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MRSKs reported weak numbers for the last quarter of 2018

In late February, MRSKs reported their full-year 2018 RAS results. The results were surprisingly weak across the board, after the generally strong performance in the first 9 months of the year.

On March 20, all four of our core MRSKs reported their full-year 2018 IFRS results, which shed more revealing light on the companies' performance than the RAS financials.

IFRS	EBIT margin 2018	2017	Net margin 2018	2017	Revenue growth
MRSK Center-Volga	18,1 %	18,7 %	12,4 %	12,5 %	4 %
MRSK Volga	11,3 %	12,8 %	9,0 %	9,4 %	8 %
MRSK Urals	1,9 %	7,4 %	0,6 %	5,0 %	24 %
MRSK North-West	4,3 %	-2,4 %	1,8 %	-4,5 %	35 %

Source: Companies, EOS

MRSKs suffered in the last quarter from higher wholesale electricity market prices that forced them to pay more to cover the electricity grid losses. As there are always electricity losses in any distribution grid, the losses have to be covered by buying the electricity from the wholesale market. 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 by the regulator. MRSKs also suffered from various other items in the last quarter, which can be seen largely as one-offs.

MRSK Urals' profitability was down significantly Y/Y due to the large write-down made and reported in 2q18. Operationally, the company performed strongly throughout the year. MRSK North-West suffered from a similar write-down in its 2017 numbers. These write-downs have resulted from supply companies running what are in effect non-payment schemes, in which they themselves are paid and are therefore able to pay what they owe to the distribution company (MRSK) but fail to do so. As MRSKs are strengthening their payment collection policies, these new policies have in effect pushed a few supply companies into insolvency. MRSKs have therefore had to write down their claims on these failed supply companies, while also taking over those companies' operational business, and this has resulted in significant revenue growth.

Despite the weaker results in the last quarter of 2018, the dividend outlook remains positive, although there is some pressure to divert a larger share of profits towards capital investment. According to mandated dividend policies, the companies should pay 50% of the higher of IFRS or RAS net profits, adjusted for non-cash items and some capex. This resulted generally in 40-50% IFRS payouts for our MRSKs last year. We anticipate our dividend yields at between around 4% for MRSK Urals and possibly up to 19% for MRSK Center-Volga.

The negative impact from the higher wholesale electricity prices will likely continue for a few quarters this year making it likely that profits will decline in Y/Y terms in the first half of 2019.

Nevertheless, MRSK managements are clearly on top of things, and are expected to keep on cutting the controllable costs.

Regulatory environment improving

The Russian government is working on introducing a new regulatory framework for MRSKs, which would involve a fixed tariff framework for 10 years ahead with annual tariff increases of 'inflation minus 0.1%' – that is, increasing by 0.1 of a percentage point less than the percentage change in the previous year's consumer price index.

This could be a game changer for the MRSKs, allowing them to manage their costs more efficiently and improve profits. It will enable Russia to benefit from a stable and sustainable electricity distribution platform to facilitate future economic development and growth. The new system could possibly be in place before mid-2020.

In addition, the Russian government is in the process of introducing a system of payment for unused grid capacity, under which electricity users have to pay for the grid capacity that they have ordered but are not using. This should generate more revenue and profits for MRSKs.

Valuations and share prices

MRSK shares experienced some weakness after the weak RAS were published in the end of February. Nevertheless, the share prices continue to be supported by the expected dividend yields.

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	19.0	20.7	18.2	15.5	11.7	10.0	10.0	9.4
MRSK Discount	-53%	-84%	-81%	-80%	-74%	-68%	-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, Marketscreener.com, EOS estimates, Date: 21 March, 2019