Executive Summary

- The stock of Donetskgirmash [DGRM UZ] has long remained a rather promising pick in the market due to its noticeably lower than the industry’s average EV/Sales and P/Sales ratios. However, for the last two years the negative profitability has been inevitably reported by the company at the year-end: USD 3.5 mln net loss in 2006 was followed by the USD 7.2 mln net loss in 2007.

- We have previously issued a “Buy” recommendation for DGRM based on the assumption that the company has been temporarily artificially inflating its costs thus showing negative earnings for the reasons related to the corporate IUD vs SCM ownership conflict. However, according to the leaked information, the conflict of the parties is no longer in play.

- According to the source, DGRM’s poor financials are mostly likely due to the inherent fundamental weaknesses as well as poor corporate governance within the company, with its operational decline propelled further by the ailing state of the domestic coal industry.

- Crucially, in the second half of October, the Ukrainian stock market was anticipating the corporate conflict at DGRM to be soon over which caused the sudden rally of DGRM stock which increased its market capitalization two times within couple of weeks, with the historically highest price deal struck at almost USD 0.70 per share.

- During the following months the price of the stock has gradually declined down to its current USD 0.40 per share, heated by the rumors that SCM was no longer interested in gaining total control over the company, while the company’s production capacities are outdated to a greater extent than most investors would think.

- We do acknowledge the fact that the information we currently have on hand might not be one hundred percent accurate and complete, which is why we are far from recommending the investor to get rid of the DGRM stock and sell it. In fact, we concede that the ongoing technical modernization at DGRM might affect positively the company’s production capacities.

- By the same token, possible improvements in the state of the domestic coal industry might become a source of additional orders for the machinery produced by DGRM in the mid- to long-term. However, at the moment, we believe that the risks of investing in the company with the two- year history of negative earnings must be substantially offset by the potential returns from such investment, which, at present, hardly seems to be the case.

Recommendation

We change our recommendation for DGRM from “Buy” to “Not Rated” given the substantial amount of risks and uncertainties associated with the company’s valuation at the given moment. We will, however, keep monitoring the progress of the company. Should any new relevant information become available, we will be sure to adjust our recommendation on DGRM stock accordingly.
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