

Teleset Networks

 FAIR VALUE CUT ON A CAUTIOUS WACC
 CALCULATION


 Buy
 169%
 Upside

8 December 2008

▲ Fair value cut due to cautious WACC increase

We have cut our fair value for Teleset Networks (Teleset) from USD 0.72 to USD 0.69 as the result of a temporary move to reassess our country specific risks in the light of the current economic climate. We note, however, that under our original calculation basis our fair value would be USD 1.00, or 287% upside. The main growth drivers are the acquisition of a fixed line operator in Ulyanovsk in September 2008 and the planned launch of long distance zonal services across the company's region of operations in 2009. We consider the WACC increase as a temporary measure which we intend to readjust as soon as the market's perception of Russia's risks has altered. We have also increased the company's cost of debt. Overall our WACC moves from 12.5% to 16.3%. Our new fair value still suggests 169% upside potential for the stock and a Buy recommendation.

▲ First acquisition outside Tatarstan

In September 2008 Teleset announced the acquisition of a 51% stake in Simbirsky Telecommunications Systems (STS), a Russian fixed line operator in Ulyanovsk city. The acquired company holds about 28,700 subscribers or 13% of the fixed line market in the city and should add about 22% to Teleset's subscriber base. STS saw USD 4.6mn in revenues in 2007, which equates to approximately 20% of Teleset's revenues during the same year.

▲ Teleset is an attractive acquisition target

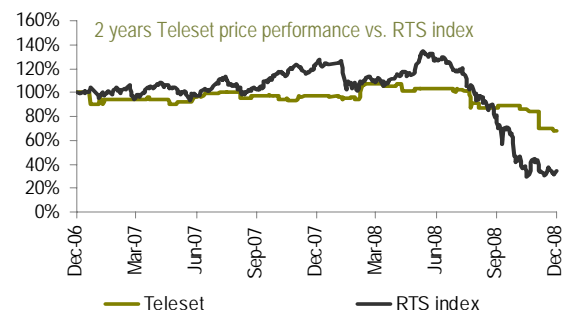
We think Teleset may be an attractive acquisition target for one of Russia's telecom majors. In the current market a deal with a proper valuation premium for existing shareholders may be hard to achieve. At the same time as soon as the market recovers telecom majors such as Comstar, VimpelCom and Rostelecom should be looking for regional expansion and last mile access. We would not be surprised if they consider Teleset as a strategic target and are willing to pay a premium to our conservative fair value.

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Rating	BUY
Fair Value (Comm.), USD	0.69
Current Price (Comm.), USD	0.26
Market Cap, USD mn	40.6
EV, USD mn	50.9
Bloomberg	TNW LN
Common Shares Outstanding, mn	157.6
52 Week High, USD:	0.85
52 Week Low, USD:	0.26
Free float %	5.3%
Average daily traded volume, USD 000	3.7
Share price performance over the last:	
1 month	-3%
3 months	-24%
12 months	-29%



Summary Valuation and Financials

	Revenues, USD '000	EBITDA*, USD '000	EBITDA margin, %	Net Income, USD '000	P/E (x)	EV/EBITDA (x)	EV/Revenues (x)
2007	22,737	12,470	54.8%	5,143	7.9	4.1	2.2
2008E	30,305	16,346	53.9%	7,662	5.3	3.1	1.7
2009E	38,726	22,270	57.5%	10,394	3.9	2.3	1.3
2010E	43,971	24,997	56.9%	11,514	3.5	2.0	1.2

* We calculate EBITDA as operating profit before depreciation and amortisation

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Investment summary

Fair value decreased on concerns over Russia's country risk

We have cut our fair value for Teleset from USD 0.72 to USD 0.69 as the result of a temporary move to reassess country specific risks in the light of the current economic climate. We have also increased the cost of debt for the company and so overall our WACC moves from 12.5% to 16.3%. Our new fair value nevertheless suggests 169% upside potential for the stock and a Buy recommendation.

New acquisition should add value

In September 2008 Teleset announced the acquisition of a 51% stake in Simbirsky Telecommunications Systems (STS), a fixed line operator in the city of Ulyanovsk. This was the first step by Teleset to acquire assets outside of Tatarstan. The acquired company holds about 13% of the fixed line market in Ulyanovsk city and should add about 22% to Teleset's subscriber base. STS saw USD 4.6mn of revenues in 2007, which equates to approximately 20% of Teleset's revenues during the same year.

Zonal license should add to the revenues stream

Teleset plans to launch zonal (long distance) services for its subscribers in 2009. This should allow the company to boost its revenues stream from long distance services and improve EBITDA margins going forward. Following the introduction of the new services we expect revenues from zonal services to more than double y-o-y in 2009 from an estimated USD 1.6mn in 2008 to USD 3.9mn. We forecast this area to generate about 8% of total revenues in 2012.

The company might be an attractive target for M&A

Russian telecom companies such as Comstar, Golden Telecom (VimpelCom) and Rostelecom are also looking for regional expansion. Teleset is in our view an attractive target for these companies as acquiring an asset such as Teleset might provide a large company with further growth opportunities. At the same time, an acquisition of Teleset could represent an exit strategy for shareholders.

Within the current market conditions a deal with a proper valuation premium for existing shareholders seems unlikely. At the same time the telecom majors are all looking for regional expansion and last mile access. This should lead to any potential buyer being prepared to pay a significant premium to our fair value of USD 0.69 per share, which we consider to be very conservative.

Comstar has historically paid in the range of 5-8x EBITDA for regional fixed line private operators. Applying a 7x EV/EBITDA to Teleset's estimated 2008 EBITDA provides an estimated EV of USD 114.4 mn, or 0.73 per share.

The acquisition of Golden Telecom by VimpelCom at the end of 2007 might also provide a benchmark for the potential acquisition value of Teleset. VimpelCom paid 10.7x the estimated 2008 EBITDA for 100% of Golden Telecom. This suggests USD 164.6mn for 100% of Teleset or USD 1.04 per share. This would provide Teleset shareholders with potential upside of about 300% to the current price. However, we believe VimpelCom overpaid for Golden Telecom and give this valuation merely for the sake of comparison.

