MRSK Center: large and profitable

MRSK Center, the second-largest distributor after MOESK in terms of EBITDA and NI, lost more than 50% of its MCap after the government announced plans to curb distribution tariffs. Nevertheless, the company is the sector's leader in terms of profitability and according to our estimates, is going to keep this status, even taking into consideration our conservative tariff forecasts, based on price cap. Being strong on fundamentals, we expect MRSK Center to capitalize after the regulator approves the 2012-2017 tariff decisions.

MRKC RU	BUY
TP 12M	USD 0.032
Current price	USD 0.019
Upside	69%
BLOOMBERG	MRKC RU
Market cap	USD 792 mn
EV	USD 1,373 mn
Number of shares, mn	42,218
Free float	25%

Financials, USD mn			
	2011	2012E	2013E
Revenue	2,348	2,269	2,530
EBITDA	533	446	496
EBIT	304	219	242
Net income	188	126	132
Margins, %			
	2011	2012E	2013E
EBITDA margin	22.7%	19.6%	19.6%
EBIT margin	12.9%	9.7%	9.6%
Net margin	8.0%	5.5%	5.2%
Market ratios			
	2011	2012E	2013E
EV/EBITDA	2.6	3.1	2.8
P/E	4.2	6.3	6.0
P/B	0.6	0.6	0.6
EV/RAB	0.4	0.4	0.4
Dividends, USD			
	2011	2012E	2013E
Common shares	0.0003	0.0003	0.0003

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We initiate coverage of MRSK Center's commons with a BUY rating and a 12-month target price of USD 0.032.

Drivers

Strong and stable margins. MRSK Center is the second-largest in the distribution sector in terms of profitability and according to our estimates, is to keep this status even taking into consideration our conservative tariff forecasts, based on price cap. It demonstrates an effective cost control, which is an additional factor of profitability growth. Based on healthy margins, a strong operating CF will ensure the forthcoming dividend payments,

Potential candidate for privatization. The state has announced its plan for one of MRSKs to be privatized in 1Q13. We regard MRSK Center as possible candidate for privatization, given that the company does not operate in the regions of great political importance, features stable financial performance and has all its regional branches operating under RAB-tariff system, which we see as the most necessary requirement for attracting a strategic investor.

Regulatory risk to be reduced. The company lost more than 50% of its MCap after the government announced its intention to curb distribution tariffs in 2011. After the government announces the company's 2012-2017 tariff decisions and CAPEX guidance, we expect regulatory risk for the name to be notably reduced.

Risks

Exposure to 'last mile' contracts. MRSK Center is involved in the so-called 'last mile' issue; the company charges large industrial consumers a fee for distribution services when these customers are physically connected to the Federal Grid Company's high voltage grid. In 2011, NLMK, the steel producer, competed for contracts with MRSK Center, calling for as much as RUB 5.1 bn in the arbitrage court considering this proceeding to be unjustified. The suit will be considered by the Moscow arbitrage court on August 17, 2012. If NLMK wins the case, it could create a negative sentiment towards MRSK Center, given that the money at issue is close to the company's annual NI.

Valuation

Heavily undervalued to global peers. We see no significant discount to domestic peers based on EV/EBITDA and P/E multiples. The company is trading at a 2012 EV/EBITDA of 3.1 and 2012 P/E of 6.3, which is in line with the sector average. MRSK Center is heavily undervalued compared to international peers, and we expect the valuation discount to decrease following the uncertainty regarding future tariff regulation and investment programs to fade away.

