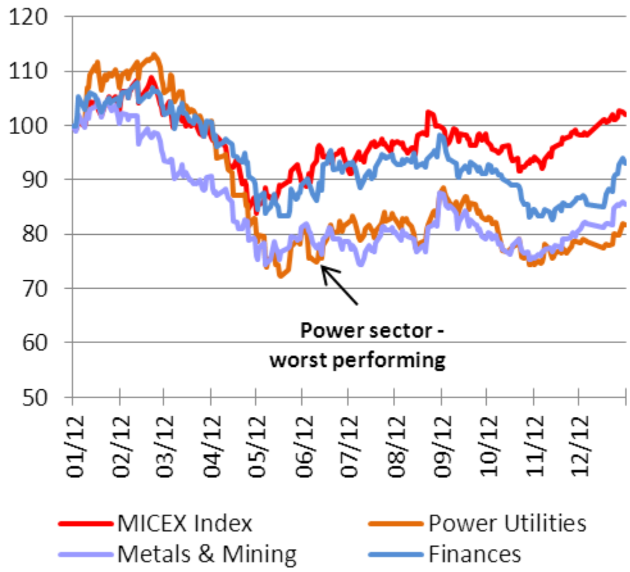
Power Stocks: Emerging from a Year-long Winter

Russian power utilities are getting their breath back after populist actions by government to rein tariffs in 2011-2012. Very low prices and better prospects suggest several opportunities at the start of 2013. We like E.ON Russia and some electricity suppliers with good dividend stories, while stocks of MRSKs offer a bet on reorganization of the parent holding company into Russian Grids.

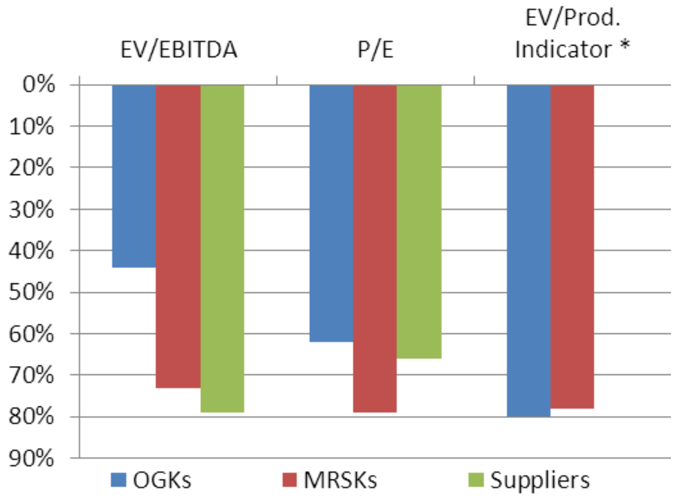
Life has been hard for the Russian power sector since 2011, due to populist regulatory actions to stall tariff growth ahead of parliamentary and presidential elections at the start of 2012. MICEX-Power, the utilities index of the Moscow exchange, performed worse than any other local sector index in the last year. Russian utility stocks are now traded with a massive 80% discount to foreign peers on some valuation multiples.

YOY worst performing sectors on MICEX-RTS



Source: Bloomberg

Discount of power stocks to EM peers



* Electric capacity for OGKs, lines length for MRSKs

Source: Bloomberg, RMG estimates

We see the current situation as favorable for power stock purchases due to historically low prices, low multiples, acceptable liquidity, and a “regulatory remission” after authorities secured their election mandate.

We pick out short-term ideas in the sector that deserve investor attention: we expect E.ON Russia to become a new dividend story; we look forward to revaluation of MRSKs as MRSK Holding merges the Federal Grid Company (FGC); and some electricity suppliers offer promise in the early spring dividend season.

E.ON Russia

In the generating segment, stocks of **E.ON Russia** (EONR RX) are traditionally popular with investors due to strong liquidity and ownership by German E.ON. The shares have escaped the major price slump of other sector companies, but prices have been flat for a long time.

We see new growth potential for E.ON Russia due to dividend promise. CFO Ulf Backmeyer said in December that the company could pay up to 100% as dividends for 2012 (payout for 2011 was 24%). A decision will be taken in 2Q 2013, when a five-year strategic program will be presented. We expect net income of R21b for 2012, so 100% payout would entail R0.28 (0.93 US cents) dividend per share, offering 10% yield, which is high compared with Russian peers of equal size and liquidity.