Risks

Local voice service tariffs are state regulated. This provides a certain risk to about 42% of the company's revenues as the regulators may not increase tariffs in line with our expectations. However, we think this is unlikely to happen as we have modelled a conservative 8% y-o-y average growth in tariffs. In contrast, regional fixed line operators under Svyazinvest are looking for about a 10% increase in 2009 and growth at least in line with the CPI going forward. We also note that the government's long-term CPI forecast is about 6% y-o-y and, historically, tariffs have risen above the CPI rate.

A rise in borrowing costs. Teleset might be exposed to the risk of higher borrowing costs due to the financial crisis. The company may need to borrow to fund any additional acquisitions or to cover capex costs. However, we argue that the company's balance sheet is currently in very good shape. At the end of 1H 08 the company's net debt/equity ratio was 0.18x. This is the lowest debt level among fixed line telecoms operators in Russia. An alternative to borrowing could be to issue more shares via a placement.

Slowdown in the regional economy. Teleset might suffer from a slowdown in the growth of Tatarstan's economy. The regional economy is heavily reliant on the production of mineral resources and oil refineries, which account for 33.4% of the regional GDP. These sectors are clearly heavily exposed to the current financial crisis in Russia.

At the same time, we think that fixed telephony usage is one of the least likely areas to be affected by an economic downturn given the very low prices charged relative to those in the EU for example. Moreover, the company argues that during the Russian crisis of 1998 telephony usage actually increased, followed by a rise in the company's revenues. Currently the company's traffic statistics indicate an increase in fixed line traffic in September 2008, supporting the company's claim.

New acquisitions might not be successful. As noted, Teleset has just acquired a new company in the city of Ulyanovsk. The company is exposed to the risk of failure following the acquisition due to management differences between the two companies. Nevertheless, the deal with STS is not Teleset's first acquisition. The company has already acquired 2 altcos - TNPKO in Kazan city and Svyazinvest Limited in Naberezhniye Chelny. So far both deals have proved successful.

Lack of acquisition targets. The company is on the look-out for further acquisition targets in the Russian regions. However, the major Russian telecom altcos are also looking for expansion. This could limit Teleset's ability to find proper targets and might also push the prices for assets up. At the same time, we expect Teleset to become an attractive acquisition target itself and the majors would be prepared to pay a premium to the current market price for the company.

Key updates

Acquisition of an asset in Ulyanovsk

In September 2008 Teleset, announced the acquisition of a 51% stake in Simbirsky Telecommunications Systems (STS), a fixed line operator. The size of the deal was USD 15.7mn

STS is based in Ulyanovsk, the capital city of Russia's Ulyanovsk Region, with a population of about 635,000 people. Ulyanovsk is 870 km from Moscow and 240 km from Kazan, where Teleset is headquartered.

In June 2008, the city was granted "Free Economic Zone" status, which is intended to attract new investment and business to the Ulyanovsk Region.

STS has 28,700 fixed line subscribers, providing a market share of about 13%. The company's network covers all four districts of the city.

Following the acquisition we expect Teleset to have about 161,278 fixed line subscribers by the end of 2008.

STS generated revenues of USD 4.6mn in 2007. This equates to 20% of Teleset's revenues over the same period. STS also saw USD 1.6mn of net profit in 2007, which equates to 31% of Teleset's net profit during the same year.

The acquisition is in line with the company's development strategy. In our view the company still has enough cash and free cash flow for further acquisitions, which we have detailed in the Cash flow section of this report.

Market shares

Teleset currently holds about 30% of the local fixed line market in Kazan, which has increased from 29% a year ago. After the acquisition of the fixed line operator Svyazinvest in the city of Naberezhniye Chelny at the end of 2007, Teleset gained access to 10% of the fixed line subscribers in that city. Currently Teleset holds 11% of this market. STS holds about a 13% market share in the city of Ulyanovsk.

Teleset is currently pursuing a strategy to become the second largest telecoms operator in the region after the main incumbent. The incumbent fixed line operator is Tattelcom in both Kazan and Naberezhniye Chelny, which is controlled by the Tatar government. Tattelcom is not part of the Russian Svyazinvest group. Tattelcom holds 58% of the fixed line market in Kazan and 74% of the market in Naberezhniye Chelny.

In Ulyanovsk the incumbent player is VolgaTelecom (part of Svyazinvest) which holds 86% of the total fixed line market.

For the sake of conservativeness we have modeled a flat market share for Teleset going forwards.

Fixed line network

Teleset runs a 100% digital fixed line network across the regions in which it operates. At the end of 2007, prior to the acquisition of STS, Teleset had about 130,755 subscribers, including 12,912 business subscribers.

We were looking for Teleset to have 136,935 fixed line subscribers by the end of 2008. Following the acquisition of STS in September 2008 we now expect Teleset to have a total of 161,278 subscribers by the end of 2008. This should include about 17,743 business subscribers or 11% of the total base. We also note that STS has a larger proportion of business subscribers than Teleset. STS had 4,600 business subscribers at the end of 3Q 08 representing 16% of the total.

Table 1:
Teleset fixed line subscriber estimates

	2007	2008E	2009E	2010E	2011E	2012E
Residential fixed line subscribers, old estimates	117,843	122,594	124,479	126,359	128,229	129,689
% growth y-o-y	13%	4%	2%	2%	1%	1%
Business fixed line subscribers, old estimates	12,912	14,341	14,941	15,541	16,141	16,641
% growth y-o-y	81%	11%	4%	4%	4%	3%
Residential fixed line subscribers, new estimates	117,843	143,535	145,420	147,300	149,170	150,630
% growth y-o-y	13.3%	21.8%	1.3%	1.3%	1.3%	1.0%
Business fixed line subscribers, new estimates	12,912	17,743	19,673	20,204	20,750	21,268
% growth y-o-y	80.6%	37.4%	10.9%	2.7%	2.7%	2.5%

Source: Company data, IFC Metropol estimates

Going forwards we are looking for rather moderate subscriber growth of about 1.3% in the residential market and 2.7% in business from 2010 onwards. Looking ahead, by the end of 2012 we forecast 171,898 total fixed line subscribers with business subscribers representing approximately 12.3%.

