

MRSKs: Underpriced Despite RAB Disappointment

	Ticker	MC, \$m	EV, \$m	Previous target price, \$	New target price, \$	Up/down	Recommendation
MRSK Center	MRKC	1 014	1 666	0.063	0.043	81%	BUY
MRSK Center&Volga	MRKP	600	1 140	0.011	0.008	45%	BUY
Kubanenergo	KUBE	250	469	5.19	4.45	73%	BUY
Lenenergo	LSNG			0.44	0.52	44%	BUY
Lenenergo-pref	LSNGP	335	942	1.81	0.63	-25%	SELL
MRSK Siberia	MRKS	470	568	0.0099	0.0090	82%	BUY
MRSK North-West	MRKZ	302	440	0.0062	0.0049	57%	BUY
MRSK Urals	MRKU	661	769	0.018	0.016	117%	BUY
MRSK Volga	MRKV	571	681	0.0051	0.0057	78%	BUY
MOESK	MSRS	2 443	3 629	0.12	0.06	22%	BUY
MRSK South	MRKY	132	596	0.0053	0.0050	90%	BUY
Tomsk RK	TORS			0.047	0.041	155%	BUY
Tomsk RK-pref	TORSP	62	47	0.041	0.035	185%	BUY
MRSK Caucasus	MRKK	65	164	5.19	4.25	92%	BUY
MRSK Holding	MRKH			0.219	0.156	67%	BUY
MRSK Hold.-pref	MRKHP	4 011	7 636	0.143	0.101	85%	BUY

