)	3	(33)
Other	(35)	(1)	(36)	3	(33)
Consolidated	273	(50)	223	36	259

Sources: Company data, Investment Capital Ukraine LLC.

Farming

Farming is the weakest spot in operations with a significant loss expected this year and a mixed outlook for fy 2015. The latest acquisition binge has produced a number of integration and execution issues that were not immediately resolved which eventually resulted in the business unit plunging into deep losses once grain prices staged a downturn in mid-cy2013. We see the EBITDA loss extending to US\$35m in fy 2014 driven by vastly underperforming corn. Meanwhile, the outlook for fy 2015 implies a modest improvement in profits with selling prices possibly down while other factors, for the most part, facilitate an improved result. Our current projection for fy 2015 EBITDA stands at US\$12m but is subject to a significant variation.

The farming division is certain to report a large loss this year on the back of poor corn yields and dramatically lower grain prices. We project a US\$35m EBITDA loss for the full year with the bulk of it attributed to underperforming corn. Of the full amount, US\$27m has already been recorded in the first half of the year with over 75% of the grain volumes already sold. Crop yields were generally higher compared to the previous year (+10-40%), but corn and soybeans that accounted for respective 42% and 16% of the total acreage significantly underperformed initial expectations. In particular, corn yields experienced three downward revisions, dropping from an initial 6.7 t/ha to the latest 5.5 t/ha, while soybeans came in virtually flat compared to the previous year. Meanwhile, production costs increased by 23% for soybeans and 30% for corn largely offsetting the positive impact from higher yields and keeping the unit costs per tonne of grain flat compared to the previous year. In contrast, selling prices plunged by up to 40% which resulted in massive margin erosion across all crops, with corn suffering the largest setback.

While a large loss in fy 2014 now looks more or less certain, next year's result still remains a wild card. Many people expect a sharp recovery in farming earnings already in fy 2015, but, in our view, improvement will likely be modest due to a negative outlook on selling prices, a lagging adjustment in production costs, and the limited effect of recent restructuring initiatives during the first year. Hence, we project EBITDA of US\$12m in fy 2015 but this number is subject to a large variation due to a mixed outlook on selling prices and yields. As a base case, we assume a 15-35% decrease in selling prices of the main

crops, an approximate 14% decrease in production costs, and a 10-40% increase in yields. Below we discuss the main factors driving farming profits in fy 2015.

Improved yields

Corn and soybeans have been a massive drag on the performance of the farming division in fy 2013 due to mediocre yields and a dominant position in crop rotation (58% combined in cy 2013). Fixing these crops became the near-term priority of Evhen Osipov, the new head of the farming division appointed in May-13. So far, a number of steps have already been announced, including the switched timing of fertilizer application, the transfer to full tillage, and the purchase of higher quality seeds and chemicals. While some of those measures are subject to debate, we hope that taken as a whole these steps will facilitate improved yields. Hence, we give the new management the benefit of the doubt and expect significantly higher yields for the new crop while being perfectly aware of downside risks. In particular, we peg corn and soybean yields at 7.5 t/ha and 2.0 t/ha, respectively, that correspond to 36% and 43% growth y/y. We also anticipate a 10% yield increase for all other crops.

Table 11. We assume significantly higher corn and soybean yields for the new crop

Crop yields in Kernel's farming business, t/ha

Crop	Unit	2009	2010	2011	2012	2013	2014	2015
Corn	t/ha	5.3	5.1	7.2	4.4	5.5	7.5	7.9
growth	%		-5%	42%	-39%	26%	36%	5%
Wheat	t/ha	4.2	3.5	3.7	3.5	4.4	4.8	5.0
growth	%		-18%	6%	-3%	23%	10%	5%
Sunflower seeds	t/ha	2.5	2.2	2.1	1.6	2.1	2.3	2.4
growth	%		-14%	-4%	-22%	26%	10%	5%
Soybeans	t/ha	1.6	1.3	1.9	1.3	1.4	2.0	2.1
growth	%		-19%	52%	-34%	11%	43%	5%

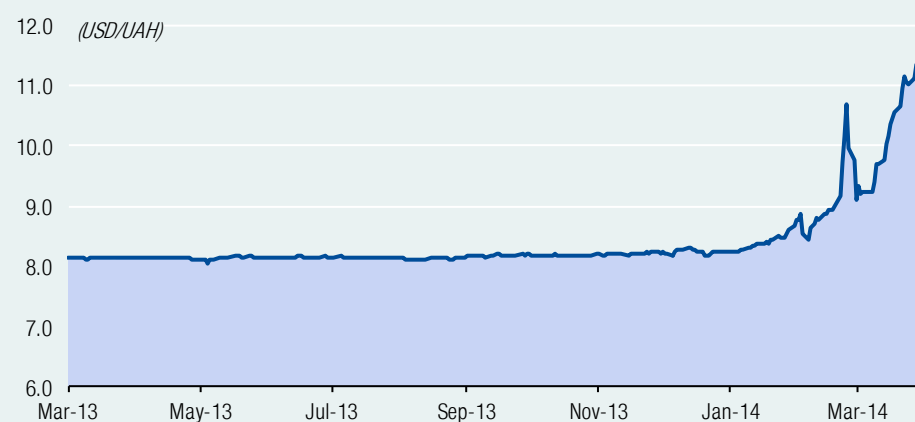
Sources: Company data, Investment Capital Ukraine LLC.

Beneficial currency depreciation

Production costs for the new crop will benefit from a significant local currency depreciation that began in mid Jan-14. Thus far, the exchange rate against the US dollar is down by over 40% from early Jan when it stood at 8.2 USD/UAH compared to the current 11.6 USD/UAH. Considerable volatility is expected to persist until Ukraine receives substantial aid from the Western countries. With about half of farming costs linked to the hryvnia, Kernel is set to greatly benefit from the ongoing depreciation. We preliminarily peg the new equilibrium exchange rate at 10.0 USD/UAH, implying just over 20% depreciation. The standalone effect of this factor is to decrease production costs by a whole 15%.

Chart 5. Sharp hryvnia depreciation during January-March 2014 will drive down UAH-denominated portion of costs

US\$ / UAH exchange rate



Source: Bloomberg.

Other factors driving production costs

Aside from currency depreciation certainly being the most important cost driver at present, there are other factors that will influence costs this year. There are two groups of factors at play – the ones linked to grain prices and those driven by production practices. In light of lower grain prices, we expect a gradual pullback in the purchase cost of chemicals, fertilizers, seeds, and spare parts together accounting for 40% of production expenses. Admittedly, only a portion of price cuts will probably feed through into costs of the new crop. On the other hand, some major adjustments to production practices are planned that will increase expenses per hectare. The switch to conventional till is set to increase costs by up to US\$30 per hectare on higher fuel use. Moreover, management also plans up to a 25% hike in the fertilizer application rate and switch to higher-quality seeds and chemicals that have relatively higher price tags.

Table 12. We expect lower production expenses for the new crop

Average cash operating expenses (US\$/ha)

Crop	2013	Cost factors (%)				2014
		Currency	Volume	Mix	Price	
Lease rent	138	-18.5				112
Seeds	115			10.0	-10.0	114
Fertilizer	120		15.0		-15.0	117
Plant protection	52			10.0		57
Fuel	53		37.7			73
Labor	112	-18.5				91
Other	263	-9.3	-28.5		0.0	171
Total	853					736

Sources: Company data, Investment Capital Ukraine LLC.

Further pressure on selling prices

While grains have already been down by up to 40% at some point in the autumn, there is a strong case for lower grain and oilseed prices following the 2014 crop harvest in the US. Barring adverse weather and major disruptions to grain flows from the Black Sea region, the US is poised to produce another huge corn crop which should replenish stocks and

improve availability. This may reignite bearish pressure on grain prices. The USDA staff already predicts average corn farm-gate price sliding to US\$3.65/bu in the 2014/15 season compared to the average Sep-Mar Chicago futures value of US\$4.46/bu. Simultaneously, we may see increased pressure on oilseed prices as a result of farmers' dedicating more acreage to soybeans that remain favorably priced against corn. Hence, we project average selling prices retreating by 15-35% in fy 2015 depending on the crop.

Table 13. Crop prices are vulnerable to downside risks

Domestic prices (exw, VAT excl)

	Unit	2009	2011	2012	2013	2014e	2015f
Corn	US\$/t	117	172	171	192	142	112
growth	%		41%	-1%	12%	-26%	-21%
Wheat	US\$/t	99	158	156	201	158	120
growth	%		46%	-1%	29%	-21%	-24%
Sunflower seeds	US\$/t	269	443	418	479	355	301
growth	%		57%	-6%	14%	-26%	-15%
Soybeans	US\$/t	350	354	380	463	445	297
growth	%		-1%	8%	22%	-4%	-33%

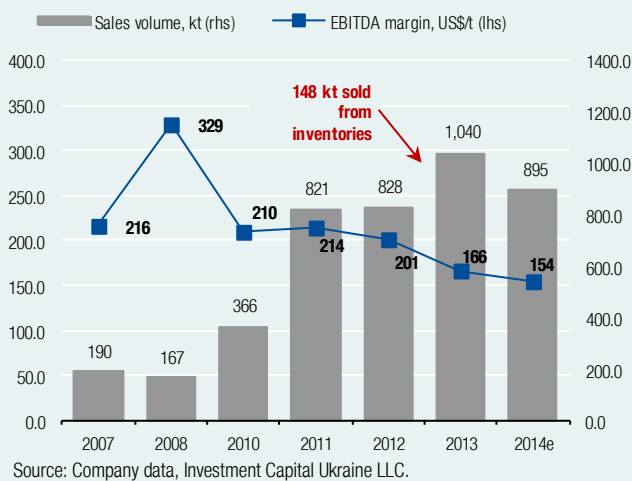
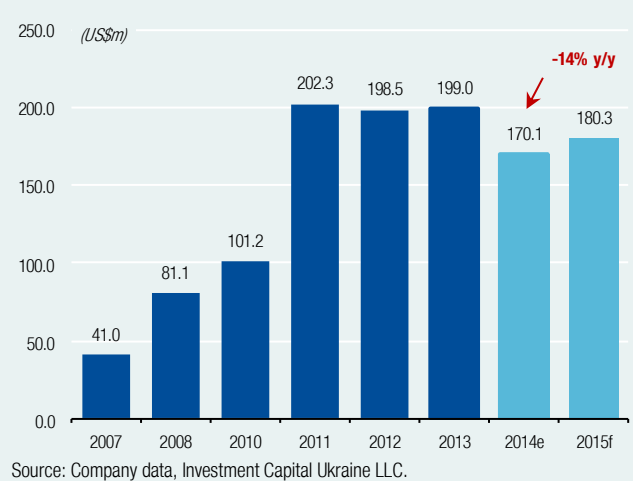
Sources: Company data, Investment Capital Ukraine LLC.

Tax policy

On Mar 27, Ukrainian parliament passed the law restoring VAT reimbursement on grain export sales starting from Oct 1, 2014. This effectively means 10-15% higher farm-gate prices for export-slanted late crops (corn, soybeans) that account for close to 60% of total planted acreage.

Oilseed crushing

Aside from farming, the oilseed crushing business also came under unprecedented pressure last year. Rampant capacity expansion, which was a distinct feature of the sector landscape for almost a decade, has finally outpaced oilseed production, resulting in large feedstock shortage and fierce competition for oilseed supplies. As a result, the EBITDA margin dropped from traditional US\$200/t to US\$166/t and only a massive inventory sell-down allowed Kernel to keep its earnings stable in absolute terms (US\$199m in fy 2013 vs US\$198m in fy 2012).

Chart 6. Tight feedstock supply will be a permanent factor going forward*Bulk oil sales volume and margin**Oilseed crushing division EBITDA (US\$m)*

Surprisingly enough, this year's bumper crop, while largely relieving the industry from the extreme stress of tight feedstock supply, did not increase the crushing margin by a significant amount. Local crushing capacity has again increased this year (+1.4 mt to a total 11.6 mt) as four new projects were completed while recently launched facilities continued their ramp-up. This could have further aggravated existing problems had Ukraine not produced a bumper sunflower seed (SFS) crop this year (11.0 mt; +1.5-2.0 mt y/y) which greatly improved oilseed balance that further relieved the industry from extreme stress. Nonetheless, the crushing margin, the primary measure of profitability, failed to recover despite the ample feedstock supply. Thus far it continues to hang marginally below the previous year's level, implying flat profitability for the full year. While this might look puzzling at first glance, there is a strong reason behind it which we will discuss in the market section of our report.

All in all, we would expect Kernel's EBITDA from oilseed crushing to drop by 14% in fy 2014. Last year, the company managed to keep the segment profit stable thanks to a massive sell-down of sunflower oil from the inventory, but there is nothing to prop the result this year. Margins remain at historically low levels. There is also no more excess inventory to unload, which means that sales volumes will be down. In addition, a terrible first quarter with EBITDA of mere US\$5m (vs US\$46m a year ago) will be a huge drag on the full-year result. Altogether, those factors might easily push the segment's EBITDA to US\$170m this year, US\$29m off the result of fy 2013.

If we forecast for next year, we see high chances of renewed margin pressure due to a possible pullback in sunflower seed supply. In 2013, Ukraine harvested by far the largest SFS crop in its history, mostly due to unprecedented yields achieved across the country. As a general rule, yields tend to retreat after extreme highs, which is what we expect to see next year. The magnitude of the retreat cannot be determined in advance, but it may easily be large enough to reduce the sunflower seed crop by at least a half million tons. Given that the crushing capacity will nominally remain the same next year, and even increase effectively due to the ramp-up of new plants, the sunflower seed supply might again become tight. This could reignite competition among crushers with a corresponding impact on margins.

While we are fully aware of the downside risk to the crushing margin during the 2014/15 season, we are cautious to put low numbers into our forecast at this time. We set an EBITDA margin of US\$160/t as our baseline projection for next year, which, while lower

than what Kernel had experienced last year, still has room for a downward revision. On the other hand, fiscal year 2015 should benefit from higher carryover stocks and hence higher production and sales volumes in the first quarter (ending Sep-14) due to large delays to the operating season 2013/14 driven by excessive rains during September when most SFS harvesting normally occurs. Ultimately, we arrive at segment EBITDA of US\$180m, which implies a slight recovery compared to the fy 2014 estimate, mostly on higher bulk oil sales volumes (948kt vs 891kt).

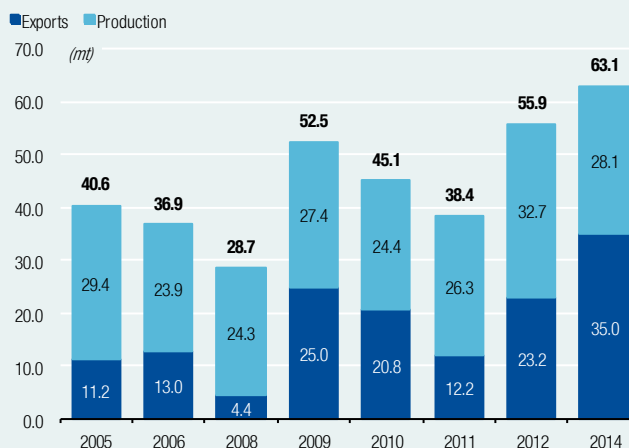
In summary, the oilseed crush business will hardly show healthy dynamics in the near term. It is poised for a significant decline this year, with EBITDA likely down by 14% year-over-year (ICUe of US\$170m in fy 2014 vs US\$199m in fy 2013). Afterwards, we are likely to see stagnant performance in fy 2015, yet with high downside risks due to still uncertain margin pressure from lower oilseed availability which we are reluctant to fully discount just yet.

Grain handling and marketing

In contrast to farming and oilseed crushing, where the short-term outlook is for the most part discouraging, the grain business is ready for a major recovery this year, driven by a superior grain crop harvested across the Black sea region.

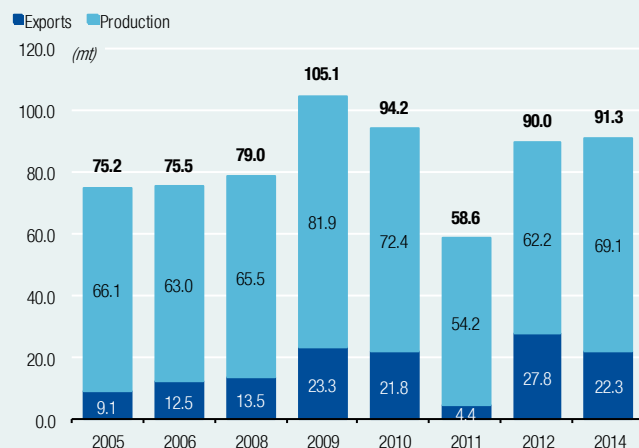
Chart 7. Both Ukraine and Russia have considerably increased their grain production and exports in the season 2013/14

Grain production and exports from Ukraine (mt)



Source: USDA, Ukrstat, Rosstat.

Grain production and exports from Russia (mt)



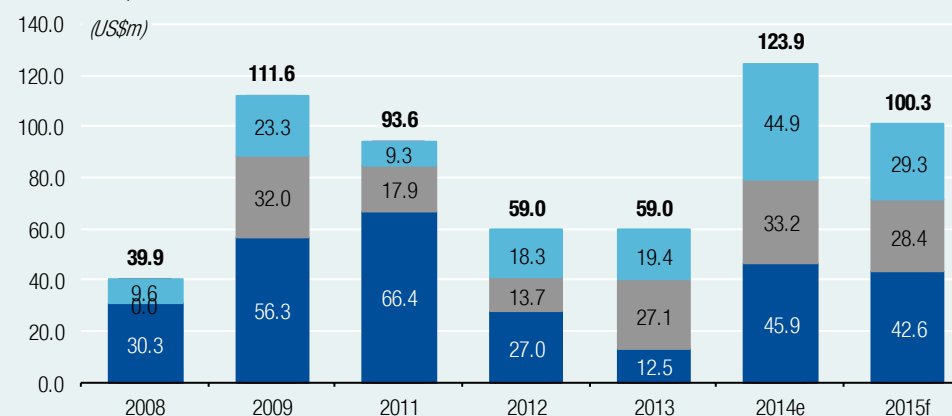
Source: USDA, Ukrstat, Rosstat.

Both Ukraine and Russia are having very good production seasons this year, with volumes up significantly on favorable weather. Ukraine has reportedly produced 63 mt of grain in 2013, topping the previous record of 57 mt seen in 2011 and outpacing the 2012 result by 18 mt. Grain exports from the country should rise strongly as a result, and might easily top 30 mt in marketing year 2014 (vs 22 mt in my2013). Russia, where Kernel started to develop operations as of late, also staged a pronounced recovery with a crop of 91 mt, up by one-third from the previous year. Grain exports from there could exceed 20 mt.

For Kernel, a larger crop means higher turnover as well as an improved margin across the board. Driven by these factors, the grain business' EBITDA may surge by a whole US\$65m this year and ultimately reach US\$124m compared to US\$59m earned in fy 2013. The bulk of growth is expected to come from grain trading and elevators which should generate an incremental US\$33m and US\$26m, respectively. Meanwhile, export terminals should hardly increase their contribution by more than US\$6m.

Chart 8. Grain division is poised for a surge in profits this year driven by large crop*Grain division EBITDA by components (US\$m)*

■ Grain ■ Export terminals ■ Silo services

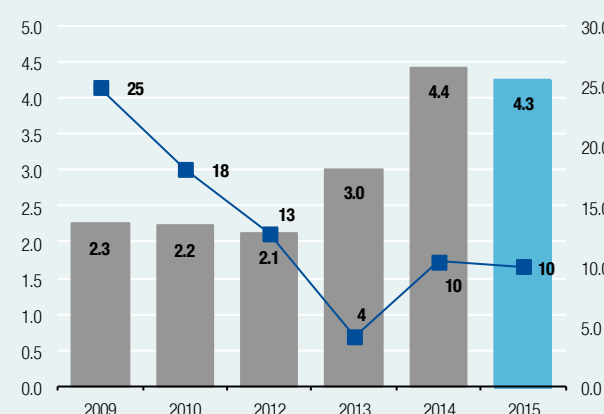


Source: Company data, Investment Capital Ukraine LLC.