Zonal licence

Teleset has recently received a zonal licence and is due to start offering long-distance services to its subscribers within its own zone from January 2009.

Before the licence Teleset offered its subscribers long-distance services as an agent of long-distance operators, such as Rostelecom and MTT. Tatttelecom also has a zonal licence in the region. Teleset received only a 9% agency fee for the zonal calls.

As a result of receiving the licence Teleset is due to charge subscribers 100% of the zonal minute price from January 2009. At the same time, the company also pays the interconnection fees to other operators which carry the calls beyond Teleset's network.

The company runs the service with an EBITDA margin of approximately 44%. This compares with the average estimated company EBITDA margin of 53.9% for 2008.

Internet access

Dial-up internet accounted for USD 6.7mn or 32% of Teleset's total internet access revenues in 2007. We expect dial-up revenues to fall to 18% of the total in 2008 and decrease to 9% by 2012. We expect dial-up users to move to the ADSL network over time, so we are modeling a decrease in revenues from this area.

Approximately 64% of Teleset's internet revenues in 2007 were generated by broadband subscribers. We expect them to be the major contributors to this revenues stream going forward.

By the end of 2008 we expect Teleset to have 25,406 ADSL subscribers including 5,500 provided by STS. We are looking for 57,802 ADSL subscribers by the end of 2012. This should account for about 33.6% of the company's fixed line subscriber base at that time.

Table 2:
Estimates for Teleset's DSL subscribers

	2007	2008E	2009E	2010E	2011E	2012E
DSL subscribers, old estimates	11,198	21,500	29,500	35,400	40,710	45,200
% growth y-o-y	177%	92%	37%	20%	15%	11%
DSL subscribers, new estimates	11,198	25,406	38,365	45,271	51,609	57,802
% growth y-o-y	177.1%	126.9%	51.0%	18.0%	14.0%	12.0%

Source: Company data, IFC Metropol estimates

Currently Teleset holds about 29% of the dial-up internet market in Kazan in terms of subscribers and 18% for broadband. This makes it the second largest player after the incumbent Tatttelecom, which holds a 28% market share in terms of broadband subscribers.

We estimate that in Naberezhniye Chelny, Teleset holds about 19% of the internet market, while Tatttelecom holds 53%. We expect Teleset to see a flat market share in the region going forwards.

Financial statement analysis

Recent results – 1H 08 IFRS

Teleset's revenues in 1H 08 came in at USD 14.75mn and showed 42% growth y-o-y. The main growth drivers were the internet and telephony traffic.

Revenues from the internet grew 55% y-o-y to USD 4.67mn in 1H 08, which came in line with our previous full year estimates of USD 9.8mn by the end of 2008.

Telephony traffic also showed higher than average growth at 47% y-o-y to USD 2.1mn in 1H 08. Although undisclosed, we would expect traffic revenues to grow on the back of fixed-to-mobile calls. Here the company is likely to beat our previous full year estimates of USD 4.2mn. A figure in the region of USD 4.4mn would not be surprising in our view

Taking into account the 1H 08 results, we expect Teleset's full year total revenues to be in excess of USD 30mn in 2008. This is well ahead of our previous conservative estimates of USD 28.4mn

Table 3:
Teleset financial results summary, USD '000

	1H 07	1H 08	2008 old estimates	2008 new estimates
Operating revenues	10,379	14,754	28,429	30,305
% growth y-o-y	-	42%	25%	33%
EBITDA	5,756	8,667	15,540	16,346
% growth y-o-y	-	51%	25%	31%
EBITDA margin	55.5%	58.7%	54.7%	53.9%
Net profit	2,162	4,350	6,349	7,662
% growth y-o-y	-	101%	23%	25%

Source: Company data, IFC Metropol estimates

Teleset saw an EBITDA of USD 8.67mn in 1H 08 or a 58.7% EBITDA margin. In our view our previous full year estimates for an EBITDA margin of 54.7% are likely to be optimistic, and around 54% now seems more realistic.

The company saw net profit of USD 4.35mn in 1H 08, which represents 101% growth y-o-y. The company is likely to beat our 2008FY estimates of USD 6.3mn. This is due to improvements in the higher margined internet services.

Teleset has also completed the integration of Svyazinvest Ltd, the telecom business in Naberezhniye Chelny which it acquired in November 2007. The impact of the acquisition seems to be better than we expected.

Revenues outlook

Local services

Teleset generated USD 7.9mn in revenues from rental fees in 2007. This accounted for 34.7% of total revenues for the year. Going forwards we expect this proportion to go down to 32% by 2012. This is due to higher revenues coming from unregulated areas of internet access. We model an 8% increase in rental fees per line over the 2009-2011 period in line with our estimates for per minute tariff rises.

Table 4:
Fixed line voice services, USD '000

	2007	2008E	2009E	2010E	2011E	2012E
Rental fees	7,888	9,878	11,953	13,669	15,100	16,210
% growth y-o-y	92%	25%	21%	14%	10%	7%
% of total revenues	34.7%	32.6%	30.9%	31.1%	31.8%	32.1%
Local voice service						
Residential	1,597	2,065	2,364	2,766	3,047	3,261
% growth y-o-y	16%	29%	14%	17%	10%	7%
Business	498	793	876	937	1,003	1,073
% growth y-o-y	67%	59%	10%	7%	7%	7%
Long distance/zonal services	1,470	1,590	3,863	3,901	3,940	3,980
% growth y-o-y	76%	8%	143%	1%	1%	1%
Total voice traffic revenue	3,565	4,448	7,102	7,604	7,990	8,313
% growth y-o-y	42%	25%	60%	7%	5%	4%
% of total revenues	15.7%	14.7%	18.3%	17.3%	16.8%	16.5%

Source: Company data, IFC Metropol estimates

We do not expect the company to suffer from a decrease in local fixed line traffic during the 2008-2009 period due to the financial crisis. Company statistics suggest that people tend to talk more during a crisis. This was the case during the 1998-1999 crisis period in Kazan and we see no reason why it would change this time.

