



Russian grid companies. Back on track



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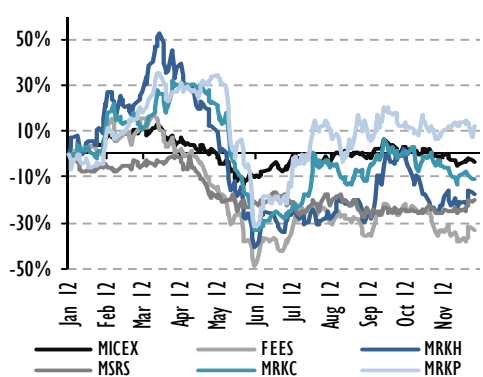
The summary of our recommendations

Company name	TP, RUB	Upside	Rating
Federal Grid Co	0.24	15%	N
Holding MRSK, ord.	2.33	18%	N
Holding MRSK, pref.	1.51	21%	N
MOESK	1.47	13%	N
MRSK Center	0.75	33%	O/W
MRSK Center and Volga	0.25	47%	O/W

*prices as of close on November 27, 2012

Source: Gazprombank estimates

Grid companies' performance on MICEX, % YTD



Source: Reuters, Bloomberg, Gazprombank

Following completion of the RAB reload and the reaching of a compromise among official authorities regarding the structure of the grids consolidation, we believe that the period of high uncertainty is now over. However, investors should keep an eye out for the upcoming terms of the deal. We expect the swap ratio to be market-based and that minority shareholders will not be offered a buyout, but instead granted the right to participate in the conversion.

We consider the regional grid companies to be safer, as they are not exposed to consolidation risks and suggest better upside. Our top picks are MRSK Center & Volga and MRSK Center. Next year, the government may begin to pilot the privatization of regional grids, which should support the MRSKs. We expect the shares of Holding MRSK to be under pressure, as the low price of the company's upcoming large additional share placement (RUB 2.16) creates a ceiling for the stock. Similarly, the potential for FGC shares looks limited, as they will be tied to MRKH through the swap ratio.

- ▶ **Holding MRSK to be the base for the grids consolidation.** After a series of changeovers of the consolidation schemes fueled by the lack of consensus between officials, the government finally proposed to contribute the state's 79.55% stake in Federal Grid Company (FGC) into Holding MRSK's charter capital, which has been approved by President Putin. Further, Holding MRSK will be renamed JSC Russian Grids and be the managing company for Russia's electricity transmission and distribution companies. It may also become Russia's biggest utilities blue chip. The deadline for the transaction is June 30, 2013.
- ▶ **Watch the terms of the consolidation.** The main terms of the deal between Holding MRSK and FSK are not known yet. We do not expect a buyout option for minority shareholders, but they will probably be granted the right to swap their FGC shares for stock in HMRSK. This may make sense depending on the swap ratio, but we believe it should reflect the market correlation of the two stocks. We also expect the grid companies to increase their dividend payouts.
- ▶ **Tariffs reloaded. More clarity.** The so-called RAB reload announced last autumn resulted in an overhaul of the previously approved long-term regulatory parameters and capped tariff growth rates for grids. A total of 21 out of 65 branches have been switched to tariff indexation. However, completion of the revision process mitigates risks and should provide better long-term visibility in the sector.
- ▶ **Privatization may be a trigger.** The authorities advocate the privatization of regional grids and proclaim their commitment to resolving the regulatory issues and major bottlenecks in the industry, such as cross-subsidization. The presidential decree on the establishment of JSC Russian Grids stipulates the gradual attraction of private investors in the distribution grids. The expected privatization should support the MRSKs in the long term, but it may seem premature to price this in just yet. We currently await more details once the government works out the development strategy for the sector.
- ▶ **Recommendations.** Reduced uncertainty regarding the grids following completion of the tariff revision and adoption of the consolidation scheme should revive investor interest in the sector. However, the growth potential in both Holding MRSK and FGC seems locked. MRKH is under pressure from the upcoming large additional share issue with the placement price being a ceiling, and FGC shares will soon be tied to MRKH through the swap ratio, which is yet to be announced. Currently we prefer the regional grids. Among the liquid MRSKs, we favor MRSK Center & Volga with a target price of RUB 0.25 per share, and MRSK Center with a target price of RUB 0.75 per share.

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Investment summary

The recent high volatility in the share prices of Russian grid companies demonstrates how much they depend on regulatory decisions. Since spring, FGC and MRSKs have underperformed the market amid overall revision of regulatory parameters and, later, the announced plans to consolidate Holding MRSK and FGC. Both decisions marked a critical change in the state's strategy regarding the sector's development.

We now consider the period of high uncertainty to be over, as the RAB reload has been accomplished and the authorities have finally reached a compromise regarding the structure of the grids consolidation, with the state's stake in FGC to be contributed to the charter capital of Holding MRSK.

The regional grid companies are less exposed to issues related to the consolidation, as they are not directly involved in the process. Coupled with the expected privatization (which may start as soon as next year) this should support MRSKs. Our top picks among the grids are MRSK Center & Volga and MRSK Center.

Watch the progress in grids consolidation

In July 2012, FGC officially assumed control over Holding MRSK as its sole executive body. However, further progress in the consolidation was questioned after the government opposed the plan of Rosneftegaz to create a nationwide grid company consolidating FGC and Holding MRSK on the base of its subsidiary. Instead, the government proposed alternative scenarios, without the participation of Rosneftegaz. However, more recently, in mid-October following a meeting on the power grid industry headed by President Putin, Energy Minister Alexander Novak rejected the idea to merge FGC and Holding MRSK. Instead, both companies were suggested to be transferred under the management of a special managing company.

Later, in November, it was reported that the Energy Ministry had drafted a decree on the creation of a grid management company based on Holding MRSK (which will be renamed Russian Grids) with the state's stake in FGC being contributed to its charter capital through an additional share placement by end 1H13. This decree (#1567) was signed by the president on November 22.

Investors should still keep track of upcoming developments regarding the consolidation, as currently its main terms are unknown.

- ▶ **Buyout.** We would not expect a buyout option for minority shareholders, as this would entail huge obligations – a factor that was responsible for the failure of some of the previous consolidation schemes.
- ▶ **Conversion and swap ratio.** We believe the probability is high that minority shareholders will be granted the right to participate in the swap, exchanging their FGC shares for stock in HMRSK. We expect the swap ratio to reflect the current market correlation between FGC and HMRSK shares, which would not provide a good conversion arbitrage.
- ▶ **Dividends.** Obtaining control over FGC should increase the profitability of Holding MRSK and result in higher dividends. However, due to high capex obligations and continuing direct support from the federal budget, this may not happen soon. That said, we would expect Holding MRSK to push its subsidiaries to pay higher dividends, which would support FGC and MRSKs.

Holding MRSK (to-be the Russian Grids) has a chance to become Russia's major blue chip in electric utilities. Thus, it may make sense for FGC minority shareholders to participate in the conversion. However, we note that the shares of Holding MRSK over the next several months will be capped by the price of the current large additional share placement. Similarly, the growth potential of FGC shares will be limited, as they will be tied to MRKH and hence also capped. Thus, we see limited upside potential in both stocks over the next several months until the placement and the consolidation deal are completed.

RAB reload provides new guidance

After a series of different measures to contain electricity prices, the state regulators announced a reload of RAB implying overall revision of the previously approved long-term tariffs for grids. The complete change of the rules ruined the brilliant investment story associated with introduction of the world's best tariff-setting practices in utilities and repelled investors from the stocks.

Following the revision, regulators cut the initial asset base values, changed the rules regarding return on invested capital and introduced a 1-11% range for the rates of return on 'existing' invested capital instead of the previously unified rates. These measures let regulators limit the tariff growth rates within the new regulatory period by just 10% per year, which complies with the price cap set earlier by the government. This illustrates the fact that the RAB reload was aimed at capping tariffs, which does not satisfy the proclaimed objectives of the guaranteed return regulation.

By November 1, the FTS had finalized the process of tariff revision, with 44 branches out of the total 65 receiving new long-term tariff plans based on RAB regulation. The rest were switched to the long-term indexation method, even though previously some of those subsidiaries were regulated under RAB (e.g. Tomsk DC, Tyumenenergo, most of the branches of MRSK Siberia). However, given the significant change in RAB regulatory rules and reapproved parameters, we believe the difference between the two tariff-setting approaches has been smoothed. We discuss this issue in more detail later in this report (see page 18).

The reload complicates the RAB-based comparison of companies and makes the traditional EV/RAB multiple unreliable, especially when compared with foreign RAB-regulated peers. We think investors should rely more on the traditional multiples, such as P/E and EV/EBITDA, to compare Russian grid companies. However, we have estimated fair EV/RAB multiples for the grid companies based on the balance between the cost of capital and the expected actual returns for 2012-13. But given the limited relevance, we did not incorporate the express-assessment results in our final valuation, providing them for guidance purposes only.

Privatization may be a catalyst for MRSKs in 2013

Given the current unfavorable market conditions and deficient track-record of the new tariff policy, the privatization of individual regional distribution grid companies within the Holding MRSK Group does not look feasible at the moment. However, the authorities expressed a commitment to launch the process of grids privatization as soon as possible with the pilot sales taking place as soon as next year.

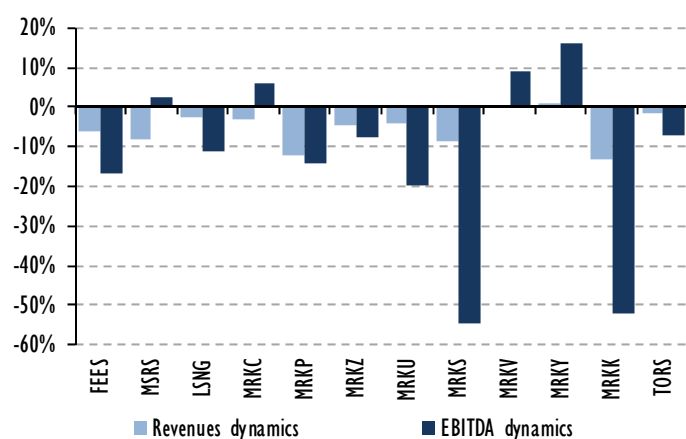
The presidential decree on establishment of JSC Russian Grids stipulates the gradual attraction of private investors to distribution grids. To do that, the regulators need to settle the major regulatory issues and bottlenecks, such as long-term tariffs, capex and opex control, and cross-subsidization, restoring investors' trust in the RAB story.

We believe that the preparation of privatization of distribution grid companies should be a good catalyst for the sector as a whole in the longer term. However, currently there is no guidance on which companies may be sold to private investors. According to Novak, the decision on privatization of regional grid companies will be taken within a few months.

Grids are still profitable

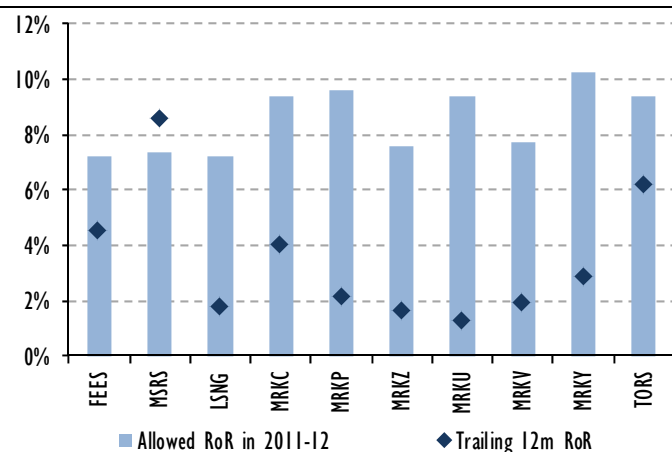
The revision of tariffs and postponement of the annual rates adjustment resulted in worsening of the grids' financial results. In 1H12, grids reported lower revenues and margins. However, we believe that the results do not look too weak, as most of the companies are still profitable and we expect the results to improve after the RAB reload.

MRSKs' revenue and EBITDA dynamics in 1h12



Source: company data, Gazprombank

MRSKs' actual rate of return vs. allowed return



Source: company data, Gazprombank

The actual returns on invested capital were predictably lower than the allowed rates (with the exception of MOESK, thanks to its high connection fees). The average return was below 3% (not even accounting for some of the companies that posted losses) compared with 9-12% set by the regulators. We expect the actual returns to stay below the allowed rates in the near future, even though RAB regulation has room for extra profits if companies exceed the performance targets set by the regulators. Still, in many cases the tariffs are insufficient, particularly since they do not account for last-mile issues or provide adequate capex funding. This suggests that some of the companies may be loss-making in the short term.

Poor liquidity limits investment capabilities

We have only assigned target prices to those companies whose shares are more or less liquid on a stock exchange (at least among the top 100 by average trade turnover on MICEX). Generally speaking, FGC and Holding MRSK ordinary shares are the only liquid stocks among the listed Russian grid companies, with average daily trade volumes on MICEX of roughly \$22 mln and \$16 mln (over the past six months), respectively.

Other MRSKs are substantially less liquid, and are characterized by larger bid-ask spreads and higher volatility. We hypothetically divide these MRSKs into two groups: more or less liquid with average daily trade volume of at least \$100,000, and less-liquid stocks with turnover below that level (see table below).

