

## EOS Russia's investment case, 01/09/2021

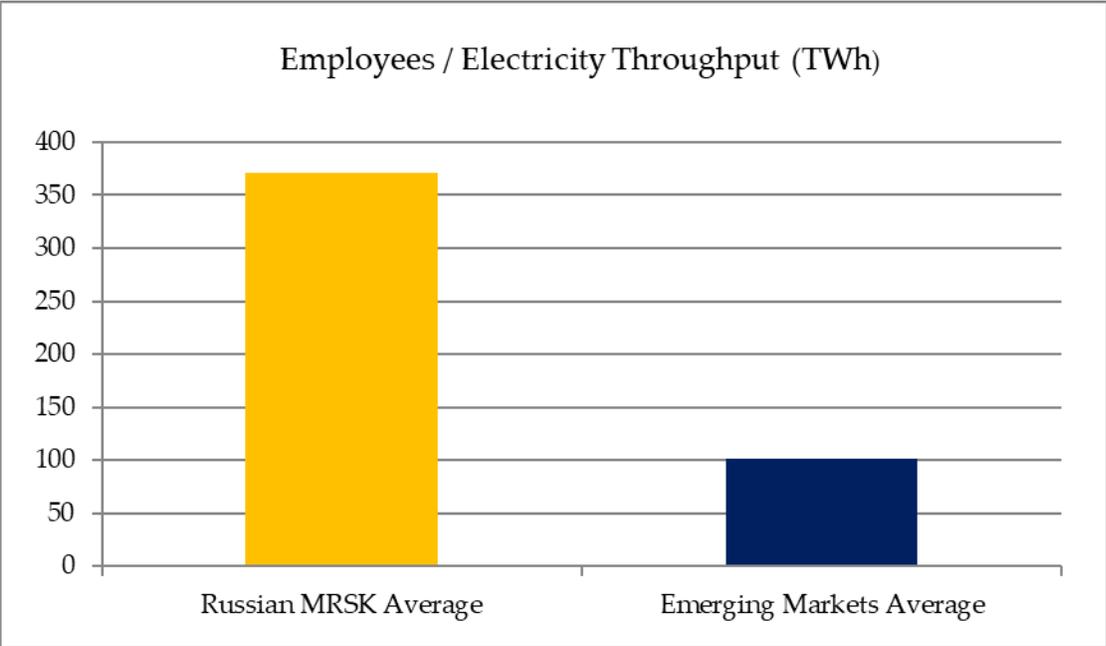
### Summary

- The MRSKs in which EOS Russia's investments are concentrated have big potential to cut costs, increase efficiency and grow profits. The potential could be unlocked especially by the launch – possibly from 2023 – of the expected long-term 5-10 year tariff contracts. In our view, these long-term contracts could result in a very significant improvement in the MRSK earnings profile, but it should be understood that their benefits are still some years away and that there could be uncertainties related to their introduction and in the way in which the system will work.
- MRSKs are valued at very large discounts to emerging markets peers on earnings multiples (66-85% discounts on 2020-22 EV/EBITDA and P/E multiples) and operational multiples (92% discount on EV/MWh distributed).
- The prospect of MRSK privatizations is unlikely to revive until the Russian economy returns to higher sustained growth.
- MRSKs started to generate meaningful and growing profits after 2014 when the regulatory framework for tariffs was changed to 'inflation minus'. As a result, EOS Russia has received even double-digit dividend yields on many of its holdings on several occasions.
- While 2019 was a weaker year and 2020 affected by the pandemic, 1H21 has shown clear signs of recovery. Despite the promising start to the year, the quality of the new Rosseti management team appointed this year remains unproved for now.
- MRSKs could benefit from the possible expansion of regional tariff unifications and these unifications could also accelerate TSO consolidations – leading, in turn, to additional cost optimization and synergy potential.
- Possible new reserve/idle capacity tariffs and a connection fee reform could also bring in additional revenue; but progress in these areas would likely require sustainably higher economic growth in Russia.
- Trading in MRSK shares in larger volumes is thin
- In the longer-run, MRSKs could be beneficiaries from the shift of the car park from ICE to electric vehicles and other consequences of policy responses to the climate crisis.

### MRSKs have big potential to increase efficiency and grow profits

EOS Russia's portfolio is concentrated in Russian electricity distribution companies (MRSKs), with the aim of benefiting from these companies' combination of very low valuations and the potential for deep cost-cutting. Particularly important for unlocking this cost-cutting potential is the implementation of long-term 5-10 year tariff contracts that are mandated by recently enacted legislation to begin in 2023. Other contributions to realizing this potential could come from regulatory changes now under active consideration: tariff unification, reserve/idle capacity tariffs and a connection fee reform.