For the sake of conservativeness we model residential per minute traffic per user per month (MOU) to grow slowly from 231 minutes estimated for 2008 to 241 minutes in 2011.

We tend to be more conservative for business traffic because we believe this area might be more exposed to the crisis. We model business MOUs to decrease from 537 minutes in 2008 to 523 minutes in 2010. After 2010 we expect traffic to recover to 560 minutes by 2013.

We also model an 8% increase in local tariffs y-o-y over the 2008-2012 period. We note that Teleset's management tend to agree with our tariff growth rates.

The majority of local voice services revenues are generated from residential subscribers. In 2008 we are looking for USD 2.1mn to come from residential subscribers and only USD 0.8mn from business subscribers. By the end of 2012 we forecast USD 4.3mn to come from local voice services, including USD 1.0mn from business subscribers.

Zonal

As mentioned above, in summer 2008 Teleset received a licence for zonal long distance call services. The company plans to launch the service in January 2009. Teleset should start receiving 100% of the charge from subscribers for zonal long-distance calls within Tatarstan. For long distance calls outside Tatarstan, Teleset is due to receive an undisclosed commission from long distance operators such as Rostelecom and MTT.

Together with the revenues from zonal traffic, Teleset also needs to record the interconnection fees which it needs to pay to other operators for the transfer and termination of zonal calls on their networks.

Before receiving the licence Teleset offered its subscribers long-distance services as an agent of the long-distance operators, such as Rostelecom and MTT or Tattelcom, which is the holder of a zonal licence in the region. Teleset received about a 9% commission for zonal calls and 12% for long distance calls outside the

Republic. The company also received about RUB 0.1 per call for the initiation of long-distance calls. The initiation charge is due to remain after 2009.

In 2008 we expect Teleset to receive about USD 1.6mn from zonal services. This is mostly agency fees received by Teleset from Tattelcom. In 2009 we are looking for USD 3.8mn to come from this area. We note that the company accounts for long distance and zonal revenues on a net basis. Gross revenues received from subscribers are adjusted for interconnection fees which, as noted, Teleset pays to other operators for the transfer and termination of calls.

We have applied a conservative approach in our forecasts for revenues from zonal services. We expect these revenues to grow by only 1% y-o-y after 2009, although most of the other regional operators experience growth in this area in the range of 2-3%. We expect the main driver for the area to be fixed-to-mobile traffic, which should in our opinion be netted out by falling fixed-to-fixed traffic. Overall, by the end of 2012 we expect Teleset to generate about USD 4.0mn from zonal services or 7.9% of total revenues in this year.

Internet

As we noted before, about 64% of Teleset's internet revenues in 2007 were generated by broadband subscribers. We expect broadband subscribers to be the major contributors to this revenues stream going forward.

Table 5:
Estimates on Teleset's DSL ARPUs and revenues

	2007	2008E	2009E	2010E	2011E	2012E
DSL ARPU, USD	47.0	34.8	28.4	27.6	26.8	26.0
% growth y-o-y	-32%	-26%	-18%	-3%	-3%	-3%
ADSL revenues, USD '000	4,295	7,641	10,884	13,846	15,557	17,043
% growth y-o-y	106.7%	77.9%	42.4%	27.2%	12.4%	9.5%
% of total internet revenues	64%	77%	83%	86%	87%	88%

Source: Company data, IFC Metropol estimates

Although we expect DSL ARPUs to go down 26% y-o-y in 2008 to USD 34.8, we are still looking for revenues to grow 78% y-o-y to USD 7.6mn on the back of growing subscribers. We also expect DSL ARPUs to decline 18% y-o-y in 2009 due to the dilutive effect of the STS acquisition. Going forwards, however, we expect ARPUs to decrease slowly at about 3% y-o-y and reach USD 26.0 by 2012. We also note that competition in the market is likely to move from a pure price war into one over speed and quality of service. We believe this should support company ARPUs at a high level above USD 20 in the long run.

Table 6:
Estimates on Teleset's internet revenues, USD '000

	2007	2008E	2009E	2010E	2011E	2012E
Total internet services revenues	6,678	9,899	13,077	16,088	17,807	19,266
% growth y-o-y	96%	48%	32%	23%	11%	8%
% of total revenues	29%	33%	34%	37%	37%	38%

Source: Company data, IFC Metropol estimates

We expect Teleset to see revenues of USD 9.9mn from total internet services including dial-up in 2008. This should account for about 33% of the company's total revenues. We anticipate that the internet should remain the main revenues driver for the company. By the end of 2012 we expect 38% of Teleset's revenues to come from these services.

Other revenues

The company also generates revenues from fees for connecting to fixed line telephony and to the internet. This segment may account for about 2% of total revenues in 2008, however we model that they are likely to fall about 13% y-o-y. This is due to proactive marketing campaigns and a general increase in competition.

Teleset also provides some business subscribers with ISDN networks. We expect that the company is likely to generate USD 2.6mn from this area in 2008 or 8.5% of total revenues. We believe that this service should grow slowly at a CAGR of 2.9% over the 2009-2015 period. We expect ISDN revenues to drop to USD 3.5mn in 2015 or 6.0% of total company revenues.

Total revenues

We are looking for the company's total revenues to grow 33% y-o-y in 2008 to USD 30.3mn. We expect the main growth drivers to be revenues of USD 3.9mn from Svyazinvest in Naberezhniye Chelny. We should also note that internet services are expected to grow 48% y-o-y in 2008.

Table 7:

Teleset revenues estimates, USD '000

	2007	2008E	2009E	2010E	2011E	2012E
Total revenues	22,737	30,305	38,726	43,971	47,497	50,452
<i>% growth y-o-y</i>	69%	33%	28%	14%	8%	6%

Source: Company data, IFC Metropol estimates

The acquisition of STS in Ulyanovsk should support Teleset's revenues in 2009. We are looking for 28% growth y-o-y to USD 38.7mn in 2009. The figure should include about USD 6.1mn, attributable to STS. Going forwards we model only organic growth in Teleset's revenues to USD 50.5mn by 2012

Profit and loss statement

Headcount

We have increased our estimates for Teleset's headcount following the acquisition of STS in September 2008. By the end of 2008 we expect the company to have about 595 employees with 140 employees at STS.