Grids' trade volumes on MICEX

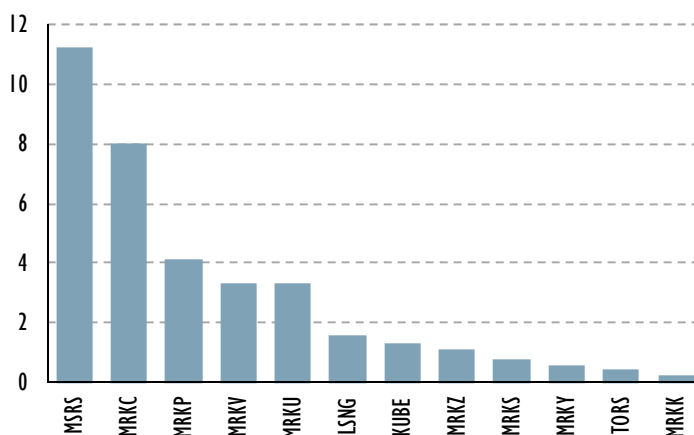
	6m turnover, RUB mln	6m turnover, \$ mln	Avg. daily turnover, \$ '000	Position on MICEX
Federal Grid	85,924	2,694	22,085	Top 10
Holding MRSK, ords	62,686	1,966	16,112	Top 20
Holding MRSK, prefs	568	18	146	Top 75
MRSK Center	459	14	118	Top 75
MOESK	408	13	105	Top 75
MRSK Center and Volga	366	11	94	Top 100
Kubanenergo	277	8.7	71	Top 100
MRSK North Caucasus	275	8.6	71	Top 100
MRSK Urals	189	5.9	49	Top 150
Lenenergo, prefs	145	4.6	37	Top 150
MRSK South	144	4.5	37	Top 150
MRSK Volga	141	4.4	36	Top 150
Lenenergo, ords	135	4.2	35	Top 150
MRSK North-West	74	2.3	19	Top 150
MRSK Siberia	35	1.1	9	Top 200
Tomsk DC, prefs	11	0.3	3	Top 300
Tomsk DC, ords	9	0.3	2	Top 300

Source: Bloomberg, Gazprombank

The relatively low liquidity of MRSK shares limits investment opportunities in the Russian electricity distribution sector. Unfortunately, MRSKs have not achieved much in

terms of improving their share liquidity so far. Certain progress in the foreseeable future may be associated with a further increase in corporate transparency, completion of the RAB reload and possible preparation for privatization.

Current free-float market capitalization, RUB bln



Source: Bloomberg, Gazprombank estimates

Our recommendations

The reduced uncertainty over the grids following completion of the tariff revision and adoption of the consolidation scheme should revive investors' interest in the sector.

Our top picks in the sector are MRSK Center & Volga and MRSK Center, with target prices of RUB 0.25 (45% upside) and RUB 0.75 (29% upside), respectively. The regional MRSKs currently look a better bet, as they are not exposed to consolidation risks and suggest better upsides. The planned privatization, which may start next year, should also be supportive for MRSKs.

The growth potential in Holding MRSK and Federal Grid shares, however, seems to be locked. MRKH is under pressure from the upcoming large additional share issue, with the placement price acting as a ceiling, while FGC shares will soon be tied to MRKH through the swap ratio, which is yet to be announced. We assign NEUTRAL ratings to FGC, Holding MRSK ordinary and preferred shares, and MOESK given the limited upside potential.

Russian electricity grid companies recommendations summary

Company name	Ticker	MCap, \$ mln	Price, RUB	TP, RUB	Upside	Rating
Federal Grid Co	FEES	8,375	0.21	0.24	15%	NEUTRAL
Holding MRSK, ord.	MRKH	3,177	1.97	2.33	18%	NEUTRAL
Holding MRSK, pref.	MRKHp	84	1.25	1.51	21%	NEUTRAL
MOESK	MSRS	2,043	1.30	1.47	13%	NEUTRAL
MRSK Center	MRKC	764	0.56	0.75	33%	OVERWEIGHT
MRSK Center and Volga	MRKP	609	0.17	0.25	47%	OVERWEIGHT

*prices as of close on November 27, 2012

Source: Bloomberg, Reuters, Gazprombank estimates

Valuation

Our assumptions

We have applied DCF modeling for the purpose of electricity grid companies' valuation. We based our forecasts on the revised long-term tariff parameters and capex plans for FGC and those branches of MRSKs where RAB regulation has been reloaded. However, the process of tariff revision is not over yet, so we expect a number of other branches to be switched back to RAB regulation. Where applicable, we factored in the forecasts on the long-term parameters proposed by the companies to the regulators.

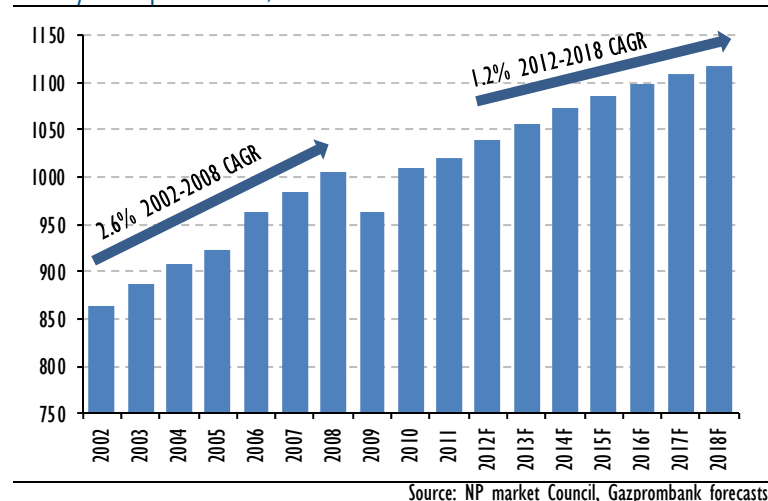
The new long-term tariff parameters are set for 2012-17 and are supposed to guarantee certain returns (in line with RAB regulation principles). However, in reality, grids earn much less than they are supposed to due to a number of factors (see page 22). We expect this situation to continue, as RAB regulation in Russia does not comply with the globally recognized principles of guaranteed return regulation.

Cautious about electricity consumption growth

We have modeled rather conservative assumptions for electricity demand dynamics. We forecast overall electricity consumption in Russia to grow at a CAGR of 1.2% in 2012-18, with the rate being higher in the Far East (1.6%) and Siberia (1.4%) than the Urals (1.1%) and the European part of Russia (1.0%). We see significant risks to consumption volumes, associated with energy-efficiency initiatives and the limited scope for further price growth for industrial consumers.

Electricity demand in Russia has recovered swiftly after falling 4.6% in 2009 on the back of the global economic crisis. In 2010, consumption topped the pre-crisis levels and continued to grow. In 2011, it reached the highest levels since 1991. However, demand growth rates slowed significantly last year. Overall consumption in 2011 grew a mere 1.2% YoY vs. CAGR of 2.6% in 2002-08.

Electricity consumption in Russia, bln kWh



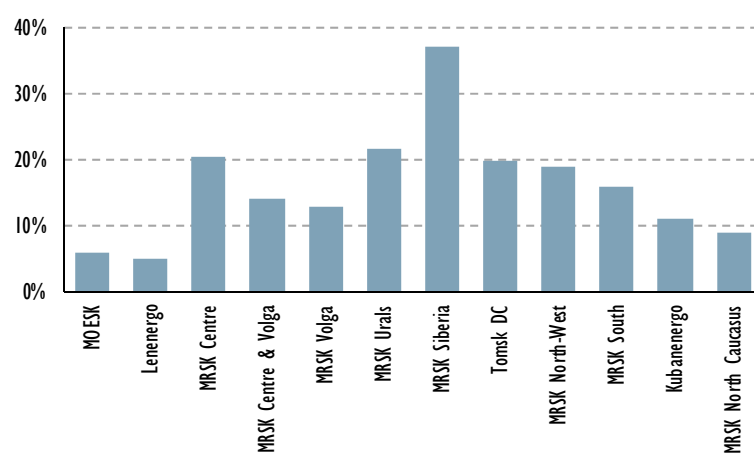
Last-mile agreements still an issue

Cross-subsidization through last-mile agreements is one of the most pressing concerns in the electricity distribution sector. Introduced as a temporary measure, last-mile agreements force industrial consumers to subsidize households and other privileged consumers through higher tariffs. Last-mile agreements are arranged between FGC and MRSKs, which rent the final leg of the electricity transmission grid from the former. MRSKs, in turn, charge industrials with their tariffs, which are higher than those of FGC. This allows them to maintain lower tariffs for privileged consumers.

Still, there has been no solution to the last-mile issue. In theory, termination of last-mile agreements should be neutral for MRSKs' profits, but in practice, unilateral dissolutions of those contracts by industrials resulted in huge losses incurred by distribution companies. In particular, in 2010, RUSAL's aluminum smelters and Russian Railways signed direct contracts with FGC breaking the last-mile agreements with MRSK Siberia, which consequently lost RUB 5.6 bln in missed revenues. More recently, Moscow Arbitration Court settled NLMK's claim to recover RUB 5.1 bln from MRSK Center. The company intends to challenge the decision, however in case it fails the regulators will probably not be able to fully compensate the loss through tariffs as they are capped.

As at the end of 2011, the subsidiaries of Holding MRSK were defendant in last-mile lawsuits for the total amount of RUB 11.7 bln. However, the company did not recognize any provision for potential losses in its consolidated financial statements.

Estimated share of MRSKs' revenues under last-mile agreements



Source: Holding MRSK, companies, Gazprombank estimates

The total volume of revenues that MRSKs receive under last-mile agreements is estimated at RUB 58 bln. The issue is especially vital for 18 regions, mainly in the Far East, Siberia and the Urals.

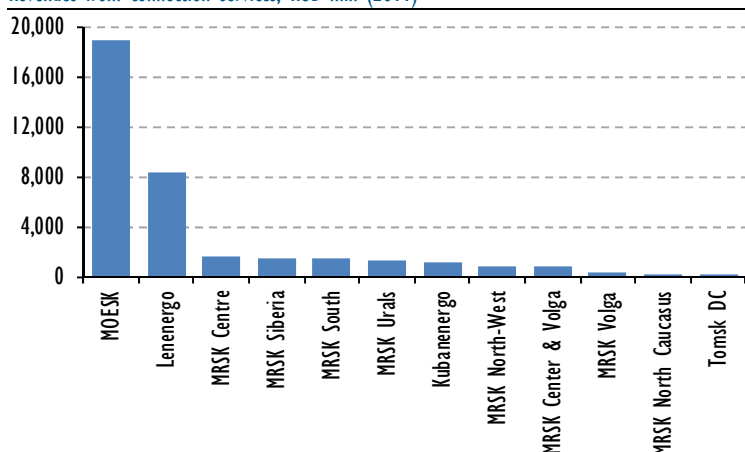
Following the recent meeting on the power grid industry in mid-October, the minister of energy Alexander Novak announced that by the end of 2012 the ministry must prepare solutions for settlement of the cross-subsidization issue in electric grids and tensions around last-mile agreements. The cross-subsidization is a complicated issue which will take probably years for the full resolution; however, designing a road map will provide more visibility and will help to address the distortions.

Connection fees to decline

Connection fees were introduced as a temporary measure amid energy system resource exhaustion in 2003, when new connections demanded serious expansion of the grid infrastructure – construction of power lines and substations. Distribution companies were unable to bear those expenses and hence they were passed on to consumers and generation via connection fees.

Proceeds from connection fees used to be one of the main sources for MRSKs to finance capex. In 2011, the share of the connection fees in Holding MRSK's overall investment program exceeded 22%, down from 37% in 2010. The regulators aim to dramatically reduce the connection fees. The major expenses for connecting consumers would shift from the latter to the grid companies. Thus, we expect a significant decline in MRSK revenues from connection services.

Revenues from connection services, RUB mln (2011)



Source: Holding MRSK, Gazprombank

More visibility on capex

The revision of long-term tariff parameters required the companies' capex programs to be reviewed as well. The Energy Ministry and regional energy commissions approved the new capex plans, which turned out to be higher than expected. In particular, the total expenditures in 2012-17 by Holding MRSK are estimated at RUB 825 bln against the previous estimate of RUB 677 bln.

Revised capex plans, RUB mln

	2012	2013	2014	2015	2016	2017	Total
Federal Grid	162,482	155,177	154,596	155,135	155,499	155,124	938,013
Holding MRSK	124,000	146,600	144,900	135,100	138,100	136,300	825,000
MOESK	37,442	52,274	56,761	47,261	38,698	41,528	273,964
Lenenergo	15,215	15,954	14,733	14,935	13,493	13,618	87,948
MRSK Center	11,176	9,845	11,529	13,512	15,588	17,804	79,454
MRSK Center & Volga	8,929	9,961	12,307	14,553	16,531	18,472	80,753
MRSK Volga	9,018	7,378	7,435	8,968	13,010	5,831	51,640
MRSK Urals	7,653	9,155	9,275	9,879	10,775	11,588	58,325
MRSK Siberia	5,333	6,060	5,957	6,550	7,217	7,269	38,386
Tomsk DC	410	415	420	470	525	575	2,815
MRSK North-West	7,828	6,057	5,961	6,704	7,538	8,397	42,485
MRSK South	5,397	5,215	4,973	5,547	6,315	6,952	34,399
Kubanenergo	9,627	17,970	595	825	931	1,062	31,010
MRSK North Caucasus	7,252	5,069	4,457	5,008	5,314	5,550	32,650

Source: Energy Ministry, Holding MRSK, Gazprombank

High volumes of the planned capital expenditures carry the risk of companies facing a shortage in funding sources. Apart from tariffs and debt, electric utilities widely use additional share issuance, which brings dilution risks for the minority shareholders. A number of companies already have plans to place additional shares, in particular, Holding MRSK, Lenenergo, Kubanenergo and MRSK North Caucasus.

WACC calculation

We have reviewed our WACC estimates for grid companies to account for the declining interest rates and emerged risks. We assume a risk-free rate of 5.0% and a typical debt/equity ratio of 30%. We also calculated new company-specific risks based on a number of factors, such as tariff regulation, operational efficiency, share liquidity etc.