There are high expectations for the grain trading segment in light of the large grain crop. Not only do we assume much higher sales volumes in fy 2014, but we also anticipate a much better margin on grain sales. More specifically, we expect grain shipments of 4.4 mt (+46% y/y) at an average margin of 10.4 \$/t (+150% y/y), which implies a US\$46m EBITDA in fy 2014, a surge of 3.7x above the previous year. Thus far, shipments are running 39% ahead of last year, with 2.2 mt of grain sold in the first half, equal to 50% of the full-year target, despite a significantly delayed corn harvesting campaign and slower sales by farmers who are holding back grain in the face of sharply lower prices. Ultimately, all of them will have to sell their volumes, which means that this season will be much more back-end loaded compared to previous years. Meanwhile, we assume that Kernel's margin will better reflect the market in 2014 after a quite weak performance seen throughout most of 2013. Therefore, we peg 10.4 \$/t for the full year, which reflects better grain availability and is largely consistent with the current market situation. At the same time, we look for confirmation in the second-quarter result since it was around that time when the margin started tumbling last year.

Chart 9. Grain marketing segment is set to enjoy superior volumes and margins compared to fy 2013*Grain marketing segment KPIs*

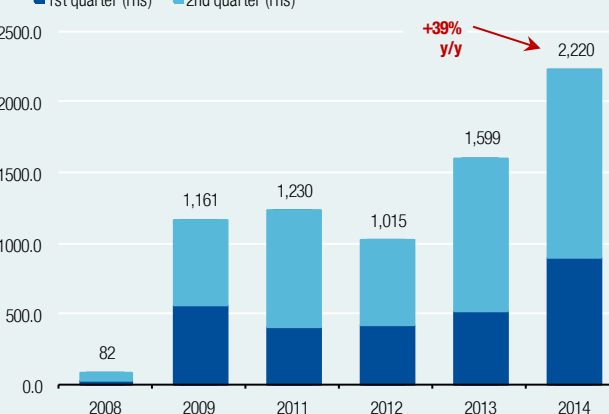
■ Sales volumes, mt (lhs) ■ EBITDA margin, US\$/t (rhs)



Source: Company data, Investment Capital Ukraine LLC.

1H grain shipments (kt)

■ 1st quarter (rhs) ■ 2nd quarter (rhs)



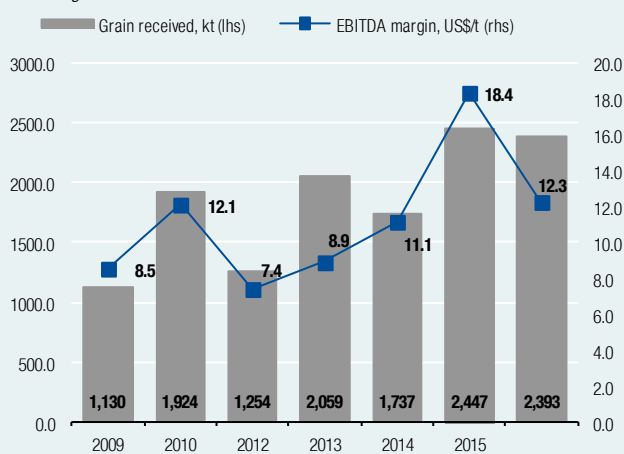
Source: Company data, Investment Capital Ukraine LLC.

Grain elevators are shaping up for their best season ever with a fy 2014 earnings outlook for up to US\$45m on an EBITDA basis. The company has already reported receiving 2.4 mt of grain in its silos as of 1-Jan, which is 41% above the previous year. Moreover, first-half

EBITDA came in at an impressive US\$34m, almost 3x above the previous year. The stellar performance was driven by large volumes of wet corn filling the pipeline after an abnormally rainy Sep. Those volumes required additional drying while elevators raised their charges countrywide in anticipation of excessive demand for their services. We anticipate an additional US\$11m in EBITDA to be earned in the second half of the year, increasing the full year number to US\$45m.

Chart 10. Grain elevators are shaping up for their best season ever

Silo segment KPIs



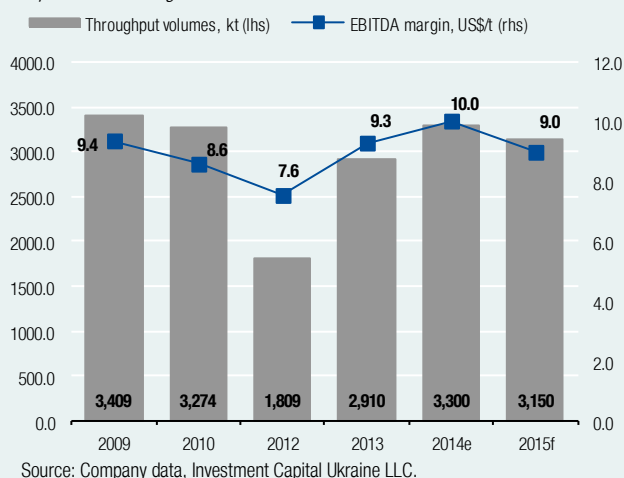
Silo segment EBITDA (US\$m)



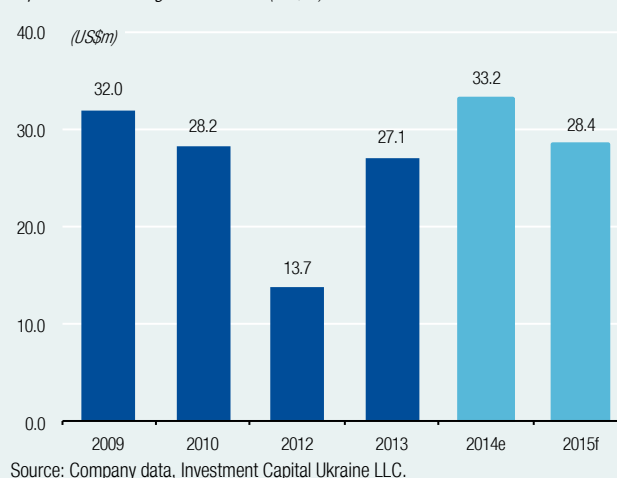
In contrast to the other two segments, export terminals will probably achieve modest gains this year. We see EBITDA growth not exceeding US\$6m in fy 2014, compared to US\$13m in fy 2013, as the beneficial effect from last year's strategy review tapers off. The first-half of the year was rather sluggish with volumes down by 26% y/y. Although we expect better dynamics in the back half, there is little chance that the segment will be able to catch up. We peg full-year throughput at 3.3 mt (+13% y/y), but admit that there are significant downside risks to our target which implies second-half throughput twice as much as usual.

Chart 11. Export terminals segment will see modest dynamics this year

Export terminals segment KPIs



Export terminals segment EBITDA (US\$m)



Looking further ahead, we assume a pullback in profits of the grain business in fy 2015, driven by expectations of lower grain production in Ukraine. There are two compelling reasons against another record-high crop in Ukraine next year. The first is significantly lower selling prices that force many local farmers to cut back on expenses and accept lower

yield prospects. The second is cyclical weather patterns which rarely repeat themselves to result in two consecutive years of bumper yields. Therefore, we assume a lower crop as our baseline outcome for 2015. This assumption, in turn, drives our projections for Kernel's grain operations where we see lower utilization of infrastructure but flat grain trading volumes due to the continued ramp-up of activity in Russia. These factors ultimately result in EBITDA of US\$100m for fy 2015, implying a US\$24m drop year-over-year which we view as conservative.

Oilseed crushing operations

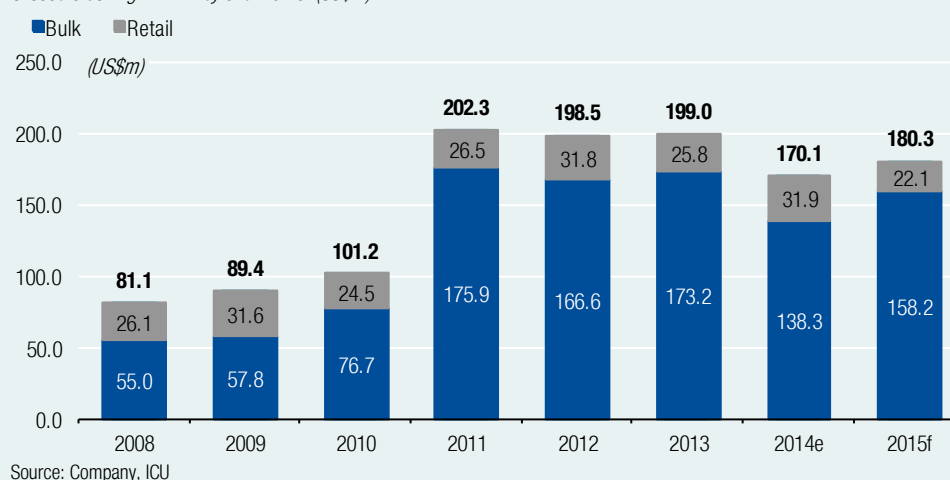
1. Kernel is the largest sunflower seed crusher in Ukraine and globally.
2. The oilseed crushing division is the most important earnings contributor to the Group.
3. The business has mostly expanded through large acquisitions.
4. After an extended period of steady profits, Kernel currently undergoes a structural downward shift in its crush margin driven by industry wide pressures.

Kernel is the largest oilseed crusher in Ukraine and the single largest producer of sunflower oil globally. With nine plants that can crush a combined 3,034 kt of oilseeds per year, Kernel produced over a million tons of crude sunflower oil in the 2012/13 season, putting the company's share at just over 7% of global production. In Ukraine, Kernel is an undisputed leader accounting for 22% of all installed crushing capacity, well ahead of Cargill which occupies the second spot with a 9% share.

Oilseed crushing is the main earnings contributor for the Group that provides the necessary firepower to back Kernel's aggressive expansion plans. In recent years, the crushing business has been generating around US\$200m in EBITDA which on average comprised approximately 65% of the Group's total. This was itself enough to pay for all acquisition expenses incurred by Kernel since 2010 which totaled US\$530-540m.

Chart 12. Oilseed crushing business is facing turbulence due to tight oilseed supply

Oilseed crushing EBITDA by end market (US\$m)



It took Kernel one decade of consistent effort to reach its current status of an industry leader in Ukraine. The company entered the edible oil business in 2001 and was just one of many mid-tier players until 2006 when it closed a landmark deal with Yevrotek, a major local competitor. This move instantly promoted Kernel to the second largest oilseed crusher in the country (14% of total capacity), placing it behind Cargill. Enjoying superior funding options and ample cash flows from existing operations, Kernel continued to expand and subsequently made several other important acquisitions along with some greenfield and

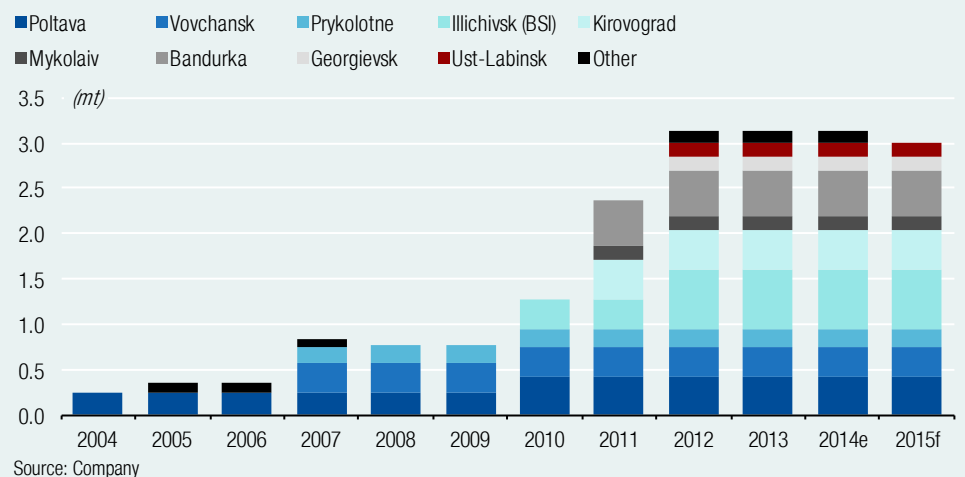
upgrade projects. This eventually allowed Kernel to become the largest domestic player and earned the company its status as the most prominent industry consolidator.

Here we slightly digress to give more detail on Kernel's origins and how company arrived at its present status.

The business originally started out with just one plant (Poltava) which Andriy Verevsky took control of in 2001 in a fierce battle between him and plant's incumbent management. In the early years, Kernel's efforts were principally focused on modernizing the Poltava facility rather than scouting for M&A opportunities. In 2004, the opportunistic acquisition of the Milove plant with its bottled oil trademark Schedriy Dar transformed the company. Aside from giving Kernel a well-recognized name on the local bottled oil market, the acquisition was not completely synergistic and the company disposed of the plant later on in mid-2007. However, despite the failure, the Milove deal shaped the future path of growth for Kernel which from that point on was focused primarily on acquisitions.

Chart 13. Kernel built the largest crushing footprint in the country

Kernel's crushing capacity evolution, mt



For some five to six years, Kernel was just one of many mid-sized players on the market controlling less than 7% of total capacity. However, Verevsky was preparing for a bold move which ultimately came in late-2006 when he struck a deal with a large local competitor, Yevrotek, for the acquisition of its production assets. Those principally included two crushing plants with nominal capacity of ~approximately 500 kt per year, which brought Group's total to 750 ktpy (excluding Milove which was sold shortly thereafter). That was a landmark acquisition for Kernel, which placed the company as the second largest oilseed crusher in the country (14% of total capacity) after Cargill and greatly raised its attraction in the run-up to an IPO which was occurred later in 2007. The timing of the deal with Yevrotek was a huge win for Kernel as it coincided with a start of the first boom in soft commodity prices that raised the local crush margin by two to three times.

In the years following the IPO (2007), Kernel continued to pursue various expansion opportunities, enjoying superior funding options due to the company's public status.

At first, in mid-2010, Kernel launched a new crushing plant in Pervomaysk located in the Mykolaiv region (492 ktpy), which was its largest greenfield project ever and the only one in the oil segment. Also, it completed an extensive upgrade of the Poltava facility, increasing its crushing capacity from 246 to 426 kt per year. On the M&A front, the company completed another two large acquisitions - Allseeds (2010) and BSI (2011). Those deals have largely finalized the expansion of Kernel on the home turf, raising the Group's total crushing capacity to the present 2,722 ktpy.

From the above, one can easily see that Kernel prefers acquisitions over organic growth when it comes to expansion. The split of capital expenditures just confirms this fact. Since 2007, Kernel has spent a total of US\$287m on acquisitions of crushing assets and less than US\$100m on greenfield projects and upgrades.

The available asset base allows Kernel to crush ~3.0 mt of oilseeds per year. Crushing assets include seven plants in Ukraine and two in Russia. Crushing capacity in Ukraine totals 8,200 tpd, which is equivalent to 2,690 kt per year, while in Russia Kernel can crush a total of 950 tpd (312 ktpy).

While the primary feedstock for the company is sunflower seeds, some facilities also have the option to crush other oilseeds after proper setup. In particular, the Bandurka plant can crush all types of oilseeds available in Ukraine (sunflower seeds, soybeans, and rapeseed), while Poltava has the option to crush soybeans which, however, looks rather theoretical.

Kernel's facilities are located all across Ukraine's Sunflower Belt except for its most eastern part. Most of them sit in the regions where competition for feedstock is high and rising due to the recent launch of multiple new facilities. Only Poltava, Vovchansk and Prykolotne, located deep in the interior, still enjoy relatively ample feedstock supply. Meanwhile, in Russia's South, where Kernel's plants are located, competition for sunflower seeds is even more intense which leads to permanently depressed capacity utilization.

Table 14. Kernel's oilseed crushing plants

Facility	Capacity (ktpy)			Country	Location	Inclusion date	Inclusion method	Last major upgrade	Process type	Feedstock competition	Other comments
	Crush	Refining	Bottling								
Poltava	426	70	57	Ukraine	Interior	2001	Acquired	2009	Extraction	Low	
Vovchansk	361			Ukraine	Interior	2006	Acquired	2007	Extraction	Low	
Prykolotne	197	77	77	Ukraine	Interior	2006	Acquired	n/a	Extraction	Low	Obsolete
Bandurka	492			Ukraine	Interior	2010	Greenfield	2010	Extraction	High	
Kirovograd	426			Ukraine	Interior	2010	Acquired	2005	Extraction	High	
Ekotrans	164			Ukraine	Port	2010	Acquired	2004	Screw press	High	Problems with local authorities
BSI	656			Ukraine	Port	2011	Acquired	2008	Extraction	High	
Georgievsk	164			Russia	Interior	2011	Acquired	n/a	Extraction	High	Obsolete
Ust-Labinsk	148			Russia	Interior	2011	Acquired	n/a	Extraction	High	Obsolete

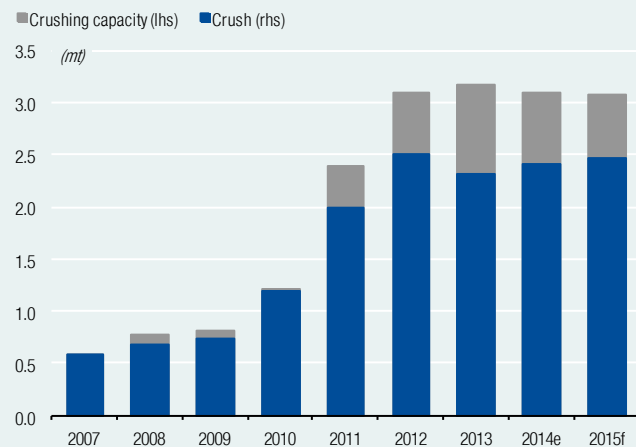
Sources: Company, ICU

Map 1. Kernel's facilities are located all across Ukraine's Sunflower Belt*Kernel's crushing footprint in Ukraine*

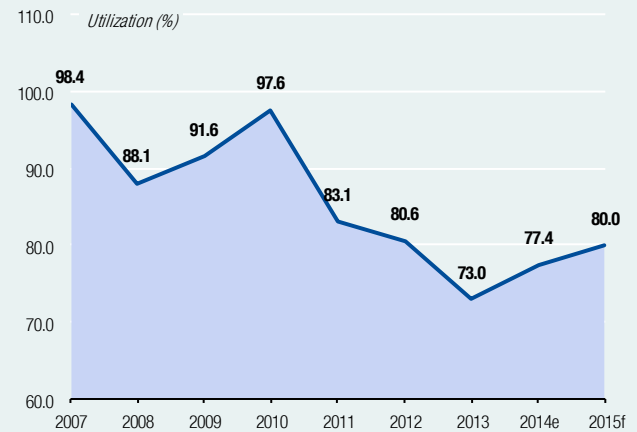
Kernel ships the bulk of its production to the global market with limited volumes sold in Ukraine. Overseas shipments include crude oil, some refined oil and sunflower meal, while local sales are restricted to bottled oil, sunflower meal and cake. Out of 1,000-1,100 kt of oil produced by the company on average each year, only about 100 kt is sold domestically while other volumes are shipped globally.

For crushers, there are two key factors which determine their operational performance—utilization and crush margin. Let's take a look each in more detail.

Low utilization has become an issue for the company in recent years. For Kernel, the comfortable capacity load is north of 90% and this is where the company traditionally used to be. However, in season 2012/2013, headline utilization has dropped to the low 70s, which is well below optimal levels. Last year, Kernel crushed a total of 2.3 mt of sunflower seeds, equal to 73% of capacity. There are several factors behind this trend. First, Kernel has been expanding into the south of Ukraine where the density of crushing plants is higher and oilseed availability is typically lower, with suboptimal utilization as a natural consequence. Second, Kernel has entered the Russian market where the situation is even worse. Third, the local crushing industry as a whole has recently moved to the condition of a structural feedstock deficit, thus slashing utilization rates for every crusher. Meanwhile, facilities in more favorable areas of the northern and central Sunflower Belt, where competition is lower, maintain utilization close to optimal in contrast to their peers in the south.

