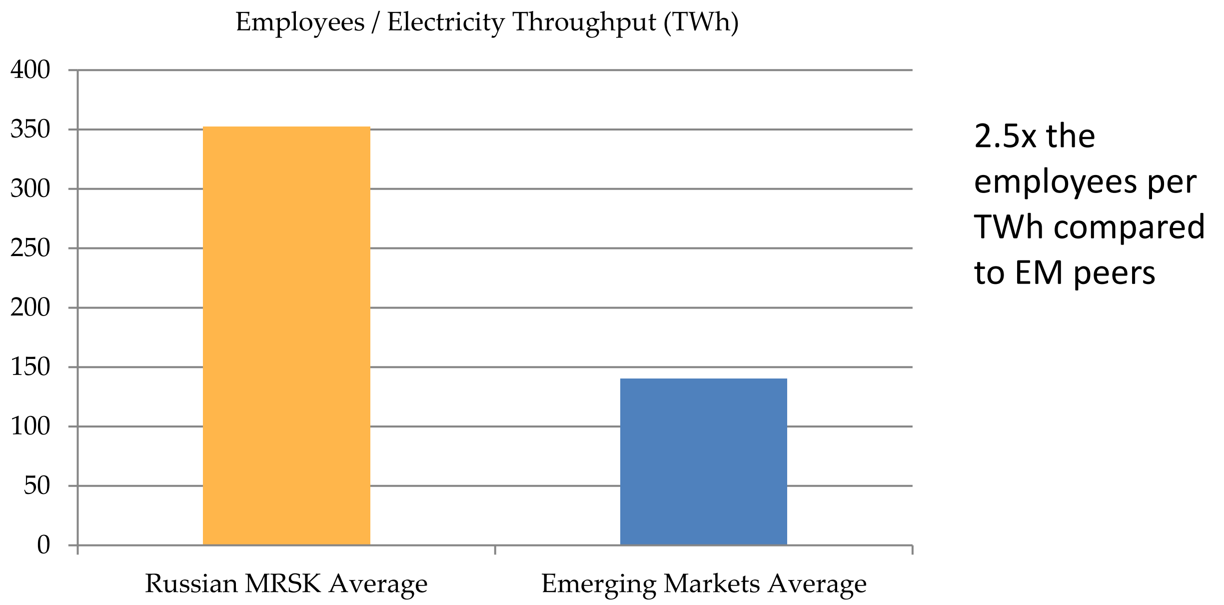
EOS Russia´s investment case, 30/08/2017

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 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.

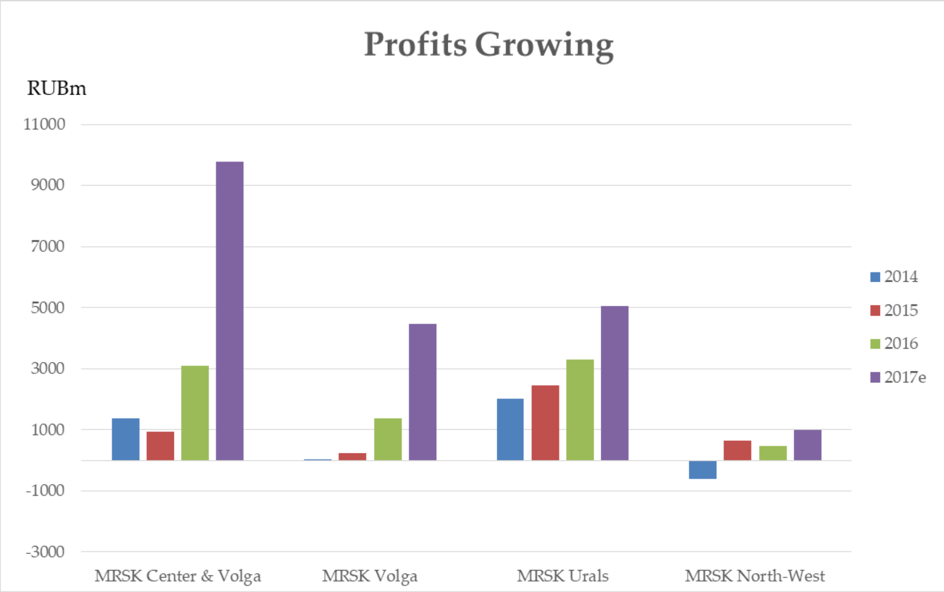
This is visible for instance when comparing the Employees to Electricity Throughput (TWh) ratio to that of Emerging Market country peers.