Indicator	2011	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E
Balance sheet, USD mn									
Property, land and equipment, and intangible assets	2,116	2,169	2,367	2,625	2,786	3,026	3,155	3,386	3,493
Receivables	286	259	289	331	366	416	456	509	550
Cash and equivalents	90	82	70	126	130	199	176	224	172
Other assets	121	131	137	149	164	181	195	208	222
Total assets	**2,613**	**2,641**	**2,864**	**3,232**	**3,446**	**3,822**	**3,982**	**4,327**	**4,437**
Capital and reserves	1,312	1,314	1,432	1,621	1,789	2,064	2,340	2,758	3,160
Loans and credits	722	818	880	1,005	1,005	1,039	872	730	385
Payables	298	279	311	356	394	448	490	548	592
Other liabilities	281	230	241	250	258	272	280	291	300
Total liabilities and share capital	**2,613**	**2,641**	**2,864**	**3,232**	**3,446**	**3,822**	**3,982**	**4,327**	**4,437**
RAB, net	**3,933**	**3,357**	**3,528**	**3,806**	**3,957**	**4,231**	**4,360**	**4,630**	**4,738**
Income statement, USD mn									
Revenue	**2,348**	**2,269**	**2,530**	**2,899**	**3,203**	**3,641**	**3,988**	**4,458**	**4,816**
Other operating income	32	23	25	29	32	36	40	45	48
Operating expenses net of depreciation	1,863	1,840	2,054	2,349	2,592	2,936	3,186	3,558	3,835
EBITDA (adjusted for non-cash items)	**533**	**446**	**496**	**573**	**643**	**742**	**841**	**944**	**1,029**
D&A	214	232	259	291	313	343	361	389	404
EBIT	**304**	**219**	**242**	**287**	**330**	**399**	**481**	**555**	**626**
EBT	**251**	**157**	**165**	**200**	**236**	**302**	**387**	**474**	**564**
Income tax	63	31	33	40	47	60	77	95	113
Net income	**188**	**126**	**132**	**160**	**189**	**241**	**310**	**379**	**451**
Margins									
EBITDA margin	23%	20%	20%	20%	20%	20%	21%	21%	21%
EBIT margin	13%	10%	10%	10%	10%	11%	12%	12%	13%
Net margin	8%	6%	5%	6%	6%	7%	8%	9%	9%
Valuation									
EV/EBITDA market	**2.6**	**3.1**	**2.8**	**2.4**	**2.1**	**1.9**	**1.6**	**1.5**	**1.3**
EV/EBITDA target	4.0	4.8	4.3	3.7	3.3	2.9	2.5	2.2	2.1
P/E market	**4.2**	**6.3**	**6.0**	**4.9**	**4.2**	**3.3**	**2.6**	**2.1**	**1.8**
P/E target	7.1	10.7	10.2	8.4	7.1	5.6	4.3	3.5	3.0
P/B market	**0.6**	**0.6**	**0.6**	**0.5**	**0.4**	**0.4**	**0.3**	**0.3**	**0.3**
P/B target	1.0	1.0	0.9	0.8	0.7	0.6	0.6	0.5	0.4
EV/RAB market	**0.4**	**0.4**	**0.4**	**0.4**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**
EV/RAB target	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.4
Key operational indicators									
Grids length, 000' km	374	376	379	381	384	388	392	394	399
Electricity output, bn kW-h	56.7	57.6	58.1	58.7	59.3	59.9	60.5	61.1	61.7
Key performance indicators									
Revenue growth		-3%	12%	15%	11%	14%	10%	12%	8%
EBITDA growth		-16%	11%	16%	12%	15%	13%	12%	9%
NI growth		-33%	5%	21%	18%	28%	28%	22%	19%
EPS, USD	0.0045	0.0030	0.0031	0.0038	0.0045	0.0057	0.0073	0.0090	0.0107
DPS, USD	0.0003	0.0003	0.0003	0.0004	0.0005	0.0006	0.0008	0.0010	0.0012
Net Debt/EBITDA	1.19	1.65	1.63	1.53	1.36	1.13	0.83	0.54	0.21

Source: FINAM estimates

Latest financial and operating data snap-shot

Stable margins despite zero-tariff growth in 1H12. MRSK Center posted 1H12 results under RAS, which we see as positive since the company has shown effective cost control. Due to zero-distribution tariff growth, the company saw a 3% y-o-y drop in revenue to RUB 33.9, which was mostly affected by a decline in sales from the connection of new consumers to power grids. Although COGS were almost flat y-o-y, operating profit fell by 11% y-o-y to RUB 5.6 bn, which was mainly due to growth in depreciation and amortization. The company saw a 3% y-o-y increase in NI to RUB 4.3 bn, which was predominantly affected by a reversal of allowance dubious debts (being 'paper' in nature). All in all, we regard 1H12 RAS results as positive, since MRSK Center demonstrated strict control over costs,

Table 1. MRSK Center: 1H12 RAS results, RUB mn

Indicator	6M12	6M11	6M12/6M11
Revenue	33,876	35,053	-3%
COGS	27,320	27,723	-1%
Operating profit	5,585	6,298	-11%
Operating margin, %	*16.5%*	*18.0%*	*-1.5 ppt*
NI	4,334	4,192	3%
Net margin, %	*12.8%*	*12.0%*	*0.8 ppt*

Source: company data, FINAM estimates

Sector leader in terms of profitability. Historically, MRSK Center features ones of the strongest margins in the MRSK universe; the 1H12 RAS numbers have confirmed this status.

