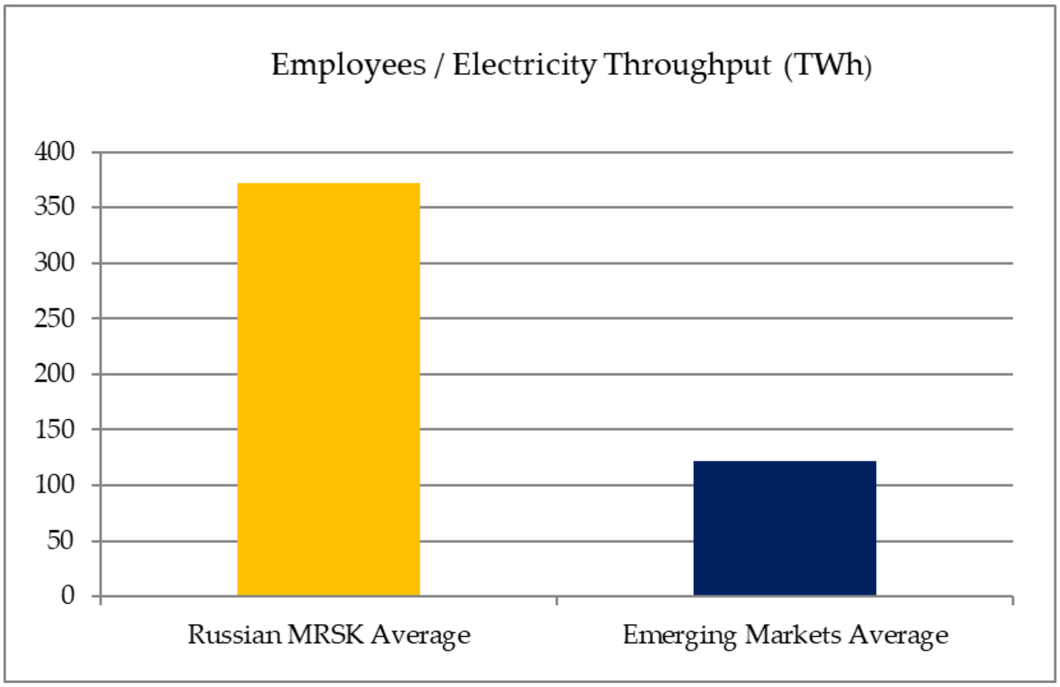
EOS Russia´s investment case, 25/08/2020

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 growing profits and dividends on the back of the early stages of improved cost control – with much of the large cost-cutting potential still untapped. The final driver is the prospective privatization of these companies.

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

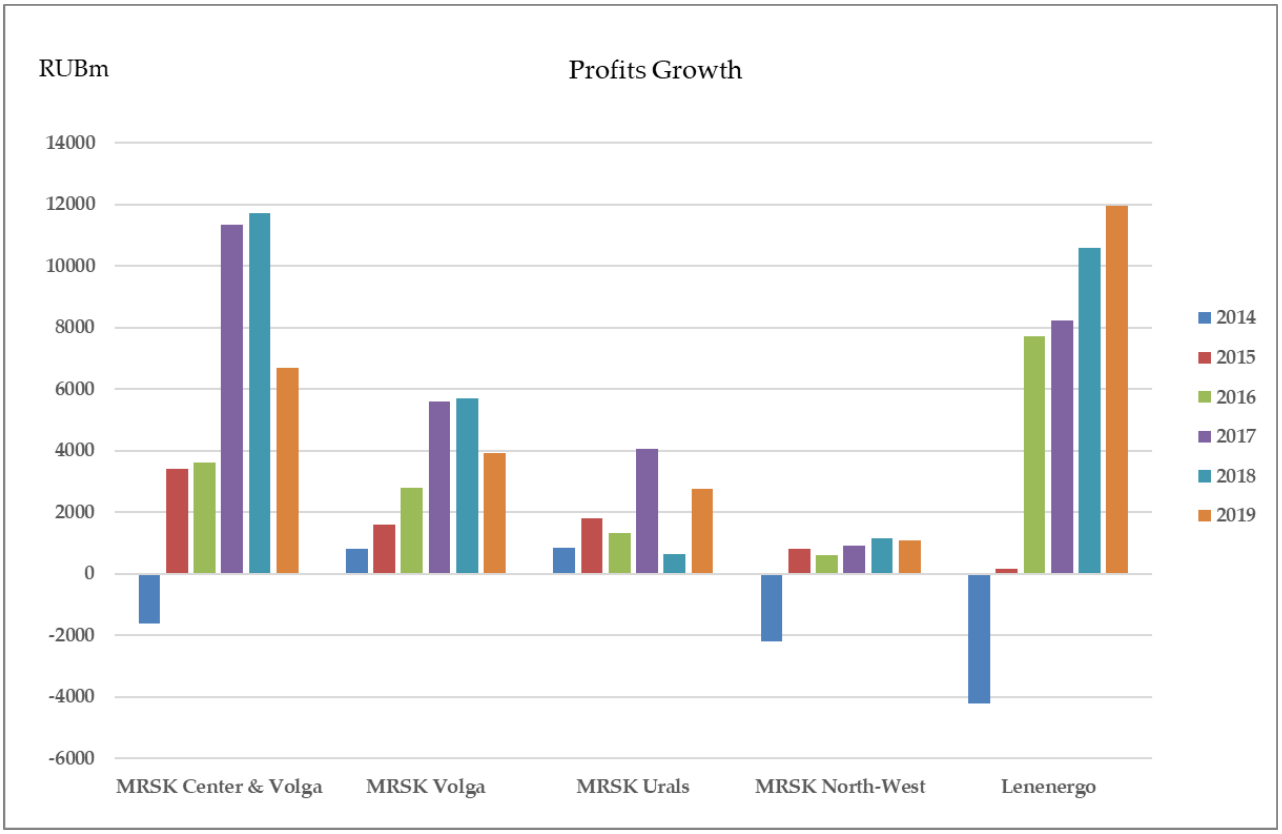
This is visible for instance when comparing the Employees to Electricity Throughput (TWh) ratio to that of Emerging Market country peers. The Russian ratio is about 3x higher.