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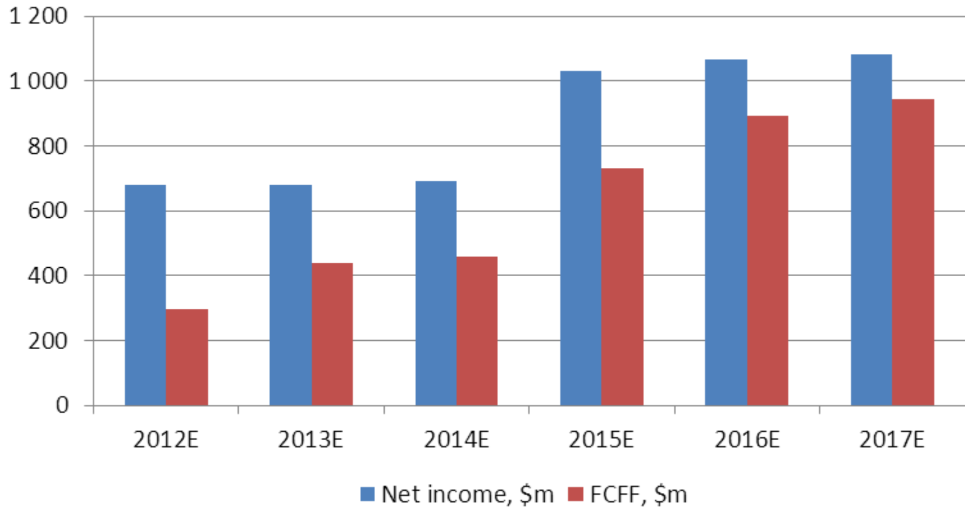
Unlike other Russian power generators E.ON Russia has completed its compulsory investment program and will experience comfortable tariff growth and modest capex in the next few years. This suggests that the company will maintain generous dividends. We expect FCF to grow faster than net income and a part of R25b (~$830m) net cash could be spent on dividends.

The good dividend prospects are in addition to large undervaluation of E.ON Russia on fundamentals: we estimate fair value about 50% higher than current price levels.

E.ON Russia financials



Source: RMG estimates

MRSKs

Electricity distributors (MRSKs, or discos) have suffered considerably from tariff-curbs by government. RAB tariffs, which had promised fair pricing, were stamped on by regulation, which kept tariffs unchanged for 18 months (until mid-2012), hitting profits and stock prices. Uncertainty over merger between MRSK Holding and the Federal Grid Company (FGC) added to problems.

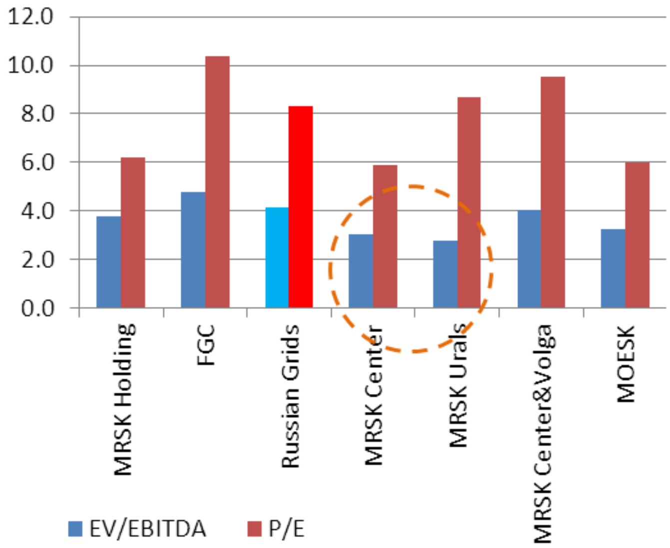
RAB tariffs are now back on track and there is more clarity over the FGC merger: President Putin ordered in late 2012 that MRSK Holding should be renamed “Russian Grids” and the government should transfer its 79.55% stake in FGC to Russian Grids in return for a new share issue, which we estimate at about 200% of the current share capital of MRSK Holding. The whole process should be completed by the end of 2Q 2013. Regional MRSKs will remain subsidiaries of Russian Grids and the FGC will also become a subsidiary.

Incorporation of FGC financials should automatically boost market valuation of discos. Based on current prices of FGC and MRSK Holding and the number of shares in the future Russian Grids (three times more than in MRSK Holding) the new company should be valued at 4.2x EV/EBITDA and 8.3x P/E compared with 3.8x/6.2x current multiples for MRSK Holding as an effect of incorporation of FGC financials.