WACC calculation for MRSKs

Company name	Equity premium	Company-specific risk	Beta	Cost of equity	Cost of debt	WACC
Federal Grid	5%	2%	1.07	16.4%	8.5%	11.6%
Holding MRSK	5%	4%	1.04	18.3%	8.7%	12.6%
MOESK	5%	4%	0.82	16.3%	8.9%	11.7%
MRSK Center	5%	3%	0.96	16.6%	9.4%	12.1%
MRSK Center and Volga	5%	5%	0.92	18.1%	9.6%	12.9%

Source: Gazprombank calculations

Valuation results

Below are the summarized final results of our DCF modeling, including calculated target prices and recommendations for all traded MRSKs and the holding company. Detailed valuation tables can be found below on the corresponding MRSK profile pages.

Summary of DCF-based target prices

Company name	Target price. RUB	Current price. RUB	Upside	Rating
FGC	0.24	0.21	15%	NEUTRAL
Holding MRSK, ordinary	2.33	1.97	18%	NEUTRAL
Holding MRSK, preferred	1.51	1.25	21%	NEUTRAL
MOESK	1.47	1.30	13%	NEUTRAL
MRSK Center	0.75	0.56	33%	OVERWEIGHT
MRSK Center and Volga	0.25	0.17	47%	OVERWEIGHT

Source: Gazprombank calculations

The key comparable valuation multiples of the grid companies under coverage

Company name	P/E-13	EV/EBITDA-13	EV/RAB	Expected RoR 2012F
Federal Grid Co.	12.2	4.3	0.62	3.1%
Holding MRSK	4.2	1.9	0.48	6.2%
MOESK	4.5	2.3	0.54	7.6%
MRSK Centre	6.9	3.2	0.75	4.8%
MRSK Centre & Volga	4.7	3.1	0.51	4.0%

Source: Gazprombank calculations

Consolidation of the grids: the scheme and outcomes

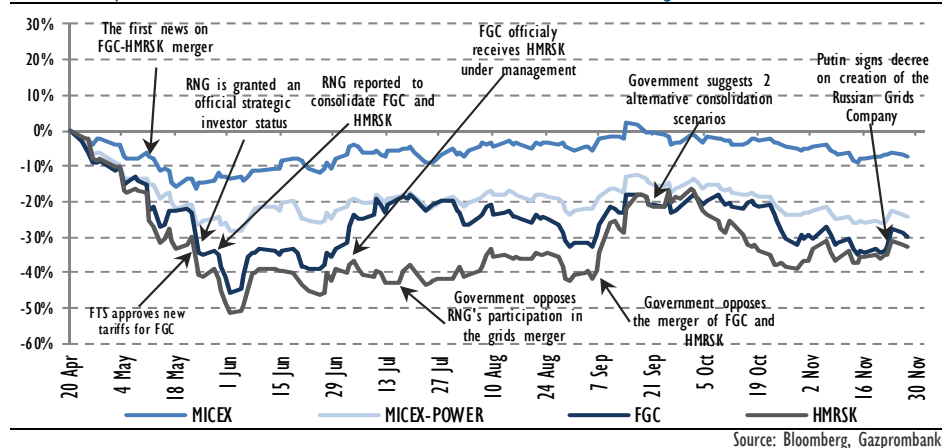
The decision to consolidate FGC and Holding MRSK marked a new era in the industry and caused turmoil on the markets. But the period of high uncertainty seems to be over as the authorities agreed on transferring the state's stake in FGC into HMRSK's charter capital. The investors should keep an eye out for the upcoming terms of the transaction.

Plans to merge the grids resulted in a sell-off

Since early July 2012, FGC has become the sole executive body of Holding MRSK. This marked a new era in Russia's electricity grid industry, as previously Holding MRSK, which controls regional electricity distribution companies, and FGC, which is in charge of high-voltage transmission power lines in Russia, were independently managed, though both are controlled by the state. The consolidation plans mean a critical change in the state's strategy for sector development and might even require the regulators to review their long-term financial plans once again, adding to the uncertainty.

The decision to unite Holding MRSK and FGC was taken by the government in May 2012 and came as a surprise to the markets. At the same time, the state-owned Rosneftegaz has been entitled the right to be an investor in electric utilities planned to be privatized before 2015. RNG proposed a plan to create a national grid giant based on FGC and Holding MRSK. Both stocks plunged as investors started to price in the emerging risks and uncertainties stemming from the consolidation – possible liquidation of Holding MRSK as an unnecessary element between FGC and MRSKs and worsening of FGC's financial profile along with a possible additional share issue.

The markets priced in the risks attributed to the consolidation of FGC and Holding MRSK



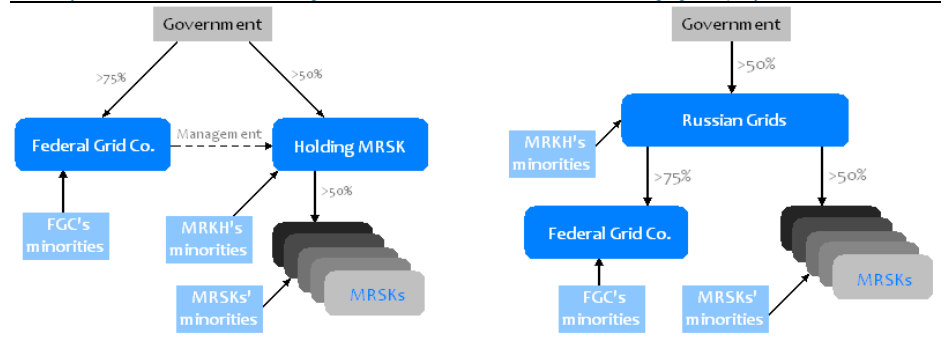
The authorities finally decide on the scheme

The government opposed the plans of Rosneftegaz to consolidate grids considering this to be very disadvantageous, contradicting current legislation and reversing electric utilities reform in Russia. The substantial divergence between the standpoints of the presidential team and the government created uncertainty regarding the future development of the sector, increasing corporate risks and suggesting that the process of consolidation may slow down.

Later, the plans to merge FGC and Holding MRSK have been cancelled, according to the government officials. Instead, they proposed to transfer both companies under a single managing company. This approach looked to be approved by the president of Russia.

However, the government finally made a complete turnaround from the initial plans which implied that the Federal Grid would probably be the basis of consolidation. The Ministry of Energy decided to hand over the state's stake in Federal Grid to Holding MRSK in the form of payment for its additionally issued shares. The relevant decree #1567 was signed by the president of Russia. As a result, Holding MRSK will be renamed into the Russian Grids and become the managing company of the Federal Grid along with MRSKs.

Currently HMRSK is under FGC's management. Russian Grids to become the managing company



Source: Gazprombank

The presidential decree sets a number of important deadlines. In one month, the officials must develop the schedule for the consolidation deal as well as the strategy of the Russian Grids Co. Within three months the government must develop and approve the strategy of the electricity grid sector, including the switch to a tariff setting based on reliability and quality of services, efficiency of operating and investment activities. The decree also envisages a gradual acquisition of the local grid operators and attraction of the private investors in the distribution grids.

Implications for the minority shareholders

After the authorities have decided to transfer the state's stake in FGC to Holding MRSK the minority shareholders of the two companies should now be ready to reshuffle their utilities portfolios and take into account emerging risks. Their decisions will probably depend on the terms of the consolidation which are not yet known. We think the investors should concentrate on the following issues:

► Buyout

We would not expect a buyout option for the minority shareholders of the Federal Grid and Holding MRSK as this would entail huge potential financial obligations – the reason why the previous consolidation schemes failed. In the context of large-scale capex programs and persisting direct cash injections from the federal budget such significant buyout expenses cannot be justified.

As far as the transaction is not a reorganization, the Federal Grid and Holding MRSK do not have to hold shareholders meetings on that issue providing a buyout option for those who do not support the deal. Further, in line with the Russian law, Holding MRSK will not be obliged to put a buyout offer for the minority shareholders of the Federal Grid once its stake in the latter exceeds a threshold of 50%. According to the Federal Law on Joint-Stock Companies, if this happens as a result of the state property being contributed to a strategic company (or state-controlled entity) through an additional share issue, buyout obligations do not arise. According to the presidential decree #1567, Holding MRSK after being renamed will be included in the list of the strategic companies of Russia. To remind, this scheme was used by Inter RAO in 2010 to absorb the state's stakes in utilities avoiding the buyout of the minority shareholders.

► Conversion

We see a high probability of minority shareholders being granted the right to participate in the swap, exchanging their FGC shares for the shares of HMRSK. This would make sense if the shareholders want to switch to a potentially bigger and more liquid stock or in case of an advantageous swap ratio. Compulsory conversion is unlikely given that FGC will remain a separate company; hence its shares will continue trading on the stock exchanges.

Also the investors should take into account the dilution risks associated with the massive increase in the charter capital of Holding MRSK needed to facilitate the transaction. To absorb the 79.55% stake in the Federal Grid, which belongs to the

Russian Federation, Holding MRSK should issue as many as 114.5 bn new shares. According to our calculations based on the 6-month average stock prices, this would increase the number of Holding MRSK's ordinary shares 3.4 times and the state's stake in its charter capital may exceed 86% compared to the current 54.5%.

▶ Swap ratio

The swap ratio is not determined yet and we expect it to reflect the market correlation between FGC and Holding MRSK shares. If so, there will be no conversion arbitrage for the shareholders and we wouldn't expect major movements in the stocks.

The shareholders of the Federal Grid will have to make choice either to stay in FGC which will remain an operational company or switch to the Russian Grids, which is going to be a holding structure.

▶ Locked potential

To remind, Holding MRSK is currently in the process of placing an additional share issue to receive cash from the government aimed at financing the capex of its subsidiaries. Given the large scale of the issue we expect the price of the placement which is RUB2.16 a share to be a ceiling for the stock limiting its growth. At the same time, once the officials set the swap ratio, the shares of the Federal Grid will be tied to MRKH and hence also capped. Thus, we see limited upside potential in both stocks within the next several months till the placement and the consolidation deal are over.

▶ Dividends

We also see some other issues related to the consolidation, which may affect the stocks' attractiveness, in particular dividends. After obtaining control over the Federal Grid, Holding MRSK should increase its profitability as FGC enjoys much higher margins. Besides, the government recently obliged state-owned companies to pay out at least 25% of their net income as dividends.

This should result in the higher dividend yield in Holding MRSK's ordinary and preferred shares. However, due to a number of constraints this may not happen soon. First of all, the IFRS profit of the Holding is not supported by the real cash flows. Holding MRSK may push its subsidiaries (FGC and MRSKs) to pay higher dividends, which is probable, in our view, and if so, will be supportive for those stocks. Secondly, the Holding MRSK cannot afford paying high dividends due to the high capex obligations. Thirdly, given the persisting direct cash injections from the federal budget high dividends look inappropriate.

RAB reload is finished. New guidance

The RAB reload proclaimed by the regulators last autumn led to a total revision of the previously approved tariffs. It can also result in some MRSK branches being switched back to the indexation method. To comply with the price caps set by the government, regulators cut the initial asset values and introduced a number of changes to the rules that limited the annual tariff growth rates by 10%. The RAB reload makes the EV/RAB ratio less reliable, and thus we suggest that investors look at the traditional P/E and EV/EBITDA ratios.

Tariff growth is capped at 10%

Throughout 2010-12, the government and regulators have been continuously introducing multiple measures to contain electricity prices for end consumers and even postponed annual tariff adjustments by half a year. Since distribution companies represent a meaningful share in the final power price, they probably suffered the most. In particular, last autumn, regulators proclaimed a RAB reload, which means a total revision of the previously approved long-term regulatory parameters. By November 1, 2012, the reload process has been completed with a number of MRSKs' subsidiaries been excluded from RAB-regulation and switched to the long-term indexation method. The FTS has approved the revised long-term tariffs for Federal Grid and 44 out of 65 MRSKs branches.

Final approved RAB implementation schedule

Company and branch name	2009	2010	1 Nov. 2010	2011	2012
MRSK Center					
Belgorodenergo					
Bryanskenergo					
Voronezhenergo					
Kostromaenergo					
Kurskenergo					
Lipetskenergo					
Orelenergo					
Smolenskenergo					
Tambovenergo					
Tverenergo					
Yarenergo					
MRSK North west					
Arkhenergo					
Vologdaenergo					
Kolenergo					
Karelenegero					
Komienergo					
Novgorodenergo					
Pskovenergo					
MRSK Urals					
Permenergo					
Sverdlovenergo					
Chelyabenergo					
MRSK Siberia					
Altayenergo					
Gorno-Altay Grid					
Buryatenergo					
Krasnoyarskenergo					
Kuzbassenergo EDG					
Omskenergo					
Khakassenergo					
Chitaenergo					
Tyvaenergo					
Tomsk DC					
Tomsk DC					
MRSK Center & Volga					
Vladimirenergo					
Ivenergo					
Kalugaenergo					
Kirovenergo					
Marienergo					
Nizhnovenergo					
Ryazanenergo					
Tulenergo					
Udmurtenergo					

Table continued on the next page

Company and branch name	2009	2010	1 Nov. 2010	2011	2012
MRSK Volga					
Saratov DG					
Samara DG					
Ulyanovsk DG					
Orenburgenergo					
Penzaenergo					
Mordovenergo					
Chuvashenergo					
MRSK South					
Astrakhanenergo					
Volgogradenergo					
Rostovenergo					
Kalmenergo					
Kubanenergo					
Kubanenergo					
Lenenergo					
Saint-Petersburg branch					
Leningrad oblast branch					
MOESK					
Moscow city DC					
Moscow region DC					
MRSK North Caucasus					
Dagenergo					
Kabardino-Balkar branch					
Karachaevo-Cherkessian branch					
North-Ossetian branch					
Stavropolenergo					
Ingushenergo					
Nurenergo					
Tyumenenergo					
Tyumenenergo					
Yantarenergo					
Yantarenergo					

Source: Holding MRSK, FTS

In most cases, the initial asset base values for branches that received new tariff plans were cut. The biggest loser is MRSK Volga, which suffered a 37% slash. The RABs for MRSK North-West, MRSK Urals and MRSK Center have been lowered by 20-25%. The companies in the South of Russia did not experience changes in their asset bases. And finally, two companies, MOESK and Lenenergo, enjoyed a slight upwards revision.