Chart 14. Crushing business witness a structural decline in utilization*Capacity and actual crushing volumes, mt*

Source: Company, ICU

Capacity utilization

With the current asset footprint, it is virtually impossible to reset headline utilization back to the comfortable level at above 90%. Competition for oilseeds in the south of Ukraine, where Kernel has 820 ktpa of capacity, has markedly intensified with the recent launch of two new crushing plants while the construction of another big one is on the table. Meanwhile, Russian assets remain an overhang due to the technical obsolescence of facilities and relentless competition for feedstock in the region. Therefore, we believe that Kernel will probably have to contend with utilization of 70-80% in the long-term under normal crop yields.

Besides volume, the major factor behind segment performance is the crush margin which is coming under increasing pressure of late. Historically, normal profit for Kernel was US\$200-210 per tonne of bulk oil. However, last year it dropped to just US\$166/t, down US\$35/t from the previous year. Although management was blaming the poor harvest alone this was not the sole factor, even not the most important one. It is true that Ukraine's sunflower seed crop slid compared to the previous year (9.1 mt in 2012 vs 9.4 mt in 2011), but the volume loss was not terrible. Another factor at play was the simultaneous increase in crushing capacity as four new facilities were commissioned to start operations in the 2012/13 season. As a result, oilseed availability has shrunk dramatically, resulting in fierce competition for feedstock in the off-season that pushed sunflower seed prices significantly higher.

Chart 15. EBITDA margin is in a downdraft with mixed outlook*EBITDA margin per ton of bulk oil sold*

At present, nothing indicates a margin recovery ahead. Instead, we fully expect subdued profits. Thus far into the new season, we continue to observe generally low crush margins despite the bumper sunflower seed crop. In fact, margins are even below the level seen last year. Therefore, unless bulk oil prices strengthen meaningfully in the coming months, we expect the full-year EBITDA margin to be flat compared to the previous year. Moreover, as we already mentioned in the market section, we doubt that a return to the previous profit rate is plausible in the long-term.

Table 15. Summary: Oilseed crushing business

Financial year		2007	2008	2009	2010	2011	2012	2013	2014	2015
End month		Jun-07	Jun-08	Jun-09	Jun-10	Jun-11	Jun-12	Jun-13	Jun-14	Jun-15
BULK OIL										
Crushing capacity	ktpa	583	767	797	1,213	2,394	3,094	3,172	3,098	3,070
Utilization	%	98%	88%	92%	98%	83%	81%	73%	77%	80%
Crush	kt	574	676	730	1,184	1,989	2,493	2,315	2,399	2,456
growth	%		18%	8%	62%	68%	25%	-7%	4%	2%
Yield										
Crude sunflower oil	%	43%	43%	43%	43%	43%	43%	43%	43%	43%
Sunflower meal	%	39%	39%	39%	39%	39%	39%	39%	39%	39%
Production										
Bulk oil	kt	247	290	314	509	855	1,072	995	1,031	1,056
Meal	kt	224	263	285	462	776	972	903	935	958
Bulk oil sales volume	kt	190	167	224	366	821	828	1,040	895	989
growth	%	159%	-12%	34%	63%	124%	1%	26%	-14%	11%
Inventory movements	kt	(12)	25	(6)	36	(74)	114	(148)	36	(36)
ASP (+ meal credit)	US\$/t	1,145	1,943	1,146	1,095	1,410	1,439	1,468	1,177	1,052
growth	%	-4%	70%	-41%	-4%	29%	2%	2%	-20%	-11%
Revenue	US\$m	217	325	257	401	1,158	1,192	1,528	1,053	1,040
EBITDA margin	US\$/t	216	329	258	210	214	201	166	154	160
growth	%	25%	52%	-22%	-19%	2%	-6%	-17%	-7%	4%
EBITDA	US\$m	41	55	58	77	176	167	173	138	158
EBITDA margin	%	19%	17%	22%	19%	15%	14%	11%	13%	15%
BOTTLED OIL										
Bottling capacity	ktpa	134	134	134	134	134	159	134	134	134
Utilization	%	50%	71%	69%	78%	79%	79%	75%	72%	75%
Production	kt	67	95	92	104	105	126	100	97	101
growth	%		42%	-3%	12%	1%	20%	-20%	-3%	4%
Sales volume	kt	72	93	90	103	109	121	100	97	101
growth	%	102%	29%	-3%	15%	5%	12%	-18%	-3%	4%
Inventory movements	kt	(5)	2	2	1	(3)	5	1	0	-
Average selling price	US\$/t	-	1,585	1,356	1,089	1,401	1,675	1,834	1,546	1,302
growth	%	0%	0%	-14%	-20%	29%	20%	9%	-16%	-16%
Bulk-to-bottle ASP spread	US\$/t	-	(358)	210	(6)	(9)	237	366	369	250
Revenue	US\$m	-	147	122	113	152	203	183	150	131
EBITDA margin	US\$/t	-	281	351	237	244	263	259	329	220
growth	%	0%	0%	25%	-33%	3%	8%	-1%	27%	-33%
EBITDA	US\$m	-	26	32	24	26	32	26	32	22
EBITDA margin	%	0%	18%	26%	22%	17%	16%	14%	21%	17%
Bulk-to-bottle incremental margin	US\$/t	-	(48)	93	27	30	62	92	175	60

Sources: Company data, ICU.

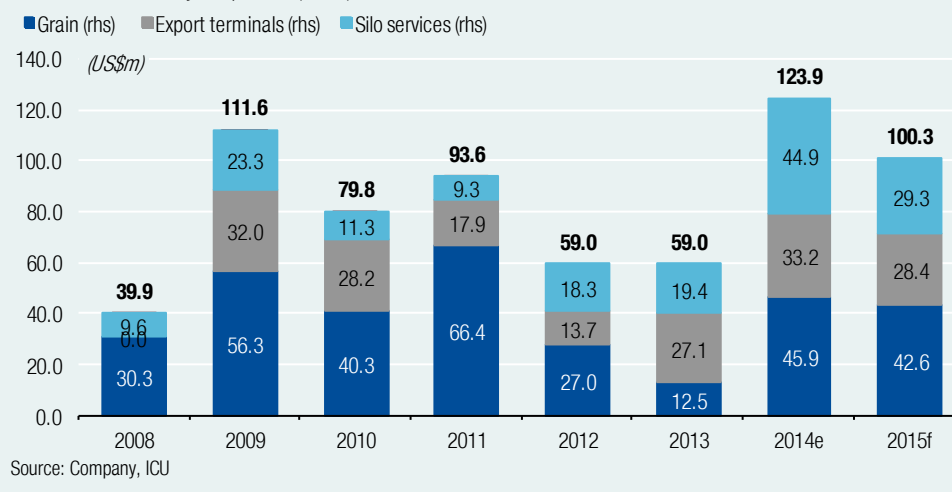
Grain operations

Kernel operates throughout the entire grain supply chain from local elevators to export loading points. First, the company purchases grain from farmers, either at the farmgate or at an interior elevator, of which it controls several dozen throughout the major grain producing areas in Ukraine, and then ships the grain to the port. This is the step where the origination margin is earned. The company also earns an additional handling margin by processing grain at its upcountry elevators and loading it onto the sea-vessels at its own export terminal. In most cases, Kernel's involvement ends at this point, but sometimes the company also charters a vessel to deliver grain directly to the destination port.

The grain business is the second most important earnings contributor to the Group after oilseed crushing. In fy 2013, grain operations generated a combined EBITDA of almost US\$60m, which makes up 22% of the total. In better years, the segment's contribution has been as high as 50% of total Group's EBITDA.

Chart 16. EBITDA dynamics in grain business

Grain division EBITDA by components (US\$m)



The grain business is split into three operational segments – grain marketing team, elevators and export terminals.

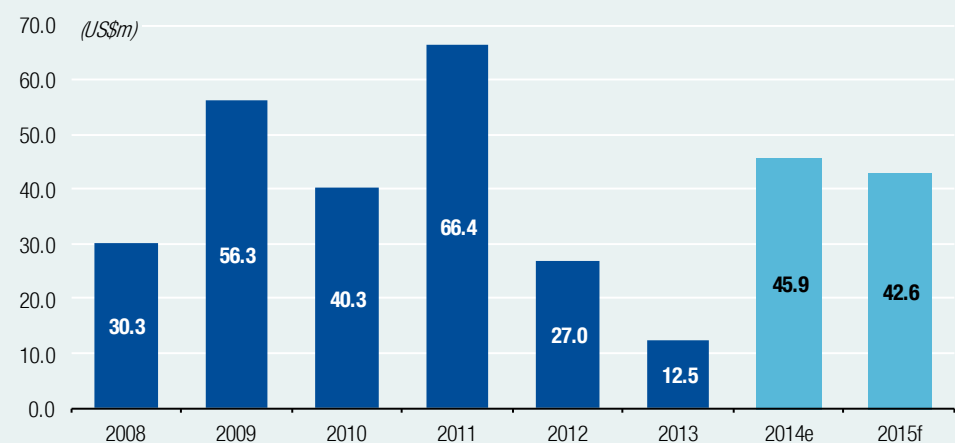
Grain marketing

1. Kernel ranks among the top five largest grain operators in Ukraine, outranking most of the prominent global players
2. Operations in Ukraine suffered a massive margin slump following the change in tax policy regarding grain export sales
3. Subsequent strategic review stipulated increased turnover across the entire supply chain to maximize overall profit
4. Kernel also entered the promising Russian grain export market to expand its geographical reach

Grain marketing is a business driven by the total volume of grain production in the country and, as such, its result can fluctuate widely depending on actual crops harvested. Given the turbulent market circumstances of the past few years, segment EBITDA ranged from US\$66m in fy 2011 to US\$13m in fy 2013. The volume of grain handled also varied from 1.8 mt in fy 2011 to 3.0 mt in fy 2013. Under the current fairly depressed conditions, the segment's EBITDA contribution dwindled to just 5% of the consolidated result in fy 2013, while historically it was as high as 27%.

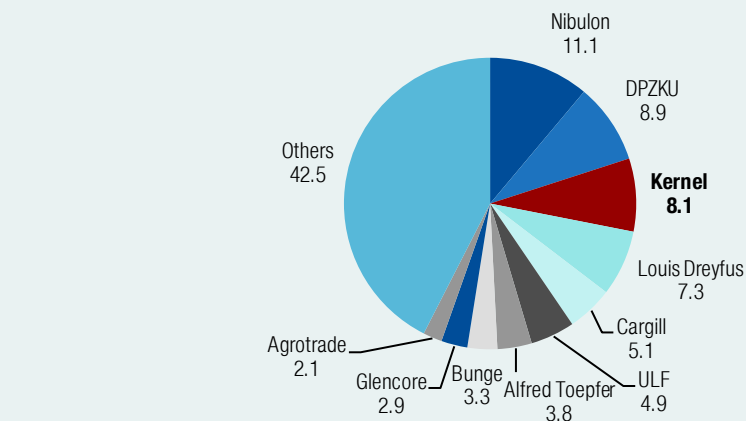
Chart 17. Grain trading profits tend to be very volatile

Grain marketing segment EBITDA (US\$m)



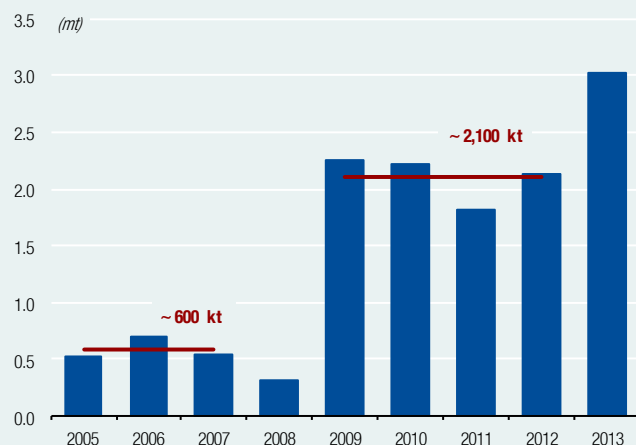
Source: Company, ICU

Kernel is a leading Ukrainian grain trader aiming to evolve into a powerful regional player. At home, Kernel consistently ranks among the top five local grain exporters, staying ahead of ABCD (ADM, Bunge, Cargill, and Louis Dreyfus) and other major multinationals most of the time. The company typically accounts for up to 12% of the country's total grain exports, equating to 2-3 mt depending on the crop volume. With options in Ukraine now mostly reduced to organic growth, the company recently started to make systematic efforts to establish itself in neighboring Russia. The ultimate goal is to become a powerful player across the entire Black Sea region, not only in Ukraine.

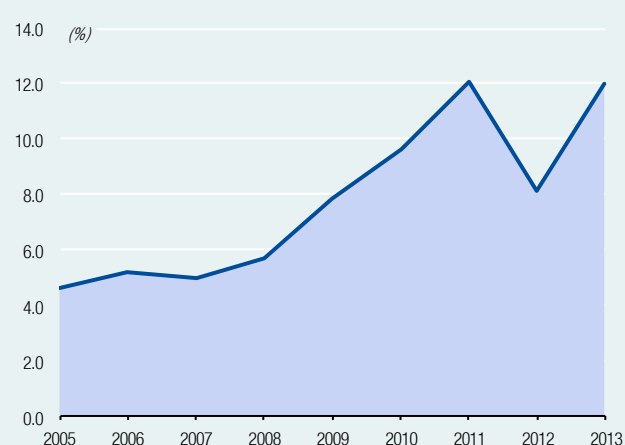
Chart 18. Kernel ranks among TOP5 largest grain operators in Ukraine*TOP 10 grain exporters Jul-Mar 2013/14*

Source: Agrochart

It took Kernel almost two decades to establish itself as a leading grain operator in Ukraine. Kernel as a company originally started in mid-90s from a small grain trading operation. In the early years, Andriy Verevskiy, Kernel's founder and CEO, was among hundreds of small dealers working with farmers on behalf of foreign grain traders. In the late nineties, he started to consolidate control over local elevators, thereby switching to a more asset heavy business model. By 2005, recently established Kernel had already become a noticeable player on the local scene commanding nearly a 5% share of local grain exports, but still aimed to become a top player. After the acquisition of TBT in 2009, the company succeeded in establishing control over the entire grain logistics chain between the farm gate and the port, while public status gave it access to cheap funding. By leveraging these advantages, Kernel raised its trading volume almost fourfold over the course of the next three years from below 600 kt prior to 2009 to firmly over 2,000 kt afterwards, thereby lifting its share of local grain exports to 8-12%.

Chart 19. Kernel significantly strengthened its positions over the past five years*Kernel's grain trading volumes, mt*

Source: Company, ICU

Share of Kernel in crop exports from Ukraine

At present, two major factors shape the performance of Kernel's grain trading business. The first is significant profit deterioration due to tremendous margin pressure in the local grain market which forced Kernel to review its strategy toward supply chain management. The second is Kernel's push into Russia where the company is attempting to establish itself as a significant market operator.

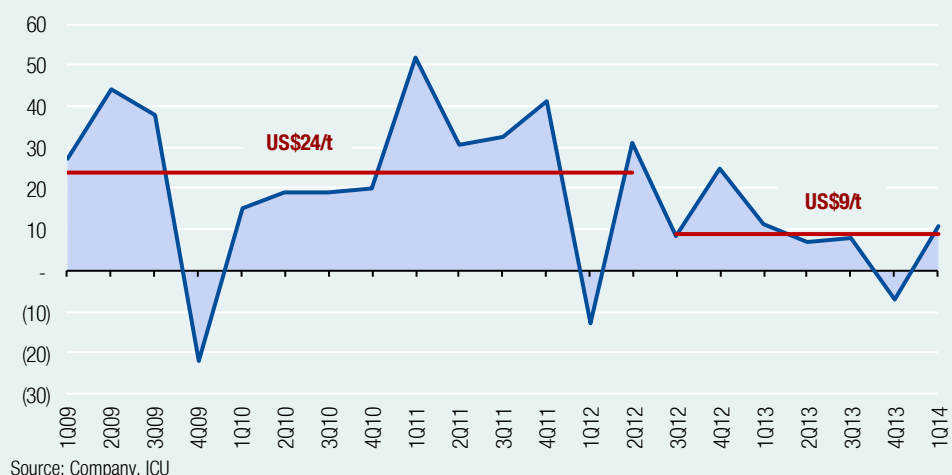
Depressed profits in Ukraine

Kernel suffered a major blow as dramatic drop in margins swept the local grain industry over the past two years. Previously, local traders easily made a margin of nearly US\$20 on each tonne of originated grain, which was considered normal. However, the margin collapsed to just US\$5-10/t following a drastic change in tax policies which occurred in Jul-11 when the much delayed and highly corrupt VAT refund on grain export sales was cancelled. The impact on Kernel's grain segment was devastating with fy 2013 EBITDA down to just a fifth of the peak figure recorded in fy 2011.

Stubbornly low margins eventually triggered a strategy reshuffle in the grain business. Apparently, there was not much the company could do to fix the low origination margin unless it would have chosen to assume directional price risk which it was reluctant to do. Instead, management decided to maximize grain turnover to capture higher profits on a captive infrastructure that earned a high handling margin. This, in turn, implied the inevitable sacrifice of some profit at marketing operations, because the company was forced to take some contracts that carried below market margins. Nevertheless, this trade-off was worthwhile.

Chart 20. Grain trading profits were squeezed by increased competition

EBITDA margin per ton of grain sold (US\$/t)



Perhaps, we need to mention that new strategy mainly referred to export terminals in the part regarding increased utilization of infrastructure. As management has limited influence over grain flows to its elevators, the option to attract additional volumes is to cut tariffs on services. As this did not occur, there is no certainty that it would have resulted in higher overall profit even if management made such a decision.

The new strategy appears to have been successful, at least on surface. In fy 2013, Kernel managed to dramatically increase turnover of TBT with in-house throughput volumes up more than twofold from an estimated 0.8 mt in fy 2012 to 1.7mt in fy 2013. That, in turn, boosted TBT's EBITDA by an incremental US\$12.1m (volume effect + higher fixed cost dilution). Expectedly, there was no visible effect on elevators where volumes decreased by 16% y/y, roughly in line with the general decline in grain production across the country (-19% y/y). Overall, the positive effect on consolidated EBITDA from the recent strategic review was capped at US\$12.1m and reflects the increase in turnover at TBT.

Expansion into Russia

Facing depressed profits and minimal growth options back at home, Kernel ultimately turned its eyes to the neighboring Russia which boasted annual grain exports in excess of

20 mt. The company decided to start its push from infrastructure by closing the big-ticket acquisition of ZTKT, discussed below. Additionally, it deployed a full-fledged origination network across Russia's South to complement port operations. Kernel did not simultaneously buy any storage facilities and management still remains undecided in this regard. Nonetheless, an owned storage network in Russia certainly remains an option for the future.

Kernel currently aims to capture 2.5 mt of grain exports from the country over time with an ultimate EBIT contribution of as much as US\$75m. The volume target of 2.5 mt corresponds to the company's expanded capacity allocation at ZTKT that Kernel plans to load with grain sourced by own trading arm. Each tonne of grain is projected to earn a margin of US\$30/t, consisting of US\$12/t handling margin of ZTKT and approximately US\$18/t margin on origination. Altogether, these assumptions yield an ultimate EBIT of US\$75m (2.5 mt x US\$30/t = US\$75m) as a goal for Russian grain operations, provided margin and volume projections materialize.

In our view, it might take at least several years to achieve the target rate of 2.5 mt of grain shipments with a competent execution team on the ground. Russian grain exports normally fall into the 20-25 mt range which means that Kernel would have to capture up to 10% of the entire volume if it is to load its expanded capacity at Taman with its own purchased grain. This certainly won't be easy because competition in the Russian market is very intense involving all key multinationals and numerous prominent local operators. Of course, control over Taman gives Kernel a material advantage over the competition, but established contact with local farmers and government relations are still crucial and those take time to build.