This still large potential for cost-cutting at the MRSKs stems from the move away from the historical 'cost-plus' tariff regulation of the MRSKs that was largely prevalent in Russia in the 1990s and 2000s and which often created perverse incentives to increase costs. This background helps explain the fact that the MRSKs' average Employees to Electricity Throughput (TWh) ratio is 3.5 times higher than in the case of their Emerging Market country peers.



*Russian average: MRSK North-West, MRSK Center-Volga, MRSK Volga, MRSK Urals, Lenenergo.  
Emerging Markets average: Equatorial Energia (BRA), Coelce (BRA), Prazhka Energetika (CZE), Manila Electric (PHI)*

It appears that significant cost savings in the MRSKs could result from, among other things, their digitalization programs, metering, new IT infrastructure, cost and grid optimization synergies from potential TSO mergers (on which more below), corporate governance improvements and labor force optimization. While the headcount rationalizations involved in any such material reduction in operating costs can be challenging, the task may be facilitated by the structural tightness of Russia’s labor market – i.e. the country’s demography now results in demand for labor exceeding supply.

The opportunity for value creation created by the prospective implementation of a stable long-term tariff framework would be enhanced by any performance-based pay incentives for MRSK management teams linked to profitability. Such schemes already exist in other large state-owned enterprises in Russia, and might therefore be introduced at some point in the Rosseti group.

The valuation upside from cost-cutting is very large. For instance, a 20 per cent reduction of the total operating costs at MRSK Volga would increase the 2019 IFRS EBIT margin from 8.1 per cent to 26.5 per cent, and EBIT from Rb5.1bn to Rb16.7bn, everything else being equal. The company’s net income would then increase from Rb3.9bn to about Rb13.2bn. Assuming a dividend payout ratio of 50% and a fair dividend yield of 5%, the share price would then be 12.7x times higher than its present level (August 10, 2021).

**Tariff reforms moving forward on several fronts**

*Long-term tariffs*

In 2019, the Russian parliament passed enabling legislation for a system of long-term tariff regulation. These laws provide for the new system to start from January 1, 2023. According to various official comments, including by the regulator, the new system should lock in tariff growth for 5-10 years. We believe that such a framework would create a very good environment for MRSKs to cut their costs and grow their profits. According

to Rosseti, the first long-term contracts have already been signed. It is probably reasonable to expect that a larger migration would happen only closer to January 2023 or possibly after.

In addition, the Russian government has been drawing up several other possible regulatory changes for MRSKs: reserve (idle) capacity payments, tariff unification within regions and a connection fee reform.

#### *Tariff unification*

In November 2020, the Russian government approved a move to unify electricity distribution tariffs in groups of regions and unify the tariffs between certain 'macro' regions. In the initial implementation phase, this tariff unification concerns the following regions that are joining together to form macro regions in this respect:

- 1) Kurgan and Tyumen
- 2) Upper Altai and Altai Oblast
- 3) Kalmykia and Rostov Oblast
- 4) Tuva and Irkutsk Oblast
- 5) St Petersburg and Leningrad Oblast

The tariff unification migrations in these regions require separate agreements with the regional authorities. In general, the federal government has been negotiating and implementing such migrations in 2021. The pilot regions do not cover the operating regions in which EOS has ownership other than Lenenergo, but nevertheless the process of tariff unification that has now begun is generally a very positive development for MRSKs, as additional regions will quite possibly be added later.

In most distribution regions, the MRSKs operate alongside other low-voltage grid companies called TSOs. Now accounting overall for a third of Russia's electricity distribution networks, these TSOs are often affiliated with interests close to oblast governments. This may explain why the TSOs often receive significantly higher tariffs (sometimes many times higher) for the same service as provided by the MRSK operating in that same region. Evening out tariff levels within distribution regions should generally result in an increase in the tariffs received by MRSKs compared to present levels and a decrease in the tariffs for TSOs. Rosseti has understandably been pressing regulators to effect such tariff unification for many years.

TSO owners may respond to this relative deterioration in their trading environment by selling their grids to MRSKs at reasonable valuations, which is clearly one of the government's goals.