Russian average: MRSK North-West, MRSK Center-Volga, MRSK Volga, MRSK Urals, Lenenergo.
Emerging Markets average: Equatorial Energia (BRA), Coelce (BRA), Prazhka Energetiska (CZE), ELMU (HUN)

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 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 9.4x times higher than its present level (August 13, 2019).

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

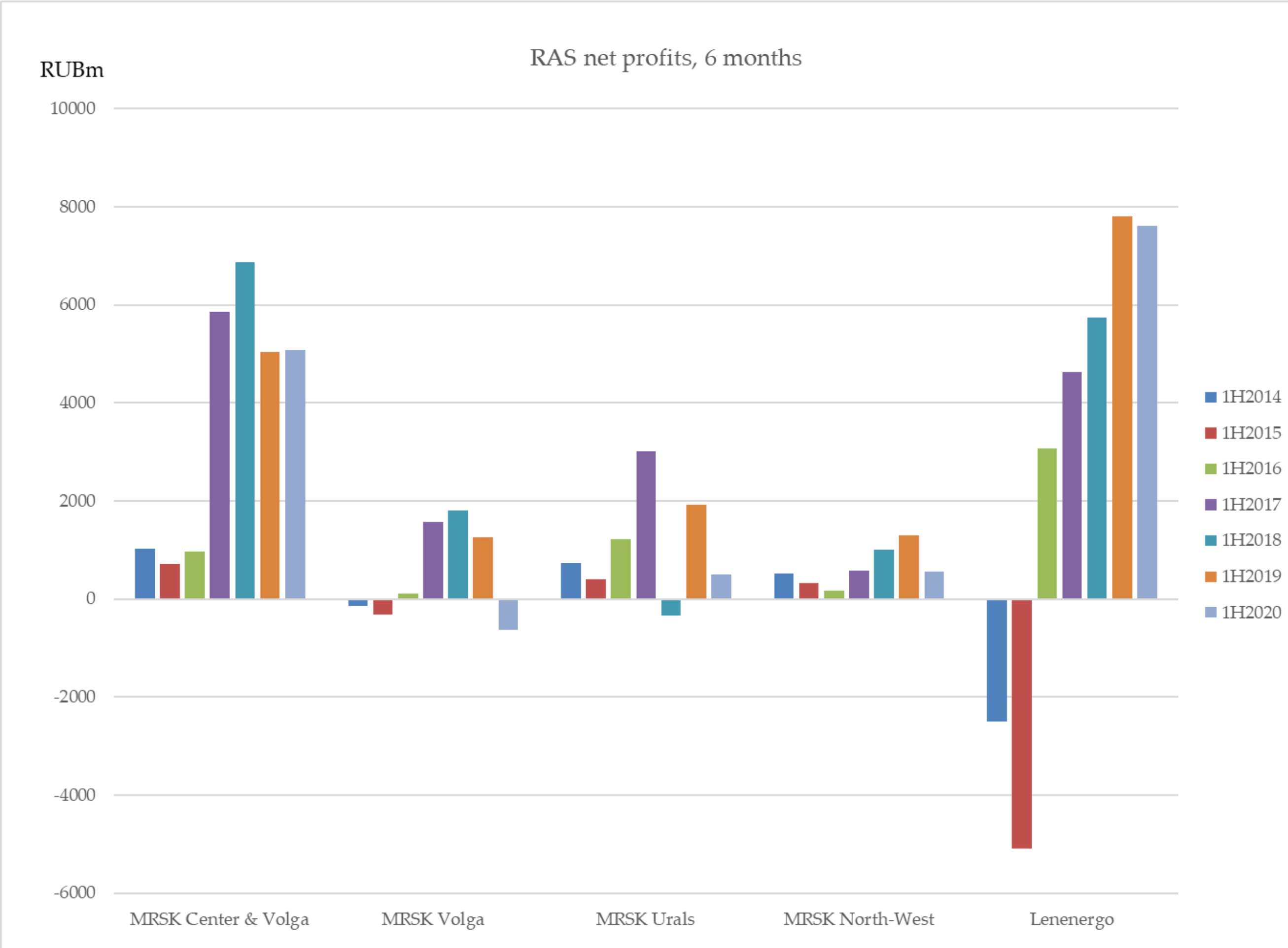


Note: IFRS net profits, excluding MRSK North-West write-down in 2017, but including MRSK Urals write-down in 2018. Source: Companies, EOS estimates

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. This change has been essential for better planning of investments and operating costs.

Nevertheless, 2019 saw overall earnings decline somewhat. While there may be a number of reasons for this development, 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 (on which more below).

MRSK results in 1H20 were adversely affected by the coronavirus lockdowns, reduced industrial production and the exceptionally warm winter. Given this unfavourable background, the results were relatively good with the exception of MRSK Volga that posted a loss in 2q20 under Russian Accounting Standards (RAS – see chart below).



There are various signs that Rosseti is becoming a more investor- friendly company.