Table 2. MRSK sector: 1H12 RAS results

Company	Operating margin, %			Net margin, %		
	1H12	1H11	y-o-y	1H12	1H11	y-o-y
MOESK	22.2%	19.6%	2.6 ppt	19.8%	11.9%	7.8 ppt
MRSK Northern Caucasus	20.7%	27.7%	-7.0 ppt	2.1%	21.4%	-19.3 ppt
MRSK South	15.4%	10.7%	4.7 ppt	5.6%	0.2%	5.4 ppt
MRSK Center and Volga	13.3%	13.9%	-0.6 ppt	1.4%	8.5%	-7.1 ppt
MRSK North-West	9.9%	12.2%	-2.3 ppt	2.7%	7.8%	-5.1ppt
MRSK Urals	8.2%	9.0%	-0.8 ppt	1.8%	5.3%	-3.5 ppt
Lenenergo	6.8%	13.6%	-6.7 ppt	1.7%	6.5%	-4.7 ppt
MRSK Volga	6.6%	8.3%	-1.7 ppt	3.5%	6.4%	-2.9 ppt
MRSK Siberia	-1.2%	10.5%	-11.7 ppt	-1.1%	6.1%	-7.1 ppt
Median	***9.9%***	***12.2%***	***-1.7 ppt***	***2.1%***	***6.5%***	***-4.7 ppt***
MRSK Center	**16.5%**	**18.0%**	**-1.5 ppt**	**12.8%**	**12.0%**	**0.8 ppt**

Source: company data, FINAM estimates

Healthy balance sheet. Due to heavy CAPEX, MRSK Center sees the permanent increase in fixed assets, which appreciated 19% and 20% in 2010-2011, respectively. Despite the high CAPEX, the company's Debt/EBITDA(2012E) ratio is 1.8x, which we find as satisfactory.

Electricity output on the rise. In 1H12, MRSK Center saw a 3.7% growth in distribution volumes to 27.9 bn kW-h, which we expect to bolster the company's revenue in terms of the restricted tariffs.

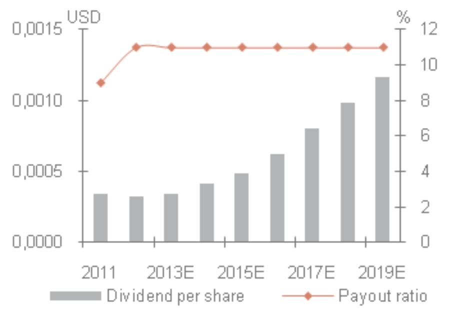
Corporate events

Possible candidate for privatization. In mid-July of 2012, the Minister of Energy Alexander Novak stated that he sees the possibility that one of MRSKs could be privatized in 1Q13. The strategic investor could enter the capital via an additional share placement, which would make it possible so that the funds raised will remain in the MRSK to finance its CAPEX. The Minister did not disclose any names that could be privatized, stating that this question is still under consideration. Although we consider the direct sell-off of the Holding MRSK's stake to the strategic investor as more beneficial for MRSK minorities (due to the potential buyout and no dilutive risks), we admit that an additional share placement might be considered as a trade-off. We regard MRSK Center as possible candidate for privatization, given that the company does not operate in the regions of great political importance (Moscow and Saint Petersburg), features stable financial performance and has all 11 of its regional branches operating under RAB-tariff system, which we see as the most necessary requirement for attracting a strategic investor.

Potential entry vehicle to the United power grid company equity. Although the government completely controls the company through Holding MRSK (which holds a 50.23% stake in MRSK Center), it also has a straight 0.46% share in the company. If the Federal Grid Company will merge with Holding MRSK, we expect that this stake will to be contributed by the state in the capital of the united company. Moreover, we have not ruled out, that the minorities of MRSK Center will be invited to exchange their shares for those of the united company as well.

Stable dividend payer in spite of heavy CAPEX. The company paid no dividends for 2008-2009 and paid out RUB 0.0145 and RUB 0.01 per share for 2010 and 2011, respectively. Although MRSK Center's dividend policy does not set a dividend payout ratio, it stipulates that the company can not allocate any dividends if its Debt/EBITDA ratio exceeds 3. Given that and based on average 2010-2011 payout ratio (11%), we have forecasted 2012-2019 dividends.

Figure 1. MRSK Center: dividend per share forecast



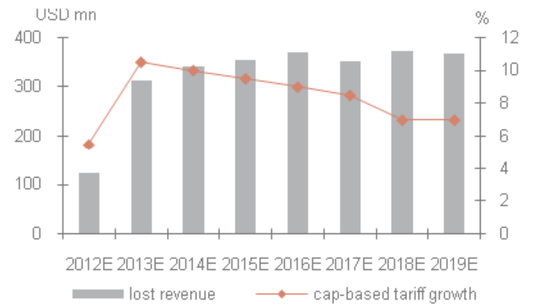
Source: FINAM estimates

Corporate governance. MRSK Center features high transparency and disclosure standards in the Russian power utilities universe. The company has been working out an option program for management, and is planning to launch a GDR listing on the LSE in the medium-term, which would increase the range of potential investors and boost the stock's liquidity.