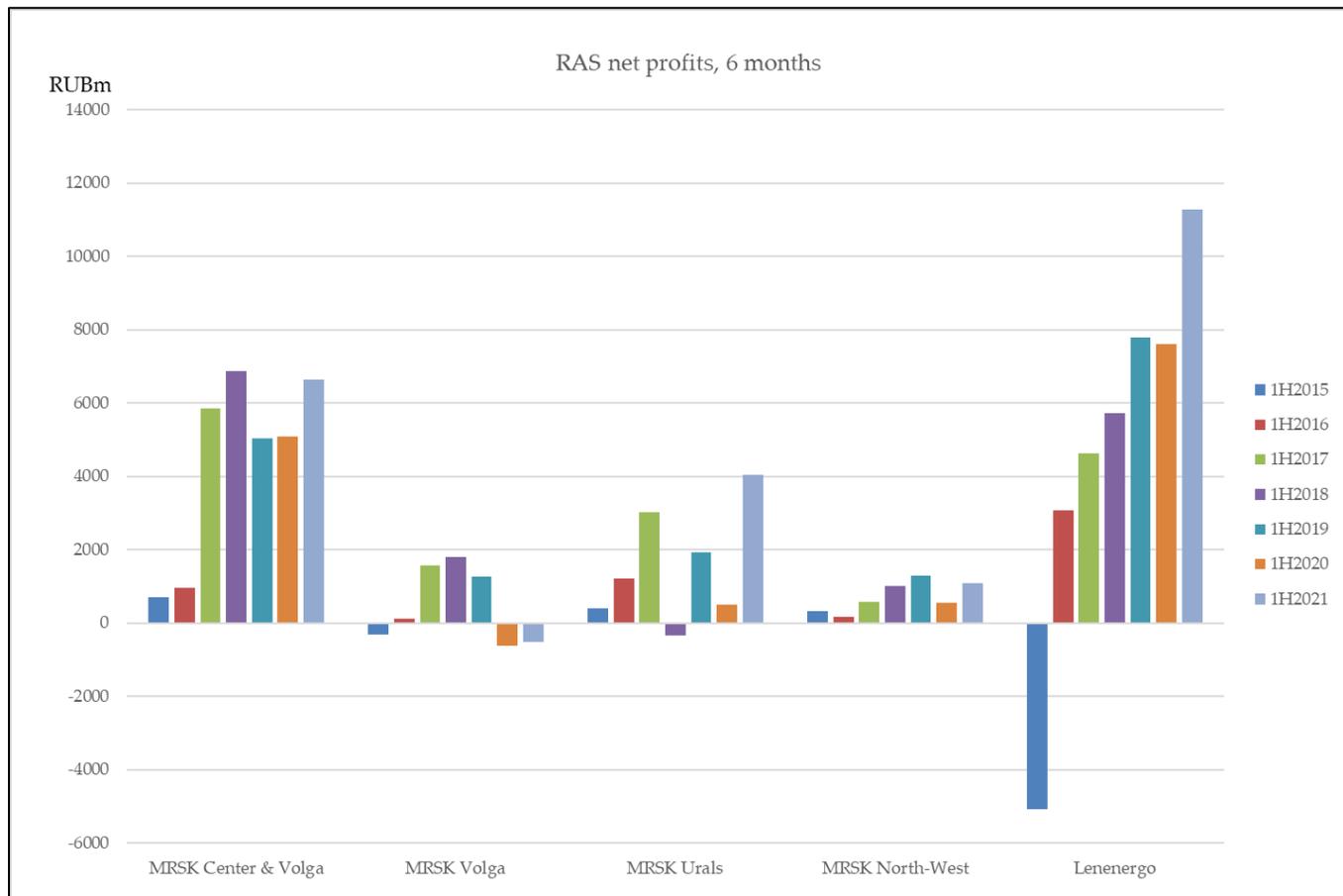
#### *Reserve (idle) capacity and connection fee reforms*

The Russian government has been considering various other tariff reforms for the electricity grids in the past years. Mooted reforms include reserve (idle) capacity payments to the grids and various connection fee reforms. In contrast with the long-term tariff and tariff unification measures described above, these other initiatives have yet to produce any tangible results. Prospects for progress in these areas would be improved if the overall growth rate of the Russian economy were to increase – in turn creating a greater need for the construction of new low-voltage grid assets.

It is worth noting that the prospective long-term tariff contracts would drive MRSKs' profitability indirectly as they do not include any real-terms tariff increases (rather the contrary). On the other hand, the tariff unification, reserve capacity payments and/or the connection fee reforms could drive up MRSKs' top-line revenue.

## MRSK profits and dividends have been generally trending higher

In the middle of the past decade, the MRSKs started to deliver material increases in their profits and dividends (see chart below).