Overall, we view the Russian venture as promising. We perceive it as a first step in a big picture strategy to establish Kernel as a major grain player in the entire Black Sea region. In our view, regional expansion is a viable option for the Group which otherwise faces depressed margins and limited growth opportunities at home. In this context, the choice of Russia as a first destination looks natural. The purchase of Taman, though costly, should greatly increase Kernel's chances of success in the new market. But even if company fails, there is a good chance it will be able to sell its stake in ZTKT to its JV partner Glencore at a valuation close to or even higher than the original purchase price.

Table 16. Summary. Grain marketing

Financial year		2008	2009	2010	2011	2012	2013	2014	2015
End month		Jun-08	Jun-09	Jun-10	Jun-11	Jun-12	Jun-13	Jun-14	Jun-15
Sales volumes	kt	317	2,260	2,225	1,810	2,123	3,022	4,426	4,264
growth	%	-41%	613%	-2%	-19%	17%	42%	46%	-4%
Average selling price	US\$/t	669	258	210	316	282	322	257	210
Revenue	US\$m	212	583	466	571	599	972	1,136	897
EBITDA margin	US\$/t	96	25	18	37	13	4	10	10
growth	%	182%	-74%	-27%	103%	-65%	-67%	150%	-3%
EBITDA	US\$m	30	56	40	66	27	13	46	43
EBITDA margin	%	14%	10%	9%	12%	5%	1%	4%	5%

Sources: Company data, Investment Capital Ukraine LLC.

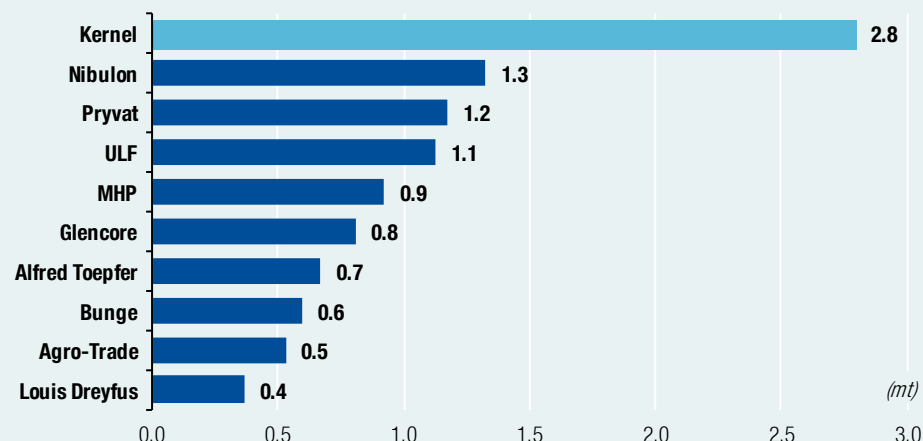
Grain elevators

- 1. Kernel operates the largest private elevator network in Ukraine with exposure to the major crop producing areas**
- 2. Aged facilities account for the bulk of storage capacity**
- 3. While there is still sufficient demand for services, the significance of Kernel's legacy infrastructure is being reduced by continued greenfield expansion**
- 4. The company itself undertakes a big expansion project to facilitate farming operations**
- 5. Kernel seems to lack the long-term vision on the growth options of the grain storage business**

Elevators play an important role in the operation of Kernel's grain business. As their basic task, they render cleaning, drying, and storage services to local farmers in exchange for a certain charge. But more importantly, they act as origination points where the Group's grain trading and oilseed crushing arms source grain and oilseeds for their operations. Furthermore, in some regions where Kernel has large farming clusters, its elevators focus on handling grain from its own production.

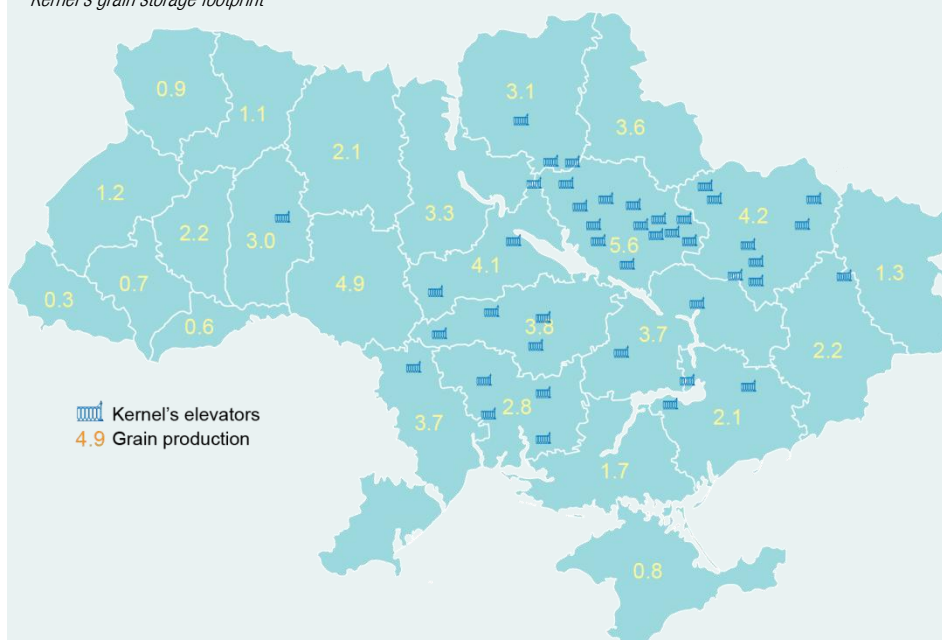
Grain handling and storage is a cyclical business driven by the pattern of crop production in the country. In bad years, Kernel's elevators could receive as little as 1.3 mt of grain, while in good years volume can rise to as much as 1.7-2.1 mt. Each tonne of grain earns the company a margin of US\$7-12/t depending on the total grain volume handled due to a high fixed cost base. The segment's EBITDA was about US\$18-19m over the past two years, that both were quite good in terms of volume (1.7-2.1 mt) and margin (US\$9-11/t). However, it is also the case that in some years EBITDA was as low as US\$9-11m on inferior crop volume and less grain received. At present, the segment contributes about 6-7% to the consolidated result.

Kernel operates the largest private grain storage network in Ukraine. Altogether, it owns over 40 facilities across the country with a total capacity of 2,800 kt. As such, the company accounts for 9% of the total off-farm storage available. In this respect, the Group is by far the largest private operator in Ukraine, staying ahead of all big multinationals and main local rivals. There is only one player ahead of Kernel in size, and that player is the government, which currently owns about 6 mt of storage capacity split among three subsidiaries.

Chart 21. Kernel commands the largest grain storage network among all private operators*Ranking of private grain storage operators by size, mt*

Source: ICU

Kernel's storage infrastructure spans some of the most important farming areas of the country, and in some places the company commands a dominant position. The location of elevators is worth special mention. The majority of them sit in key farming areas of Central Ukraine that offer plentiful grain sourcing options for Kernel's trading arm. Just as important, those are the regions with a high share of corn in rotation. Corn, as a matter of note, generates a bulk of turnover and higher profit for elevators than do other grains. In particular, Kernel is a major force in such top-ranking regions as Poltava and Kharkiv where it controls 25% and 19%, respectively, of all off-farm storage capacity. Poltava ranks the first in Ukraine by total grain output (5.6 mt; 9% of the total) while it also produces the largest amount of corn (4.1 mt, 13% of the total). In general, this region occupies the position similar to that of Iowa in the US. In turn, Kharkiv ranks the third in Ukraine with grain volume of 4.2 mt (7% of the total) yet a relatively low share of corn.

Map 2. Kernel's storage infrastructure spans some of the most important farming areas in Ukraine*Kernel's grain storage footprint*

Source: ICU

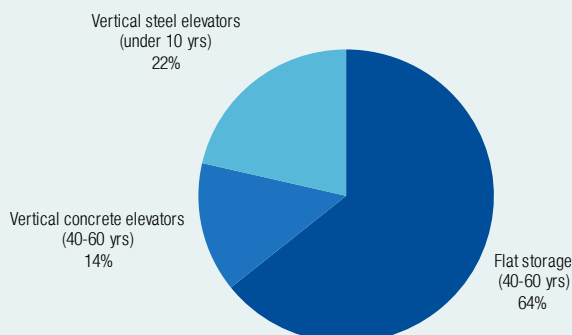
Elevators were among the first assets acquired by Kernel back in the early years. During 1998-2003, the company consolidated two dozen standalone silos, mainly in its home Poltava region. All those were legacy Soviet elevators (some were vertical concrete silos, but the great majority were simple flat storage facilities) that were previously sold by the government to private investors during the extensive privatization campaign of 1998-1999.

In 2003-2008, Kernel stopped expanding its elevator network on purpose, and instead continued to add storage assets via large M&A deals where elevators comprised a small portion of the total asset portfolio. There were two major transactions which brought the bulk of incremental capacity in subsequent years. Those were the deals with Yevrotek and Allseeds which added a total of 1,200 kt of storage. Of note, the great majority of acquired assets were the same old-fashioned flat storage with few vertical concrete elevators and only two large modern silos among them – one in Kirovograd (100 kt) and another one in Viktorivka (60 kt).

Thus, one should not be surprised to hear that aged Soviet facilities comprise the bulk of Kernel's grain infrastructure. Built 40-60 years ago, they are old and often obsolete facilities, inferior to modern elevators in all respects. In particular, they feature high labor intensity, excessive energy consumption, low-capacity drying equipment and low railcar loading speed. Those are just a few of the big problems. Older flat storage that currently accounts for up to 1.8 mt, (nearly 65% of the total) are the least efficient, while legacy vertical silos are somewhat more efficient due to better mechanization and improved grain handling.

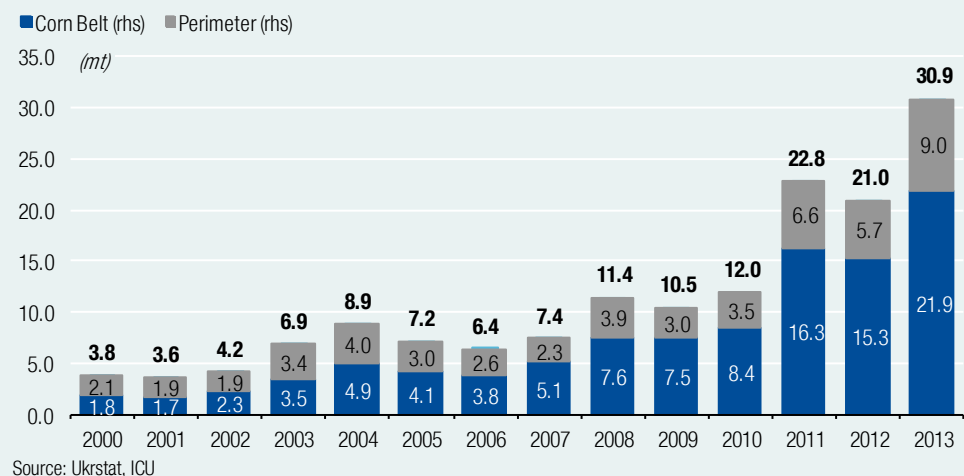
Chart 22. Aged facilities account for 3/4 of all storage

Age profile of Kernel's storage network



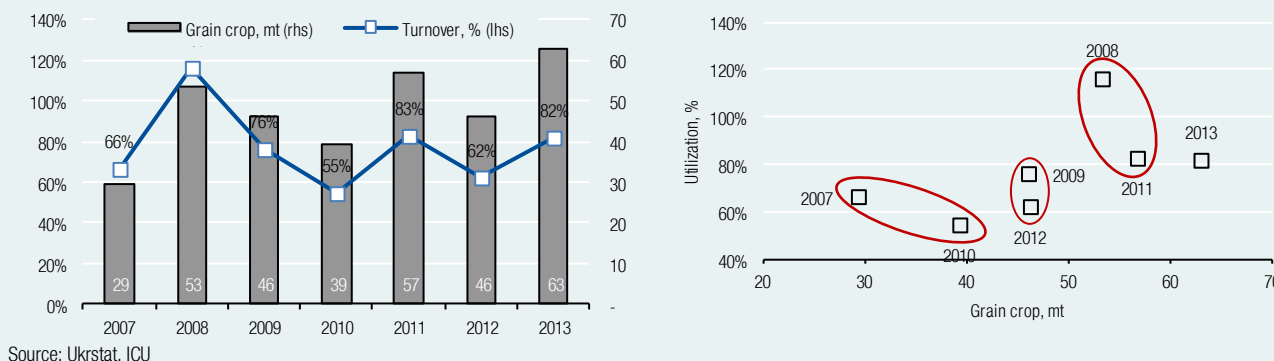
Source: ICU

While Kernel's older elevators might not be the most efficient and profitable, demand for their services remains strong for the time being. There is simply no alternative to the legacy infrastructure in many areas of the country, like the eastern and southern regions for example, while in the Corn Belt huge corn crops of recent years keep all existing facilities very busy. This is very fortunate for Kernel that historically has a strong presence in the Corn Belt, especially in its eastern part.

Chart 23. Exploding corn production keeps Kernel's older infrastructure busy*Corn production in Ukraine, mt*

Unfortunately, Kernel's legacy grain storage slowly but steadily loses its significance on a country level in the wake of the massive construction boom of recent years. The current soft commodities cycle spurred massive investment in grain infrastructure across the country, particularly in the Corn Belt, to accommodate increasingly large amounts of grain being produced. As a result, there was a big roll-out of new capacity, including in some of the areas where Kernel historically used to dominate. In particular, 15-20 new large facilities have been built in Kernel's home Poltava region, raising total capacity there by 1.4 mt, of which only about 100 kt was attributed to Kernel. New capacity significantly diluted Kernel's originally dominant position which historically relied on 800 kt of legacy storage. Other traditional regions were less affected like, for example, Kharkiv, where only some 100 kt of new capacity was built against 2.3 mt of existing storage, of which 550 kt is attributed to Kernel.

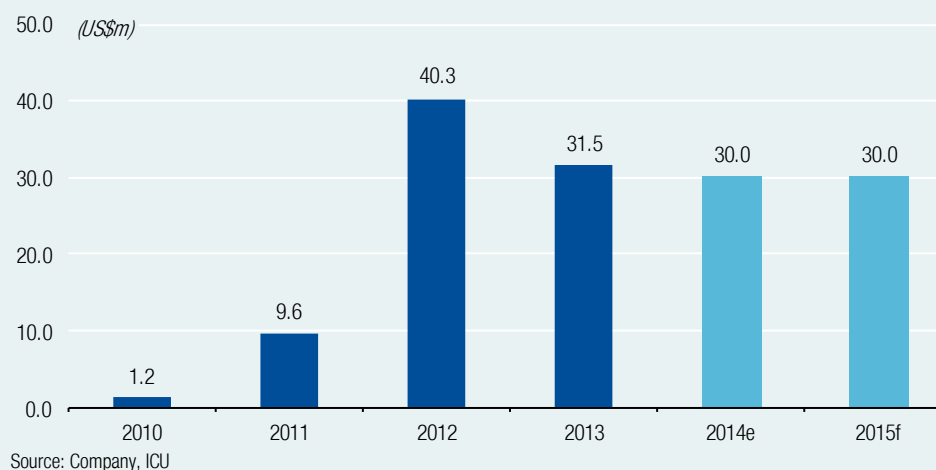
The underlying usage pattern confirms the decline in significance of Kernel's aged storage infrastructure. Isolated review of either volumes handled or utilization rates of storage facilities does not reveal the subtle trend in demand for their services. However, once we put utilization into the context of actual grain production in the country, we instantly notice that Kernel's elevators are being increasingly less used by the market. The decline became evident starting from 2010, when Kernel recorded just 55% utilization on grain production of 39 mt, a sharp contrast to the situation in 2007 when turnover reached 66% against a crop of 29 mt. In 2011, utilization was down 33 percentage points compared to 2008, although grain production was up by 4 mt. In 2012, turnover was at 62%, down by 14pp vs 76% in 2009, while crop volume came out exactly the same at 46 mt. Overall, it is fairly obvious that usage has declined in recent years. The most likely reason for that is continued new construction across the country which diverts incremental grain volumes away from Kernel's aged facilities.

Chart 24. Kernel's aged infrastructure sees decreased usage

It is worth mentioning that Kernel recently initiated its own development program specifically tailored to facilitate its concomitant push into farming. It envisages the construction of a dozen large primary elevators to be located right next to the Group's largest farming clusters in order to handle most of the grain produced by its own farms. Since 2011, when the program was approved, six new facilities with a combined capacity of 460 kt have already been commissioned. New capacity was added in the Poltava, Khmelnytsk, Kirovograd and Cherkasy regions, where the Group's farming clusters sport over 40% of acreage under corn and thus have an overwhelming need for quality drying and storage services. Capital expenditures for this project already totaled US\$83m at this point, with average capital cost for each tonne of storage capacity equal to US\$180/t, which is broadly in line with the market. This year, the company plans to spend another US\$30m on new construction. Management states that this rate will hold in the coming years. The ultimate target, however, remains uncertain, and it seems that even management does not have a clear vision in this regard.

Chart 25. Thus far Kernel spent US\$83m on new storage infrastructure

Capital investments in new elevators (US\$m)



Kernel seems to be lacking a comprehensive development plan for the grain storage business that would go beyond the immediate needs of its farming division. At a meeting with investors in Sep-13, Kernel founder and CEO Andriy Verevskiy did not sound particularly enthusiastic about investment in grain storage infrastructure in isolation from the farming business. He spoke about low returns on invested capital, rising competition in some regions, and other discouraging factors thus leading us to believe that the company does not entertain any major expansion effort at present. However, we have to point out

that this downbeat approach has already resulted in a significant deterioration of Kernel's dominance in core operating regions which should continue unless some proactive action is taken.

Table 17. Summary: Grain elevators

Financial year		2008	2009	2010	2011	2012	2013	2014	2015
End month		Jun-08	Jun-09	Jun-10	Jun-11	Jun-12	Jun-13	Jun-14	Jun-15
Storage capacity	kt	1,700	1,655	1,655	2,300	2,490	2,790	2,990	3,190
Turnover	%	66%	116%	76%	55%	83%	62%	82%	75%
Throughput volumes	kt	1,130	1,924	1,261	1,254	2,059	1,737	2,447	2,393
growth	%	21%	70%	-34%	-1%	64%	-16%	41%	-2%
Average fees	US\$/t	22	21	20	21	25	27	33	27
growth	%		-6%	-7%	8%	17%	8%	25%	-18%
Revenue	US\$m	25	41	25	27	51	46	82	65
External customers	US\$m	19	31	13	11	31	19	30	10
Intersegment	US\$m	7	10	12	16	20	27	52	55
EBITDA margin	US\$/t	8.5	12.1	9.0	7.4	8.9	11.1	18.4	12.3
growth	%		42%	-26%	-18%	20%	25%	65%	-33%
EBITDA	US\$m	10	23	11	9	18	19	45	29
EBITDA margin	%	38%	57%	46%	35%	36%	42%	55%	45%

Sources: Company data, Investment Capital Ukraine LLC.

Export terminals

Export terminals are a key element of the grain supply chain. They receive grain from up-county elevators and load it onto the ships which then deliver grain overseas. For large grain operators of Kernel's size, an owned port infrastructure is essential to secure export capacity and improve its competitive stance by cutting out intermediary service providers.

Kernel owns three export loading facilities to facilitate its grain trading and vegetable oil operations across the Black Sea region. In Ukraine, the company manages a grain export terminal in Ilichivsk with 4mt in capacity and an oilseed products terminal in Mykolaiv which can handle up to half million tons of oil and meal. In Russia, the Group, together with Glencore, jointly controls the Taman grain export terminal designed to load 3 mt of grain at full capacity.

Map 3. Kernel controls three export loading facilities in the Black Sea region

Export loading facilities under Kernel's control



Kernel has built its port infrastructure via a series of deals with the very first one taking place in June-08. Back then, Kernel purchased Tranbulkterminal (TBT) which became its principal export outlet in Ukraine. Subsequently, there was a minor addition of an oil terminal in Mykolaiv as part of Allseeds deal in mid-2010. Finally, in Sep-12, Kernel purchased a deep-water grain terminal in Russia through the JV with Glencore in order to facilitate its push into the Russian grain export market.