We suggest purchasing undervalued stocks of regional MRSKs, as the ratio of their valuation to that of Russian Grids should eventually be the same as their current valuation ratio to MRSK Holding. We see **MRSK Center** (MRKC RX) and **MRSK Urals** (MRKU RX) as most attractive based on their fundamentals, which include relatively low multiples and good trading liquidity (see graphs below).

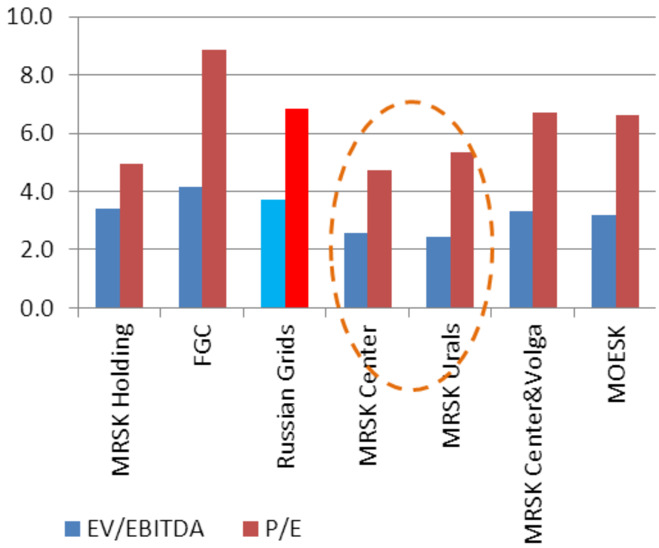
Russian Grids to become a benchmark for discos valuation

Valuation based on 2012 estimates



Source: Bloomberg, RMG estimates

Valuation based on 2013 estimates



Source: Bloomberg, RMG estimates

Also, the government has promised one MRSK to be sold to a strategic investor in 1Q 2013, and we believe the choice is between MRSK Center, **MRSK Center&Volga** (MRKP RX) and **MRSK Volga** (MRKV RX). Media reports suggest that some foreign strategics are interested in such a purchase.

We also note speculative potential in **preferred shares of MRSK Holding**. Prefs are currently valued with 40% discount to commons. After FGC merger their share in total equity of Russian Grids will be only 1%, which makes their conversion into commons or repurchase highly likely. Such expectations could reduce the discount to about 25% (close to the discount of prefs in Rostelecom or Sberbank).

Electricity suppliers

Electricity supply companies also suffered at the hands of government: the unregulated income from trading on the wholesale market, which they received in addition to regulated income, was abolished or cut, slashing profits and raising debt levels from 4Q 2011 and through 2012.

Cash shortages have put an end to generous dividend traditions at many electricity suppliers: Samaraenergo posted large losses in 2-3Q 2012; large payout by the Mordovia supplier in 2011 is unlikely to be repeated; the Perm supplier already paid interim dividends for 2012, so remaining dividends will be low; and shares of the Kostroma supplier are illiquid an there is a threat of a squeeze-out.

However, a few supply stocks could still offer dividend interest. Based on 9M results we expect the top-5 dividend payers to offer 15-17% yield.

Expected top-5 dividend payers among electricity suppliers

	2012E dividend, R	Common dividend yield, %	Preferred dividend yield, %
Moscow electicity sales company	0.081	17%	-
Kuban electricity sales company	26.2	15%	-
Rostov electricity sales company	0.06 *	15%	15%
Nizhnov electricity sales company	131.8 *	17%	17%
Yaroslavl electricity sales company	14.2 *	15%	15%

* including 1Q 2013E interim dividends

Source: RMG estimates

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We see the **Moscow supplier** (MSSB RX) as most attractive, forecasting R0.081 (0.27 US cents) dividends with 17% yield. This is a rare stock with net cash (R4b) on the balance sheet, though the amount has fallen from R16b at the beginning of 2012 as the company repaid credit liabilities and used cash to pay dividends for 2011.

Four stocks owned by Transservice-S, namely **Kuban** (KBSB RX), **Rostov** (RTSB RX, RTSBP RX), **Nizhnov** (NNSB RX, NNSBP RX) and **Yaroslavl** (YRSB RX, YRSBP RX) electricity suppliers, may offer 15-17% dividend yield, based on current prices. We note the latter two are almost entirely consolidated by the main shareholder and shares may be repurchased. We also have some doubts over Kuban and Rostov, due to growth of bank loans through the year, which may influence their decision to pay dividends.

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