Note: RAS net profits. Source: Companies, EOS estimates

In our view, the key factor behind the profit improvement since 2014 has been the tariff regime, which, starting from 2014, became predictable and stable. Annual tariff increases have been much smaller than before, with all MRSKs receiving a tariff increase slightly below inflation every July (inflation minus). This change has been an essential spur for managements to improve the planning of investments and operating cost controls.

The year 2019 saw generally somewhat weaker profit performance. While there may be a number of reasons for this, it may arguably be attributed to the new senior management team of Rosseti (the state-controlled parent company of MRSKs) losing focus ahead of the expected imminent launch of a new long-term regulation system, which ended up being postponed until 2023.

in the following year (2020), MRSK results were adversely affected by the coronavirus lockdowns, reduced industrial production and the exceptionally warm winter. In 1H21, the results have improved markedly on the back of expanding industrial activity, the easy-to-beat numbers for 1H20, and some improvements in management actions, especially with regard to bad debt collections. While some MRSKs have in the past suffered from a few material write-downs of receivables, it would appear that managements are now getting a

better handle on these risks. This would explain some recent positive surprises in the form of previously written-off debts being recovered.

It is also worth noting that the Russian government has brought about substantial increases in state-owned enterprise dividend payouts and dividends over the past years. Six years ago, MRSKs were still essentially without any clear dividend policies and paid tiny dividends. The improvement seen in the period since then has resulted in the dividend yields on some EOS holdings even reaching double digits.

On 10 June 2021, a Government Commission on Electricity approved Rosseti's new 2030 strategy. According to the strategy, Rosseti's dividends from MRSKs would increase from R16bn in 2020 to R76bn in 2030 (i.e. by a factor of 4.75x). It goes without saying that such predictions ten years forward involve considerable uncertainties; but, at the same time, they highlight the significant earnings and dividend potential of the MRSKs.

We believe that the Rosseti 2030 Strategy indirectly reflects the fact that the MRSKs have been relative under-receivers in the Russian electricity sector in the past 13 years. The generation companies (OGKs/TGKs) were largely privatized in 2007-08 and received substantial injections of external capital with which to build new generation capacities. Meanwhile FSK (the Federal Grid Company) has enjoyed a favorable tariff regime throughout the past decade enabling it, among other things, to carry out large scale investment. A change in this relative disadvantage for the MRSKs seems in prospect in the light of the various actual and potential tariff reforms described above.

### **Potential structural changes**

During the past decade, there has been much discussion among policy makers and electricity industry leaders of possible structural changes to Rosseti and MRSKs. On the one hand, certain industry players – notably some of the former Rosseti management teams – have advocated consolidating the MRSKs into Rosseti. On the other hand, official government documents have set goals of gradually privatizing at least some of the MRSKs.

At present, however, such discussions have ceased. In the case of privatizations, senior policymakers have not mentioned this possibility since the middle of the past decade. It seems reasonable to infer that this reflects shifts in policy priorities in the Kremlin, with economic trends providing an important part of the explanation. The period since the 2008-09 global financial crisis has been one of successive shocks and weak economic growth in Russia. The need to raise external capital would likely arise in an environment of sustained higher economic growth rates requiring significant new electricity connections. Just such an environment was seen in Russia in 2006-07, and the authorities responded by introducing connection fees as an urgent short-term measure for the purpose of ensuring adequate funding for capex.

### **MRSKs in the electric car and hydrogen economy**

In the light of the rapid decline in the production costs of electricity batteries and storage, and of solar and wind generation technologies – as well as general climate change concerns – the future for electricity sectors all over the world is clearly going to look very different from the past. Electricity will account for a higher share of total energy consumption. One factor here is the construction of electricity-intensive hydrogen production capacity, which would require massive expansion in electricity generation.

