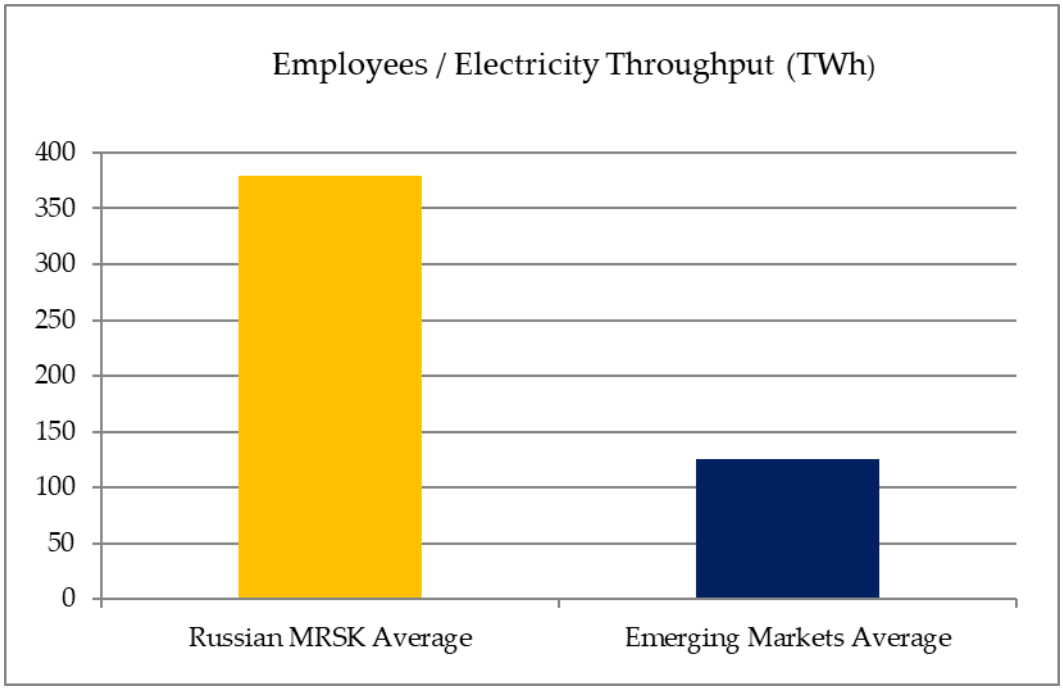
EOS Russia´s investment case, 22/08/2019

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.

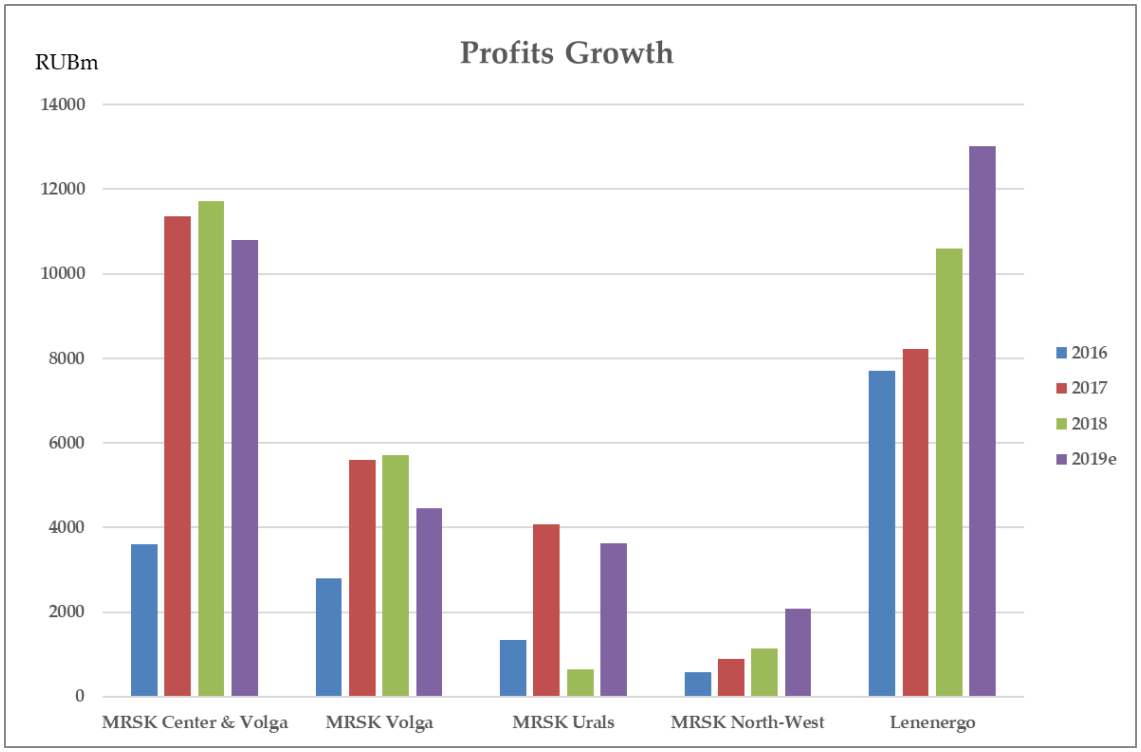
This is visible for instance when comparing the Employees to Electricity Throughput (TWh) ratio to that of Emerging Market country peers. The Russian ratio is about 3x higher.



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 2018 IFRS EBIT margin from 11.3 per cent to 27.6 per cent and EBIT from Rb7.2bn to 17.6bn, everything else being equal. The net income would then increase from Rb5.7bn to about Rb14.0bn. Assuming a dividend payout ratio of 50% and a fair dividend yield of 5%, the share price should be 8.2x times higher than currently (Aug 16, 2018).