Table 18. Export terminals. Transaction summary

Target	Date	Stake (%)	Capacity (ktpa)	FV of PP&E (US\$m)	Cash paid (US\$m)	Net debt (US\$m)	EV (US\$m)	EBITDA (US\$m)	FV of PP&E (US\$/t)	Cash paid (US\$/t)	EV (US\$/t)	EV/EBITDA (x)
Tranbulkterminal	Jun-08	100%	4,000	62	95	-	95	32	16	24	24	3.0
Oiltransterminal	Jun-10	100%	500	14	14	-	14		29	29	29	
Taman	Sep-12	50%	3,000	127	96	73	265	32	42	64	88	8.2
Total					205	73						

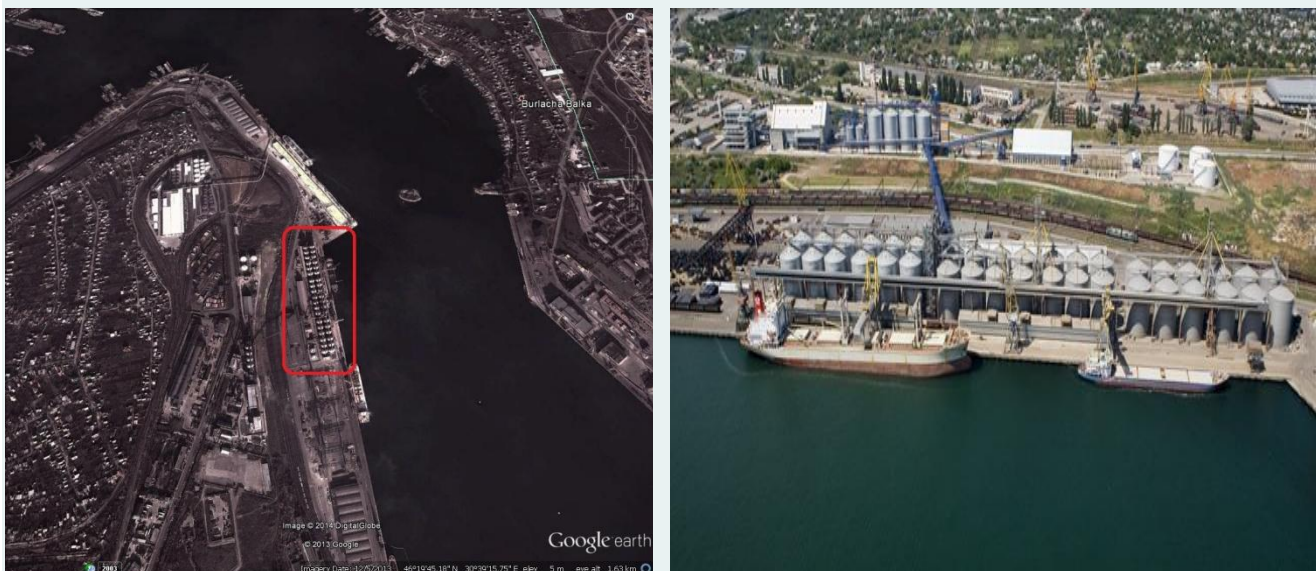
Sources: Company, ICU

Transbulkterminal (TBT)

1. Low-cost purchase of TBT in 2008 placed Kernel among the top-ranked grain exporters from Ukraine.
2. TBT is primarily used to ship small grains due to its inferior corn handling ability.
3. This factor and captive status keep TBT underutilized.
4. After a prolonged slump, performance has improved in recent years, but further growth is constrained by dynamics of the grain trading arm.
5. TBT is set to lose its largest third-party customer next year which could slash volumes by 15%.

TBT is one of the largest grain export outlets in Ukraine located in the seaport of Illichivsk, to the south of the larger seaports of Odesa and Yuzhny. It is the oldest private grain terminal in the country, with its first stage commissioned in 1998 and its expansion completed in 2002. The facility is designed to handle up to 4 mt of grain per year and some volumes of sunflower oil and meal produced by the nearby crushing plant. Production assets include 38 silo beans with capacity of 200 kt, 4x rail and 2x truck outload stations (20 ktpd in total), and two ship loaders (700 and 900 tph). The outlet has sufficient draft to accommodate Panamax-type vessels which could be loaded two at a time.

Chart 26. TBT is one of the largest grain export outlets in Ukraine located in the seaport of Illichivsk



Source: ICU

TBT has its own strong and weak points. Large storage capacity and deepwater access are among its definite advantages. On the other hand, the facility cannot originate grain from the nearby regions efficiently due to its distant location compared to Odessa and Yuzhny as well as inferior truck access. TBT is also not particularly well suited for corn, a major disadvantage for Kernel which typically originates a lot of the latter crop.

TBT is a typical captive export facility that is primarily used to service its own grain trading arm with little volume provided by third-party operators. TBT's primary customer is Kernel-

Trade, a subsidiary of Kernel, among other things responsible for grain trading operations. Typically, it accounts for 60-70% of the volumes handled at the outlet, while the rest is due to third parties. Third parties used to ship over 1.5 mt of grain through TBT in the past, but their volumes have dropped dramatically since fy 2011 and at present do not exceed 0.7 mt.

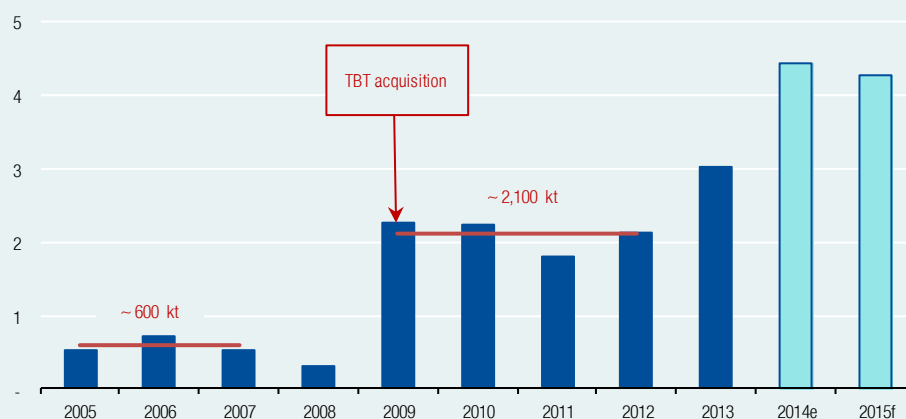
TBT traditionally specializes in wheat and barley, while corn remains its weak spot. We presume that the terminal was not designed for corn originally as it was built at a time when corn comprised just a small part of local grain production. Therefore, it has problems with handling this specific crop. That constitutes a major disadvantage for Kernel which prefers to send significant corn volumes to other export terminals instead of shipping them through TBT. During the 2012-2013 seasons, Kernel did not ship any meaningful amount of its own corn through TBT, but instead was using outlets in the Yuzhnyy seaport for this purpose. This year, we might finally see Kernel shipping some of its corn through TBT again, but this should not be treated as a change in preferences but rather as a sign of strong competition and a shortage of slots at major corn handling points.

Kernel acquired TBT in a landmark deal with Estron Corp back in 2008 when the Group snatched the facility from a larger rival Bunge which previously was the terminal's largest client and concurrently a partner to Estron in a JV to manage a crushing plant located right next to TBT. This was a huge win for Kernel, which thus managed to establish control over one of the largest grain export terminals in the country for a reasonable price. Back in those days, TBT was of huge significance to the local grain industry. Apart from it, there were a mere four other modern export loading facilities in Ukraine, two of which were, in fact, captive and thus virtually closed to other operators. Kernel agreed to pay US\$95m for the asset, a good price given its standalone EBITDA contribution to the tune of US\$30m (nearly 3x EBITDA multiple) and numerous synergies with legacy grain trading operations.

TBT was an asset of strategic importance for Kernel which greatly facilitated the company's rapid transformation into a top grain player in Ukraine. Besides the substantial earnings stream, having its own grain terminal also gave Kernel ample export capacity, flexibility in marketing options, and timing of delivery. Moreover, the company enjoyed additional grain flows that naturally occur around export facilities. Successfully leveraging TBT's strengths, Kernel managed to raise its grain trading volumes almost fourfold from its typical 500-700 kt prior to the acquisition to 2-3 mt afterwards.

Chart 27. Purchase of TBT facilitated 3.5x boost to volumes at grain trading arm

Grain volumes at marketing arm, mt



Source: Company, ICU

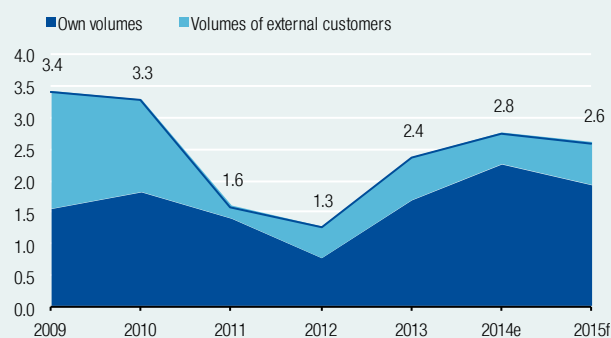
Initially, TBT used to perform really well boasting high capacity load and superb returns. In the first two years after acquisition, TBT handled 3.3-3.4 mt of grain each year sporting utilization in excess of 80%, of which an estimated half was attributed to external customers. Standalone EBITDA was about US\$30m with ROIC firmly in the mid-20s.

However, soon thereafter, TBT entered a prolonged slump. Throughput dropped by half in 2010/11 and then by another 21% during 2011/12. We estimate that TBT handled a mere 1.3 mt of grain at a trough in fy 2012, which corresponds to turnover of just 31%, and this is despite a record high crop harvested in Ukraine that year. Two factors were responsible for this. First, TBT lost a bulk of its third-party customers that permanently switched to other export outlets during 2010/11. Second, Kernel, surprisingly enough, diverted its own corn volumes away from its captive TBT to export loading facilities in Yuzhnyy during 2011/12, which signaled that for some reason TBT was not particularly efficient when handling corn. As a direct consequence, EBITDA dropped by almost 70% from US\$28m in fy 2010 to an estimated US\$9m in fy 2012 while ROIC plunged to a shockingly low 6%.

In fy 2013, TBT staged a dramatic recovery driven by a new strategy towards the grain business. The new approach adopted in 2013 aimed to substantially increase turnover at TBT with additional volumes of grain coming from grain trading operations at a cost of some margin sacrificed upon grain origination. The strategy proved successful insofar as TBT is concerned. Throughput increased by over 80% to an estimated 2.4 mt (59% turnover) with its own volumes accounting for the bulk of growth. Meanwhile, the EBITDA contribution jumped by 2.5x to US\$22m driven by higher volumes and operating leverage. As a result, ROIC recovered by 13 percentage points to an estimated 19%, not far from the numbers seen before fy 2011.

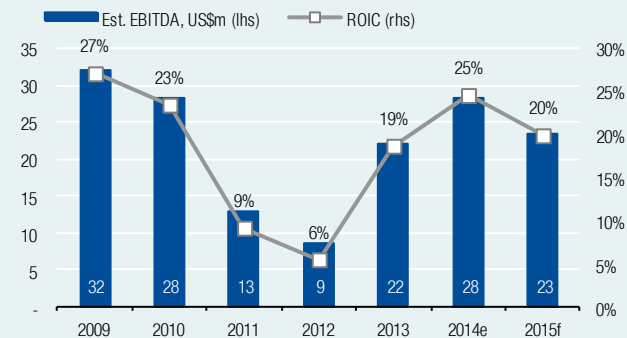
Chart 28. Volumes and profits slumped to their lowest in 2012 with pronounced recovery afterwards

Throughput volume dynamics, mt



Source: Company, ICU

Earnings dynamics



Despite a slow start, TBT should continue to ramp up volumes this year. We project 2.8 mt in throughput at TBT (+0.6 mt at OTT) in 2014, driven by i) a bumper crop facilitating much higher grain exports from the country (30+ mt in 2014 vs 22 mt in 2013), and ii) a 2.3x surge in grain production at captive farming operations (1.4 mt vs previous crop of just 0.6 mt). Meanwhile, the start of the year was rather slow due to annoying port delays and massive rains which hampered spring crop harvesting in Sep. Under such circumstances, TBT and OTT handled just 1.3 mt of cargo during 1H14, which was 26% below the previous year. To catch up with our target of 3.3 mt, they have to ship an additional 2.0 mt during the remaining months, which is almost twice as much as they normally do in that period. While there is a strong downside risk to our target, there is still time to try to catch up. We await the MarQ operating update to adjust our target.

Meanwhile, it is almost certain that TBT will soon lose its only large external customer – a big international grain trader which might slash throughput by up to 15%. The latter has

recently acquired a 50% stake in the Bruklin-Kyiv grain terminal in Odessa which is currently under construction. The facility is set for completion by Aug-14. With a capacity of 4 mt, it should be able to accommodate all volumes annually exported by this grain operator from Ukraine. Thus, it might easily happen that Kernel will lose the entire throughput attributed to this customer already next season. At present, the customer accounts for up to 400 kt of volumes handled at TBT, representing about 15% of this year's expected throughput.

Honestly, we do not see many options for TBT to dramatically increase its earnings contribution in the near- to mid-term beyond what we already peg for this year. We admit that the facility has enough headroom to raise its throughput from the present level. However, it seems uncertain how it will exceed the dynamics of the grain trading arm without a major upgrade to enable efficient corn handling or some effort to attract additional third-party volumes.

From the point of view of strategic appeal, TBT lost most of its previous significance over the past few years. The local market witnessed a major capacity rollout in the years since Kernel's acquisition in 2008 with six large export loading facilities commissioned, bringing total industry capacity to 45-50 mt. As such, TBT now accounts for below 10% of the country's capacity compared to twice as much before. Almost all of the new facilities have superior truck access to facilitate grain transportation from nearby regions. Moreover, there occurred a shift in the crop mix away from wheat and barley towards corn, which has left TBT on the sidelines of a major increase in grain export flows due to its inferior ability to handle that particular crop. Altogether, this has significantly eroded TBT's competitive position with options now virtually reduced to servicing its own trading arm.

ZTK Taman (ZTKT)

1. Kernel plans to use its allocation at ZTKT to establish a full-fledged grain export operation in Russia
2. Having a number of advantages, ZTKT is well-positioned to snatch some volumes from shallow Azov ports
3. The major hurdle is a lack of rail access that prevents grain delivery from distant areas of the Central and Volga regions
4. Taman's valuation upon purchase significantly exceeded that of TBT due to the strategic importance of the asset and scarcity of options
5. Currently, ZTKT is being upgraded to increase throughput capacity from 3 mt to 5 mt next year

Recently, Kernel started to take important steps to move beyond its historical frontiers and expand across the entire Black sea region. The acquisition of a unique grain terminal in the deep seaport of Taman on Russia's Black Sea coast was an integral part of this strategy and a visible manifestation of the Group's regional ambitions. It is conceived that this grain complex with capacity of 3 mt (5mt after expansion) will become the core of a full-fledged grain network which the company plans to develop to establish itself as a key operator in the Russian grain export market.

Background

The Taman grain complex is a part of a massive greenfield project to develop a huge deep seaport on Russia's Black sea coast to remove a severe bottleneck constraining the country's bulk commodity exports. It is a high priority national project backed by the Russian government which has committed to spend up to US\$4.0bn on port infrastructure alone. The project began in 2006 and is scheduled for completion by 2025. Upon completion, the seaport will have the capacity to handle over 90 mt of bulk commodities, including crude oil, iron ore, coal, fertilizers, grain, etc. and will ultimately rank as the second largest port in the Black Sea after Novorossiysk which can ship up to 150 mt of bulk cargoes.

At present, ZTKT is the only grain loading facility in the port. The latter is still in the early stages of construction with activity still principally focused on establishing the basic infrastructure for future coast development. In fact, commissioned in Sep-2011, ZTKT became the first fully-functional facility in the area. At present, although various players voice their intention to construct other grain terminals in the port, none of those has advanced to the project stage so far. Nevertheless, it seems that ultimately most of the development in the grain export infrastructure will be taking place in Taman rather than anywhere else along the coast because of its vast expansion potential.

Chart 29. The Taman grain complex is a part of a large greenfield port project being developed on Russia's Black Sea coast



Source: ICU

Facility overview

ZTK Taman has the capacity to handle 3 million tons of grain with plans to eventually expand the volume to 5 million tons. The first stage completed in 2011 comprised the following equipment: 7 silos with a combined 89 kt of capacity, a wharf with 2(x)1,100 tph ship loaders, 2 truck outload points, and 2 parking lots. The second stage envisages the construction of 12 additional silo bins to raise total storage capacity to 200 kt and an additional outload point for grain trucks. The cost of the project is about US\$40m which will be financed via available credit facilities. Project implementation has already started in Nov-13 to be completed in fall of 2014.

Taman has a natural advantage compared to nearby Russian seaports. In contrast to the deepwater ports in Novorossiysk and Tuapse, it has plenty of room for expansion and will also have superior road access to enable large-scale grain delivery by trucks. Compared to the shallow ports on the Sea of Azov, it has deep water access and can handle Panamax vessels which reduce shipping costs by US\$20-25/t. In fact, the original idea behind the grain terminal in Taman was to capture a percentage of grain export flows currently going through the less efficient shallow ports on the Sea of Azov. With a freight advantage of US\$20-25/t and an extended operating season due to the absence of a freezing period, Taman is well positioned to win volumes from the Azov ports. Hence, we believe Taman is shaping up to eventually become the largest grain hub on the Black Sea unless the government backs out of the project.

While the Taman grain terminal is certainly a highly valuable asset, it also has its hurdles. The biggest one is the lack of rail access which limits the service region to a 500-800 km radius, thus hampering grain flows from the distant areas of the Central and Volga regions. This factor comes to the fore in the second half of the season when grain supplies in the principal exporting regions of Russia's South grow increasingly tight. Market operators then move to distant areas to secure the export flows. Our major concern in this regard is that partners might not be able to fill capacity sourcing only from Russia's South given the intense competition from other traders in that particular part of a country. If they fail, subpar utilization might become a permanent feature of ZTKT, similar to what previously happened with TBT in Ukraine. Although there is an intention to eventually build a railway spur to the

terminal, the second stage of the project does not list it among the targets, meaning that its construction is certainly not a priority over the next two years.

Overview of purchase transaction and JV with Glencore

Kernel and Glencore established joint control over ZTK Taman in Sep-12, paying the previous owner Efko a total of US\$192m for a 100% stake. This was certainly the most expensive purchase of Kernel to date with a transaction multiple in the high single digits. The deal value was equal to US\$265m and included cash consideration of US\$192m, of which Kernel contributed half, and debt of US\$73m. At the time of purchase, the facility was operating well below its design capacity, but theoretically it could be making up to US\$32m in EBITDA in a typical year based on a margin of US\$12/t (US\$19/t fee – US\$7/t in operating expenses) and throughput of some 2.7 mt (90% capacity load). The deal thus implied an EBITDA multiple of 8.2x, well above anything that Kernel ever paid before. In comparison, the TBT transaction, which was closed by Kernel at the peak of the previous commodity cycle in mid-2008, implied just a 3.0x EBITDA multiple.

The high purchase price was motivated by a combination of factors, including the strategic significance of the asset and the total lack of comparable offers. Basically, Russia has only five deepwater export terminals with no definitive plans for the construction of additional facilities. All of them, with the only exception of ZTKT, are controlled by strategic logistics operators who thus far expressed no interest in selling control. It was no wonder that Efko's offer to sell a 100% stake in ZTKT ignited wide interest among multinational grain traders. Literally speaking, it might have been the only chance to establish control of a deepwater facility on Russia's Black Sea coast, thus resulting in the aggressive bidding among traders and extreme price paid for the asset.

Operations

Two years since its launch in Sep-2011, the terminal was unable to ramp up to its design capacity. In 2011/12, it handled just 1,430 kt of grain (48% load) as a natural consequence of the lengthy ramp-up process while in 2012/13 the weak crop caused volumes to slump to 1,134 kt (38% load) with the second half of the year being particularly slow.