Source: MICEX-RTS, RMG estimates

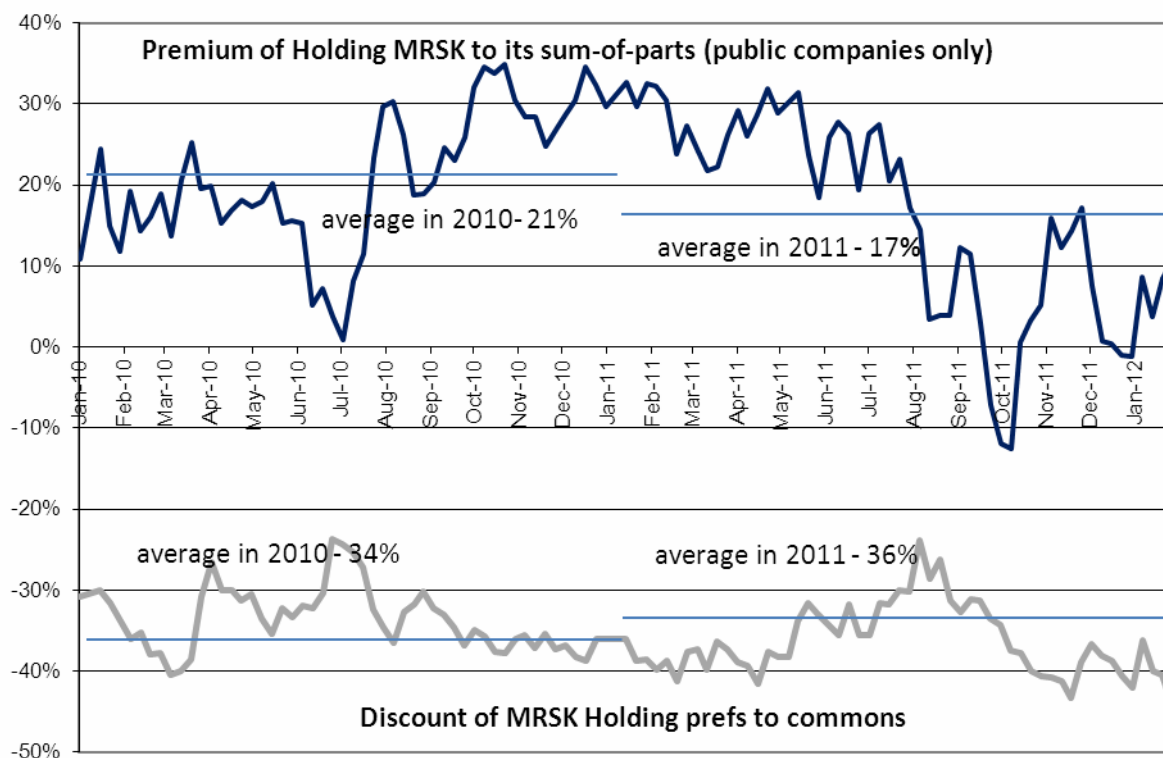
Investment Summary

We upgrade our models for MRSKs and MRSK Holding to reflect tariff growth ceilings in 2012-14. Despite confusion due to government revision of the RAB system, we view the 35-60% decline of MRSK shares since the start of 2011 as unjustified and see buying opportunities throughout the segment at present (all shares expect Lenenergo prefs offer attractive upside). Possible privatization could be a substantial driver for stocks, but much depends on future compliance by government with its own “rules of the game”.

- ✓ As discussed in our last report on MRSKs (11.07.2011), the government has kept effective control over tariffs of distribution companies, despite introduction of an RAB tariff system at most companies last year. Tariffs increased by only 13.5% in 2011 due to enforced “revenue smoothing” (postponement of tariff hikes due to RAB introduction until later years). A government resolution (№ 1178) published in January strikes another blow at RAB, ordering that tariff growth in 1H 2012 will be zero and that from July 1, 2012 MRSKs will either be transferred to RAB with new parameters (see details below), or to revenue indexation principle. The choice between these alternatives will be made by regulators, which have been instructed to ensure that distribution tariff growth does not exceed target ceilings for 2012-14 (6%, 10% and 9-10%, respectively).
- ✓ Changing “the rules of the game” may be partly justified by objective reasons (inefficient investments and low incentives for cost reduction by companies), but seems to be principally motivated by political considerations (preventing large tariff hikes for end-users).
- ✓ New RAB parameters should be published by the Federal Tariff Service by April 1. RAB tariff growth potential will be limited by lengthening the regulatory period, or lowering the return on “old” capital, or increasing the period of capital return, or, as a last resort, lowering the capital base. Regional regulators will also reduce MRSK investment programs. As we see it, there will be little effective difference between RAB and revenue indexation and the former could even be a worse alternative, because, in accordance with Resolution № 1178, companies using RAB must have at least 25% debt-to-capital ratio at the end of each year (the RAB system is intended for a context, where companies make large borrowings to finance capex), their capital base will not be increased until new facilities are commissioned (instead of when money is actually spent), and tariff levels will depend on loading of new facilities.

continued on the next page

- ✓ MRSK financials will remain under pressure in 2012, and some companies have already released preliminary forecasts for the year. MRSK Center expects revenue and EBITDA growth of 4% and 10%, respectively. MRSK Urals forecasts revenue growth by 4.5%, but EBITDA decline by 32%. Lenenergo expects revenue to grow by 3.5% and EBITDA by 16% (after 20% decline in 2011), but the company predicts a net loss in core business (electricity transmission).
 - ✓ We revise our MRSK models based on the government tariff growth ceilings (6%, 10% and 10% in 2012-14) and move our target prices to the end of 2012. We apply higher WACC for MRSK Siberia and MRSK North-West to reflect the risk of cancellation of “last mile” agreements, which bring 30% and 20% of their revenue, respectively. We also apply WACC of 17% to MRSK Caucasus to reflect higher risks of financial stability and corporate governance. We continue to use WACC of 14% for other MRSKs.
 - ✓ Our new targets confirm the attractiveness of commons and prefs of Tomskaya RK, which will be managed by the French distributor, ERDF, has a net cash position and pays dividends annually, and also of MRSK Urals, which has low share of “last mile” agreements and low share in end-user tariffs compared with other distributors. We also like MRSK Center, Kubanenergo, MRSK Volga, MRSK South and MRSK Siberia, which offer attractive upsides after 50-70% decline in 2011. MRSK North-West, MRSK Center and Volga, MOESK and Lenenergo commons are also of interest, though to a lesser extent. We recommend to BUY all of these shares.
 - ✓ We change our recommendation for Lenenergo prefs from HOLD to SELL to reflect expected profit declines of 74% and 65% in 2011 and 2012 relative to 2010. Current dividend yield for Lenenergo is only 4%.
 - ✓ We estimate fair value of MRSK Holding, which has controlling stakes in the regional MRSKs, based on 19% premium to sum-of-parts (public companies only) and 35% discount of prefs to commons (both indicators calculated as averages for the last two years) and we recommend to BUY both commons and prefs of MRSK Holding with upsides of 71% and 98%, respectively.
 - ✓ MRSK Holding recently published a strategy up to 2020, confirming that Tomskaya RK and MOESK will be put under management by ERDF and Gazprombank, respectively, and that one more MRSK (it is unclear which one) will be merged with an independent grid. MRSK Holding also says that it will consider privatization of MRSKs (reduction of the holding stake to less than 50%) in 2013 or later, depending on “results, quality of regulation and demand from strategic investors”. We view privatization as a substantial growth driver for the grid sector, mainly due to potential increase of operating efficiency. However, the key to investment attractiveness of MRSKs is the government’s compliance with its own new “rules of the game”.
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Source: MICEX-RTS, RMG estimates