Restated comparable asset bases (incl. figures for reloaded branches only)

	RAB-2011, RUB bln	Revised RAB-2012, RUB bln	Asset base change, %
Holding MRSK	639.4	574.0	-10%
MOESK	180.0	182.5	2%
Lenenergo	69.4	72.2	4%
MRSK Center	85.6	66.6	-22%
MRSK Center and Volga	81.7	77.1	-6%
MRSK Volga	77.0	48.3	-37%
MRSK Urals	52.8	40.8	-23%
MRSK Siberia	10.4	9.4	-9%
MRSK North-West	22.9	17.5	-24%
MRSK South	22.5	22.5	0%
Kubanenergo	20.6	20.6	0%
MRSK North Caucasus	16.4	16.4	0%

Source: Federal Tariff Service, company data, Gazprombank

Apart from a downward revision of the asset bases and a pause in annual tariff adjustments, a number of changes in the rules and parameters governing return on capital calculation will weigh on the grid companies' financials:

- ▶ The rules regarding return on invested capital have been changed: henceforth, grid companies will receive this part of regulated revenues only once objects are commissioned. Previously, the tariffs were calculated based on actual capex.
- ▶ The rates of return on invested capital (old RAB) are now being governed by regional energy commissions, which can set them in a range of 1-11%. Previously the rates were unified and did not vary across regions.
- ▶ The X-factor, which sets the annual required cut in operating costs, has been

increased to 3% for a number of regional MRSK branches, namely MRSK Center, MRSK Urals, MRSK South and MRSK Volga.

As a result of the RAB reload, the previously approved long-term regulatory parameters for MRSKs were revised, which, coupled with decreased rates of return and enhanced operational performance parameters, led to lower tariff growth rates.

Re-approved electricity distribution tariff growth rates in some regions

	1H12/2011	2H12/1H12	2012	2013	2014	2015	2016	2017	CAGR 2012-17
MRSK Centre									
Orel oblast	-4.3%	4.3%	-0.7%	10.0%	10.0%	10.0%	10.0%	10.0%	8.1%
Belgorod oblast			-1.0%	8.6%	9.7%	7.2%	6.1%	7.7%	6.3%
Kursk oblast	-2.7%	5.4%	1.4%	7.3%	6.0%	6.1%	6.1%	7.2%	5.7%
MRSK Centre & Volga									
Ivanovo oblast			4.7%	7.4%	8.6%	9.1%	7.9%	6.1%	7.3%
Ryazan oblast			7.0%	9.0%	9.0%	8.8%	9.4%	7.8%	8.5%
Kirov oblast			2.4%	8.3%	9.5%	9.4%	9.7%	6.6%	7.6%
Kaluga oblast			2.7%	8.7%	9.5%	9.5%	9.5%	10.0%	8.3%
Rep. of Udmurtia	-2.9%	10.7%	2.3%	6.9%	5.8%	6.0%	5.7%	5.4%	5.3%
MRSK Volga									
Rep. of Mordovia			8.3%	9.8%	9.9%	8.4%	6.7%	5.3%	8.1%
Rep. of Chuvashia			4.1%	7.9%	9.7%	8.3%	7.9%	3.8%	6.9%
Penza oblast			2.0%	4.7%	6.6%	7.9%	6.9%	5.4%	5.6%
Orenburg oblast			5.9%	9.3%	9.2%	9.4%	7.7%	5.6%	7.8%
MRSK Urals									
Sverdlov oblast			5.1%	7.3%	1.5%	3.0%	3.0%	2.0%	3.6%
MRSK North-West									
Vologda oblast			4.2%	9.9%	8.3%	7.8%	7.7%	7.5%	7.6%
MRSK North Caucasus									
Stavropol Krai	0%	11.0%	5.6%	4.9%	10.0%	10.0%	10.0%	8.7%	8.2%
Rep. of Karachaevo-Cherkessia			6.2%	4.6%	3.5%	8.1%	4.7%	4.7%	5.3%
Rep. of Kabardino-Balkaria			4.4%	9.2%	9.2%	9.0%	9.0%	8.5%	8.2%
Rep. of Northern Ossetia			2.5%	9.4%	10.0%	9.9%	9.7%	9.7%	8.5%
MRSK South									
Rostov oblast	-4%	4.8%	0.4%	9.5%	8.0%	7.3%	6.7%	7.5%	6.5%
Astrakhan oblast	-0.1%	7.2%	3.4%	8.3%	9.5%	9.5%	9.8%	9.8%	8.4%

Source: Federal Tariff Service, Gazprombank calculations

As can be seen from the table above, the tariff growth rates within the next regulatory period are set in a range of 0-10% vs. the previously approved hikes of 20-25% on average. This corresponds with the 10% price cap set by the government and suggests that this limitation was apparently the master criteria for regulators. This also explains why the revision of the initial asset bases was so uneven across regions.

Is there much difference between RAB regulation and indexation now?

The fundamental advantage of RAB regulation compared with the former Cost Plus policy (now transformed into the Long-term Indexation method) is the guaranteed return on capital, which is an explicit component in the allowed revenues. The return on capital implies compensation for asset depreciation as well as the cost of invested capital.

RAB regulation assumes long-term tariffs (a five to seven-year period in Russia), which substantially improves the visibility and transparency of regulated utilities' future cash flows, allowing them to attract long-term debt.

In addition, this technique enables regulators to introduce a number of requirements regarding the quality of electricity distribution services as well as promote operational efficiency. On the contrary, indexation encourages companies to inflate their costs in order to be granted higher tariffs.

Below we summarize the most important advantages of RAB regulation compared with the indexation method:

- ▶ explicit return on capital guarantee;
- ▶ long-term tariff setting;
- ▶ more predictable and transparent cash flows;
- ▶ ability to attract long-term debt;
- ▶ operational efficiency incentives;

- ▶ connection fee cancellation;
- ▶ service quality targets;
- ▶ excuse for tariff hikes.

However, the practice of introducing RAB regulation in Russia suggests that the regulators failed to capitalize on most of the basic advantages of this approach.

Theoretical and practical implications of RAB regulation

Theoretically	In reality	Comment
Explicit return on capital guarantee	Partly	Revenue-smoothing mechanism and not always fair rates of return led to actual returns being below those allowed
Operational efficiency incentives	Partly	Efficiency incentives were distorted by revenue smoothing
Long-term tariff setting	No	RAB reload cancelled previously approved long-term tariff parameters
More predictable and transparent cash flows	No	Long-term visibility is hardly possible given the RAB reload and the complete change of previous parameters and rules of the game
Ability to attract long-term debt	No	Without long-term visibility, grid companies' ability to take on debt was limited
Connection fee cancellation	No	Connection fees not cancelled. In 2011, MRSKs' total revenues from connection services increased by 13% to RUB 38.8 bln. FGC's connection fees more than tripled to 2.2 bln.
Excuse for tariff hikes	No	Big tariff hikes were smoothed and then entirely revised and capped
Service quality targets	Partly	Service quality targets are not fully applied

Source: Gazprombank

As can be seen from the table above, most of the objectives of RAB regulation have been realized only partially or not at all. The companies' actual rates of return are far below the allowed levels. The smoothed revenues will probably not be compensated. The long-term visibility turned into a period of high uncertainty after the RAB reload was declared. Moreover, another revision of the approved parameters cannot be ruled out. For investors, this situation should mean that the difference between RAB regulation and indexation is not that significant, or in other words that so-called RAB regulation in Russia actually masks long-term indexation of tariffs.

RAB-based approach to fair value calculation

The nature of RAB regulation, which provides a fixed annual return, suggests that the fair value of a regulated entity can be calculated using tariff parameters set by the regulator, namely the regulatory asset base and the rate of return. As allowed, revenues under RAB regulation are comprised of return on invested capital and depreciation (both parameters determined by the regulated asset base – as a percentage of its residual and full value, respectively) as well as opex. Combining the return and depreciation together with income tax results in EBITDA.

Under RAB regulation, companies generate future cash flows that cover their costs, returns to shareholders and depreciation of assets in accordance with the asset base value employed by the regulator in setting tariffs. Thus, the net present value of future income streams will equal the value of the regulated asset base upon the condition that the true cost of capital is in line with the allowed rate of return.

However, given that the actual cost of capital (WACC) may diverge from the allowed rate of return (RoR), the fair EV of a company regulated under RAB principles should be calculated as follows:

$$\text{Fair EV} = \text{RAB} * (\text{RoR} / \text{WACC})$$

As we discussed earlier, the rate of return employed by the regulator is not the only factor that can influence a company's value. RAB regulation sets efficiency targets that may or may not be achieved, which turns into extra profits or losses. To further develop the fair value formula, it should be adjusted for efficiency gains/penalties:

$$\text{Fair EV} = \text{RAB} * (\text{eRoR} / \text{WACC}), \text{ where}$$

The eRoR component accounts for the effective rate of return, which includes the

return plus excess gains/penalties.

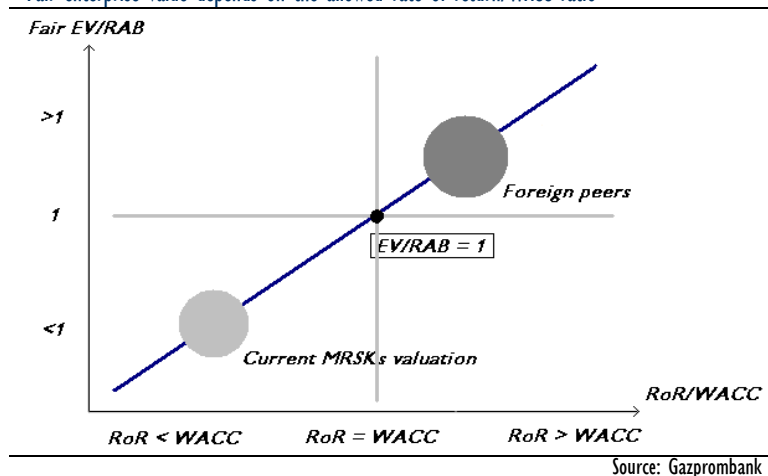
$$eRoR = (R + G/P) / RAB, \text{ where}$$

R is the return on invested capital and G/P accounts for gains/penalties.

That said, if the rate of return set by the regulator precisely reflects a company's WACC and excess gains/penalties can be neglected, the fair enterprise value equals its asset base. However, in practice, as already noted, all the MRSKs received unified target rates of return, which have been reduced for the first two years since the transition. Thus, weighted-average allowed rates for MRSKs range between 6% and 12%.

Apart from the fact that MRSKs have different actual costs of capital, in 2011, average allowed rates of return will be below their WACCs. This is the major reason why Russian distribution companies trade with discounts to their foreign peers. Moreover, depressed rates of return, which are below the companies' WACCs, cause capex to erode shareholder value due to the negative NPVs.

Fair enterprise value depends on the allowed rate of return/WACC ratio



We have calculated 'fair' upsides/downsides of the traded grid companies in line with the approach discussed above. We based our estimates of the asset bases on the revised figures where applicable and our estimates of the RABs for those branches which are expected to be switched back to the guaranteed return regulation.

To calculate the actual returns on RAB, we used the average of the forecast returns in 2012 and 2013. As the fair value calculations are based on the expected earnings, we excluded the companies that will probably be loss-making, in particular MRSK Siberia, Kubanenergo, MRSK North West and MRSK South.

We have updated our WACC calculation based on the declining interest rates and rising corporate risks. The summarized results are presented in the table on page 11.

Implied fair valuation under the simplified formula

Company name	Revised RAB, RUB bln	Expected RoR in 2012-13	WACC	Current EV/RAB	Fair EV/RAB	Upside
Federal Grid	647.6	3.1%	11.6%	0.62	0.27	-57%
Holding MRSK	574.0	6.2%	12.6%	0.48	0.49	2%
MOESK	182.5	7.6%	11.7%	0.54	0.65	19%
Lenenergo	72.2	1.7%	12.4%	0.30	0.14	-54%
MRSK Centre	66.6	4.8%	12.1%	0.75	0.40	-47%
MRSK Centre & Volga	77.1	4.0%	12.9%	0.51	0.31	-39%
MRSK Volga	48.3	2.6%	12.3%	0.37	0.21	-41%
MRSK Urals	40.8	6.4%	11.9%	0.52	0.54	4%
MRSK North Caucasus	16.4	2.8%	14.9%	0.17	0.19	11%

Source: Gazprombank

The calculations show significant divergence in the fair EV/RAB ratios between the companies, which is explained by the difference in the expected returns and

WACCs. The grids have different company-specific risks, borrowing costs and share liquidity, and RAB regulation does not guarantee that companies' profits will match the allowed returns.

EV/RAB multiple becomes unreliable

It must be noted that we do not incorporate the above made estimates in our target price calculations, as they are suitable only for a rough valuation. Unlike DCF modeling, this formula does not account for many relevant factors, such as cash proceeds from non-RAB regulated business, particularly connection fees and electricity retail business, planned capex etc. Furthermore, this approach does not work in cases of only partial adoption of the guaranteed return regulation, particularly for MRSK South, MRSK North-West, MRSK Siberia and MRSK North Caucasus or when a company is loss-making.