Valuation

Regulated on RAB principles, but with a tariff cap. We used the principal assumption that MRSK Center's financials in the forecast period will continue to be regulated according to RAB-tariff parameters. To curb distribution tariff growth, we expect the regulator to adjust a return on existing (old) capital and to revise the Regulated asset base (RAB) of the company downward, which is valued at RUB 121 bn. Given this, we decreased by 20% the RAB value of MRSK Center. To account for the uncertainty surrounding return rates on capital and final RAB value, starting in 2012 we applied a cap on the tariff growth, setting an average 8.4% annual tariff-cap growth in 2012-2019. In revenue calculations, we used the minimum of two ways-calculated tariffs. According to our estimates, due to applying tariff caps, the company will see a USD 2.6 bn lost revenue in the forecasted period.

Figure 2. MRSK Center: Lost revenue forecast due to cap on tariffs



Source: FINAM estimates

Estimate of financial results. According to our model, due to tariff growth and increasing electricity output, we estimate MRSK Center's revenue to rise at a 2012-19 CAGR of 9.8%, while COGS should grow at CAGR of 9.2%. This will result in EBITDA increasing from USD 446 mn to USD 1,029 mn in the forecast period. Nevertheless, due to the capped tariff growth, we expect that the company will see a decline in EBITDA and NI in 2012 y-o-y both in absolute terms and margins. Our DCF-model suggests that the capping of tariff growth will entail almost flat margins in 2012-15, with some improvement beyond 2016.

Figure 3. MRSK Center: Revenue, COGS and EBITDA forecast

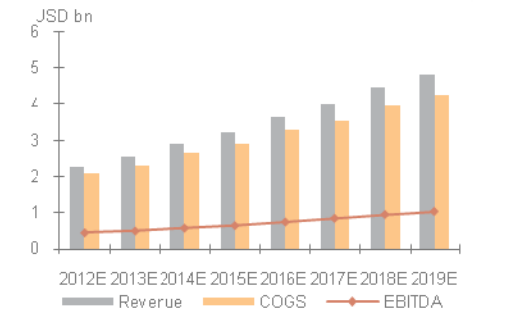
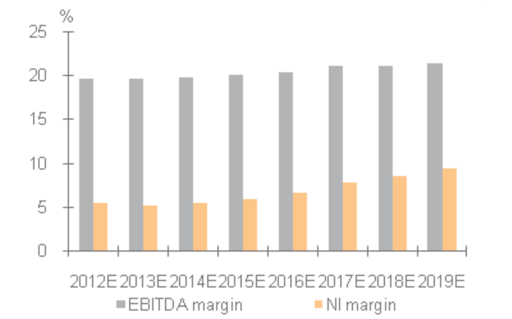


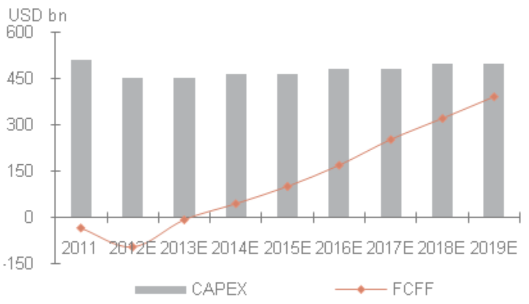
Figure 4. MRSK Center: EBITDA and net margins forecasts



Source: FINAM estimates

Estimate of CAPEX. Due to tariff restrictions conducted by the regulator, the company expects to see a 6% decline in CAPEX to RUB 14.3 bn in 2012. In 2010-2011, MRSK Center faced a deficit of its operating CF to completely finance its investment program, raising a debt. According to the company, it is going to decrease its CAPEX if Net Debt/EBITDA ratio exceeds 3. Since the company's investment program is still under review, we modeled an average annual RUB 14.1 bn CAPEX in 2012-19, which is close to 2012 figure. We expect that due to growing operating CF (based on strong margins), MRSK Center will turn free cash flow positive starting in 2014. Although according to our estimates, the company will continue resort to debt to finance its investment program in 2012-2013, we estimate its Debt/EBITDA ratio to remain in the 0.4-1.8x range. We believe this will be a base of dividend payments and will imply no risk of unfavorable additional share issues.

