**EOS Russia – MRSK Newsletter 16/05/19**

**MRSKs reported a solid first quarter despite the headwinds**

In late April, MRSKs reported their first quarter 2019 RAS results (highlights summarized in the table below). The results were solid given the headwinds from the significantly increased wholesale electricity prices. Such increases adversely affect MRSKs as they must buy in electricity from the wholesale market to cover electricity grid losses (some such losses being inevitable in any distribution grid). As a result, a higher wholesale electricity price can pressure the earnings of the MRSKs in the short-run. However, in the longer-run, the higher price should be compensated for by the regulator.

| | | | | | |
|---|---|---|---|---|---|
| | EBIT margin | | Net margin | | Revenue |
| RAS | 1q19 | 1q18 | 1q19 | 1q18 | growth |
| MRSK Center-Volga | 18,4 % | 20,4 % | 13,3 % | 16,1 % | -5 % |
| MRSK Volga | 8,3 % | 9,8 % | 6,0 % | 10,7 % | 1 % |
| MRSK Urals | 8,4 % | 11,2 % | 3,8 % | 7,4 % | 48 % |
| MRSK North-West | 13,4 % | 10,3 % | 9,2 % | 5,7 % | -20 % |
| Lenenergo | 28,1% | 20,7% | 20,4% | 15,3% | 9 % |

Source: Companies, EOS

MRSK Urals enjoyed very high sales growth on the back of the local supply company consolidation, while, on the contrary MRSK Center-Volga and MRSK North-West saw sales declines owing to the divestment of some supply companies. Nevertheless, the core electricity distribution business in itself grew, for instance, in the case of MRSK Center-Volga, by 8.5%.

The non-core electricity supply business in Russia is a high-turnover but a low-margin business. In the past 1-2 years, the MRSKs have been forced on a few occasions to take over temporarily the supply functions in a few regions to deal with fraudulent non-payment schemes in those businesses.

Therefore, to understand better the underlying profitability trend, it is now more enlightening to compare the EBIT with year-on-year (Y/Y) growth of net profit.

| | 1q19 EBIT growth Y/Y | 1q19 net profit growth Y/Y |
|---|---|---|
| MRSK Center-Volga | -14% | -22% |
| MRSK Volga | -15% | -43% |
| MRSK Urals | 9% | -24% |
| MRSK North-West | 3% | 28% |
| Lenenergo | 48% | 46% |

Source: Companies, EOS

The EBITs of MRSK Center-Volga and MRSK Volga declined by 14-15% Y/Y due to the higher wholesale prices. However, MRSK Urals, MRSK North-West and Lenenergo actually managed to grow their EBITs.

Against the headwinds, this is a solid performance by all the companies and creates a foundation for sustaining this performance in 2019 given that:

1. the impact from the higher wholesale prices will probably subside after the second quarter or the third quarter of this year;

2. the increase in wholesale prices is likely to be offset by regulatory tariff increases in the second half of the year;

3. the Y/Y comparables become undemanding in the final quarter; and

4. the companies are evidently continuing the successful cost management strategies of the past four years as evidenced by the relatively solid first quarter results, and there remains substantial potential for further efficiency gains, as evidenced for instance by the Employees/TWh ratio (see Investment Case, 24/08/2018, on EOS' web site).

**MRSKs to pay solid dividends for 2018**

In the past two weeks, the Board of Directors of the MRSKs have made their recommendations for the 2018 dividend payments.

| | Recommended dividend/share | Dividend yield | Portfolio weight | Dividend payout of the IFRS net profit | Dividend payout of the RAS net profit |
|---|---|---|---|---|---|
| MRSK Center-Volga | 0.0407 | 14.3% | 37.0% | 40% | 50% |
| MRSK Volga | 0.0132 | 12.5% | 31.5% | 44% | 59% |
| MRSK Urals | 0.003 | 1.7% | 19.3% | 41% | 33% |
| MRSK North-West | 0.0039 | 6.9% | 11.4% | 33% | 62% |
| Lenenergo pref* | 11.14 | 11.0% | 0.8% | na | na |

Source: Companies, EOS. *In the case of Lenenergo pref, not a Board recommendation but based on the formula in the company charter.

The dividend ex-dates have been set in June at least for the four MRSKs in the EOS Russia portfolio.

The companies are building decent track records on dividends, with solid payouts especially in terms of the RAS (Russian Accounting Standards) net profit, but also in terms of the IFRS net profit.

**Valuations and share prices**

MRSK share prices have shown some strength in the past month helped especially by dividend expectations.

The companies continue to be very attractively valued. They are currently trading at substantial discounts of 80-83% to emerging market peers on 2018-19 estimated P/E and EV/EBITDA multiples.

| | P/E | | | | | EV/EBITDA | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2016 | 2017 | 2018 | 2019e | | 2016 | 2017 | 2018 | 2019e |
| MRSK Average | 8.9 | 3.4 | 3.4 | 3.0 | | 3.1 | 3.2 | 1.7 | 1.7 |
| GEM Average | 18.6 | 20.4 | 18.2 | 15.5 | | 11.4 | 9.8 | 10.0 | 9.1 |
| MRSK Discount | -52% | -84% | -81% | -80% | | -73% | -67% | -83% | -82% |

Note: MRSK average: Center-Volga, Volga, North-West, Urals; GEM average: Light (BRA), Equatorial Energia (BRA), Manila Electric (PHI). Note: Ratios exceeding 25 have been excluded. Source: Companies, 4-Traders, EOS estimates, Date: 10 May, 2019