After the RAB regulation has been reloaded, a blunt comparison of the grid companies on an EV/RAB basis no longer looks reliable and can be misleading, for a number of reasons.

First, not all of the regions have been switched back to RAB. For example, only three branches out of seven are regulated under RAB at MRSK North-West, whereas MOESK and MRSK Siberia have not received the new long-term tariff plans at all (but still have a chance).

Secondly, as the rates of return are now at the discretion of the local regulators and can vary across regions, the difference between the companies' cost of capital and effective rate of return is even more significant. Apparently, the grid companies with the highest real return should have a higher valuation.

Third, the companies' performance depends on a number of factors other than just asset base and return, and thus the net financial results do not always correspond with the allowed returns on the asset base.

In this circumstance, we think investors should rely more on traditional multiples, such as P/E and EV/EBITDA, to compare the grid companies.

Also, we now see little sense in comparing Russian grid companies with their foreign peers regulated under RAB principles, as aside from all the tariff parameters, revisions and amendments to the rules, there are no more explicit guarantees of a fair return on invested capital or long-term visibility. In fact, the difference between the RAB regulation and tariff indexation is not significant.

2012 financial results – not that bad

Most of the grid companies have reported their 1H12 financial statements under IFRS and many of them have already disclosed RAS reports for 9m12.

The figures alone do not look overly disappointing given that the annual tariff adjustment had been postponed by half a year and the RAB reload ended up in the total revision of regulatory parameters.

Even though grids reported lower revenues and EBITDA on the back of downward tariff revision, they are still profitable thanks to rising electricity throughput and declining free electricity prices resulting in lower costs on electricity purchases for compensation of losses.

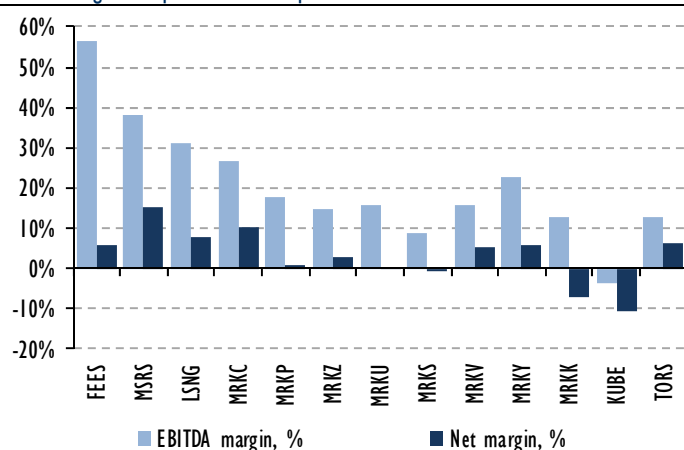
Grid companies' financial performance in 1H12, RUB mln

	Revenue	YoY	EBITDA	YoY	Net income	YoY	EBITDA margin	Net margin	Reporting standard
FGC	66,909	-6.0%	37,761	-16.9%	3,914	-91.1%	56.4%	5.8%	IFRS
Holding MRSK	302,654	-6.1%	60,173	-8.2%	15,617	-40.2%	19.9%	5.2%	IFRS
MOESK	57,134	-8.3%	21,678	2.3%	8,653	-7.8%	37.9%	15.1%	IFRS
Lenenergo	15,364	-2.8%	4,775	-11.1%	1,217	n/a	31.1%	7.9%	IFRS
MRSK Center	34,153	-3.0%	9,093	5.9%	3,456	-9.9%	26.6%	10.1%	IFRS
MRSK Center & Volga	29,298	-12.0%	5,201	-14.2%	217	-92.4%	17.8%	0.7%	IFRS
MRSK North-West	16,430	-4.5%	2,404	-7.8%	470	-43.6%	14.6%	2.9%	IFRS
MRSK Urals	30,247	-4.3%	4,728	-19.6%	168	-93.7%	15.6%	0.6%	IFRS
MRSK Siberia	25,425	-8.7%	2,194	-54.8%	-157	n/a	8.6%	-0.6%	IFRS
MRSK Volga	24,487	0.5%	3,817	9.0%	1,319	-14.5%	15.6%	5.4%	IFRS
MRSK South	12,229	0.8%	3,062	28.0%	689	2579%	25.0%	5.6%	RAS
MRSK N.Caucasus	5,956	-13.4%	0,768	-52.3%	-422	n/a	12.9%	-7.1%	IFRS
Kubanenergo	13,630	-1.2%	-0,493	n/a	-1,463	34.7%	-3.6%	-10.7%	RAS
Tomsk DC	3,280	-1.5%	0,426	-7.1%	209	-16.1%	13.0%	6.4%	RAS

Source: companies' data, Gazprombank

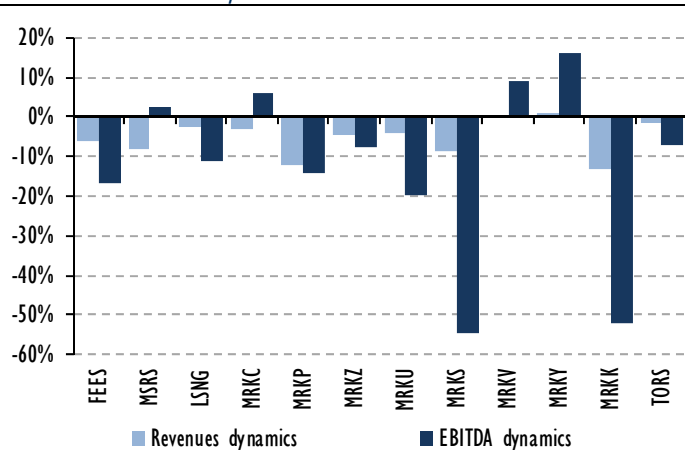
The only exceptions were Kubanenergo, MRSK North Caucasus and MRSK Siberia. Kubanenergo's net loss is explained by its large capex program (one of the largest among MRSKs compared with the asset base) and insufficient tariffs. Similarly, MRSK North Caucasus in its IFRS consolidates the results of loss-making Dagenergo branch, where tariffs do not cover for huge electricity losses and other costs. MRSK Siberia has been loss-making since RUSAL withdrew from the last-mile agreement back in 2010. The regulators do not compensate for the shortfall in the company's income.

Most of the grid companies remained profitable in 1H12



Source: compan data, Gazprombank

MRSKs' revenue and EBITDA dynamics in 1H12



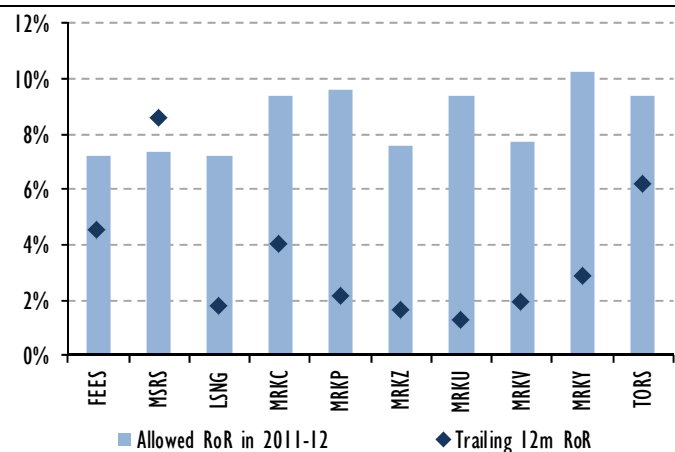
Source: company, Gazprombank

Based on trailing 12m net income (covering 2H11 and 1H12), we have calculated the actual returns on the invested capital (based on previously approved asset bases). As can be seen from the chart below, the grid companies earn substantially less than they should according to the allowed rates of return. The latter vary by company due to different RAB transition schedules, as the rates for existing and new invested capital are not the same.

The only exception here is MOESK, which can be explained by profits from connection services, as they are also accounted in net profit. In 2H11 and 1H12, revenues from the connection fees totaled RUB 18.6 bln.

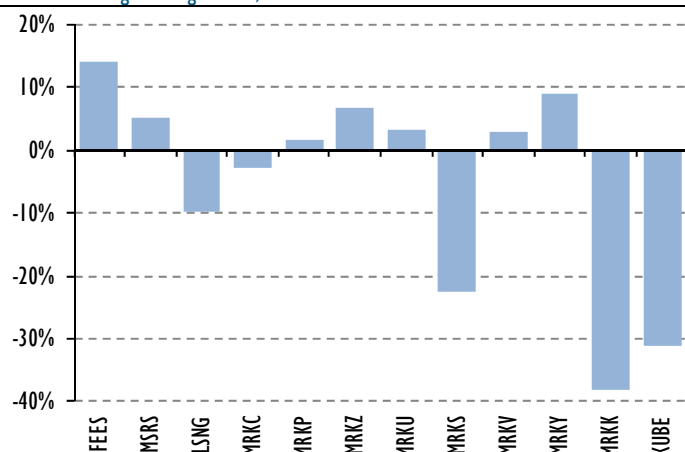
Overall, low actual returns compared with the allowed figures may be explained by revenue smoothing and tariff revision within the RAB reload coupled with the freezing of all the tariffs in 1H12. We also see a number of other reasons why companies earn less than they should, based on the allowed rates of return. In particular, the regulators do not always take into account the last-mile issues or provide sufficient funds to finance capex; the cost control objectives are not always achievable; companies are not compensated for borrowing costs.

MRSK's actual returns on RAB vs. allowed



Source: company, Gazprombank

Net debt change through 1H12, %



Source: company, Gazprombank

Having extensive capex programs, grid companies must enhance leverage, as the tariff sources do not fully cover their financing needs. The companies have therefore increased borrowing and placed bonds (for example, FGC, MOESK, MRSK Center).

However, the revision of tariffs coupled with the tough situation on financial markets accounted for the fact that grids did not aggressively take on debt. Some of the companies rely more on raising cash via the placement of additional shares. In particular, Lenenergo, Kubanenergo and MRSK North Caucasus have placed large share issues, which explains the fall in their net debt. The coming additional share placement by Holding MRSK is also aimed at raising cash to provide the subsidiaries with funds to finance their CAPEX.

Additional share issues negatively affect stocks due to dilution risks. Besides, in case of large issuances, the placement price may cap the stock, as is the case with Holding MRSK.

Federal Grid Company (FGC)

Federal Grid Company is the operator and manager of Russia's unified electricity transmission grid system. Based on the length of transmission lines and installed transformer capacity, Federal Grid is the largest publicly traded electricity transmission company in the world. Federal Grid's business is to provide electricity transmission and technological connection services. It maintains and develops the grid system and supervises grid facilities and infrastructure in 73 regions, covering a territory of 13.6 mln sq. km. Its customers are regional distribution companies, electricity suppliers and large industrial enterprises.

Since 2010, FGC has operated under RAB-regulation. After the RAB reload, the company has received new tariff plan for 2012-2014.

FGC's shares are listed on the MICEX-RTS stock exchange being the most liquid name in the utilities. It's GDRs are traded on the London Stock Exchange. The Company's shares are included in the MSCI Emerging Markets and MSCI Russia indices.

Currently FGC manages Holding MRSK, which operates Russia's distribution network through its subsidiaries. However, according to the latest plans of the government, the state's stake in FGC will be contributed in the charter capital of Holding MRSK.

Market data

Ticker	FEES
Market price, RUB	0.21
Market Cap, USD bln	8.4
TP, RUB	0.24
Upside	15%
Rating	NEUTRAL

Source: Bloomberg, Gazprombank estimates

Operational data (2011)

Throughput, bln kWh	484.7
Lines, '000 km	124.6
Losses, %	4.7%
RAB, rub bln	647.6
Asset depreciation ratio, %	41%
Capex 2012-17, RUB bln	938.0

Source: company, Gazprombank estimates

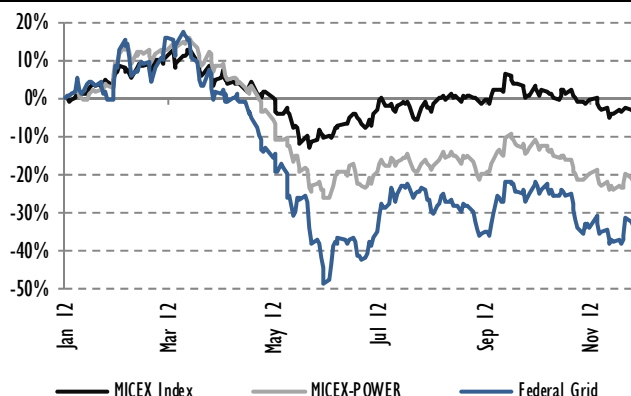
Ratios and valuation

EV/RAB	0,62
P/E 2013F	12,2
CAPEX/RAB*	1,45
Expected RoR 2012F	3,1%
RoR/WACC	0,27
Fair EV/RAB 2012F	0,64

*6-year capex plan for 2012-2017

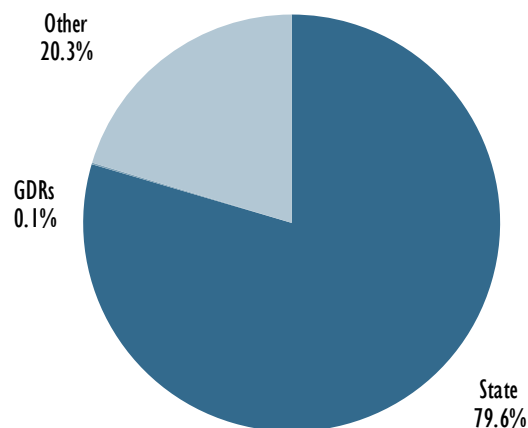
Source: Bloomberg, Gazprombank estimates