Although we might expect the company to decrease the number of employees going forwards, we have retained the headcount at 595 in 2009 for the sake of conservativeness. The company may optimise headcount at some point following the acquisition of STS. Although the company's management does not intend to increase headcount, we have modelled a 1% y-o-y increase in headcount to 613 people by 2012.

Table 8:

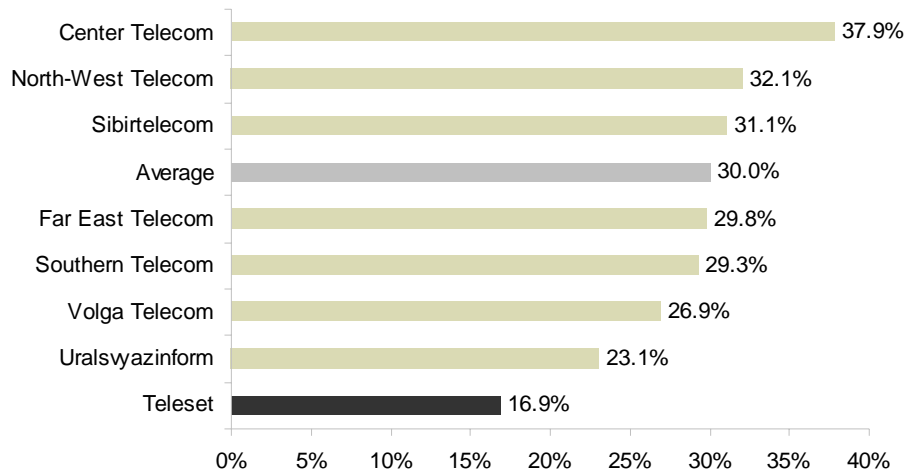
Wages and salaries estimates, USD 000

	2007	2008E	2009E	2010E	2011E	2012E
Headcount, old estimates	439	455	469	480	490	500
<i>% growth y-o-y</i>	23%	4%	3%	2%	2%	2%
Headcount, new estimates	439	595	595	601	607	613
<i>% growth y-o-y</i>	23%	36%	0%	1%	1%	1%
Wages and salaries expenses	3,331	5,120	6,350	7,112	7,681	8,219
<i>% growth y-o-y</i>	82%	54%	24%	12%	8%	7%
<i>% of total revenues</i>	-14.7%	-16.9%	-16.4%	-16.2%	-16.2%	-16.3%

Source: Company data, IFC Metropol estimates

In terms of wages and salaries, Teleset is more efficient than the incumbent regional fixed line operators. In 2008 we expect the company to only see 17% of its total revenues reflected as employee costs. At the same time wages and salaries are expected to comprise the equivalent of some 30% of the incumbent's revenues.

Chart 1:
Estimates for wages and salaries of regional fixed line operators as % of total revenues in 2008



Source: Company data, IFC Metropol estimates

Teleset's average salary is about RUB 17,156 (USD 680) per month per employee. In August 2008 the average salary was raised 6% y-o-y. Going forward we expect Teleset to increase salaries at about 7% a year over the 2008-2016 period in order to be competitive in the market as an employer.

Internet traffic

Another key component within the operating costs is rental and telecoms expenses, which mainly comprise fees paid to wholesale providers for internet traffic. In theory the traffic costs should rise in line with the amount of internet traffic used by Teleset subscribers. However, Teleset experienced a sharp fall in the cost of traffic per megabit due to increased competition among wholesale internet traffic providers. In 2008 the rental fee for internet traffic has halved according to company estimates.

This should lead to slower growth in rental expenses versus sharp growth in internet traffic consumption and revenues. We expect these expenses to reach USD 2.56mn in 2008, increasing to USD 3.9mn in 2012. This implies an 11% CAGR over 2008-2012, which compares with an 18% CAGR in internet revenues over the same period.

EBITDA

In 2008, we expect the company to see an EBITDA of USD 16.3mn, which is higher than our previous estimate of USD 15.5mn. At the same time, EBITDA margins should hit 53.9%, which is lower than our original expectation of 54.7%.

Table 9:
EBITDA* estimates, USD '000

	2007	2008E	2009E	2010E	2011E	2012E
EBITDA, old estimate	12,471	15,540	17,685	18,964	20,258	21,704
% growth y-o-y	54%	25%	14%	7%	7%	7%
EBITDA margin, old estimate	54.8%	54.7%	54.7%	52.8%	50.9%	49.3%
EBITDA, new estimate	12,471	16,346	22,270	24,997	26,533	27,676
% growth y-o-y	54%	31%	36%	12%	6%	4%
EBITDA margin, new estimate	54.8%	53.9%	57.5%	56.9%	55.9%	54.9%

* We calculate EBITDA as operating profit before depreciation and amortisation

Source: Company data, IFC Metropol estimates

The company runs the business at a very high EBITDA margin. The average EBITDA margin for regional operators in Russia by our estimates for 2008 is 36.1%. This emphasises the quality of Teleset's management.

After the introduction of zonal services in 2009 we expect the company's EBITDA to improve to 57.5% by the end of the year. This is higher than the 54.7% originally expected. Going forwards we are looking for competition to increase in the sector, which should start depressing margins. By 2012 we are looking for the EBITDA margin to go down to 54.9%. Our long term projection for the EBITDA margin is 49.6% in 2018 versus our previous estimates of 45.0% for the same period.

We expect zonal services and booming internet revenues to support EBITDA and the EBITDA margin at relatively high levels going forward.

Net profit

We expect Teleset to see a depreciation of USD 4.3mn in 2008 or 14.2% of total revenues. We have not modelled the acquisition of any other altcos going forward. We also assume that the company is likely to follow a conservative capex program which we have modelled. In this case depreciation expenses should grow steadily. We are looking for just USD 6.7mn or 13.2% of revenues to account for depreciation expenses in 2012.