Russian average: MRSK North-West, MRSK Center-Volga, MRSK Volga, MRSK Urals, Lenenergo.
Emerging Markets average: Equatorial Energia (BRA), Colece (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 Urals, would increase the 2016 IFRS EBIT margin from 4.4 per cent to 23.8 per cent and EBIT from Rb3.2bn to 17.7bn, everything else being equal. The net income would then increase from Rb1.3bn to about Rb11.8bn. Assuming a dividend payout ratio of 50% and a fair dividend yield of 5%, the share price should be 8x times higher than currently (Aug 14, 2017).

Indeed, MRSKs have started to grow their profits and dividends significantly over the past 2.5 years owing to somewhat improved cost management.



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

In our view, the key factors behind the improvement include:

- The oil price collapse in 2014 that resulted in the government demanding bigger dividends and better operational management to help to balance the state budget.

- A 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 forced the companies to cut costs and investments to safeguard government dividend demands.

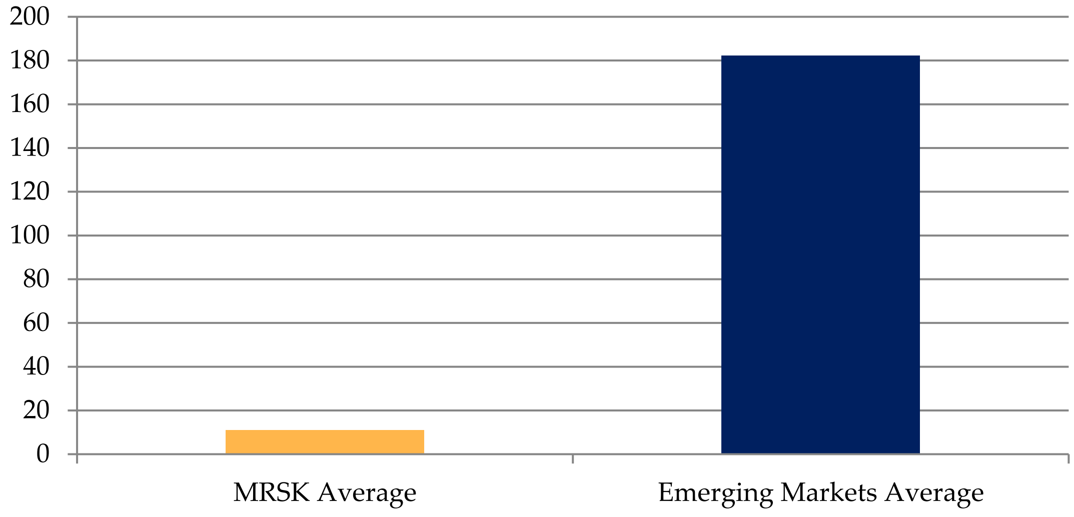
- A much more hands-on approach to management by the Ministry of Energy since 2014. After the creation of Rosseti in 2013, the management and the government became more focused on operational issues rather than corporate structure changes.

- Minority shareholder pressure is helping to bring about substantial improvements and this is showing up particularly in a number of our holdings.

Despite the improvements, it is clear that the companies are still very inefficient, and continue to have large potential to improve cost management corporate governance.

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 $15/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)

With this year's MRSK earnings growth continuing at such a strong and accelerating pace, they are traded at very deep discounts of 71-80% to Emerging Market peers on 2017 estimated P/E and EV/EBITDA multiples.

	P/E			EV/EBITDA		
	2015	2016	2017e	2015	2016	2017e
MRSK Average	9,4	8,3	3,0	3.8	3.5	2.3
GEM Average	24,1	15,7	14,8	10.5	9.0	7.9
MRSK Discount	-61%	-47%	-80%	-64%	-61%	-71%

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, 4-Traders, EOS estimates, Date: 21 August, 2017

It is also worth noting that the Russian government has been significantly increasing the state-owned company dividend payouts over the past years. A few years ago, MRSKs were still essentially without any clear dividend policies and paid tiny dividends.

For 2015, all MRSKs paid 50 per cent of the higher of their RAS (Russian Accounting Standards) or IFRS net income as dividends. For 2016, this was reduced by the amount of connection fees, which slightly reduced the payouts of our MRSKs. MRSKs Center-Volga, Volga and Urals made 37-54% payouts.

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 4-7 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 EU 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 steadily growing – typically by about 2-4% per year. This combined with the continuing migration to larger cities is inevitably 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 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.