Rosseti paid its first meaningful dividends this spring. It has also recently appointed two new Board members who are well-respected on the financial markets. Nevertheless, a lot remains to be done in the areas of transparency, corporate governance, dividend payments, investor relations and improved profitability on all levels.

When the new senior management team of Rosseti started just under two years ago, its stated aim was to increase the market capitalisation of Rosseti to Rb1 trillion. At the time of that announcement, this goal implied share price upside of around 6-7x; but as the shares have performed well since, the implied upside to the target is currently 3.1x.

The Russian parliament last year 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.

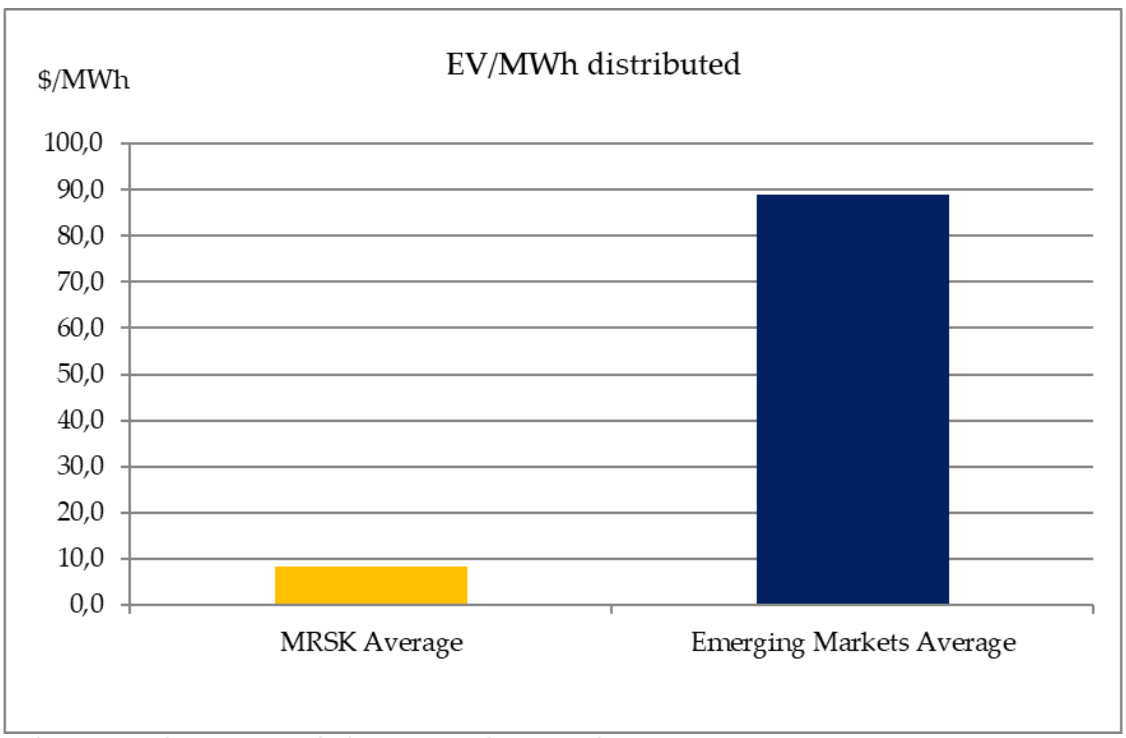
In addition, the Russian government has been working on several other possible regulatory changes for MRSKs: idle capacity payments, reference (*etalonnie*) tariffs, residential user connection fee reform and the effective return of the last-mile payments. These plans were disrupted by the change of government in early 2020 followed by the coronavirus outbreak, but they will likely return to the agenda, and some of them will probably be realised at some point. Any of them would be positive for MRSKs.

