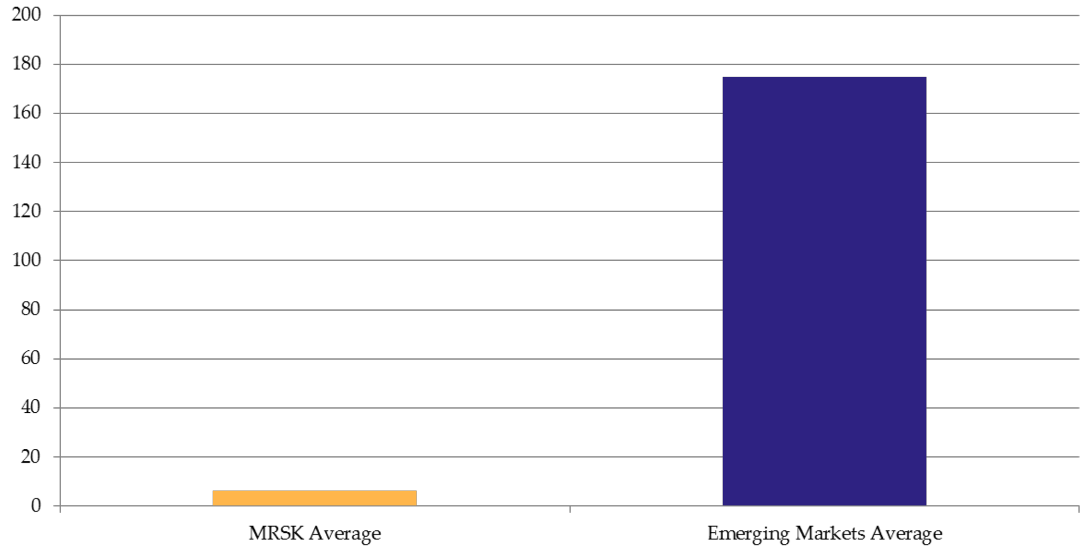
EOS Russia´s investment case, 08/31/2016

EOS Russia's portfolio is concentrated in Russian electricity distribution companies (MRSKs), with the aim of benefiting from these companies' very low valuations, large cost-cutting potential, growing profits and dividends and from their prospective privatizations.

The very low valuations of the MRSKs may be evidenced using a wide range of measures.

On an EV/MWh basis, the Russian MRSKs are discounted deeply to their emerging market peers. The MRSKs are traded at an EV/MWh of only $6/MWh compared to nearly $180/MWh on average in the case of the EM peer group.



MRSK average: MRSK North-West, MRSK Center-Volga, MRSK Volga, MRSK Urals
Emerging Markets average: Manila Electric (PHN), Equatorial Energia (BRA), Coelce (BRA)

In terms of earnings multiples, MRSKs are traded at discounts of 62-80% on 2013-15 EV/EBITDA and P/E multiples to Emerging Market peers (August 29, 2016).

	P/E			EV/EBITDA		
	2015	2016e	2017e	2015	2016e	2017e
MRSK Average	5,2	4,3	3,4	3,9	2,9	2,6
GEM Average	25,1	21,9	15,8	10,3	9,0	8,3
MRSK Discount	-79%	-80%	-79%	-62%	-67%	-69%

Note: MRSK average: Center-Volga, Volga, North-West Urals; GEM average: Light (BRA, Equatorial Energia (BRA), Manila Electric (Phi)
Source: Companies, 4-Traders, EOS estimates

We believe that there is large potential for cost-cutting at the MRSKs. The historical 'cost-plus' regulation of the MRSKs has often created perverse incentives to increase costs.

The valuation upside from cost-cutting is very large. For instance, a 20 per cent reduction of the total operating costs at MRSK North-West, would increase the 2015 RAS EBIT margin from 7.5 per cent to 27.5 per cent and EBIT from Rb2.9bn to 10.9bn, everything else being equal. The net income would then increase from Rb0.6bn to about Rb6.6bn. Assuming a dividend payout ratio of 50% and a fair dividend yield of 5%, the share price should be 13.7x times higher than currently.

MRSKs have grown their profits and dividends significantly over the past 18 months on the back of somewhat improved cost management.

It is also worth noting that the Russian government has been constantly increasing the state-owned company dividend payouts over the past years. This spring all MRSKs started to pay 50 per cent of the higher of their RAS (Russian Accounting Standards) or IFRS net income as dividends.

On July 5, 2016, Interfax reported that the Ministry of Finance had submitted amendments to the government dividend regulations extending the demand for a 50% payout indefinitely.

The bulk of EOS Russia's investment in the electricity distribution sector is divided between four different MRSKs (MRSK Volga, MRSK Center-Volga, MRSK North-West and MRSK Urals), in which it holds 6.3-14.4 per cent stakes.

EOS Russia believes that there will be opportunities to form larger divestment alliances with other market players. In the case of several MRSKs, the combined shareholding of participants in such alliances may be a blocking stake (more than 25 per cent of the voting shares present at AGM/EGM). EOS Russia has sold several 1-2 per cent stakes in TGKs and other Russian electricity companies over the past 3-6 years. Some of these sales were priced at significant premiums relative to market share prices on the day of the transactions, some of which were carried out with the help of similar divestment alliances.

Over the past years, the Russian government has taken steps to privatize the MRSKs. Although progress on this front has been slow, a significant catalyst for an increase in value of the MRSKs would be their privatisation. Significant milestones on the policy path towards MRSK privatization have been as follows:

March 2011: the then President Medvedev stated that the MRSKs should be privatized or put under external management.
April 2013: publication of the government’s Grid Strategy, which set a deadline of preparing a pilot MRSK privatization and a drawing up an overall privatization program for the MRSKs by the end of 2013. Although the Federal Property Fund started to consider and draft MRSK privatization plans in November-December 2013, the government missed that deadline.
October 2014: President Putin confirmed the intention of the Russian authorities to privatize the MRSKs.

After these developments, the privatization processes were essentially frozen following the increased geopolitical tensions due to the Ukrainian crisis. We do not expect much to happen on the MRSK privatization front before significant parts of the European sanctions are withdrawn.

Even though the Russian economy has suffered two major contractions in the past ten years (2009 and 2015), the Russian residential electricity demand has been growing steadily typically by about 2-4% / year. This combined with the continuing migration to larger cities is inevitably increasing need for new electricity distribution assets. As there is little budget financing available for a major new asset build-up, the asset construction need may at some point be a key trigger for privatizations.

If the recent improvement in the portfolio companies’ earnings and dividends is sustained – a prospect which EOS Russia believes is plausible – EOS Russia intends to distribute to its shareholders by means of the existing synthetic share buyback programme the portion of the dividends in excess of tightly controlled running costs; and in the event of any attractively priced divestments (resulting from privatization prospects or some other driver), EOS Russia intends to distribute the proceeds by the same mechanism or some other means.