The company managed to decrease its net interest payments in 2008 due to interest income generated from the cash on its balance sheet. We are only looking for USD 0.8mn of net interest expenses in 2008 versus our previous estimates of USD 1.3mn. In 2010 we expect a peak in these expenses at USD 1.6mn, before a decline to USD 0.7mn by 2012. We do not expect the company to raise any additional debt.

Table 10:
Net profit estimates, USD '000

	2007	2008E	2009E	2010E	2011E	2012E
Net profit, old estimate	5,143	6,349	7,250	7,865	8,483	9,145
Net margin, old estimate	22.6%	22.3%	22.4%	21.9%	21.3%	20.8%
Net profit, new estimate	5,143	7,662	10,394	11,514	12,421	13,415
Net margin, new estimate	22.6%	25.3%	26.8%	26.2%	26.2%	26.6%

Source: Company data, IFC Metropol estimates

The company is looking for a 31.7% effective tax rate in 2008 versus the 36.2% originally estimated. We have decreased our long term effective tax rate from 33% to 28% because Teleset has implemented tax optimization procedures across the group. Overall we are increasing our estimates for net profit. In 2008 we are looking for approximately USD 7.7mn versus USD 6.3mn in our previous report. In 2012, we expect the company to generate USD 13.4mn of net profit versus USD 9.1mn that we originally forecast. The main difference comes from the impact of the recently acquired company STS and a decrease in its effective tax rate.

A more detailed profit and loss statement is located in the appendix of this report.

Balance sheet

Table 11:
Balance sheet summary, USD '000

	2006	2007	2008E	2009E	2010E	2011E	2012E
Current assets	10,082	22,781	30,853	29,691	32,967	34,729	37,541
Fixed assets	35,804	47,474	66,687	68,912	69,122	68,848	67,898
Total assets	45,886	70,255	97,540	98,603	102,089	103,578	105,439
Current liabilities	5,433	3,845	11,124	10,548	13,435	13,884	14,374
Long-term liabilities	20,508	26,411	29,810	27,203	22,070	16,653	11,141
Total liabilities	25,942	30,256	40,935	37,751	35,505	30,537	25,516
Shareholders' equity	19,944	39,999	56,605	60,852	66,583	73,041	79,923
Total liabilities and shareholders' equity	45,886	70,255	97,540	98,602	102,088	103,577	105,439
Net debt	15,519	7,627	10,129	8,120	2,606	-4,414	-12,571
Net debt/equity (x)	78%	19%	18%	13%	4%	-6%	-16%
Net debt/EBITDA (x)	191%	61%	62%	36%	10%	-17%	-45%

Source: Company data, IFC Metropol estimates

Teleset's balance sheet significantly improved in 2007 and is expected to remain in a healthy position in the future. The net debt/equity ratio decreased from 78% in 2006 to 19% in 2007. Such a sharp decline can be explained by an additional stock issue and an increase in cash and equivalents in 2007. There was another stock issue in 2008 and we expect Teleset to end the year with some USD 20.7mn in cash. At the same time, the increase in total debt was not very significant, which brought the net debt/equity to such low values. The dynamics of the net debt/EBITDA ratio are quite similar, declining from 191% in 2006 to 61% in 2007.

We expect Teleset's net debt to decline gradually over the next few years and the company to see net cash by 2011. This assumes that the company does not borrow heavily to fund capex and acquisitions. We believe that the company still has scope to raise funds through additional stock issues. However, a good overall debt position should not pose any problems for the company should they need to finance its investment programme with borrowed funds.

Cash flow statement

Table 12:

Cash flow statement summary, USD '000

	2007	2008E	2009E	2010E	2011E	2012E
Pretax profit	7,925	11,484	16,096	17,821	19,253	20,456
Depreciation and amortization	3,488	4,303	4,884	5,716	6,270	6,660
Interest expenses, net	1,113	842	1,412	1,560	1,110	660
Income tax paid	-2,723	-3,642	-4,869	-5,391	-5,824	-5,932
Changes in net working capital	-1,159	-1,147	-1,405	-875	-293	-164
Other adjustments	341	0	0	0	0	0
Cash flows from operating activities	8,985	11,840	16,117	18,831	20,516	21,679
Capital expenditures	-3,851	-8,300	-7,500	-6,000	-6,175	-6,155
Acquisition of subsidiaries, net of cash	-10,812	-15,800	0	0	0	0
Other	1,033	0	0	0	0	0
Cash flows used in investing activities	-13,630	-24,100	-7,500	-6,000	-6,175	-6,155
Free cash flow	-4,645	-12,260	8,617	12,831	14,341	15,524
Common stock issuance	14,579	10,600	0	0	0	0
Proceeds / (Repayment) of borrowings	2,564	8,148	-6,000	-4,000	-6,000	-6,000
Interest and dividends paid	-1,983	-842	-6,609	-7,317	-7,321	-7,368
Cash flows from financing activities	15,161	17,906	-12,609	-11,317	-13,321	-13,368
Cash and cash equivalents, beginning of the year	4,352	15,025	20,671	16,680	18,194	19,214
Net cash flow	10,516	5,646	-3,991	1,514	1,021	2,156
Cash and cash equivalents, end of the year	15,025	20,671	16,680	18,194	19,214	21,371

Source: Company data, IFC Metropol estimates

Teleset saw negative free cash flow of USD 12.8mn and USD 4.6mn in 2006 and 2007 respectively due to the recent acquisitions, while operating cash flows have shown stable growth. We expect free cash flow to remain negative in 2008 due to the same reasons. However, common stock issuance and, to a lesser extent, new borrowings, offset the negative free cash flow, as we have argued above. Given that, cash and cash equivalents have been increasing steadily since 2006, we expect them to reach USD 20.7mn by the end of 2008.