In February 2020, the new deputy prime minister with overall responsibility for the energy sector, Yury Borisov, approved in general the plans to start idle capacity payments from January 2021. For now, however, it is unclear whether and how the coronavirus pandemic may affect the implementation of these plans.

The plan for reference (*etalonnie*) tariffs would mean making tariffs equal within one distribution region, which typically comprises a number of the constituent parts (variously known as “oblasts”, “krais” etc) of the Russian Federation. 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 receive significantly higher tariffs (sometimes many times higher) for the same service as provided by the MRSK operating in that same region. By evening out tariff levels within distribution regions, ‘reference tariffs’ should result in an increase in the tariffs received by MRSKs compared to present levels. The introduction of 'reference tariffs' would also encourage a process of consolidation, in which MRSKs would be acquiring TSOs in line with the federal government’s wishes, All in all, MRSKs could gain many synergy and cost-savings benefits as well as more favourable tariffs from this process. At the same time, there are some risks involved in this possible introduction of reference pricing. The system may prove complicated and difficult to administer in the varying regions of Russia.

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 $10/MWh compared to nearly $90/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)

MRSKs are traded at very deep discounts of 60-70% to Emerging Market peers on 2019-20 estimated P/E and EV/EBITDA multiples.

	P/E			EV/EBITDA		
	2018	2019	2020e	2018	2019	2020e
MRSK Average	2,7	3,8	4,9	1,2	1,8	2,1
GEM Average	18,5	9,5	16,4	6,9	6,0	6,8
MRSK Discount	-85%	-60%	-70%	-83%	-70%	-69%

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: 13 August, 2020

It is also worth noting that the Russian government has brought about substantial increases in state-owned enterprise dividend payouts over the past years. Five years ago, MRSKs were still essentially without any clear dividend policies and paid tiny dividends.

To take the examples of the four MRSKs (Volga, Center-Volgs, North-West and Urals) that account for the bulk of EOS Russia's investment in the electricity distribution sector and in which it holds 6.3-14.4 per cent stakes: these companies paid out 36-57% of their 2019 RAS profits or 27-33% of their 2019 IFRS earnings as dividends. The dividend yields on EOS Russia's NAV have been hovering around 10% in recent years.

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 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 over the past 7-10 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 divestment alliances.

The final positive valuation driver for the MRSKs could be prospective privatizations of at least some of these companies. Policymaking highlights as regards MRSK privatizations include:

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 support for privatizations in the Government and the Kremlin has started to weaken.

It is no surprise that this policy option has ceased to be mentioned by senior officials since the middle of the past decade. This may partly be explained by general trends: the period since the 2008-09 global financial crisis has been one of successive shocks and weak economic growth in Russia. This has has had the effect of putting privatisation plans on the back-burner as there has been little need to raise new equity financing for new capex. A specific factor has been geopolitical tensions between Russia and some Western governments since the Ukraine crisis in 2014. We do not expect much to happen on the MRSK privatization front before significant parts of the EU's sanctions are withdrawn and the Russian economy shows more sustained growth.

Since Pavel Livinsky's appointment as CEO, management at Rosseti has concentrated on consolidating assets in various regions and on plans for digitalization of the system, showing a preference for centralization, particularly in the light of the projected merger with FSK (the Federal Grid Company).

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 all dividend receipts in excess of tightly controlled running costs, and allowing 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 allowing for a prudent contingency which may be invested in liquid shares if appropriate. While we do not expect to add to our investments in the distribution business, we may temporarily increase our exposure to liquid shares in other parts of the power sector, in particular in generation companies in order to hedge our exposure to rising electricity prices.