Figure 5. MRSK Center: CAPEX vs. free cash flow to firm (FCFF)



Source: FINAM estimates

DCF analysis

To estimate the fair value of MRSK Center shares, we have used a DCF-model adjusted to the previously described prerequisites.

Table 3. MRSK Center: free cash flow forecast, USD mn

Indicator	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E
EBIT	219	242	287	330	399	481	555	626
- tax on EBIT	44	48	57	66	80	96	111	125
+ depreciation	232	259	291	313	343	361	389	404
- investments in net working capital	54	11	13	13	14	14	14	14
- CAPEX	450	450	464	464	480	480	499	499
Free cash flow	-96	-8	44	100	169	252	321	391

Source: FINAM estimates

Table 4. WACC

Indicator	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E
Cost of equity	18.0%	18.0%	18.0%	17.8%	17.6%	17.0%	16.5%	15.6%
Cost of debt capital	10%	10%	10%	10%	10%	10%	10%	10%
Share of debt capital	38%	38%	38%	36%	33%	27%	21%	11%
WACC	**14.2%**	**14.2%**	**14.2%**	**14.3%**	**14.4%**	**14.6%**	**14.7%**	**14.8%**

Source: FINAM estimates

Table 5. Valuation of MRSK Center

Indicator	2013	12M
Terminal growth rate	3%	3%
PV of terminal value, USD mn	1,333	1,446
PV of total cash flow, USD mn	1,950	2,121
Net debt, USD mn	736	780
Total equity value, USD mn	1,214	1,341
Number of commons, mn	42,218	42,218
Fair price per common share, USD	0.029	0.032
Upside potential	53%	69%

Source: FINAM estimates

Peer-group analysis

On a 2012 EV/EBITDA and a 2012 P/E multiples, the company is trading in line with domestic peers (MRSK universe). MRSK Center is currently trading with EV/RAB of 0.4, which is at a 33% premium to 0.3x multiple for MRSKs Weattribute this to the fact that the company is well protected to any revision of the RAB-tariff regulations. MRSK Center is heavily undervalued to international peers on 2012 EV/EBITDA, P/E, and EV/RAB multiplies, trading with an average 60% discount. This discount is rooted in the far less efficiency of its assets in cash flow generation terms and high regulatory risk surrounding the MRSK sector.

Table 6. Peer-group analysis

Company	MCap, USD mn	EV, USD mn	EV/EBITDA (2012F)	P/E (2012F)	EV/RAB
MRSK Center	**792**	**1,373**	3.1	6.3	0.4
Premium (Discount) to domestic peers			-	7%	33%
Premium (Discount) to international peers			-66%	-55%	-66%
Domestic peers					
MRSK North-West	210	394	4.0	Neg.	0.2
MRSK Urals	519	726	3.1	8.7	0.3
MRSK Siberia	237	367	2.7	Neg.	0.2
MRSK South	86	603	4,7	171.2	0.6
MRSK Volga	385	543	3.2	12.8	0.2
MRSK Center and Volga	571	1,183	4.0	5.9	0.5
MRSK North Caucasus	28	126	1.9	2.0	0.2
Lenenergo	174	751	2.6	3.7	0.3
MOESK	1 ,979	3,099	2.6	4.1	0.6
Median			**3.1**	**5.9**	**0.3**
International peers					
Terna Rete Elettrica SpA (Italy)	7,397	15,544	9.0	14.0	1.2
Red Electrica Copr SA (Spain)	6,005	13,560	7.9	9.0	n/a
ITC Holdings Copr	3,867	6,425	10.9	18.2	n/a
Elia System Operator SA/NV (Belgium)	2,484	5,999	9.9	14.6	1.2
Transelectrica SA (Romania)	368	633	4.2	9.5	0.7
Median			**9.0**	**14.0**	**1.2**

Source: Bloomberg, RTS, FINAM estimates

Our estimates vs. the Street

We note that our FY12 and FY13 estimates are in line with the Street's expectations in terms of revenue and EBITDA. As to NI, we find that the Street is overly optimistic regarding FY12-13 figures, which we attribute to our more conservative forecasts on the company's financial expenses (debt service).

Table 7. FINAM FY12 and FY13 estimates vs. the Street's consensus, USD mn

	FINAM	Street	Dif. %
2012			
Revenue	**2,269**	2,240	1%
EBITDA	**446**	437	2%
NI	126	142	-11%
2013			
Revenue	**2,530**	2,448	3%
EBITDA	**496**	511	-3%
NI	132	196	-33%

Source: Bloomberg, FINAM

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