Furthermore, we model a sharp rise in free cash flow in 2009, assuming that the company does not make any new acquisitions. If this is the case, Teleset would end up with a large amount of cash on the balance sheet. If the company is unable to find a good acquisition target, we assume that they may pay large dividends. We model a dividend payout ratio of 50% of net profits for 2009-2012.

If Teleset finds a suitable company to acquire, its own cash reserves may well be sufficient for the deal. This assumes that the cash position remains at a high level of around USD 20mn. Alternatively, the company could potentially issue additional stock or borrow, which should not become an issue for Teleset given its low leverage.

Valuation

DCF Valuation

We base our cost of equity calculations on a combination of a risk-free rate, a standard equity risk premium and a company-specific risk premium.

We adjust the risk-free rate, which is based on the US Treasury 10-year note, by adding the 1-month average yield difference between the note and the most liquid Russian Eurobond, the Russia-30, to derive an overall risk-free rate adjusted for Russia's country-specific risk premium.

Table 13:
WACC calculation

Risk-free rate: 10-year US Treasury yield, 1M average	3.6%
Yield difference: 10-year US Treasury/Russia-30, 1M average	6.8%
Overall risk-free rate (adjusted for Russia's country risk premium)	10.4%
Standard equity risk premium	5.0%
Company-specific risk premium	3.5%
Total cost of equity	18.9%
Cost of debt (after tax)	6.1%
% Equity	79.8%
% Debt	20.2%
WACC	16.3%

Source: IFC Metropol estimates

We left the company specific risk premium unchanged at 3.5% from our last report. One of Teleset's major issues is a lack of liquidity. Although the technical free float of the company is 5.3% the average monthly trading volume is only USD 26,879 versus USD 1.5mn for VolgaTelecom for example.

We have increased the company's cost of debt from 5.5% after tax to 6.1%. We still argue that the company does not need to raise any new debt unless it plans to acquire any other altcos in the near future. For the sake of conservativeness we have not modeled this scenario.

Overall we derive a WACC of 16.3% for Teleset, which is significantly higher than the 12.5% used in our previous report.

Table 15:
DCF, USD '000

	2007	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E
Revenues	22,737	30,305	38,726	43,971	47,497	50,452	53,296	56,019	58,409	60,763	63,211
% growth y-o-y	68.9%	33.3%	27.8%	13.5%	8.0%	6.2%	5.6%	5.1%	4.3%	4.0%	4.0%
EBIT	8,981	12,043	17,386	19,281	20,263	21,016	21,592	22,144	22,562	22,956	23,388
% growth y-o-y	56.9%	34.1%	44.4%	10.9%	5.1%	3.7%	2.7%	2.6%	1.9%	1.7%	1.9%
% of revenues	39.5%	39.7%	44.9%	43.9%	42.7%	41.7%	40.5%	39.5%	38.6%	37.8%	37.0%
Less taxes on EBIT	-2,782	-3,642	-4,869	-5,391	-5,824	-5,932	-6,175	-6,158	-6,317	-6,198	-6,315
Tax rate	-31.0%	-30.2%	-28.0%	-28.0%	-28.7%	-28.2%	-28.6%	-27.8%	-28.0%	-27.0%	-27.0%
Add											
Depreciation & amortisation	3,489	4,303	4,884	5,716	6,270	6,660	7,088	7,451	7,827	8,142	8,470
% of revenues	15.3%	14.2%	12.6%	13.0%	13.2%	13.2%	13.3%	13.3%	13.4%	13.4%	13.4%
(Increase)/ decrease in NWC	-1,159	-1,147	-1,405	-875	-293	-555	-586	-616	-643	-668	-689
% of revenues	-5.1%	-3.8%	-3.6%	-2.0%	-0.6%	-1.1%	-1.1%	-1.1%	-1.1%	-1.1%	-1.1%
Less											
Net capex	-14,663	-24,100	-7,500	-6,000	-6,175	-6,155	-6,129	-6,274	-6,133	-6,198	-6,195
% of revenues	-64.5%	-79.5%	-19.4%	-13.6%	-13.0%	-12.2%	-11.5%	-11.2%	-10.5%	-10.2%	-9.8%
Net free cash flow	-6,134	-12,543	8,495	12,731	14,241	15,033	15,790	16,546	17,296	18,034	18,660
% growth y-o-y	-51.5%	104.5%	-167.7%	49.9%	11.9%	5.6%	5.0%	4.8%	4.5%	4.3%	3.5%

Source: Company data, IFC Metropol estimates

Using a DCF analysis, we value Teleset at USD 0.69 per share. Our fair value implies 169% upside potential and hence a Buy recommendation. We reiterate that we are decreasing our fair value from our previous estimates of USD 0.72, largely due to an increase in the WACC, based on a new assessment of the Russia risk premium. The calculation is detailed below.

Table 16:
DCF Valuation summary, USD '000

PV of Cash Flow	79,670
+Terminal Value	39,997
-Net Debt/(Cash)	10,300
Equity Value	109,371
Number of shares, '000	157,557
Fair Value, USD per share	0.69

Source: IFC Metropol estimates

We believe that the WACC increase should be a temporary measure and that the previous WACC of 12.5% for Teleset looks more reasonable to us. Should we use our previous WACC for Teleset, our fair value would be USD 1.00 per share. We also include a sensitivity analysis, in order to provide more cautious investors with the ability to look at our fair value when using different WACC and terminal growth rate assumptions.

Table 17:
Sensitivity Table, USD

Terminal Growth	WACC				
	12.5%	15.5%	16.3%	20.0%	22.0%
2.5%	0.94	0.72	0.67	0.52	0.47
3.0%	0.97	0.73	0.68	0.53	0.47
3.5%	1.00	0.74	0.69	0.53	0.47
4.0%	1.03	0.76	0.71	0.54	0.48
4.5%	1.06	0.77	0.72	0.54	0.48

Source: IFC Metropol estimates

Peer group valuation

Russian peers

Currently there are no publicly traded Russian companies that are directly comparable to Teleset in our view. The companies we have included in our analysis are all incumbent operators, not alternative telecom companies. Also, the Russian regional operators, such as Sibirtelecom and Uralsvyazinform, have different scales of operation and market capitalizations to Teleset. Moreover, we note that the state-owned regional operators are not even fully comparable among themselves, given the considerable differences in digitization and debt levels. Additionally, some of these companies also have cellular operations, further complicating the analysis. Nevertheless, for the sake of completeness we have included these companies in our peer group analysis.