This year, ZTKT has all the prerequisites to dramatically improve its performance. In 2013, Russia harvested a decent crop of 91 mt (up from 67 mt last year), of which 22 mt might ultimately go for export. This healthy number should theoretically facilitate much-higher capacity utilization compared to previous seasons. Actual throughput for the first half of the year stands at 1,498 kt, which is already higher than the full previous season's throughput. While the second half is traditionally slower, we can still expect turnover of some 2.3 mt for the full year, very close to full capacity, and more than twice above that of the previous year.

Looking further ahead, we argue that the facility is almost sure to be adequately utilized because Glencore is the largest grain trader in Russia that can alone secure over 3 mt of turnover through Taman in a typical year. Thus, even if Kernel's plans to ramp its Russian grain trading operations to 2.5 mt eventually fail, its partner should easily fill the gap with its volumes.

Table 19. Summary. Export terminals

Financial year		2009	2010	2011	2012	2013	2014	2015
End month		Jun-09	Jun-10	Jun-11	Jun-12	Jun-13	Jun-14	Jun-15
TBT + OTT								
TBT	kt	4,000	4,000	4,000	4,000	4,000	4,000	4,000
OTT	kt	-	-	500	500	500	500	500
Port handling capacity	kt	4,000	4,000	4,500	4,500	4,500	4,500	4,500
Utilization	%	85%	82%	48%	40%	65%	73%	70%
TBT (est)	kt	3,409	3,274	1,591	1,259	2,360	2,750	2,600
OTT (est)	kt	-	-	550	550	550	550	550
Throughput volumes	kt	3,409	3,274	2,141	1,809	2,910	3,300	3,150
growth	%	0%	-4%	-35%	-16%	61%	13%	-5%
Average handling charge	US\$/t	16	16	15	16	17	17	16
growth	%		5%	-6%	4%	6%	0%	-4%
Revenue	US\$m	53	54	33	29	49	56	51
growth	%		1%	-39%	-12%	70%	14%	-9%
EBITDA margin	US\$/t	9	9	8	8	9	10	9
growth	%		-8%	-3%	-9%	23%	8%	-10%
EBITDA	US\$m	32	28	18	14	27	33	28
EBITDA margin	%	60%	52%	54%	47%	55%	59%	56%
ZTKT JV								
Grain handling capacity	kt					3,000	3,000	4,500
Utilization	%					38%	77%	75%
Throughput volumes	kt					1,134	2,298	3,375
growth	%					-21%	103%	47%
EBITDA	US\$m					1	25	39
EBITDA margin	US\$/t					-	11	11
EBITDA margin	%						59%	61%
Net profit	US\$m					(4)	13	23
Kernel's equity share in JV	%					50%	50%	50%
Share of profit of JV	US\$m					(2)	7	12

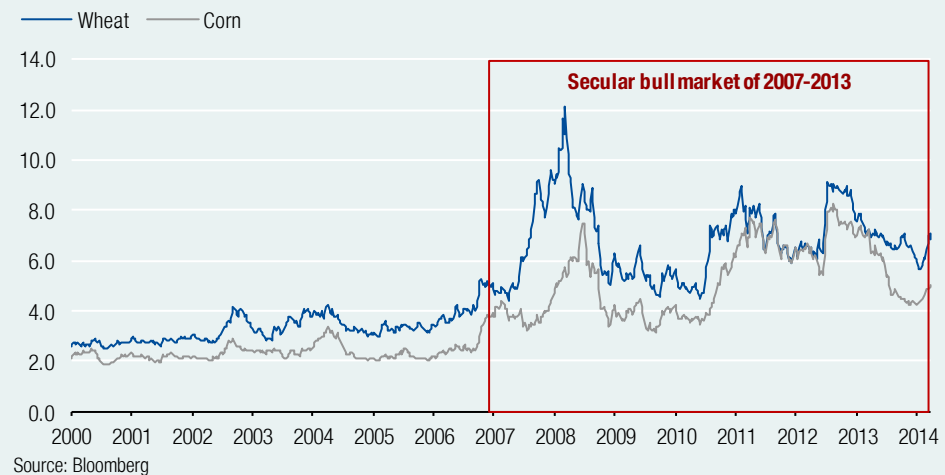
Sources: Company data, Investment Capital Ukraine LLC.

Farming operations

- 1. Ukrainian farming sector experienced a massive consolidation drive during last decade.**
- 2. Kernel initially lagged behind, but eventually caught up in recent years, creating the second largest farming operation in Ukraine, though at a higher cost.**
- 3. Unfortunately, operational results constantly underperformed expectations due to issues with integration and control that proved too difficult to resolve.**
- 4. New head of farming was hired in May-13 to streamline operations and achieve higher yields.**
- 5. A number of steps were announced to fix underperformance; however, the recent drop in grain prices may derail the ultimate recovery.**

Crop farming has probably been the most exciting business opportunity in Ukraine for quite some time now. With a promising investment outlook and very supportive price environment over most of the last decade, it has drawn the attention of legions of investors, both local and foreign, with Kernel being just one of them. Although somewhat late to the party, Kernel was eager to catch up, thus acquiring farmland by hundreds of thousands of hectares, in an attempt to capitalize on opportunities presented by the great commodity super-cycle. Although Kernel did succeed in creating the second largest farming operation in Ukraine, operational results achieved to date have been rather disappointing. Nonetheless, there is a hope for an eventual turnaround as the company recently engaged one of the best farming managers in Ukraine to remediate the situation and propel the company to the top tier.

The farming story started back in 2007 when skyrocketing commodity prices awakened the market to the vast potential of Ukrainian farmland. Although price appreciation began during fall of 2006, it took another eight months before a bull market came into full force in mid-2007. At the height of the boom in Mar 2008, global grain prices were three to four times above normal levels seen before. All of a sudden, Ukraine's farming sector, which previously was largely ignored by investors, now moved into the spotlight as people acknowledged its immense growth potential. A massive land grab ensued almost immediately with huge swathes of farmland ultimately falling into the hands of large commercial farmers that blossomed like mushrooms after a spring rain.

Chart 30. Surging grain prices awakened investors to opportunities in Ukraine*CBT grain futures dynamics, US\$/bu*

Much to its regret, Kernel missed out on early opportunities for a low-cost expansion of its farming operations. Although the company had some farmland under control before the onset of the secular bull market in soft commodities in 2006, farming had the least priority for management at that time. Aside from a bundle purchase of 15k ha of farmland as a part of the Yevrotek deal that closed in Dec-06, Kernel stayed on the sidelines during the early stages of farming industry consolidation in Ukraine that began in mid-2006. During that period, first movers were grabbing idle and mismanaged farmland at no cost aside from registration and agent fees that usually totaled under US\$50 per hectare. Such companies as UAI, NCH Capital, Mriya and Astarta managed to consolidate hundreds of thousands of hectares that way.

Kernel joined the rush at the peak of the bubble. Flush with liquidity from its recent IPO, in Jan-08, Kernel announced a plan to create a 250k ha farming operation. However, the company managed to acquire only 54k ha by Sep-08 when all M&A activity was suspended in the wake of Lehman's collapse and the unfolding of the liquidity crisis in Ukraine. Acquisitions made in 2008 were expensive as they reflected all-time-high grain prices seen in early 2008. As a result, actual deals closed by Kernel implied valuations of farmland in excess of US\$500/ha that was an order of magnitude higher than what other companies paid in previous years. Part of the differential was due to the fact that Kernel was allegedly buying relatively well-managed farms sparing itself the need for additional time and expenses required to restore idle farmland back to production.

Table 20. Farming companies. Transaction summary

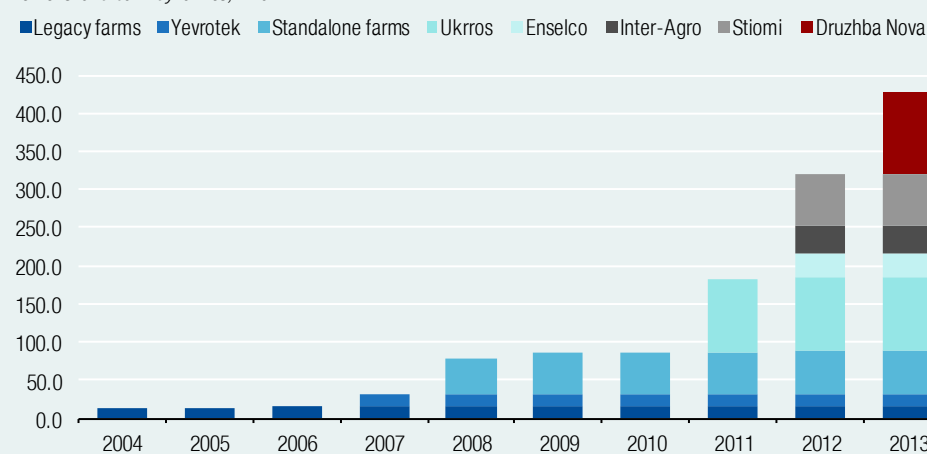
	Date	Stake	Farmland	FV of land lease rights	Cash paid	Net debt	Enter-prise value	FV of land lease rights	Cash paid	Enter-prise value	EBITDA (prev year)	EV/ EBITDA
		%	k ha	US\$m	US\$m	US\$m	US\$m	US\$/ha	US\$/ha	US\$/ha	US\$/ha	x
Standalone farms	Jan-Aug 08	100%	54	29	47	18	65	542	875	1,204	290	4.1
Ukrros	Jun-11	71%	100	35	40	113	169	352	561	1,689	266	6.4
Enselco	Oct-11	100%	29	14	51	2	53	462	1,753	1,816	266	6.8
Inter-Agro	Apr-12	100%	39	16	39	20	59	404	1,021	1,537	266	5.8
Stiomi	Apr-12	100%	66	33	35			500	534		266	
Druzhba Nova	Jul-13	83%	106	59	69	84	167	557	782	1,572	276	5.7
Subtotal 2011-2013			340	156	235	218	448	460	779			
ex-Stiomi			274	123	200	218	448	450	839	1,636	270	6.1
Total			394	186	282	236	512	471	792			

Sources: Company, ICU

Kernel was a keen buyer during the second wave of industry consolidation, increasing its land bank to 400k ha. After an almost two-year long lull, activity in the local land market revived in mid-2010, driven by new spike in grain prices. This time around, Kernel itself led the market consolidation along with Ukrlandfarming (ULF). Both have chosen a similar strategy of large-scale acquisitions to fast track their land bank expansion to quickly capitalize on the ongoing strength in grain prices. There were five large deals closed during that period that ranged from 30k ha to over 100k ha in size. As a result, Kernel raised its land bank nearly five-fold to 420k ha between the spring of 2011 and 2013. In subsequent months, the company sold some of the remote plots totaling 20k ha in a move to streamline its portfolio and eliminate underperforming spots.

Chart 31. Kernel consolidated the bulk of its farmland over the past three years

Kernel's land bank dynamics, k ha



Source: Company

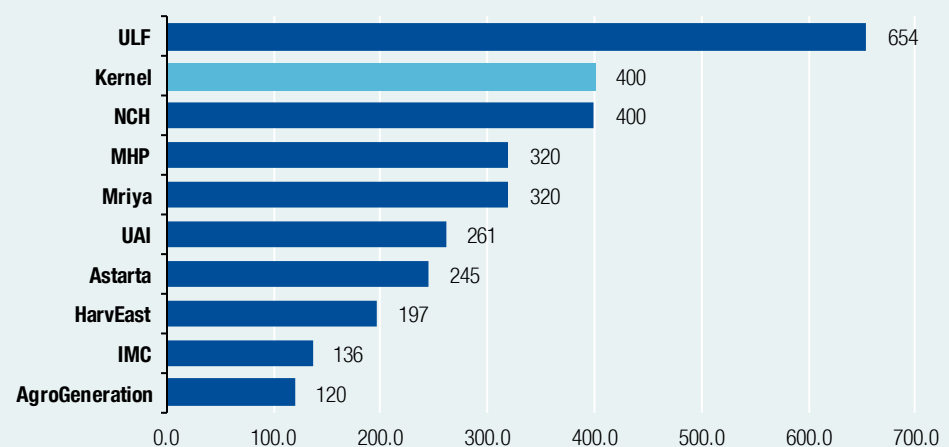
We note that some of the recent acquisitions proved misguided and ill-conceived. We highlight the cases of Stiomi and Druzhba-Nova as examples. The purchase of Stiomi announced two years ago in Apr 2012 still drags on because of the legal dispute between Kernel and the previous owner regarding the deal terms which thus far already resulted in a loss of title to some of the farmland purchased. Furthermore, the latest acquisition of

Druzhba-Nova was particularly shortsighted. The deal was closed just few months before the collapse in grain prices that resulted in a general downturn in the local farmland market that slashed local prices by one-third. Moreover, Kernel failed to retain the previous management team responsible for the company's prior innovation and success. Without it, Druzhba Nova, previously a pioneer of precise farming in Ukraine, was largely reduced to a land bank, in our view.

At present, Kernel is the second largest farmland operator in Ukraine, with 400k ha under control. It shares the second spot with NCH Capital, which also has 400k ha, and ranks right after the clear leader ULF that manages 654k ha. Much like ULF, Kernel has emerged as a leading farming player during the latest phase of the secular bull market that lasted from 2010 to 2013.

Chart 32. Kernel is the second largest commercial farmer in Ukraine

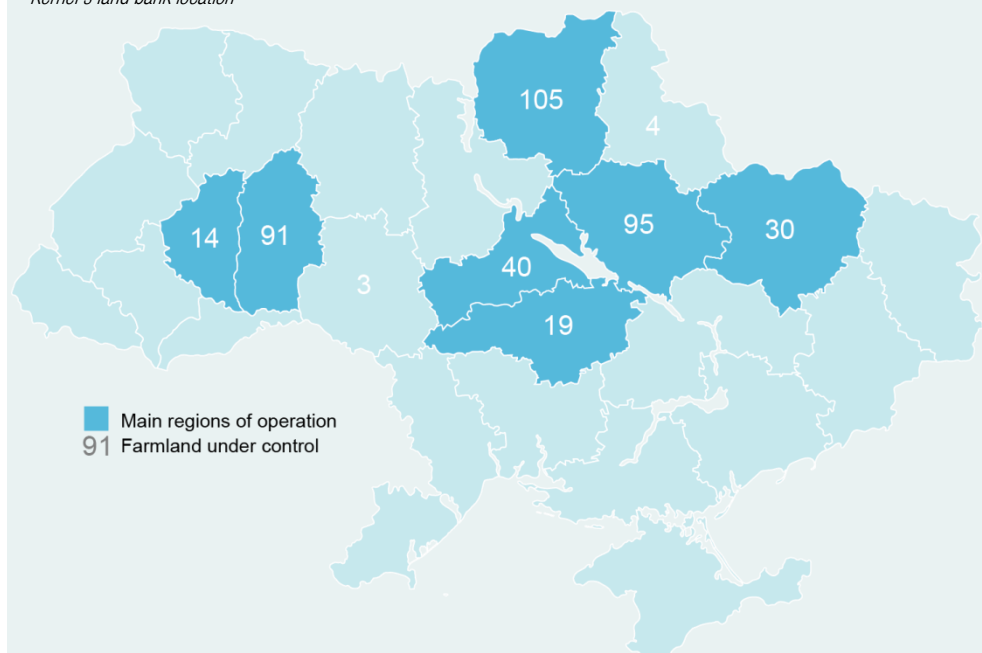
TOP 10 largest farmland operators in Ukraine



Source: ICU

Map 4. Kernel predominantly operates in the advantaged regions with the highest crop yield potential

Kernel's land bank location

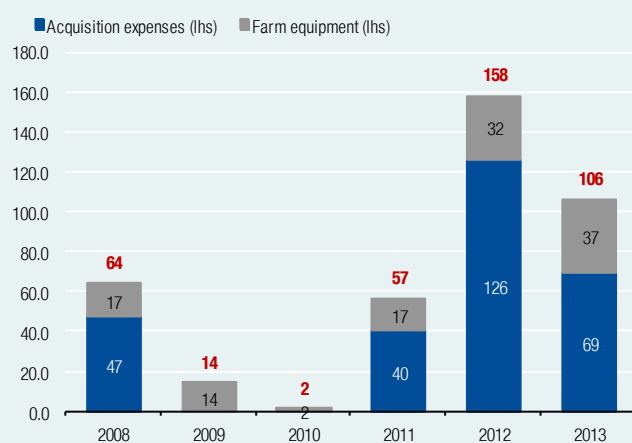


Source: ICU

In total, the company spent nearly US\$400m on the development of its farming business since 2008, of which farm acquisitions consumed US\$282m, and US\$235m was attributed to the latest round of expansion in 2011-2013. Besides, Kernel invested US\$120m into farm equipment. This corresponds to US\$375 per acquired hectare in excess of any equipment the farms previously had.

Chart 33. Farming consumed over US\$400m in investments, bulk of it over the last three years

Annual capital investments in farming business, US\$m



Source: Company, ICU

Cumulative capital investments in farming business, US\$m



Unfortunately for Kernel, its bet on farming has so far fallen short of expectations. Although total investments in this area were comparable to those made into the oilseed crushing business (US\$402m vs US\$378m), the results achieved were vastly different with the farming EBITDA never breaking above \$50m versus nearly US\$200m on average in the oilseed crushing division. The farming business has constantly underperformed due to apparent issues with the integration of recent acquisitions. Worse yet, the cyclical downturn in grain prices this year pushed the division into deep losses which could extend into next year.

Chart 34. Farming heavily underperforms oilseed crushing despite similar capital investments

Farming segment EBITDA, US\$m



Source: Company, ICU

After two years of declining performance, Kernel finally took some steps to remediate the laggard farming division. Recognizing the failure of management, Kernel reshuffled the farming executive team by appointing Evhen Osyrov as the new head of the farming division on May-13 to streamline operations and improve yields to the levels of Kernel's

peers. At the time of hire, Evhen Osyov served as a CEO of fellow-listed IMC, where he worked in this capacity from the date of creation in 2007. IMC achieved good results under his watch and became one of the largest and better managed farming companies in Ukraine. His strong track record speaks in favor of his appointment to turn around Kernel's farming division.

The new director developed a number of initiatives that aim at improved yields. First of all, steps were made to streamline the land bank through the disposal of isolated plots located in high-risk farming regions that steadily achieved sub-par yields. Furthermore, a thorough review of operations recognized corn and soybeans as the weak crops and proposed necessary remediation to production practices. As we have already mentioned, these include a switch to conventional till, modified fertilizer application strategy, and a focus on higher quality seeds and chemicals. Besides, there were select changes within mid-level management accompanied by additional flexibility and powers delegated to cluster-level managers.

The new crop will be a test for the new head of farming and his ability to turn the situation around. While some of the announced initiatives will take 2-3 years to produce results, the rest of the steps should have an immediate visible impact on yields. Higher rates and revised timing of fertilizer application, in addition to higher quality seeds and chemicals, are the factors that should raise yields as soon as this year, assuming normal weather conditions. We anticipate the highest impact will be on corn and soybeans, the main laggards of previous years. As such, we set yield targets for these crops at 7.5 t/ha and 2.0 t/ha, respectively, which implies a nearly 40% improvement over the result of 2013. Meanwhile, we recognize the increased downside risks related to our lofty targets.

Table 21. We assume significantly higher corn and soybean yields for the new crop

Crop		2009	2010	2011	2012	2013	2014	2015
Corn	t/ha	5.3	5.1	7.2	4.4	5.5	7.5	7.9
growth	%		-5%	42%	-39%	26%	36%	5%
Wheat	t/ha	4.2	3.5	3.7	3.5	4.4	4.8	5.0
growth	%		-18%	6%	-3%	23%	10%	5%
Sunflower seeds	t/ha	2.5	2.2	2.1	1.6	2.1	2.3	2.4
growth	%		-14%	-4%	-22%	26%	10%	5%
Soybeans	t/ha	1.6	1.3	1.9	1.3	1.4	2.0	2.1
growth	%		-19%	52%	-34%	11%	43%	5%

Sources: Company, ICU

Our working assumption is that the farming business will eventually recover from the trough and deliver decent results in the long-term. We expect that the current distress will not last beyond fy 2015 with the restructuring gradually taking hold and the company successfully adjusting to the low price environment. Eventually, we see the farming division's EBITDA recovering to over US\$200/ha, corresponding to a 30% EBITDA margin, resulting in a total farming EBITDA contribution of over US\$80m.