YTD stock performance against main indices



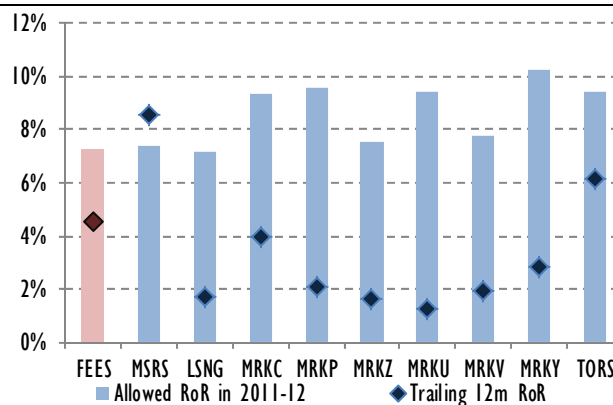
Source: company data

Shareholders breakdown



Source: company data

Actual return on RAB v allowed rate of return



Source: company data

DCF valuation results, RUB mln

	2012	2013	2014	2015	2016	2017	2018	2019	2020
EBIT	28,370	38,005	49,058	56,111	63,217	77,454	108,662	116,762	133,029
Taxes on EBIT	-4,348	-5,476	-7,011	-7,777	-9,711	-12,777	-18,824	-20,890	-25,156
Depreciation & amortization	49,961	55,855	63,121	71,988	81,829	92,789	92,039	92,873	89,998
Changes in working capital	2,679	-2,857	-1,467	-2,711	-765	-3,258	-3,460	-1,200	-1,950
Operating cash flow	76,662	85,528	103,701	117,612	134,570	154,209	178,417	187,545	195,921
CAPEX	-135,702	-133,040	-132,108	-133,355	-133,663	-133,126	-100,855	-94,909	-89,937
Free cash flow	-59,040	-47,511	-28,407	-15,743	906	21,083	77,562	92,635	105,984
Terminal growth rate	0%								
WACC	11.6%								
DFCF	4,139								
DTV	376,200								
Enterprise value	380,339								
Net debt	170,283								
Non-controlling interest	739								
Equity stakes	56,556								
Market capitalization	265,873								
Number of shares, mln	1,260,387								
Target price, RUB	0.24								

Income statement, RUB mln

	2011	2012	2013	2014	2015	2016	2017
Revenue	139,571	138,490	157,179	176,615	194,412	213,244	240,272
Connection fees	2,178	2,175	2,066	1,963	1,865	1,772	1,683
Operating expenses	100,750	118,681	128,569	138,234	150,180	163,183	177,125
EBITDA	105,889	78,331	93,861	112,179	128,100	145,046	170,243
EBIT	71,837	28,370	38,005	49,058	56,111	63,217	77,454
Net income	48,988	17,392	21,902	28,044	31,108	38,843	51,108
EBITDA margin	75.9%	56.6%	59.7%	63.5%	65.9%	68.0%	70.9%
Net margin	35.1%	12.6%	13.9%	15.9%	16.0%	18.2%	21.3%
EPS, RUB	0.039	0.014	0.017	0.022	0.025	0.031	0.041

Source: FGC, Gazprombank forecasts

Balance sheet, RUB mln

	2011	2012	2013	2014	2015	2016	2017
ASSETS							
Non-current assets							
Property, plant & equipment	980,677	1,067,196	1,145,081	1,214,699	1,276,633	1,328,979	1,369,775
Intangible assets	6,973	6,195	5,494	4,863	4,296	3,785	3,325
Long-term promissory notes	14,928	14,319	14,319	14,319	14,319	14,319	14,319
Investments in associates	910	1,506	1,506	1,506	1,506	1,506	1,506
Available-for-sale investments	69,979	69,979	69,979	69,979	69,979	69,979	69,979
Other non-current assets	1,039	1,039	1,039	1,039	1,039	1,039	1,039
Total non-current assets	1,074,506	1,160,234	1,237,418	1,306,405	1,367,772	1,419,607	1,459,944
Inventories	6,320	6,731	7,050	6,621	6,880	6,309	6,547
Accounts receivable and prepayments	32,944	34,273	38,609	41,328	45,538	48,704	53,392
Short-term promissory notes	20,737	20,737	20,737	20,737	20,737	20,737	20,737
Other current assets	3,543	3,543	3,543	3,543	3,543	3,543	3,543
Cash and cash equivalents	25,627	45,495	49,385	60,793	73,324	83,004	74,533
Total current assets	89,171	110,779	119,324	133,021	150,022	162,297	158,751
TOTAL ASSETS	1,163,677	1,271,013	1,356,742	1,439,427	1,517,794	1,581,904	1,618,695
EQUITY AND LIABILITIES							
Equity							
Share capital	627,974	630,193	633,159	633,159	633,159	633,159	633,159
Treasury shares	-5,522	-5,161	-5,161	-5,161	-5,161	-5,161	-5,161
Share premium	10,501	10,501	10,501	10,501	10,501	10,501	10,501
Reserves	314,323	314,323	314,323	314,323	314,323	314,323	314,323
Accumulated deficit	-49,962	-33,075	-12,354	14,265	43,620	77,414	122,353
Equity attributable to the shareholders of FGC	897,314	916,781	940,468	967,087	996,442	1,030,236	1,075,176
Non-controlling interest	793	739	672	585	490	370	212
TOTAL EQUITY	898,107	917,520	941,140	967,672	996,932	1,030,606	1,075,388
Non-current liabilities							
Deferred tax liabilities	80,572	80,572	80,572	80,572	80,572	80,572	80,572
Non-current debt	130,778	215,778	275,778	330,778	291,000	321,000	336,000
Retirement benefit obligations	4,686	5,191	5,503	5,833	6,183	6,566	6,908
TOTAL NON-CURRENT LIABILITIES	216,036	301,541	361,853	417,183	377,755	408,138	423,480
Current liabilities							
Accounts payable to FGC's shareholders	2,275	2,275	2,275	2,275	2,275	2,275	2,275
Current debt and current portion of n/c debt	2,002	0	0	0	86,778	85,000	60,000
Accounts payable and accrued charges	44,974	49,394	51,191	52,013	53,772	55,602	57,270
Income tax payable	283	283	283	283	283	283	283
TOTAL CURRENT LIABILITIES	49,534	51,952	53,749	54,571	143,108	143,160	119,828
TOTAL LIABILITIES	265,570	353,493	415,602	471,754	520,863	551,298	543,307
TOTAL EQUITY AND LIABILITIES	1,163,677	1,271,013	1,356,742	1,439,427	1,517,794	1,581,904	1,618,695

Source: FGC, Gazprombank forecasts

Cash flow statement, RUB mln

	2011	2012	2013	2014	2015	2016	2017
Operating cash flows before w/c changes and income tax paid	83,012	78,606	93,980	112,287	128,182	145,114	170,356
Working capital changes	-9,853	2,711	-3,044	-1,662	-2,889	-954	-3,528
Income tax paid	-13,875	-4,348	-5,476	-7,011	-7,777	-9,711	-12,777
Net cash generated by operating activities	68,645	76,970	85,461	103,614	117,516	134,450	154,051
Cash flow from investing activities	-124,743	-135,702	-133,040	-132,108	-133,355	-133,663	-133,126
Cash flow from financing activities	68,152	78,600	51,469	39,901	28,371	8,893	-29,396
Increase/(decrease) in cash	12,054	19,868	3,890	11,408	12,532	9,679	-8,471
Cash at the beginning of the year	13,573	25,627	45,495	49,385	60,793	73,324	83,004
Cash at the end of the year	25,627	45,495	49,385	60,793	73,324	83,004	74,533

Source: FGC, Gazprombank forecasts

HOLDING MRSK

Holding MRSK operates Russian electricity distribution network through its subsidiaries, MRSKs. The Holding unites 97 subsidiaries within 69 regions across Russia managing a power network of different voltage types, ranging from 0.4 kV to 220 kV. The total length of MRSKs' grids exceeds 2.1 mln km. Holding MRSK ranks among the world's largest electric grid companies in terms of network volume and number of customers.

Since 2009 Holding MRSK's regional subsidiaries started to migrate to RAB-regulation. After the RAB reload proclaimed in autumn 2011, 44 out of 65 MRSKs' branches are operated under RAB tariff policy.

The shares of Holding MRSK are traded on the MICEX-RTS stock exchange. In the end of 2011, Company's depository receipts started trading on the International Order Book of the London Stock Exchange.

Currently Holding MRSK is under management of the federal Grid Co. However, according to the latest plans of the government, the situation may change entirely with the state's stake in FGC being contributed in the charter capital of Holding MRSK and the latter becoming a managing company of both, distribution and transmission infrastructure in Russia.

Market data

	MRKH, MRKHp
Ticker	MRKH, MRKHp
Market price, RUB	1.97
Market Cap, USD bln	3.3
TP (ordinary), RUB	2.33
Upside	18%
TP (preferred), RUB	1.51
Upside	21%
Recommendation	NEUTRAL

Source: Bloomberg, Gazprombank estimates

Ratios and valuation

EV/RAB	0.48
P/E 2013F	4.2
CAPEX/RAB*	1.44
Expected RoR 2012F	6.2%
RoR/WACC	0.49
Fair EV/RAB 2012F	0.78

*6-year capex plan for 2012-2017 estimates

Source: Bloomberg, Gazprombank estimates

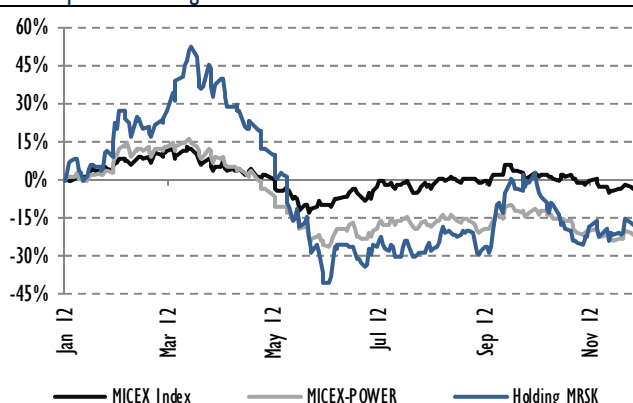
Operational data (2011)

Throughput, bln kWh	643.9
Lines, '000 km	2,087
Losses, %	8.4%
RAB (adjusted for HMRSK's share in subsidiaries), rub bln	331
Asset depreciation ratio, %	59%
Capex 2012-2017, RUB bln	825.0
Last-mile agreements, %*	14%

Source: company, Gazprombank estimates

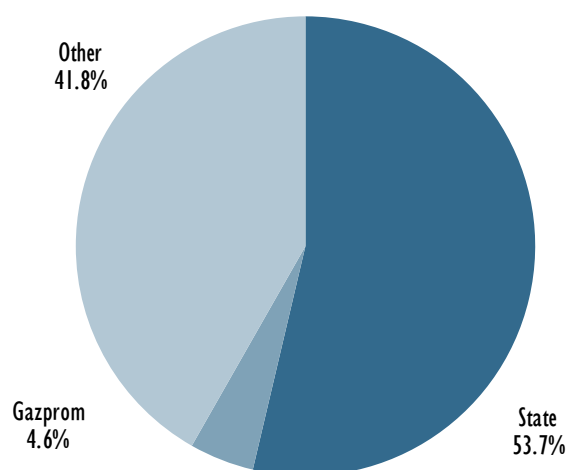
*Share of revenue received under LMA

YTD stock performance against main indices



Source: company data

Shareholders breakdown



Source: company data

Holding MRSK's stakes in distribution companies

MOESK	50.9%
Lenenergo*	50.3%
MRSK Center	50.2%
MRSK Center & Volga	50.4%
MRSK North-West	55.4%
MRSK Urals	51.5%
MRSK Siberia	52.9%
Tomsk DC*	52.0%
MRSK Volga	67.6%
MRSK South	51.7%
Kubanenergo	40.6%
MRSK North Caucasus	57.7%
Tyumenenergo	100.0%
Yantarenergo	100.0%

*Stake in ordinary shares

DCF valuation results, RUB mln

	2012	2013	2014	2015	2016	2017	2018	2019	2020
EBIT	54,451	65,253	64,459	72,512	81,413	100,784	113,945	121,722	119,826
Taxes	-10,890	-13,051	-12,892	-14,502	-16,283	-20,157	-22,789	-24,344	-23,965
NOPAT	43,561	52,203	51,567	58,010	65,130	80,628	91,156	97,377	95,861
D&A	64,594	76,493	86,369	96,001	107,131	117,313	126,377	136,199	148,013
Changes in working capital	-9,639	-6,650	3,197	-3,211	2,173	1,000	-17	241	174
Operating cash flow	98,516	122,045	141,134	150,800	174,434	198,940	217,516	233,817	244,047
CAPEX	-117,647	-142,330	-140,680	-131,165	-134,078	-132,330	-137,590	-142,922	-148,317
Free cash flow	-19,131	-20,285	454	19,635	40,357	66,610	79,926	90,895	95,730
Terminal growth rate	0.0%								
WACC	12.6%								
DFCF	151,304								
DTV	286,620								
Enterprise value	437,924								
Net debt	174,470								
Non-controlling interest	155,573								
Capitalization	107,881								
Number of common shares, mln	49,947								
Number of preferred shares, mln	2,075								
Target price, common, RUB	2.33								
Target price, preferred, RUB	1.51								