Forecast financials, \$m

MRSK Center

	2010	2011E	2012E	2013E	2014E	2015E	2016E	2017E
Revenues	2 042	2 399	2 409	2 565	2 753	2 848	2 947	3 154
EBITDA	461	546	508	591	702	765	817	900
- margin	22.6%	22.8%	21.1%	23.0%	25.5%	26.9%	27.7%	28.5%
Net income	168	175	129	195	286	337	382	441
- margin	8.2%	7.3%	5.3%	7.6%	10.4%	11.9%	13.0%	14.0%
Capex	405	460	457	442	427	412	426	456

Source: company data, RMG estimates

MRSK Center & Volga

	2010	2011E	2012E	2013E	2014E	2015E	2016E	2017E
Revenues	1 813	2 151	2 286	2 463	2 667	2 785	2 909	3 143
EBITDA	216	336	305	422	512	549	590	654
- margin	11.9%	15.6%	13.4%	17.2%	19.2%	19.7%	20.3%	20.8%
Net income	28	111	57	156	230	263	297	345
- margin	1.5%	5.2%	2.5%	6.3%	8.6%	9.4%	10.2%	11.0%
Capex	277	306	313	313	315	316	326	349

Source: company data, RMG estimates

Kubanenergo

	2010	2011E	2012E	2013E	2014E	2015E	2016E	2017E
Revenues	808	965	1 033	1 122	1 224	1 289	1 357	1 479
EBITDA	11	33	51	77	107	131	158	193
- margin	1.4%	3.4%	4.9%	6.8%	8.8%	10.2%	11.6%	13.0%
Net income	-64	-51	-40	-21	1	18	37	59
- margin	neg.	neg.	neg.	neg.	0.1%	1.4%	2.7%	4.0%
Capex	82	89	88	86	83	80	83	89

Source: company data, RMG estimates

Lenenergo

	2010	2011E	2012E	2013E	2014E	2015E	2016E	2017E
Revenues	1 145	1 307	1 397	1 500	1 620	1 701	1 787	1 942
EBITDA	396	352	278	311	343	364	387	424
- margin	34.6%	27.0%	19.9%	20.8%	21.2%	21.4%	21.6%	21.9%
Net income	157	52	54	61	71	117	128	145
- margin	13.7%	4.0%	3.9%	4.1%	4.4%	6.9%	7.2%	7.5%
Capex	521	549	356	336	316	294	304	326

Source: company data, RMG estimates

MRSK Siberia

	2010	2011E	2012E	2013E	2014E	2015E	2016E	2017E
Revenues	1 467	1 750	1 873	2 033	2 217	2 334	2 458	2 677
EBITDA	59	149	76	100	253	290	329	385
- margin	4.0%	8.5%	4.1%	4.9%	11.4%	12.4%	13.4%	14.4%
Net income	-79	-63	-54	-15	33	63	94	133
- margin	neg.	neg.	neg.	neg.	1.5%	2.7%	3.8%	5.0%
Capex	129	141	142	140	138	136	141	151

