

## MTS: Safe Haven, Good Outlook

### Investment Summary

We are pleased by planned changes to MTS dividend policy, which will raise payout levels and make them more predictable. Our updated model uses conservative assumptions compared with management guidance, including relatively high capex to keep up with rivals (particularly Megafon), but we believe that the company can maintain impressive OIBDA margin above 40% in coming years. After shift to the end of 2013 our target price is almost unchanged at \$12.2 per share, a clear BUY with 56% upside.

### Financials

MTS has reduced its guidance for FY12 revenue growth to 7% (in ruble terms) in response to ruble depreciation and uncertain macroeconomic conditions, and now anticipates 42% OIBDA margin, which is still a high level. Guidance for 2012 capex (mainly build-out of 3G networks and preparation for LTE roll-out) has been increased from 20-22% to 23-24% of revenue (about \$2.9b), but management stressed that the increase is due to currency effects on equipment costs and not to any major revision of investment plans. The MTS CEO said that capex should decrease to 15-18% over the next three years.

Our model is more conservative on revenue, predicting 4% growth in ruble terms this year, and upper single-digit figures in 2013-2015. We slightly lowered our forecast for revenue growth from value-added services, since the market is highly competitive and led by Megafon. We think that MTS can show sustainable OIBDA margin of 43% in coming years thanks to 3G-4G expansion, despite increase of labor costs (due to higher social taxes), and rise of rent and maintenance expenses. We are less optimistic than management about reduction of capex, expecting it to stay at 24% of sales as the company invests to support business growth.

### Dividend plans

MTS is currently amending its dividend policy to tie the payout level to free cash flow. Based on the company's own free cash forecast, it is ready to commit R114b to dividend payments in the three years 2012-2014, which is 25% more than was paid in 2009-2011. The new mechanism for dividend calculation will be submitted for approval by the AGM in 1H13. We welcome the change, since cash flow is less subject to volatility than the bottom line, and therefore promises more predictable dividends.

If MTS allocates one third of R114b, i.e. R38b (\$1.2b), to dividends for 2012 (equal to 60% of forecast 2013 FCFF), then payment will be R18.3 per share, offering 8% yield at current prices. We think that MTS can generate sustainable FCFF of roughly \$2b per year in 2013-2015, which is sufficient to strike a balance between business development spending and shareholder incentives.

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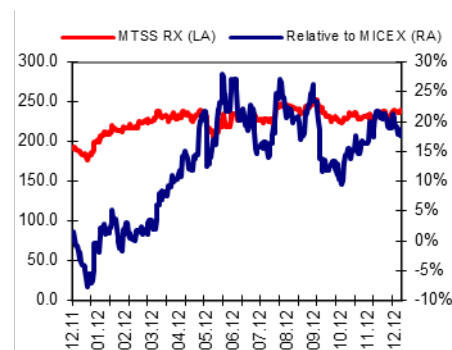
### MTSS RX

**BUY \$12.2▲56%**

Current market cap, \$m	16 118
EV, \$m	22 637
Estimated free-float, %	47%
<b>Common shares</b>	
- ticker (MICEX-RTS)	MTSS RX
- number, m	2 066.4
- market price, \$	7.8
- fair price, \$	12.2
- up/down,	56%
- previous fair price, \$	12.1
<b>Other stock exchanges</b>	
LSE	N/L
NYSE (1 ADR = 2 shares)	MBT

GAAP, \$m	11	12E	13E	14E
Revenues	12 319	12 153	12 968	13 499
OIBDA	5 144	5 242	5 664	5 821
- margin, %	42%	43%	44%	43%
Op. income	2 809	2 944	3 173	3 228
Net income	1 444	1 047	2 045	2 089
- margin, %	12%	9%	16%	15%
EPS, \$	0.70	0.51	0.99	1.01

	11	12E	13E	14E
EV/S	1.8	1.9	1.7	1.7
EV/OIBDA	4.4	4.3	4.0	3.9
EV/FCFF	65.7	18.4	11.5	11.8
P/E	11.2	15.4	7.9	7.7



## Comparison with Megafon

The recent IPO by Megafon invites comparison between that company and MTS. Before the IPO Megafon was viewed as a growth story, while MTS was viewed as a good defensive stock with a clear dividend policy (thanks to its main shareholder, Sistema). But the IPO makes the companies more similar: Megafon is now likely to increase its dividends (5% yield for FY12) to catch up with MTS, while we expect MTS to invest in business growth, reacting to higher levels of competition, particularly from Megafon, which currently has best exposure to the particularly promising mobile Internet segment, with 37% market share in 1H 2012 ahead of both MTS (34%) and Vimpelcom (25%), and also leads 4G rollout. Megafon currently trades close to the MTS level for EV/EBITDA 2012 (4x).