Income statement, RUB mln

	2011	2012	2013	2014	2015	2016	2017
Revenue	634,608	655,836	731,249	785,613	843,409	902,417	966,155
Operating expenses	577,214	603,194	668,065	723,506	773,466	823,830	868,471
Depreciation and amortization	54,075	64,594	76,493	86,369	96,001	107,131	117,313
EBITDA	113,329	119,046	141,746	150,828	168,513	188,544	218,098
EBIT	59,254	54,451	65,253	64,459	72,512	81,413	100,784
Net income	38,966	30,641	40,061	37,205	46,432	56,730	72,186
Non-controlling interest	15,528	12,210	15,964	14,826	18,503	22,607	28,766
EBITDA margin	17.9%	18.2%	19.4%	19.2%	20.0%	20.9%	22.6%
EBIT margin	9.3%	8.3%	8.9%	8.2%	8.6%	9.0%	10.4%
Net margin	6.1%	4.7%	5.5%	4.7%	5.5%	6.3%	7.5%
EPS, RUB	0.75	0.59	0.77	0.72	0.89	1.09	1.39

Source: Holding MRSK, Gazprombank forecasts

Balance sheet, RUB mln

RUB mln	2011	2012	2013	2014	2015	2016	2017
ASSETS							
Non-current assets							
Property, plant & equipment	687,489	744,125	814,830	875,615	919,260	957,198	986,342
Intangible assets	4,368	4,896	5,167	5,117	4,666	3,712	2,131
Investments in equity accounted investees	1,280	1,360	1,536	1,712	1,888	2,064	2,239
Accounts receivable	16,818	16,818	16,818	16,818	16,818	16,818	16,818
Other investments and financial assets	9,837	9,837	9,837	9,837	9,837	9,837	9,837
Deferred tax assets	2,599	2,599	2,599	2,599	2,599	2,599	2,599
Total non-current assets	722,391	779,635	850,788	911,698	955,068	992,228	1,019,966
Current assets							
Inventories	12,907	11,778	12,397	12,863	13,347	13,850	14,373
Other investments and financial assets	8,728	8,728	8,728	8,728	8,728	8,728	8,728
Current tax assets	4,516	4,516	4,516	4,516	4,516	4,516	4,516
Trade and other receivables	81,682	74,805	90,647	99,167	106,509	114,190	122,209
Cash and cash equivalents	48,853	29,361	12,494	13,502	14,556	13,899	16,865
Total current assets	156,686	129,187	128,782	138,777	147,656	155,182	166,691
TOTAL ASSETS	879,077	908,823	979,569	1,050,475	1,102,724	1,147,411	1,186,658
EQUITY AND LIABILITIES							
Equity							
Share capital	45,039	49,947	59,207	59,207	59,207	59,207	59,207
Share premium	6,036	16,244	26,986	26,986	26,986	26,986	26,986
Treasury shares	-1,786	-1,786	-1,786	-1,786	-1,786	-1,786	-1,786
Reserves	9,662	4,782	4,168	4,155	4,108	3,826	3,564
Retained earnings	207,790	224,689	246,782	267,300	292,908	324,194	360,395
Total equity to shareholders	266,741	293,875	335,356	355,862	381,422	412,427	448,366
Non-controlling interest	177,136	189,346	205,311	220,137	238,640	261,247	290,013
TOTAL EQUITY	443,877	483,222	540,667	575,998	620,062	673,674	738,379
Non-current liabilities							
Loans and borrowings	168,831	167,321	195,711	174,282	170,000	180,000	140,000
Trade and other payables	30,081	30,081	30,081	30,081	30,081	30,081	30,081
Employee benefits	9,660	9,660	9,660	9,660	9,660	9,660	9,660
Deferred tax liabilities	32,478	32,478	32,478	32,478	32,478	32,478	32,478
Total non-current liabilities	241,050	239,540	267,930	246,501	242,219	252,219	212,219
Current liabilities							
Loans and borrowings	26,954	36,510	11,610	56,429	64,282	35,000	40,000
Trade and other payables	161,920	141,276	151,713	164,493	169,651	180,500	190,490
Provisions	4,757	7,849	7,149	6,511	5,929	5,400	4,918
Current tax and liabilities	519	426	501	543	580	618	651
Total current liabilities	194,150	186,061	170,972	227,976	240,443	221,518	236,060
TOTAL LIABILITIES	435,200	425,601	438,902	474,476	482,662	473,737	448,279
TOTAL EQUITY AND LIABILITIES	879,077	908,823	979,569	1,050,475	1,102,724	1,147,411	1,186,658

Source: Holding MRSK, Gazprombank forecasts

Cash flow statement, RUB mln

	2011	2012	2013	2014	2015	2016	2017
Operating cash flows before w/c changes and income tax paid	113,980	129,129	146,723	154,633	172,559	192,674	222,559
Working capital changes	1,140	-24,509	-12,316	-663	-7,341	-2,277	-3,758
Income tax paid	-12,186	-10,983	-12,976	-12,850	-14,465	-16,245	-20,123
Net cash generated by operating activities	89,338	77,705	107,352	125,832	138,189	164,703	189,228
Cash flow from investing activities	-121,818	-118,827	-145,708	-146,354	-138,385	-143,242	-144,043
Cash flow from financing activities	56,443	21,629	21,489	21,530	1,249	-22,119	-42,219
Increase/(decrease) in cash	23,963	-19,493	-16,867	1,009	1,054	-658	2,967
Cash at the beginning of the year	24,890	48,853	29,361	12,494	13,502	14,556	13,899
Cash at the end of the year	48,853	29,361	12,494	13,502	14,556	13,899	16,865

Source: Holding MRSK, Gazprombank forecasts

MOESK

MOESK, operating within Moscow and the Moscow region, is one of the largest Russian interregional distribution grid companies and the biggest subsidiary of Holding MRSK. The main activities of the company are related to electric power distribution and technological connection of consumers to the grid. Among MRSKs, MOESK enjoys by far the largest proceeds from the connection fees.

The company services the area of 47 thousand sq. m and delivers electricity to more than 17 mln people, occupying a roughly 95% share in the two regions.

MOESK has been switched to RAB-regulation starting 2011. However, in 2012 after the RAB reload the company received a new long-term tariff plans with the initial RAB parameters not experiencing significant adjustments.

The shares of MOESK are traded on the MICEX-RTS stock exchange and are the most liquid among Holding MRSK's subsidiaries.

The company pays out dividends with DPS for 2011 equaling RUB 0.025.

Operational data (2011)

Throughput, bln kWh	84.2
Lines, '000 km	138.0
Losses	10.3%
RAB, RUB bln	182.9
Assets depreciation ratio	51%
Capex 2012-2017, rub bln	274.0
Last-mile*	6%

Source: company data, Gazprombank estimates

*Share of revenue received under last-mile agreements

Market data

Ticker	MSRS
Market price, rub	1.30
Market Cap, USD bln	2.0
TP (ordinary), rub	1.47
Upside	13%
Recommendation	NEUTRAL

Source: Bloomberg, Gazprombank estimates

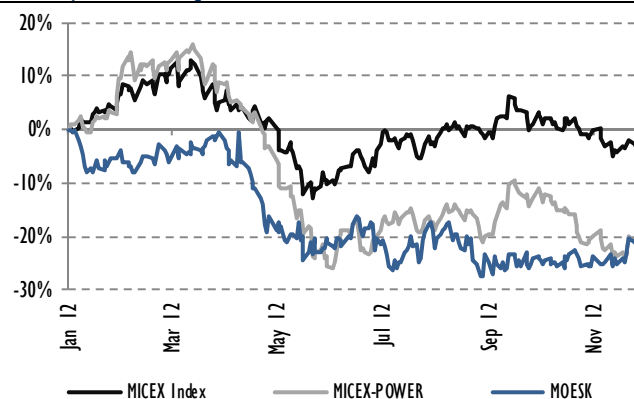
Ratios and valuation

EV/RAB	0.54
P/E 2013F	4.5
CAPEX/RAB*	1.50
Expected RoR 2012F	7.6%
RoR/WACC	0.65
Fair EV/RAB 2012F	0.59

*6-year capex plan for 2012-2017 estimates

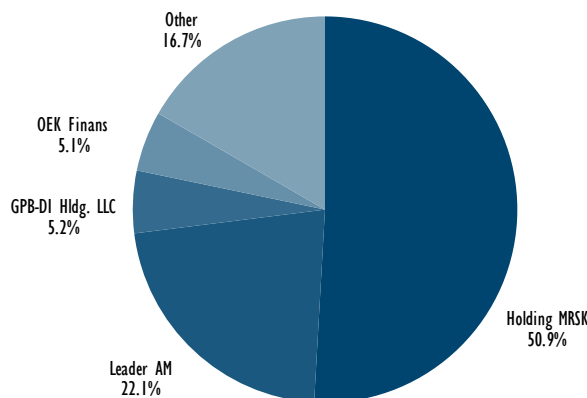
Source: Bloomberg, Gazprombank estimates

YTD stock performance against main indices



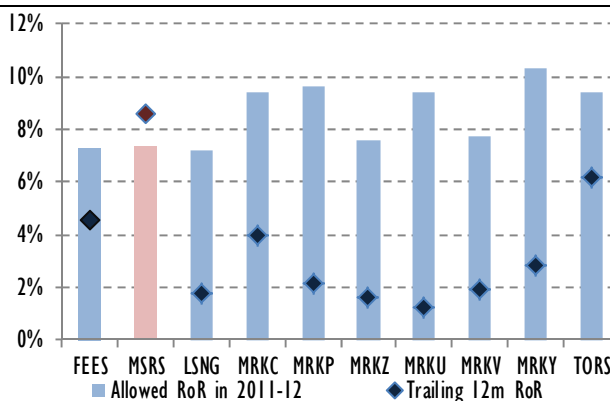
Source: company data

Shareholders breakdown



Source: company data

Actual return on RAB v allowed rate of return



Source: company data

DCF valuation results, RUB mln

	2012	2013	2014	2015	2016	2017	2018	2019	2020
EBIT	21,335	21,891	19,828	16,706	16,818	19,834	21,180	23,183	24,892
Taxes	-4,267	-4,378	-3,966	-3,341	-3,364	-3,967	-4,236	-4,637	-4,978
NOPAT	17,068	17,513	15,863	13,365	13,454	15,868	16,944	18,546	19,914
D&A	18,707	21,116	24,072	26,918	27,530	27,811	28,426	28,868	29,676
Changes in working capital	4,915	-4,669	-1,822	-1,735	-3,502	-3,617	676	408	582
Operating cash flow	40,690	33,959	38,112	38,548	37,482	40,061	46,047	47,822	50,172
CAPEX	-29,129	-41,616	-45,188	-37,625	-30,808	-33,061	-32,565	-31,914	-29,680
Free cash flow	11,560	-7,657	-7,075	923	6,674	7,000	13,481	15,908	20,492
Terminal growth rate	0,0%								
WACC	11,7%								
DFCF	30,166								
DTV	70,926								
Enterprise value	101,092								
Net debt	35,855								
Non-controlling interest	619								
Capitalization	64,619								
Number of shares, mln	48,707								
Target price, RUB	1,47								

Income statement, RUB mln

	2011	2012	2013	2014	2015	2016	2017
Revenue	129,366	123,810	136,921	143,318	148,460	154,566	162,811
Operating expenses	105,634	106,700	115,900	125,370	133,760	139,846	145,154
Depreciation and amortization	16,539	18,707	21,116	24,072	26,918	27,530	27,811
EBITDA	41,649	40,042	43,006	43,900	43,624	44,348	47,645
EBIT	25,110	21,335	21,891	19,828	16,706	16,818	19,834
Net income	18,043	13,414	14,187	12,725	9,584	9,285	11,089
Non-controlling interest	95	134	142	127	96	93	111
EBITDA margin	32.2%	32.3%	31.4%	30.6%	29.4%	28.7%	29.3%
EBIT margin	19.4%	17.2%	16.0%	13.8%	11.3%	10.9%	12.2%
Net margin	13.9%	10.8%	10.4%	8.9%	6.5%	6.0%	6.8%
EPS, rub	0.37	0.28	0.29	0.26	0.20	0.19	0.23

Source: MOESK, Gazprombank forecasts

Balance sheet, RUB mln

RUB mln	2011	2012	2013	2014	2015	2016	2017
ASSETS							
Non-current assets							
Property, plant & equipment	205,734	216,273	236,960	258,350	269,440	273,238	279,179
Intangible assets	473	1,477	1,989	2,590	3,299	4,146	5,163
Long-term investments	561	0	0	0	0	0	0
Other non-current assets	14,009	14,009	14,009	14,009	14,009	14,009	14,009
Total non-current assets	220,776	231,758	252,958	274,948	286,749	291,393	298,351
Current assets							
Inventories	2,100	2,235	2,323	2,415	2,510	2,610	2,713
Income tax receivable	461	461	461	461	461	461	461
Trade and other receivables	22,102	21,859	24,174	25,303	26,211	27,289	28,745
Short-term investments	175	175	175	175	175	175	175
Cash and cash equivalents	3,945	9,112	12,913	13,690	11,759	12,433	21,838
Total current assets	28,782	33,842	40,046	42,043	41,116	42,967	53,931
TOTAL ASSETS	249,559	265,600	293,004	316,992	327,864	334,360	352,282
EQUITY AND LIABILITIES							
Equity							
Share capital	24,354	24,354	24,354	24,354	24,354	24,354	24,354
Additional paid-in capital	18,581	18,581	18,581	18,581	18,581	18,581	18,581
Retained earnings	79,494	92,104	105,439	117,401	126,410	135,137	145,006
Total equity to shareholders	122,429	135,038	148,374	160,335	169,344	178,072	187,940
Non-controlling interest	484	619	760	888	984	1,076	1,187
TOTAL EQUITY	122,913	135,657	149,134	161,223	170,328	179,148	189,128
Non-current liabilities							
Loans and borrowings	39,967	41,160	43,660	56,160	61,160	71,160	66,160
Trade and other payables	22,471	22,471	22,471	22,471	22,471	22,471	22,471
Employee benefits	1,357	1,357	1,357	1,357	1,357	1,357	1,357
Deferred tax liabilities	7,782	7,782	7,782	7,782	7,782	7,782	7,782
Total non-current liabilities	71,577	72,770	75,270	87,770	92,770	102,770	97,770
Current liabilities							
Loans and borrowings	6,509	3,808	17,500	17,500	15,000	5,000	20,000
Trade and other payables	47,458	52,265	49,999	49,398	48,666	46,341	44,284
Provisions	988	988	988	988	988	988	988
Other taxes payable	113	113	113	113	113	113	113
Total current liabilities	55,069	57,174	68,600	67,999	64,767	52,442	65,385
TOTAL LIABILITIES	126,646	129,944	143,870	155,769	157,537	155,212	163,155
TOTAL EQUITY AND LIABILITIES	249,559	265,600	293,004	316,992	327,865	334,360	352,282