Source: company data, RMG estimates

MRSK North-West

	2010	2011E	2012E	2013E	2014E	2015E	2016E	2017E
Revenues	954	1 120	1 178	1 257	1 347	1 393	1 441	1 541
EBITDA	80	117	84	103	143	197	207	227
- margin	8.3%	10.4%	7.1%	8.2%	10.6%	14.1%	14.4%	14.7%
Net income	-10	2	-31	-30	-17	63	71	82
- margin	neg.	0.2%	neg.	neg.	neg.	4.5%	4.9%	5.3%
Capex	89	98	100	100	100	101	104	111

Source: company data, RMG estimates

MRSK Urals

	2010	2011E	2012E	2013E	2014E	2015E	2016E	2017E
Revenues	1 880	2 179	2 292	2 444	2 618	2 705	2 795	2 987
EBITDA	275	308	210	296	408	422	436	467
- margin	14.6%	14.1%	9.2%	12.1%	15.6%	15.6%	15.6%	15.6%
Net income	78	93	20	65	96	144	151	197
- margin	4.2%	4.3%	0.9%	2.7%	3.7%	5.3%	5.4%	6.6%
Capex	187	202	202	198	194	189	195	209

Source: company data, RMG estimates

MRSK Volga

	2010	2011E	2012E	2013E	2014E	2015E	2016E	2017E
Revenues	1 306	1 538	1 621	1 732	1 859	1 925	1 992	2 133
EBITDA	131	231	194	228	266	280	294	319
- margin	10.0%	15.0%	12.0%	13.2%	14.3%	14.5%	14.7%	15.0%
Net income	19	82	47	74	103	113	123	138
- margin	1.4%	5.3%	2.9%	4.3%	5.6%	5.9%	6.2%	6.5%
Capex	277	306	313	313	315	316	326	349

Source: company data, RMG estimates

MOESK

	2010	2011E	2012E	2013E	2014E	2015E	2016E	2017E
Revenues	3 729	4 054	4 155	4 337	4 576	4 684	4 807	5 113
EBITDA	1 252	1 165	1 114	1 138	1 195	1 188	1 193	1 249
- margin	33.6%	28.7%	26.8%	26.2%	26.1%	25.4%	24.8%	24.4%
Net income	565	587	421	425	453	430	415	422
- margin	15.2%	14.5%	10.1%	9.8%	9.9%	9.2%	8.6%	8.3%
Capex	643	878	917	777	714	687	662	656

Source: company data, RMG estimates

MRSK South

	2010	2011E	2012E	2013E	2014E	2015E	2016E	2017E
Revenues	725	870	926	1 000	1 084	1 133	1 185	1 281
EBITDA	138	114	113	246	286	308	330	366
- margin	19.0%	13.1%	12.1%	24.6%	26.4%	27.1%	27.9%	28.6%
Net income	-118	-83	-83	-64	-41	-30	-16	0
- margin	neg.	neg.	neg.	neg.	neg.	neg.	neg.	neg.
Capex	59	63	62	60	57	54	56	60

Source: company data, RMG estimates

Tomsk RK

	2010	2011E	2012E	2013E	2014E	2015E	2016E	2017E
Revenues	186	219	231	246	265	274	283	303
EBITDA	18	24	26	31	36	38	41	45
- margin	9.7%	10.9%	11.3%	12.5%	13.6%	13.9%	14.3%	14.7%
Net income	7	12	14	18	22	25	28	32
- margin	3.8%	5.5%	5.9%	7.2%	8.5%	9.2%	9.9%	10.6%
Capex	13	14	14	13	13	13	13	14

Source: company data, RMG estimates

MRSK Caucasus

	2010	2011E	2012E	2013E	2014E	2015E	2016E	2017E
Revenues	345	408	434	467	500	517	536	573
EBITDA	62	82	74	107	121	125	130	140
- margin	18.0%	20.2%	17.0%	23.0%	24.3%	24.2%	24.3%	24.4%
Net income	20	33	37	49	59	61	64	69
- margin	5.9%	8.1%	8.6%	10.5%	11.9%	11.8%	11.9%	12.0%
Capex	72	77	75	71	68	64	66	71

Source: company data, RMG estimates

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