Although we give due credit to the new management and assume an eventual recovery, we remain fully aware of the downside risks. There are numerous examples of large farming companies who failed to recover from the previous downturn in grain prices that occurred in 2008-2009. Some of them were subsequently acquired by advantaged competitors (Rise, Dakor, Ukrros), a few disintegrated and were sold in pieces (Ukrzernoprom, Nafkom-Agro), while the remainder struggle with few prospects for growth (Sintal, Agrotom). Kernel may suffer the same fate under certain circumstances, though we admit that such a threat looks

rather remote at present. Nonetheless, the risk of failure could grow dramatically, particularly if the new head of farming does not succeed.

Table 22. Summary: Farming

Financial year		2009	2010	2011	2012	2013	2014	2015
End month		Jun-09	Jun-10	Jun-11	Jun-12	Jun-13	Jun-14	Jun-15
Farmland planted	k ha	78	85	85	181	245	389	388
Total cash crop volumes	kt	-	268	218	550	614	1,372	1,878
Acreage								
Corn	k ha	8	9	8	27	59	162	174
Wheat	k ha	23	27	22	54	58	33	47
Sunflower seeds	k ha	12	15	17	28	38	104	70
Soybeans	k ha	9	14	18	29	55	61	78
Yields								
Corn	t/ha		5.3	5.1	7.2	4.4	5.5	7.5
Wheat	t/ha		4.2	3.5	3.7	3.5	4.4	4.8
Sunflower seeds	t/ha		2.5	2.2	2.1	1.6	2.1	2.3
Soybeans	t/ha		1.6	1.3	1.9	1.3	1.4	2.0
Operating expenses								
Corn	US\$/ha		519	518	764	833	1,079	931
Wheat	US\$/ha		385	385	495	600	688	593
Sunflower seeds	US\$/ha		376	387	461	540	697	601
Soybeans	US\$/ha		341	336	438	509	628	542
Price (exw, VAT excl)								
Corn	\$/t	117	123	172	171	192	135	112
Wheat	\$/t	99	108	158	156	201	170	120
Sunflower seeds	\$/t	269	283	443	418	479	365	301
Soybeans	\$/t	350	358	354	380	463	436	297
External customers	US\$m	9	4	4	26	54	51	63
Intersegment	US\$m	40	38	50	145	139	221	213
Revenue	US\$m	48	42	55	171	193	273	276
EBITDA	US\$/ha	318	167	266	276	205	(91)	30
EBITDA	US\$m	25	14	23	50	50	(35)	12
EBITDA margin	%	52%	34%	42%	29%	26%	-13%	4%

Sources: Company data, Investment Capital Ukraine LLC.

Market overview

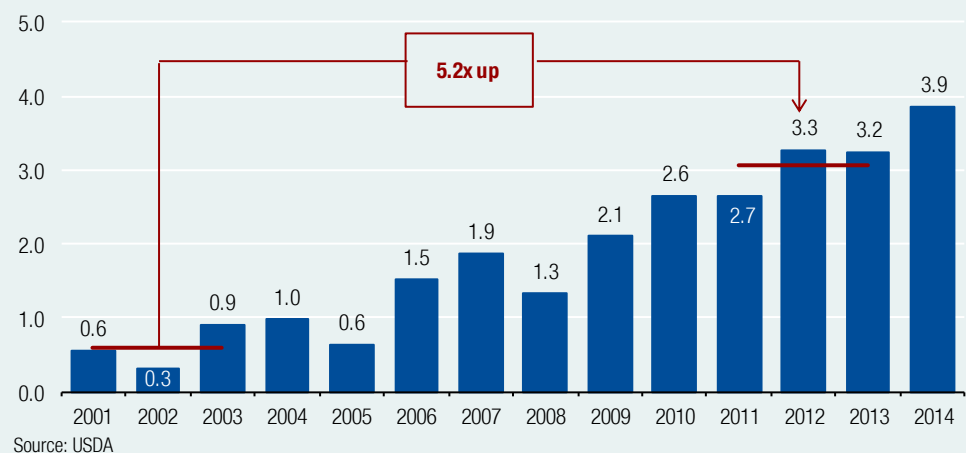
1. Ukraine has emerged as a dominant supplier of sunflower oil to the global market, commanding 55% of the global trade flows.
2. Last year, the local crushing industry entered a phase of tight feedstock supply after many years of relentless capacity expansion.
3. Margin squeezed as a result, with many arguments now in favor of the structural nature of this move.
4. Although it seems that explosive growth of the last decade has come to an end, there is still room for well-conceived greenfield projects that could squeeze out obsolete capacity and benefit from organic growth in oilseed production.

Ukraine's position in the global market

Over the last decade, Ukraine has emerged as a dominant supplier of sunflower oil (SFO) to the global market. Sunflower oil exports from the country have increased from an average of 590 kt during the 2001-2003 seasons to 3,053 kt during the 2011-2013 seasons. Ukraine's share in global trade flows nearly doubled from 27% to 56%.

Chart 35. Ukraine raised its SFO exports 5.2x over the past decade

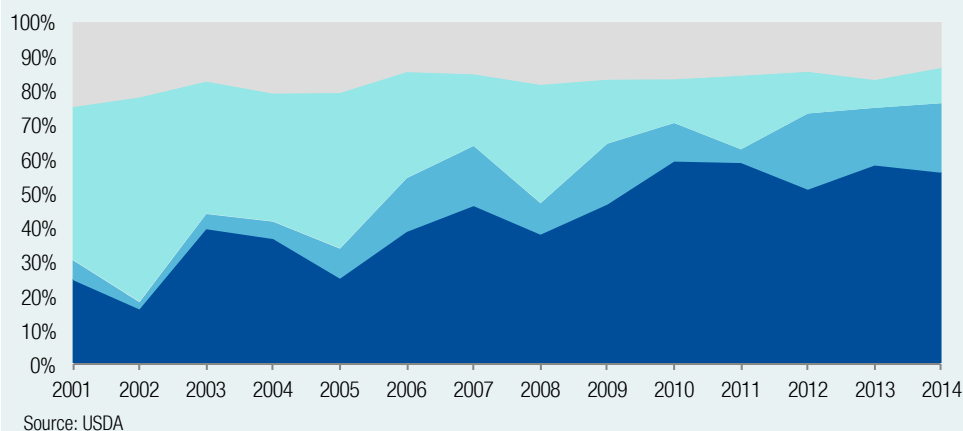
Sunflower oil export volume from Ukraine (mt)



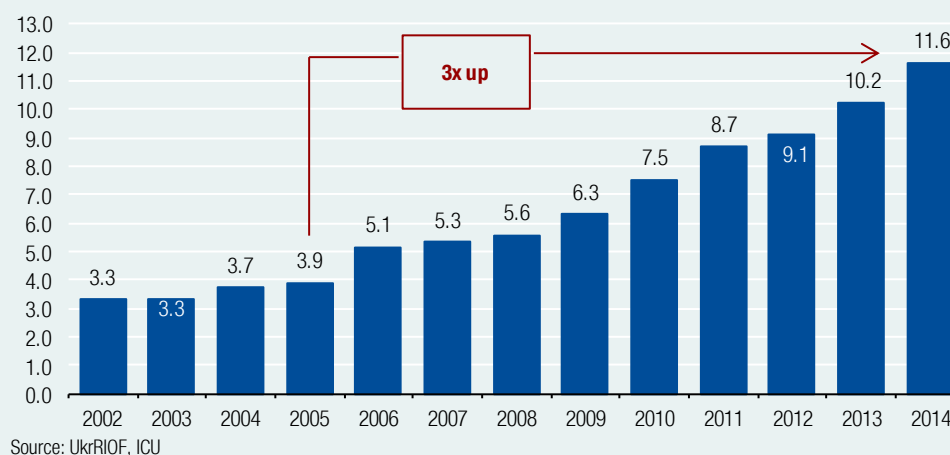
Nowadays, Ukraine is an undisputed leader on global sunflower oil market. In the 2012/13 season, the country shipped 3,245 kt of sunflower oil for exports while its main competitors, Russia and Argentina, exported only 942 kt and 465 kt, respectively. In relative terms, Ukraine commands over half of the global sunflower oil trade flows, with Russia being distant second with a share of 17%.

Chart 36. Ukraine commands over half of global SFO trade flows*Ukraine's share of sunflower oil trade flows*

■ Ukraine ■ Russia ■ Argentina ■ Others

**Local crushing industry overview**

Ukraine's rise to power in the world scene was driven by dramatic multi-year expansion in local crush capacity and oilseed acreage fueled by constantly growing demand for edible oils worldwide. Since 2005, Ukraine's oilseed crushing industry has attracted huge capital investments, with over 20 new crushing plants built across the country on top of the 15-20 existing facilities. Development has intensified over the past five years with about one million tons of additional capacity rolled out each year. As a result, crushing capacity has expanded from 3.9 mtpy in the 2004/05 season to almost 11.6 mtpy in the 2013/14 season – a threefold increase in less than a decade. In parallel, sunflower seed production has jumped from 3.5 mt to 11.0 mt over the same timeframe, driven by planted area expansion and substantial yield improvement.

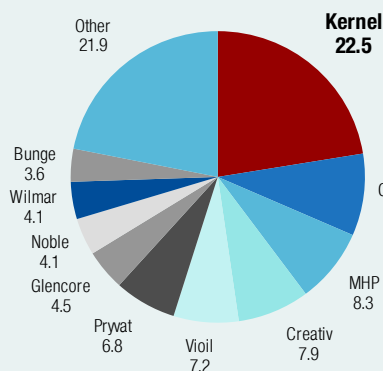
Chart 37. Crushing capacity expanded threefold since 2005*Crushing capacity evolution in Ukraine (mt)*

Ukraine's crush industry is moderately concentrated with the 10 largest players controlling 78% of total capacity. However, within this group, only Kernel has a market share in excess of 10% (22% to be exact), while everyone else falls below this threshold. Over the entire past decade, consolidation efforts were mostly led by Kernel and to some degree by Glencore. Between 2006 and 2011, Kernel purchased two major local competitors and forced Bunge to part with its newly built facility in Illichivsk, thereby lifting its market share to

30% at one point in 2011. However, Kernel's position has been heavily diluted since then (-8pp to the present 22%) due to continued expansion efforts of other participants. After the latest bout of deals which occurred during 2010-2012, consolidation efforts tailed off with an emphasis now entirely on greenfield projects.

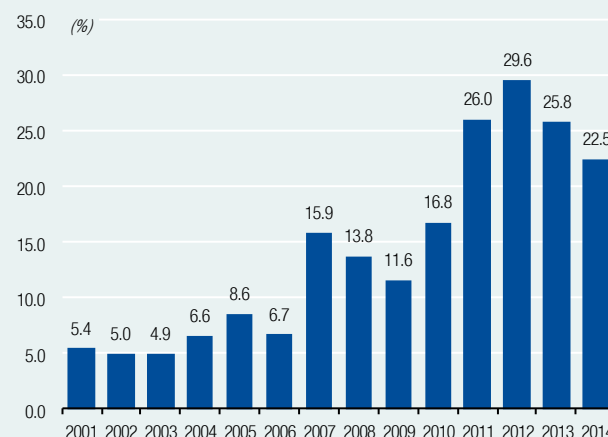
Chart 38. Crushing industry is modestly concentrated with Kernel being largest market consolidator

Breakdown of Ukraine's SFO exports by company



Source: UkrRIOF, ICU

Kernel's market share dynamics

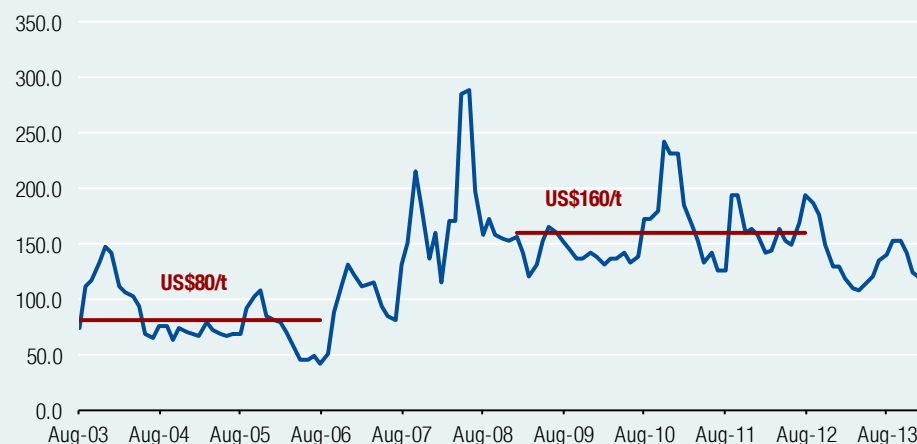


Recent developments

For many years, the crush industry in Ukraine has enjoyed superior profitability, which, along with ample external demand, fueled rapid capacity buildup in the country. The dramatic margin expansion occurred during the commodity boom of 2007 when the crush margin surged above US\$200 per tonne of seeds for a brief moment in 2007 versus the normal level of about US\$80/t seen in previous years. Subsequently, the margin settled at around US\$160/t, which still was twice as much as before. During those years, top players like Kernel, Cargill, and others made profits in excess of US\$200 per tonne of bulk oil sold, equivalent to EBITDA margin north of 15% compared to a normal range of 3-6% earned in developed countries.

Chart 39. Industry enjoyed superior crush margins in boom years

Crush margin per ton of sunflower seeds (US\$/t)



Source: APK-Inform, ICU

In the 2012/13 season, after many years of fast growth, the local crushing industry suffered the first major supply shock after oilseed production for once failed to match the increase in capacity. In that year, four new crushing plants started operations in Ukraine instantly lifting

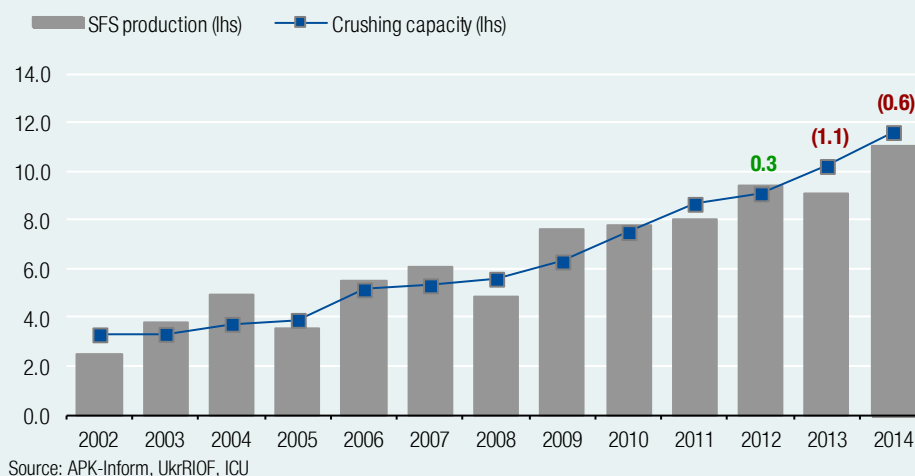
local crushing capacity by a combined 1.1 mt. In contrast, the sunflower seed crop dropped by 0.3 mt y/y on adverse weather despite higher planted area. A significant feedstock deficit developed as a result, forcing crushers to engage in fierce competition for oilseeds that became particularly intense towards the end of the season.

No wonder that the crush margin collapsed under such circumstances. Profit per tonne of oil, as evidenced by Kernel's result, declined 17%, which was the first such significant margin compression in years. Sharp deterioration was particularly pronounced towards the end of the year when crushers facing extremely tight oilseed supplies drove the price of sunflower seeds up by 10% to over US\$500/t (excl VAT) against flat to slightly lower sunflower oil. Hence, in the second half of the year, the crush margin dropped by 30% compared to the first half and by 23% year-over-year.

After the worst season in recent history, the industry is set to enjoy a substantially improved feedstock supply this year in light of a record-high sunflower seed crop. In 2013, Ukraine harvested 11.0 mt of sunflower seeds which was by far the largest crop on record. As a result, oilseed supply improved by 1.5-2.0 mt compared to the previous year. While capacity has also increased (+1.4 mt to a total 11.6 mt) with the launch of 3-4 new crushing plants, overall the balance sheet should still be much healthier than in 2013. Our estimates imply that the sunflower seeds shortage might decline from 1.1 mt in 2013 to 0.6 mt in 2014, at least partially relieving the industry from extreme stress.

Chart 40. Last year's bumper crop greatly improved sunflower seed availability

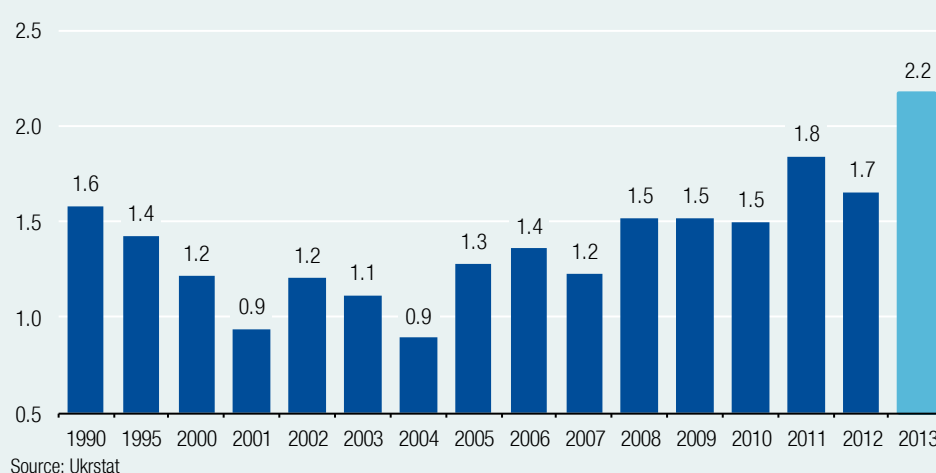
Ukraine's sunflower seed balance, mt



Nevertheless, we are not convinced that a meaningful recovery in the crush margin is at hand. Since the start of the new season, the spot crush margin has been lingering below levels seen last year despite significantly improved oilseed availability. While this situation might look puzzling at first glance, there might actually be a reason behind it. While sunflower oil and meal export prices have dropped 20-30% y/y driven by a decline in soybean oil futures (-19% y/y in DecQ-13), with the crush margin essentially flat year-over-year, local farmers were forced to sell their sunflower seeds at prices up to 30% below the previous year. If crushers were to insist on higher margin now, farmers with higher costs who held back on sales, ultimately undercutting the oilseed supply to crushing plants, would sell at even lower prices. Thus, the current modest crush margin might in fact be justified, given the above argument.

Chart 41. Crush margin trails behind last year despite improved supply*Crush margin per ton of sunflower seeds, US\$/t***Near-term outlook**

After an all-time-high crop, we naturally expect a lower crop next year, which should reduce sunflower seed availability and put further pressure on the crush margin in the 2014/15 season. Beating this year's bumper crop is a tough task. Planted area will probably benefit from a switch out of troubled corn. However, the critical factor is not acreage but yields which have jumped this year to a record 2.2 t/ha, or 35% above the 5yr avg of 1.6 t/ha. Unless this much-higher yield is sustained, the 2014 crop will fall below this year's level, perhaps materially, bringing back pressure on the feedstock supply. On the other side of the equation, all recently started plants will be able to work at full throttle next year which should raise the total effective crush capacity even in the absence of new project launches. Altogether, it looks that the 2014/15 season will see significantly lower oilseed availability and renewed margin pressure.

Chart 42. Last year's bumper yield will be hard to match*Country average sunflower seed yield, t/ha*

Overall, it seems that the explosive growth of the last decade is finally coming to a halt. The depressed crush margin and shrinking sunflower seed availability made new projects much less attractive than before. This is fully reflected in the current thin project pipeline which features no facilities under construction and only one or two significant projects in the planning stage. One of them is from Bunge which intends to build a large crush plant (787

kt) right next to its grain terminal in Mykolaiv. The project was announced in Apr-13 and still waits to move to the construction stage. Press reports also mention a new project in Yuzhnyy (656 kt) contemplated by Allseeds Black Sea, led by one of the former owners of Allseeds. However, we would say that this project looks much less certain than the one from Bunge because of inferior funding options available to local players under current circumstances.