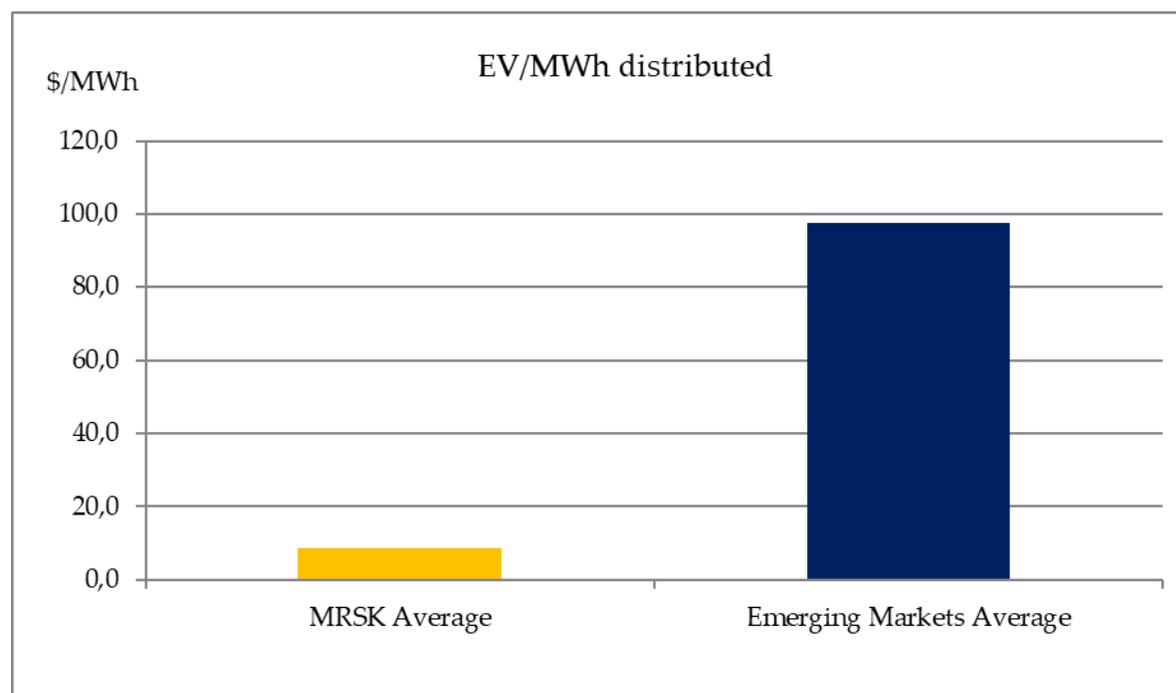
In the nearer future, Rosseti is estimating that converting just 3-4% of the Russian car park into electric vehicles (EVs) increases electricity demand by 1%. In other words, shifting to EVs would increase electricity demand by up to around 30%. These are obviously huge numbers in the context of electricity consumption, and would require large electricity distribution investment.

Rosseti has said that it should have a special tariff for EV charging stations. As it has been in practice the MRSKs that have been launching electric car charging stations, it should therefore be the MRSKs that receive this additional business and tariff.

## MRSKs are very low-valued on the stock markets

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

On an EV/MWh basis, the Russian MRSKs are deeply discounted to their emerging market peers. The MRSKs are traded at an EV/MWh of less than \$8/MWh compared to nearly \$98/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 (PHI), Equatorial Energia (BRA), Coelce (BRA)

MRSKs are traded at very deep discounts of 66-85% to Emerging Market peers on 2020-22 estimated P/E and EV/EBITDA multiples.

	P/E			EV/EBITDA		
	2020	2021e	2022e	2020	2021e	2022e
MRSK Average	N/A	2.9	3.5	1.4	1.2	1.1
GEM Average	12.9	13.1	10.2	7.2	8.0	7.0
MRSK Discount	N/A	-78%	-66%	-81%	-85%	-84%

Note: MRSK average: Center-Volga, Volga, North-West, Urals; GEM average: Light (BRA, Equatorial Energia (BRA), Manila Electric (PHI)). Note: Ratios exceeding 30 have been excluded. Source: Companies, Marketscreener, EOS estimates, Date: 19 August, 2021

The reasons for the low valuations of the MRSKs include, among other things: the currently low market valuations of Russian companies in general, in part caused by generally negative sentiment around raw material economies; the limited number of intermediaries in daily stock trading and price formation; scant foreign portfolio investment in Russian small cap stocks, on which the sell-side research coverage is scant and low-quality; the mostly-lacking IR activities by MRSKs; and the portfolio investment community's low level of interest and understanding as regards the electricity distribution business globally and locally.

### **Liquidity of MRSK shares**

MRSK shares are listed in Moscow and have mostly relatively tight bid-ask -spreads. However, the market is less liquid for larger volumes. The actors on the market are largely retail investors.

### **EOS is returning capital to shareholders**

EOS Russia believes that there may later 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 amount to a blocking stake (more than 25 per cent of the voting shares present at AGM/EGMs). EOS Russia has sold several 1-2 per cent stakes in TGKs and other Russian electricity companies in the past. 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 divestment alliances.

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 use the existing synthetic share buyback program to distribute to its shareholders the resulting cash holdings in excess of those required to meet the company's tightly controlled running costs, allowing also for a prudent contingency. 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.