Indeed, MRSKs have started to grow their profits and dividends significantly over the past 4.5 years owing to somewhat improved cost management, although this year the rapid increase in wholesale electricity prices has dented earnings growth.



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 factors factor behind the profit improvement is the tariff regime that has been predictable and unchanged since 2014 with materially smaller tariff increases than before. All MRSKs have received a tariff increase slightly below inflation every July. This has been essential for better planning of investments and operational costs. This predictability of the regulatory approach combined with the more hands-on approach by Ministry of Energy, the tariff regulator and Rosseti has made the difference.

The Russian government is working on a long-term tariff regulation framework that could lock in tariff growth for 5-10 years (based on the current planning likely for 10 years). This new system could be in place from 2020. We believe that such a framework would create a very good environment for MRSKs to cut their costs and grow their profits.

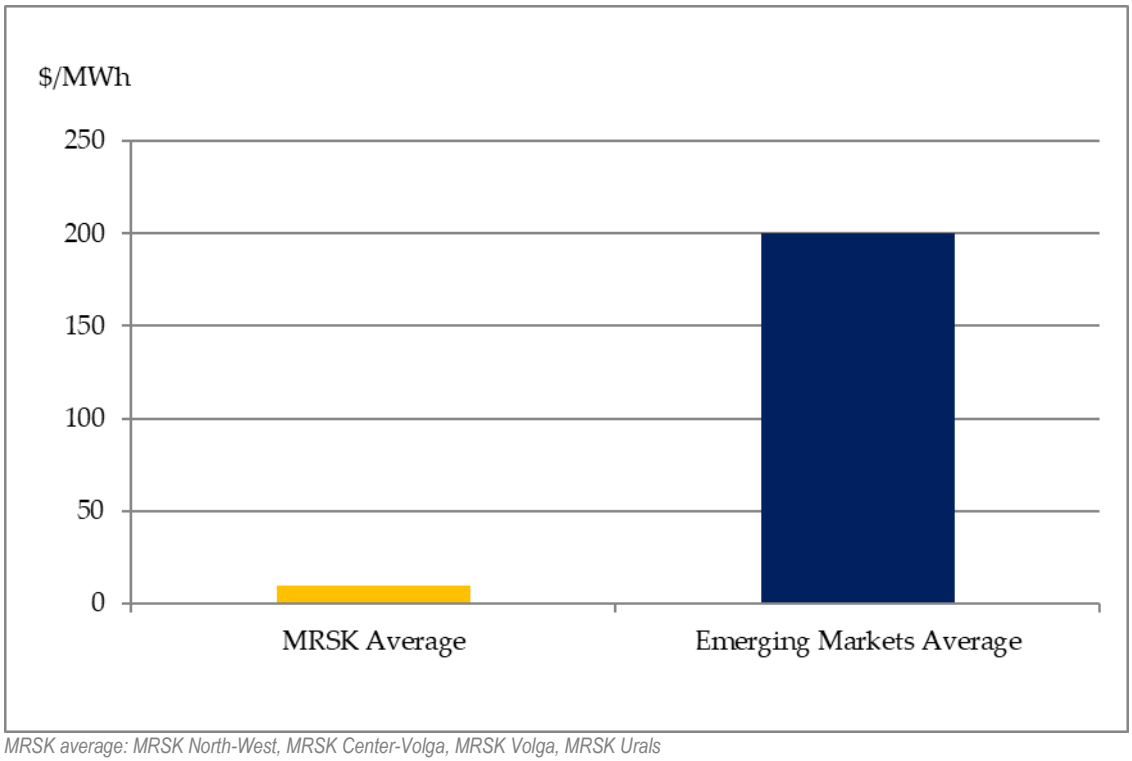
There is also talk in Russia of introducing so-called 'reference tariffs'. This would mean making tariffs equal within one distribution region, which typically comprises a number of the administrative units (variously known as “oblasts”, “krais” etc) of the Russian Federation. In most distribution regions, 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. It can be a complicated system 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 only $10/MWh compared to $200/MWh on average in the case of the EM peer group.

EV/MWh distributed



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 68-84% to Emerging Market peers on 2017-19 estimated P/E and EV/EBITDA multiples.

	P/E				EV/EBITDA		
	2017	2018	2019e		2017	2018	2019e
MRSK Average	3.1	3.4	2.9		3.2	1.7	1.6
GEM Average	20.2	18.2	17.6		10.1	9.9	9.5
MRSK Discount	-85%	-81%	-84%		-68%	-83%	-83%

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: 15 August, 2019

It is also worth noting that the Russian government has been significantly increasing the 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.

For instance, for 2018, MRSK Center-Volga, MRSK Volga and MRSK Urals paid 50-62% of their RAS profits or 40-44% of their IFRS net profits as dividends. The dividend yield projections for EOS Russia's portfolio for 2019 currently exceed 10%.

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/EGMs). EOS Russia has sold several 1-2 per cent stakes in TGKs and other Russian electricity companies over the past 6-9 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.

Over the past years, the Russian government has been developing its policy as regards privatizing the MRSKs. Although progress on this front has been slow, a significant catalyst for an increase in value of the MRSKs would be their privatization. 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 EU's sanctions are withdrawn.

In July 2018, the new Rosseti CEO Pavel Livinsky said in a newspaper interview that the government should first introduce a long-term tariff regulation framework and resolve the cross-subsidization issue, after which the question of privatizing the MRSKs could be discussed with the benefit of carrying out such privatizations at high prices.

Even though the Russian economy has twice been in recession during the past decade (2009 and 2015), Russian residential electricity demand has been steadily growing – typically by about 2-4% per year. This combined with the continuing migration to larger cities is steadily increasing the 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 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.