Our view on long-term industry profits

In the long-term, we doubt the return to the traditional EBITDA margin of US\$200-210 per tonne of oil, relevant for large crushers with modern facilities, is possible in a sustainable manner. ROIC at this level was high enough to spur a huge wave of investment in fixed capital over the past couple years that resulted in rampant overcapacity and a subsequent drop in profitability.

The big question now is where the new equilibrium margin is going to be. Unfortunately, there is no definite answer to this question. In our view, all efforts to arrive at any single number are futile. Instead, we would rather focus on identifying the possible levels of support and resistance.

We see long-term EBITDA margin somewhere in the range of US\$135-200/t, perhaps closer to the low end. Resistance obviously sits at US\$200/t because this is the level that was historically proved to incentivize new projects. Finding support is a harder task. In our view, one should look for a minimal rate of return that would still motivate investment in the sector as a reference point. It is reasonable to take major multinational crushers like ADM and Bunge because they have lower ROIC targets due to superior funding options. Their explicit objective for ROIC is WACC + 2pp. At present, their WACC is around 6% albeit in the environment of historically low interest rates. Under normal circumstances, their WACC might rise to 8%. So, target ROIC would stay at around 10%. For Ukraine, it should be somewhat higher due to high country risks (ownership rights and tax issues) so we would add a minimum of two extra percentage points to base ROIC for projects in Ukraine. Eventually, we arrive at a fair ROIC of 12% which translates into approximately US\$135/t in EBITDA margin under a number of assumptions regarding project cost and working capital turnover.

Growth options

At present, although there seems to be no room for new SFS-based crushing projects in Ukraine, growth options may emerge over time, particularly those driven by organic growth in oilseed production and the gradual shut-down of obsolete capacity. The hyper-expansion of recent years and resulting tight feedstock supply cut the prospects for significant capacity additions in the near-term. However, the industry might still be able to accommodate another several large crushing projects over time. New opportunities lie in the eventual retirement of older capacity under pressure from decreasing margins and the gradual expansion in sunflower seed production if oilseeds continue to command better economics than grains do on a local level.

If at some point in the future the margin moves towards the lower end of our target range, a dozen obsolete facilities across the country will be mothballed. Those facilities are scattered principally across the eastern and southern sections of the traditional Sunflower Belt and currently account for 2.2 mt of country's crushing capacity. Their largest disadvantage is a high crush cost which easily exceeds that of modern facilities by a factor of two. Moreover, they typically have to pay more for their feedstock due to significantly higher competition in those locations. As it makes little economic sense to upgrade those facilities, we would expect the majority of them to be ultimately shut down and replaced by new projects.

Regarding long-term sunflower seed supply, we ultimately see it in a 12-16 mt range which over time should help resolve the issue of excess capacity and maybe even accommodate a number of additional projects. The estimated range is based on planted acreage of 5.8-6.7 m ha (vs 5.1 m ha harvested in 2013) and a weighted-average yield of 2.0-2.4 t/ha (vs 5yr avg 1.6 t/ha).

Given superior returns compared to grains and the lack of other options in high-risk farming areas of Ukraine, oilseeds will probably continue to conquer additional acres in crop rotation. We believe that acreage under sunflower could ultimately reach 5.8-6.7 m ha over the next decade (vs 5.1 m ha harvested in 2013). Meanwhile, ultimate success in the wide adoption of soybeans should determine whether it is going to be at the higher or lower end of the range as soybeans increasingly compete with sunflower on the perimeter of traditional Sunflower Belt.

In this light, yield expansion might be viewed as a more important driver of production growth. Yields in Ukraine have been constantly rising from 1.1 t/ha on avg in 2001-2005 to 1.7 t/ha in 2009-2013. Given the results of more efficient farmers who consistently achieve yields to the tune of 3 t/ha, we view the target range of 2.0-2.4 t/ha as absolutely reasonable.

Table 23. Estimated long-term sunflower seed production in Ukraine

Crop			2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Long-term target	
													Min	Max
Total planted cropland														
Sunflower Belt	mn ha		15.1	14.7	15.1	15.2	15.6	15.5	15.4	15.7	15.6	16.0	16.0	16.0
Perimeter	mn ha		8.5	8.2	7.8	7.9	8.4	8.4	8.5	8.7	8.9	9.0	9.0	9.0
Other	mn ha		3.1	3.1	3.0	3.0	3.1	3.1	3.1	3.2	3.3	3.3	3.3	3.3
Total	mn ha		26.8	26.0	25.9	26.1	27.1	27.0	27.0	27.7	27.8	28.3	28.3	28.3
Sunflower acreage														
Sunflower Belt	mn ha		3.1	3.4	3.6	3.1	3.8	3.8	3.9	4.0	4.3	4.1	4.6	5.1
Perimeter	mn ha		0.3	0.3	0.3	0.3	0.4	0.4	0.6	0.7	0.8	0.9	1.1	1.5
Other	mn ha		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Total	mn ha		3.4	3.7	3.9	3.4	4.3	4.2	4.5	4.7	5.1	5.1	5.8	6.7
Share in crop rotation														
Sunflower Belt	%		21%	23%	24%	21%	25%	24%	25%	25%	27%	26%	29%	32%
Perimeter	%		3%	4%	4%	3%	5%	5%	7%	8%	9%	10%	12%	16%
Other	%		0%	0%	0%	0%	1%	0%	1%	1%	1%	1%	2%	2%
Total	%		13%	14%	15%	13%	16%	16%	17%	17%	18%	18%	20%	24%
Yield														
Sunflower Belt	t/ha		0.9	1.3	1.4	1.2	1.5	1.5	1.5	1.8	1.6	2.1	1.9	2.3
Perimeter	t/ha		0.9	1.3	1.3	1.5	1.7	2.0	1.7	1.9	2.1	2.5	2.4	2.8
Other	t/ha		1.0	1.1	1.1	1.3	1.5	1.6	1.3	1.7	1.7	2.1	1.9	2.3
Total	t/ha		0.9	1.3	1.4	1.2	1.5	1.5	1.5	1.8	1.7	2.2	2.0	2.4
Production														
Sunflower Belt	mt		2.8	4.3	4.9	3.8	5.8	5.5	5.7	7.2	6.7	8.7	8.9	11.6
Perimeter	mt		0.2	0.4	0.4	0.4	0.7	0.8	1.0	1.4	1.6	2.3	2.6	4.2
Other	mt		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.2
Total	mt		3.0	4.7	5.3	4.2	6.5	6.4	6.8	8.7	8.4	11.0	11.6	15.9

Sources: Ukrstat, ICU

Appendix 1. Peer analysis

Company	Ticker	Country	Mkt Cap (US\$m)	EV/EBITDA			EBITDA margin		
				LTM	2014	2015	LTM	2014	2015
Local food producers									
MHP	MHPC LI	Ukraine	1,321	6.2	5.1	4.6	27%	32%	31%
Astarta	AST PW	Ukraine	339	6.6	4.5	5.1	20%	27%	20%
Local median				6.4	4.8	4.9	24%	29%	26%
Traders									
ADM	ADM US	United States	29,031	10.5	7.8	7.6	3%	5%	5%
Bunge	BG US	United States	11,709	11.8	9.5	9.0	3%	4%	4%
Andersons	ANDE US	United States	1,756	13.3	8.0	7.8	3%	4%	4%
Grain Corp	GNC AU	Australia	1,906	7.1	9.0	7.4	8%	8%	9%
Traders median				11.2	8.5	7.7	3%	4%	4%
Crushers									
IOI	IOI MK	Malaysia	9,406	16.9	16.1	15.5	17%	17%	17%
Kuala Lumpur Kepong	KLK MK	Malaysia	7,861	16.2	14.2	12.8	17%	18%	18%
Felda	FGV MK	Malaysia	5,167	13.4	12.2	11.3	11%	9%	10%
Genting Plantations	GENP MK	Malaysia	2,548	20.8	15.8	12.7	28%	35%	37%
TSH Resources	TSH MK	Malaysia	911	21.7	14.7	13.5	17%	22%	23%
Hap Seng Plantations	HAPL MK	Malaysia	679	12.1	8.8	7.7	37%	45%	46%
Malaysia median				16.6	14.4	12.7	17%	20%	20%
Astra Agro Lestari	AALI IJ	Indonesia	3,771	11.6	10.3	9.2	28%	29%	30%
Salim Ivomas	SIMP IJ	Indonesia	1,287	8.3	6.8	6.1	18%	21%	22%
London Sumatra	LSIP IJ	Indonesia	1,420	n/a	10.2	8.9	n/a	31%	33%
BW Plantation	BWPT IJ	Indonesia	526	17.5	11.5	8.9	42%	50%	52%
Sampoerna Agro	SGRO IJ	Indonesia	336	10.0	6.6	5.6	18%	22%	25%
Indonesia median				10.8	10.2	8.9	23%	29%	30%
Wilmar	WIL SP	Singapore	17,741	18.1	16.3	14.7	5%	5%	5%
Golden Agri	GGR SP	Singapore	6,103	10.9	10.2	9.0	11%	11%	12%
First Resources	FR SP	Singapore	3,202	10.1	9.8	8.5	56%	48%	47%
Indofood Agri	IFAR SP	Singapore	1,234	9.4	8.6	7.3	20%	20%	22%
Mewah	MII SP	Singapore	590	14.6	11.8	10.1	2%	2%	2%
Singapore median				10.9	10.2	9.0	11%	11%	12%
China Agri Industries	606 HK	Hong Kong	2,139	102.1	8.4	7.6	0%	4%	4%
Fuji Oil	2607 JP	Japan	1,162	5.9	6.1	5.8	10%	9%	9%
Other Asia-Pacific median				54.0	7.3	6.7	5%	7%	7%
Crushers median				13.4	10.3	9.0	17%	21%	22%
Farmland operators									
Adecoagro	AGRO US	Luxembourg	1,089	11.9	7.3	6.5	20%	28%	30%
SLC Agricola	SLCE3 BZ	Brazil	829	10.1	8.7	7.6	22%	22%	23%
Cresud	CRES AR	Argentina	621	25.6	10.0	8.0	10%	37%	40%
Brasilagro	AGRO3 BZ	Brazil	240	35.2	13.1	9.0	9%	21%	26%
Farmland operators median				18.7	9.3	7.8	15%	25%	28%
Kernel	KER PW	Ukraine	761	9.5	6.8	5.9	8%	9%	12%
Discount/(premium) to									
MHP				-53%	-33%	-27%			
Astarta				-44%	-52%	-16%			
Traders				15%	19%	24%			
Crushers				29%	33%	34%			
Farmland operators				49%	27%	24%			

Source: Bloomberg, ICU

Appendix 2. Summary of financials

Financial year		2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
INCOME STATEMENT											
Net revenue	US\$m	1,047	1,020	1,899	2,072	2,797	2,493	2,152	1,971	2,014	2,078
Cost of sales	US\$m	(714)	(711)	(1,432)	(1,597)	(2,361)	(2,086)	(1,720)	(1,538)	(1,566)	(1,614)
Gross profit	US\$m	333	310	467	475	436	407	432	433	448	464
SG&A	US\$m	(167)	(161)	(208)	(266)	(316)	(315)	(278)	(259)	(261)	(266)
Other operating income, net	US\$m	18	10	10	24	64	39	20	27	28	29
D&A	US\$m	23	23	32	66	90	92	85	81	78	76
EBITDA	US\$m	208	181	301	299	273	223	259	282	294	303
Other income, net	US\$m	(8)	7	(26)	7	(15)	(42)	12	18	18	19
EBIT	US\$m	177	166	242	241	169	90	186	219	234	246
Interest expense, net	US\$m	(32)	(23)	(42)	(63)	(75)	(66)	(85)	(60)	(50)	(53)
PBT	US\$m	145	143	200	178	94	23	101	159	183	193
Income tax expense	US\$m	5	0	18	9	(6)	(9)	(21)	(22)	(24)	(25)
Net profit	US\$m	150	143	217	187	88	14	79	137	159	168
Unusual items	US\$m	-	-	-	-	-	-	-	-	-	-
IAS41 gains	US\$m	(18)	9	9	24	17	(21)	-	-	-	-
Net profit, after unusuals and gains	US\$m	132	152	226	211	105	(7)	79	137	159	168
BALANCE SHEET											
Cash and equivalents	US\$m	129	59	116	83	79	84	67	197	343	492
Accounts receivable	US\$m	32	65	112	146	150	137	118	108	110	114
Inventories	US\$m	99	148	184	410	270	286	236	211	215	221
Biological assets	US\$m	19	26	96	153	247	224	183	191	196	196
Other current assets	US\$m	99	300	303	326	352	328	180	203	205	210
Current assets	US\$m	378	599	810	1,118	1,097	1,058	784	910	1,068	1,232
Fixed assets	US\$m	222	379	503	728	767	759	756	756	759	765
Intangibles	US\$m	81	118	152	228	320	300	283	268	256	245
Investments in associates	US\$m	-	-	-	-	94	94	94	94	94	94
Other long-term assets	US\$m	19	29	109	41	88	68	68	68	68	68
Long-term assets	US\$m	321	526	763	998	1,269	1,220	1,200	1,186	1,176	1,172
Total assets	US\$m	700	1,125	1,573	2,116	2,367	2,279	1,984	2,096	2,245	2,404
Short-term borrowings	US\$m	162	210	266	266	450	444	246	250	255	260
Accounts payable	US\$m	8	11	27	25	52	46	38	34	34	35
Other short-term liabilities	US\$m	26	131	102	155	204	94	77	69	70	73
Current liabilities	US\$m	195	352	395	446	705	583	361	353	359	368
Long-term borrowings	US\$m	133	135	156	427	276	296	164	167	170	173
Other long-term liabilities	US\$m	14	32	24	33	34	34	34	34	34	34
Long-term liabilities	US\$m	147	168	180	460	309	329	197	200	203	207
Total liabilities	US\$m	342	520	575	906	1,015	913	558	553	563	574
Share capital	US\$m	278	360	501	506	506	506	506	506	506	506
Retained earnings	US\$m	240	392	618	825	947	961	1,020	1,137	1,276	1,424
Reserves	US\$m	(162)	(149)	(147)	(151)	(118)	(118)	(118)	(118)	(118)	(118)
Treasury shares	US\$m	-	-	-	-	-	-	-	-	-	-
Non-controlling interest	US\$m	2	3	26	31	18	18	18	18	18	18
Equity	US\$m	357	605	997	1,211	1,352	1,366	1,426	1,543	1,682	1,830
Total liabilities & equity	US\$m	700	1,125	1,573	2,116	2,367	2,279	1,984	2,096	2,245	2,404

Appendix 2. Summary of financials (cont)

Financial year		2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
CASH FLOW STATEMENT											
Profit before tax	US\$m	145	143	200	178	94	23	101	159	183	193
Non-cash adjustments	US\$m	11	40	40	47	90	92	85	81	78	76
Change in working capital	US\$m	(25)	(97)	(180)	(242)	157	42	233	(9)	(11)	(11)
Income tax expense	US\$m	(2)	(1)	(3)	(7)	(43)	(40)	(21)	(22)	(24)	(25)
Cash from operating activities	US\$m	129	85	56	(24)	298	117	398	210	226	233
Capital expenditures	US\$m	(89)	(56)	(48)	(93)	(86)	(63)	(65)	(67)	(69)	(71)
Acquisitions	US\$m	(7)	(69)	(78)	(137)	(174)	(83)	-	-	-	-
Other investing activities	US\$m	-	-	-	1	(2)	21	-	-	-	-
Cash from investing activities	US\$m	(95)	(126)	(126)	(229)	(262)	(125)	(65)	(67)	(69)	(71)
Change in borrowings	US\$m	36	(77)	(18)	220	(45)	14	(330)	7	8	8
Shares sale	US\$m	-	81	141	5	-	-	-	-	-	-
Dividends paid	US\$m	-	-	-	-	-	-	(20)	(20)	(20)	(20)
Other financing activities	US\$m	-	-	-	-	-	-	-	-	-	-
Cash from financing activities	US\$m	36	4	124	225	(45)	14	(350)	(13)	(12)	(12)
Net changes in cash	US\$m	70	(37)	54	(28)	(10)	5	(17)	130	146	150
Cash and equivalents (bop)	US\$m	59	98	58	110	83	73	78	61	191	336
Translation difference	US\$m	(30)	(3)	(1)	0	0	-	-	-	-	-
Cash and equivalents (eop)	US\$m	98	58	110	83	73	78	61	191	336	486
Cash restricted	US\$m	31	2	6	-	6	6	6	6	6	6
RATIOS											
Earnings	US\$/sh	2.18	1.93	2.87	2.35	1.10	0.17	0.99	1.71	1.98	2.10
Dividends	US\$/sh	-	-	-	-	-	-	0.25	0.25	0.25	0.25
Book value	US\$/sh	5.2	8.2	13.2	15.2	16.9	17.1	17.8	19.3	21.0	22.9
EBITDA	US\$/sh	3.03	2.45	3.98	3.76	3.42	2.79	3.24	3.53	3.67	3.79
Net debt	US\$/sh	2.55	4.07	6.54	7.69	11.47	10.63	7.33	6.12	6.44	6.62
Growth											
Sales	%	58%	-3%	86%	9%	35%	-11%	-14%	-8%	2%	3%
Gross profit	%	102%	-7%	51%	2%	-8%	-7%	6%	0%	3%	3%
EBITDA	%	86%	-13%	66%	-1%	-9%	-18%	16%	9%	4%	3%
Net profit	%	111%	-5%	52%	-14%	-53%	-84%	472%	73%	16%	6%
Margins											
Gross	%	31.8%	30.3%	24.6%	22.9%	15.6%	16.3%	20.1%	22.0%	22.3%	22.3%
EBITDA	%	19.9%	17.8%	15.8%	14.4%	9.8%	8.9%	12.0%	14.3%	14.6%	14.6%
Net	%	14.3%	14.0%	11.4%	9.0%	3.1%	0.6%	3.7%	7.0%	7.9%	8.1%
Net profit margin	%	14.3%	14.0%	11.4%	9.0%	3.1%	0.6%	3.7%	7.0%	7.9%	8.1%
Total asset turnover	x	1.44	1.02	1.19	1.05	1.10	0.99	0.95	0.90	0.86	0.83
ROA	%	20.6%	14.3%	13.7%	9.5%	3.4%	0.5%	3.5%	6.3%	6.8%	6.7%
Equity multiplier	x	1.82	2.07	1.98	1.78	1.99	1.86	1.63	1.47	1.45	1.42
ROE	%	37.6%	29.7%	27.1%	16.9%	6.8%	1.0%	5.7%	9.2%	9.9%	9.6%
NOPAT	US\$m	139	127	190	198	142	74	153	192	204	216
Invested capital	US\$m	537	923	1,328	1,854	2,032	2,055	1,802	1,796	1,797	1,804
NOPAT margin	%	13.2%	12.4%	10.0%	9.6%	5.1%	2.9%	7.1%	9.7%	10.2%	10.4%
Capital turnover	x	1.95	1.11	1.43	1.12	1.38	1.21	1.19	1.10	1.12	1.15
ROIC	%	25.8%	13.7%	14.3%	10.7%	7.0%	3.6%	8.5%	10.7%	11.4%	12.0%
FCF	US\$m	41	29	8	(117)	212	53	333	143	157	161
FCF conversion	%	27%	20%	4%	n/m	242%	384%	419%	104%	99%	96%
Net debt	US\$m	165	286	306	610	646	655	342	219	82	(60)
D/E	x	0.82	0.57	0.42	0.57	0.54	0.54	0.29	0.27	0.25	0.24
ND/EBITDA	x	0.79	1.58	1.02	2.04	2.36	2.94	1.32	0.78	0.28	n/m
Interest coverage	x	6.45	7.95	7.09	4.74	3.65	3.36	3.03	4.70	5.83	5.72

Source: Company, ICU

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