## Valuation and recommendation

We still like MTS overall, based on a low risk factor (very important in the current environment) and stated commitment to generous dividends. We expect capex to be higher than management forecasts, but think that resulting business growth will support the share price in the medium term. Our outlook for financials lowers due to more conservative growth assumptions, but we shift of target price to the end of 2012 leaves the final figure almost unchanged at \$12.2 per share. We find that 8% dividend yield and 56% upside potential make MTS a clear BUY.

## Key assumptions

	2008	2009	2010	2011	2012E	2013E	2014E	2015E
<b>Macroeconomics</b>								
CPI (y-o-y), %	28.3%	-26.2%	21.4%	24.8%	7.0%	8.4%	7.9%	7.4%
R/\$ average exchange rate	24.84	31.87	30.36	29.39	31.00	31.97	32.82	33.69
R/\$ end of period	29.38	30.24	30.48	32.20	31.48	32.39	33.26	33.69
<b>Key operational</b>								
Mobile segment in Moscow:								
- # subscribers, 000	61 015	67 055	70 371	70 700	70 350	71 054	71 764	72 482
- MOU, minutes per month	208	213	234	269	306	322	338	355
- APPM, R	1.25	1.16	1.08	1.01	1.01	1.01	1.01	1.01
Mobile segment in Ukraine:								
- # subscribers, 000	19 059	17 834	18 134	19 500	20 145	20 893	21 102	21 313
- MOU, minutes per month	279	462	535	580	610	641	673	673
- APPM, UAH	0.13	0.08	0.07	0.07	0.07	0.07	0.07	0.07
# subscribers in Uzbekistan, 000	5 700	7 100	8 800	9 284	9 500	0	0	0
# subscribers in Armenia, 000	2 017	2 073	2 461	2 400	2 400	2 400	2 400	2 400

Source: Company data, RMG estimates

## Operating income model, \$m

	2008	2009	2010	2011	2012E	2013E	2014E	2015E
Revenue	11 822	9 850	11 291	12 319	12 153	12 968	13 499	13 884
Cost of sales (excl. D&A and one-offs)	5 898	5 270	6 308	7 150	6 912	7 303	7 678	8 036
OIBDA	5 924	4 580	4 983	5 169	5 242	5 664	5 821	5 847
- OIBDA margin	50.1%	46.5%	44.1%	42.0%	43.1%	43.7%	43.1%	42.1%
Operating income	3 568	2 539	2 732	2 809	2 944	3 173	3 228	3 180
- Operating margin	30.2%	25.8%	24.2%	22.8%	24.2%	24.5%	23.9%	22.9%
Net interest expenses	163	467	693	657	657	657	657	657
Foreign currency exchange gain/(loss)	-566	-253	20	-158	-5	7	6	0
Other expenses	11	337	-4	43	0	0	0	1
Income tax	743	505	517	532	434	478	488	479
Net income	2 000	1 014	1 548	1 568	1 047	2 045	2 089	2 044
Minority interest	-187	20	168	124	0	0	0	0
Net income, referred to shareholders	2 187	994	1 380	1 444	1 047	2 045	2 089	2 044
- Net margin	18.5%	10.1%	12.2%	11.7%	8.6%	15.8%	15.5%	14.7%