Table 18:
Russian peers

	Ticker	P/E (x)			EV/EBITDA (x)		
		2008E	2009E	2010E	2008E	2009E	2010E
North-West Telecom	SPTL RU	2.6	2.1	2.0	1.6	1.4	1.3
VolgaTelecom	NNSI RU	1.5	1.2	1.0	1.9	1.7	1.5
Sibirtelecom	ENCO RU	1.0	0.9	0.8	2.0	1.8	1.7
Uralsvyazinform	URSI RU	2.6	2.1	1.7	2.7	2.4	2.1
CenterTelecom	ESMO RU	2.1	1.7	1.2	2.4	2.1	1.7
Southern Telecom	KUBN RU	4.0	1.9	1.7	3.5	3.0	2.8
Far East Telecom	ESPK RU	1.2	0.5	0.9	1.9	1.7	1.6
Comstar UTS	CMST RU	4.2	3.4	3.1	3.1	2.7	2.5
Russian median		2.6	1.9	1.7	2.4	2.1	1.7
Teleset Networks	TNW LN	5.3	3.9	3.5	3.1	2.3	2.0

Source: IFC Metropol estimates

Based on 2009 EV/EBITDA estimates, Teleset appears slightly overvalued, trading at 2.3x versus the Russian peer group median of 2.1x. On an estimated 2009 P/E multiple, Teleset also looks expensive trading at 3.9x versus the Russian peer group median of 1.9x. We note again however, that Teleset is not truly comparable to any of these incumbent operators. We think the main reason for this situation is the market crash in autumn 2008. During the recent crash shares in the regional operators fell by 70-80%, whereas Teleset's went down by only 24%. At the same time Teleset does not have much liquidity and the fall of 24% occurred on very low trading volumes.

The acquisition of Golden Telecom by VimpelCom at the end of 2007 might also provide a benchmark for the potential value of Teleset as an acquisition target. VimpelCom paid 10.7x the estimated 2008 EBITDA for 100% of Golden Telecom. This implies a value of USD 164.6mn for 100% of Teleset or USD 1.04 per share. This would provide Teleset shareholders with about 300% upside potential to the current price. However, we believe VimpelCom overpaid for Golden Telecom and give this valuation merely for the sake of comparison.

International peers

Table 19:
International peers

Company	Ticker	P/E (x)			EV/EBITDA (x)		
		2008E	2009E	2010E	2008E	2009E	2010E
KCOM GROUP PLC	KCOM LN	2.1	3.8	3.2	3.0	4.1	4.0
PAETEC HOLDING	PAET US	NA	NA	NA	4.2	4.1	3.9
CONSOLIDATED COM	CNSL US	16.8	13.0	12.6	6.6	6.3	6.4
MNI	MNI PW	8.7	7.8	7.6	4.8	4.7	5.2
TT&T PCL	TTNT TB	NA	NA	NA	0.2	0.2	0.2
International median		8.7	7.8	7.6	4.2	4.1	4.0
Teleset Networks	TNW LN	5.3	3.9	3.5	3.1	2.3	2.0

Source: Bloomberg, IFC Metropol estimates

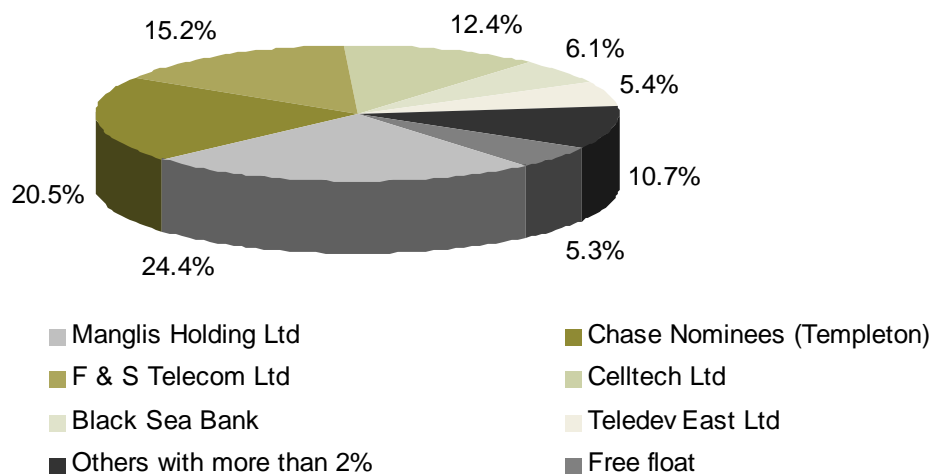
We have attempted to select a group of international peers that we believe are similar to Teleset in terms of their business structure. This peer group comprises small, private fixed line operators from the EU and the US. Their businesses are similar to Teleset's, but their market capitalizations are on average five times higher. We compare Teleset with its peers on the basis of 2009 estimates, using our estimates for Teleset and Bloomberg consensus estimates for the company's peers.

Based on estimated 2009 EV/EBITDA multiples, Teleset appears to be cheaper than international peers with a ratio of 2.3x versus the 4.1x median for international peers. On estimated 2009 P/E multiples, Teleset is trading at 3.9x versus the international peer median of 7.8x. This suggests 100% upside potential to Teleset's current price and implies a fair value of USD 0.52 per company share. Nevertheless, we reiterate our view that a peer group analysis is not an appropriate valuation tool given the considerable differences between the companies.

Shareholders structure

Teleset has 157.6mn ordinary shares currently in issue. We regard about 5.3% of the shares as part of the free float. The rest of the shares belong to what we consider as the company's strategic investors. This includes the major group creditor Black Sea Trading and Development Bank located in Greece. The bank holds 6.1% of the company's shares.

Chart 2:
Teleset Shareholders structure, %



Source: Company Data



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