Source: Company data, RMG estimates

**Revenue forecast, \$m**

	2008	2009	2010	2011	2012E	2013E	2014E	2015E
Mobile business, \$m	10 057	8 018	8 899	9 600	12 035	13 074	13 757	14 259
Fixed business, \$m	1 765	1 496	1 687	1 831	1 816	1 768	1 729	1 691
Handsets and accessories, \$m	0	337	705	874	924	923	926	929
Eliminations	0	0	0	-2 183	-2 621	-2 797	-2 912	-2 995
<b>Total revenues</b>	<b>11 822</b>	<b>9 850</b>	<b>11 291</b>	<b>12 305</b>	<b>12 153</b>	<b>12 968</b>	<b>13 499</b>	<b>13 884</b>

Source: RMG estimates

**COGS forecast, \$m**

	2008	2009	2010	2011	2012E	2013E	2014E	2015E
Cost of services	2 447	2 011	2 261	2 633	2 711	2 712	2 903	3 108
#subscribers	91	98	103	102	102	94	95	96
Cost of services per subscriber, \$	27	21	22	26	27	29	30	32
Cost of handsets and accessories	170	375	728	903	806	879	908	938
Sales and marketing expenses	931	728	851	878	676	655	683	713
as % of sales, %	8%	7%	8%	7%	6%	5%	5%	5%
General and administrative expenses	2 160	1 982	2 274	2 436	2 526	2 853	2 970	3 054
as % of sales, %	18%	20%	20%	20%	21%	22%	22%	22%
One-off expenses	205	197	250	99	0	0	0	1
Other operating expenses	190	173	194	194	192	203	214	224
Depreciation & Amortization	2 151	1 844	2 000	2 335	2 298	2 491	2 593	2 667
<b>TOTAL COGS (incl. D&amp;A)</b>	<b>8 254</b>	<b>7 311</b>	<b>8 559</b>	<b>9 478</b>	<b>9 209</b>	<b>9 794</b>	<b>10 271</b>	<b>10 704</b>
<b>TOTAL COGS (excl. D&amp;A and one-offs)</b>	<b>5 898</b>	<b>5 270</b>	<b>6 308</b>	<b>7 044</b>	<b>6 912</b>	<b>7 303</b>	<b>7 678</b>	<b>8 036</b>

Source: Company data, RMG estimates

**Cash flow, \$m**

	2009	2010	2011	2012E	2013E	2014E	2015E
EBIT*(1-T)	2 006	2 234	2 276	2 385	2 571	2 615	2 576
Depreciation & amortization	1 844	2 000	2 335	2 298	2 491	2 593	2 667
Capex	2 328	2 647	2 585	2 871	3 112	3 240	3 332
Change in net working capital	-635	-99	1 682	579	-22	44	32
<b>FCFF</b>	<b>2 157</b>	<b>1 687</b>	<b>344</b>	<b>1 232</b>	<b>1 971</b>	<b>1 925</b>	<b>1 880</b>

Source: RMG estimates

**WACC composition**

Risk-free rate, %	7.0%
Equity market risk premium, %	5.0%
Company analogues beta	0.8
D/E	2.4
Leveraged beta	2.4
Cost of equity, %	20.8%
Cost of debt, %	9.0%
<b>WACC, %</b>	<b>11.2%</b>

Source: RMG estimates

**Fair price calculation**

Terminal growth rate, %	2.5%
Terminal value, \$m	30 509
PV of terminal value, \$m	24 692
Discounted value for 2013-2015, \$m	5 224
Fair EV, \$m	29 916
Net debt, \$m	6 419
Minority interest, \$m	100
<b>Fair MCap, \$m</b>	<b>23 397</b>
Number of common shares (ex. treasury stocks), m	1 912
<b>Common share fair price, \$</b>	<b>12.2</b>

Source: RMG estimates

Terminal growth rate, %	Discount rate = WACC, %						
	10.0%	10.5%	11.0%	11.16%	11.5%	12.0%	12.5%
1.5%	12.6	11.8	11.0	10.8	10.3	9.7	9.1
2.0%	13.5	12.6	11.7	11.5	10.9	10.3	9.6
<b>2.5%</b>	<b>14.6</b>	<b>13.5</b>	<b>12.5</b>	<b>12.2</b>	<b>11.7</b>	<b>10.9</b>	<b>10.2</b>
3.5%	17.1	15.7	14.4	14.1	13.3	12.4	11.5
4.0%	18.6	17.0	15.6	15.2	14.3	13.3	12.3

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