Source: MOESK, Gazprombank forecasts

Cash flow statement, RUB mln

	2011	2012	2013	2014	2015	2016	2017
Operating cash flows before w/c changes and income tax paid	45,381	40,042	43,006	43,900	43,624	44,348	47,645
Working capital changes	-11,565	4,915	-4,669	-1,822	-1,735	-3,502	-3,617
Income tax paid	-4,391	-4,267	-4,378	-3,966	-3,341	-3,364	-3,967
Net cash generated by operating activities	29,425	40,690	33,959	38,112	38,548	37,482	40,061
Cash flow from investing activities	-29,776	-29,452	-41,769	-45,287	-37,897	-31,469	-34,023
Cash flow from financing activities	1,365	-6,070	11,611	7,951	-2,582	-5,339	3,366
Increase/(decrease) in cash	1,014	5,168	3,801	776	-1,931	674	9,405
Cash at the beginning of the year	2,931	3,945	9,112	12,913	13,690	11,759	12,433
Cash at the end of the year	3,945	9,112	12,913	13,690	11,759	12,433	21,838

Source: MOESK, Gazprombank forecasts

MRSK Center

MRSK Center (Interregional Distribution Grid Company of Center) was established in 2004 and is a subsidiary of Holding MRSK. The company operates electricity distribution network in 11 regions of the Central Russia, including Belgorod, Bryansk, Voronezh, Kursk, Kostroma, Lipetsk, Tver, Smolensk, Oryol, Tambov and Yaroslavl regions. MRSK Center dominates the local markets occupying a 72-98% share of the power distribution services markets in the regions.

Three out of eleven branches of MRSK Center have been switched to RAB-regulation since 2009 with the rest migrating to the new tariff policy in 2010-2011. However, after the RAB reload three branches were excluded from RAB-regulation and received long-term tariffs based on the indexation method instead.

The shares of MRSK Center are traded on the MICEX-RTS stock exchange and are included into the calculation basis of MICEX and MICEX-POWER indices.

The company pays out dividends with DPS for 2011 equaling RUB 0.01 and the total payout corresponding to 8% of the company's net income under RAS.

Operational data (2011)

Throughput, bln kWh	62.9
Lines, '000 km	370.0
Losses	9.9%
RAB, rub bln	54.0
Assets depreciation ratio	65%
Capex 2012-2017, rub bln	79.5
Last-mile*	20%

Source: company data, Gazprombank estimates

*Share of revenue received under last-mile agreements

Market data

Ticker	MRKC
Market price, rub	0.56
Market Cap, USD mln	764
TP (ordinary), rub	0.75
Upside	33%
Recommendation	OVERWEIGHT

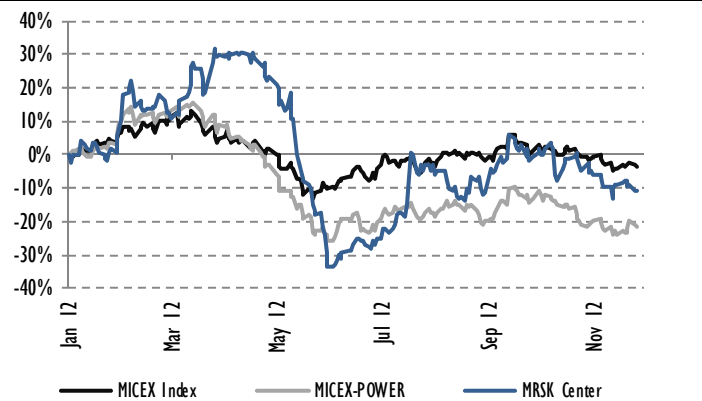
Source: Bloomberg, Gazprombank estimates

Ratios and valuation

EV/RAB	0.75
P/E 2013F	6.9
CAPEX/RAB*	1.19
Expected RoR 2012F	4.8%
RoR/WACC	0.40
Fair EV/RAB 2012F	0.87

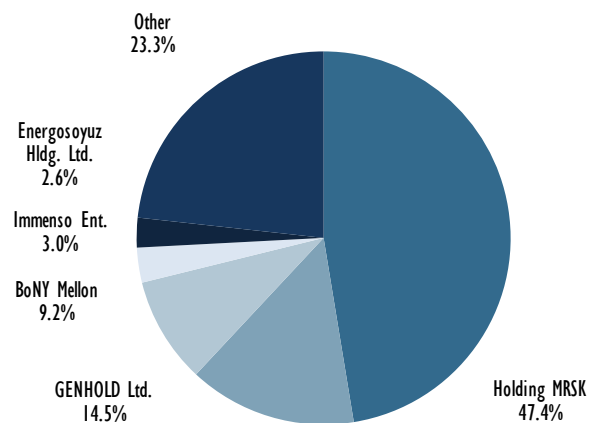
*6-year capex plan for 2012-2017 Source: Bloomberg, Gazprombank estimates

YTD stock performance against main indices



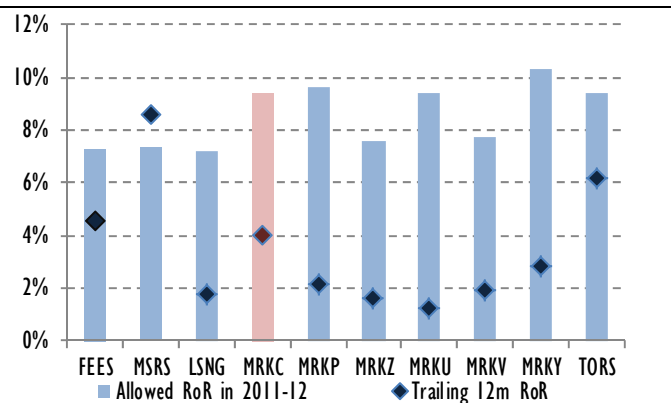
Source: company data

Shareholders breakdown



Source: company data

Actual return on RAB v allowed rate of return



Source: company data

DCF valuation results, RUB mln

	2012	2013	2014	2015	2016	2017	2018	2019	2020
EBIT	5,636	6,961	11,801	17,663	19,021	18,853	15,990	16,451	17,148
Taxes	-1,127	-1,392	-2,360	-3,533	-3,804	-3,771	-3,198	-3,290	-3,430
NOPAT	4,509	5,569	9,440	14,130	15,217	15,083	12,792	13,161	13,719
D&A	7,342	8,805	10,523	12,384	14,345	16,366	20,200	22,355	24,197
Changes in working capital	-1,009	-135	-542	-706	-203	-57	26	680	477
Operating cash flow	10,842	14,239	19,421	25,808	29,359	31,391	33,017	36,197	38,393
CAPEX	-16,679	-20,213	-23,219	-23,856	-25,765	-25,327	-24,896	-24,473	-24,057
Free cash flow	-5,837	-5,974	-3,798	1,952	3,594	6,064	8,121	11,723	14,335
Terminal growth rate	0.0%								
WACC	12.1%								
DFCF	7,912								
DTV	46,961								
Enterprise value	54,873								
Net debt	26,415								
Non-controlling interest	4								
Capitalization	28,454								
Number of shares, mln	42,218								
Target price, RUB	0.75								

Income statement, RUB mln

	2011	2012	2013	2014	2015	2016	2017
Revenue	69,041	69,660	77,458	87,267	98,948	106,336	111,938
Operating expenses	61,063	65,807	73,206	78,327	84,366	90,624	96,613
Depreciation and amortization	6,285	7,342	8,805	10,523	12,384	14,345	16,366
EBITDA	15,217	12,978	15,766	22,324	30,047	33,366	35,220
EBIT	8,932	5,636	6,961	11,801	17,663	19,021	18,853
Net income	5,534	2,940	3,431	6,727	11,783	12,988	12,334
Non-controlling interest	3	1	2	3	6	6	6
EBITDA margin	22.0%	18.6%	20.4%	25.6%	30.4%	31.4%	31.5%
EBIT margin	12.9%	8.1%	9.0%	13.5%	17.9%	17.9%	16.8%
Net margin	8.0%	4.2%	4.4%	7.7%	11.9%	12.2%	11.0%
EPS, rub	0.13	0.07	0.08	0.16	0.28	0.31	0.29

Source: MRSK Center, Gazprombank forecasts

Balance sheet, RUB mln

	2011	2012	2013	2014	2015	2016	2017
ASSETS							
Non-current assets							
Property, plant & equipment	62,196	71,840	83,597	96,688	108,604	120,519	130,028
Intangible assets	945	909	847	756	634	481	292
Investments and financial assets	534	534	534	534	534	534	534
Other non-current assets	174	174	174	174	174	174	174
Total non-current assets	63,849	73,457	85,151	98,152	109,947	121,708	131,027
Current assets							
Inventories	1,446	1,507	1,552	1,598	1,646	1,653	1,659
Other current assets	9	9	9	9	9	9	9
Income tax receivable	457	457	457	457	457	457	457
Trade and other receivables	8,410	7,379	8,205	9,244	10,482	11,264	11,858
Cash and cash equivalents	2,646	1,452	2,194	4,682	6,468	7,172	13,795
Total current assets	12,968	10,804	12,418	15,991	19,062	20,555	27,778
TOTAL ASSETS	76,817	84,261	97,569	114,143	129,009	142,263	158,806
EQUITY AND LIABILITIES							
Equity							
Share capital	4,222	4,222	4,222	4,222	4,222	4,222	4,222
Additional paid-in capital	89	89	89	89	89	89	89
Retained earnings	34,257	37,049	40,306	46,693	57,882	70,214	81,309
Total equity to shareholders	38,567	41,359	44,617	51,004	62,192	74,525	85,619
Non-controlling interest	11	12	14	17	23	29	35
TOTAL EQUITY	38,578	41,371	44,630	51,021	62,215	74,554	85,654
Non-current liabilities							
Loans and borrowings	20,070	26,632	36,882	34,614	42,444	42,444	44,594
Employee benefits	2,083	2,083	2,083	2,083	2,083	2,083	2,083
Deferred tax liabilities	4,007	4,007	4,007	4,007	4,007	4,007	4,007
Other non-current liabilities	754	754	754	754	754	754	754
Total non-current liabilities	26,914	33,476	43,726	41,458	49,288	49,288	51,438
Current liabilities							
Loans and borrowings	1,167	1,235	297	12,205	7,467	7,797	10,547
Trade and other payables	8,485	6,506	7,242	7,786	8,365	8,952	9,494
Other current liabilities	1,413	1,413	1,413	1,413	1,413	1,413	1,413
Tax payable	260	260	260	260	260	260	260
Total current liabilities	11,325	9,414	9,213	21,664	17,506	18,422	21,714
TOTAL LIABILITIES	38,239	42,890	52,939	63,122	66,794	67,710	73,152
TOTAL EQUITY AND LIABILITIES	76,817	84,261	97,569	114,143	129,009	142,263	158,806

Source: MRSK Center, Gazprombank forecasts

Cash flow statement, RUB mln

	2011	2012	2013	2014	2015	2016	2017
Operating cash flows before w/c changes and income tax paid	15,804	12,978	15,766	22,324	30,047	33,366	35,220
Working capital changes	-517	-1,009	-135	-542	-706	-203	-57
Income tax paid	-981	-1,127	-1,392	-2,360	-3,533	-3,804	-3,771
Net cash generated by operating activities	12,818	9,115	12,014	16,576	23,181	26,742	28,212
Cash flow from investing activities	-15,542	-16,791	-20,412	-23,392	-23,898	-25,719	-25,256
Cash flow from financing activities	5,111	6,483	9,141	9,304	2,503	-319	3,667
Increase/(decrease) in cash	2,387	-1,194	742	2,488	1,785	704	6,623
Cash at the beginning of the year	259	2,646	1,452	2,194	4,682	6,468	7,172
Cash at the end of the year	2,646	1,452	2,194	4,682	6,468	7,172	13,795

Source: MRSK Center, Gazprombank forecasts

MRSK Center and Volga

MRSK Center & Volga (Interregional Distribution Grid Company of Center and Volga Region) is a subsidiary of Holding MRSK. The company operates electricity distribution network in 9 regions, including Vladimir, Ivanovo, Kaluga, Kirov, Nizhny Novgorod, Ryazan, Tula regions, the Republic of Mary El and the Republic of Udmurtia. The market share of MRSK Center & Volga on the electricity distribution markets of its presence is roughly 60%.

Two out of nine branches of MRSK Center & Volga have been switched to RAB-regulation since 2009 with the rest migrating to the new tariff policy in 2010-2011. After the RAB reload all the company's branches maintained RAB-regulation receiving new long-term tariff plans.

The shares of MRSK Center & Volga are traded on the MICEX-RTS stock exchange and are included into the calculation basis of MICEX and MICEX-POWER indices.

In 2011-2012 company paid out dividends with DPS for the year 2011 equaling RUB 0.0028.

Operational data (2011)

Throughput, bln kWh	59.7
Lines, '000 km	263.4
Losses	9,0%
RAB, rub bln	89,4
Assets depreciation ratio	60%
Capex 2012-2017, rub bln	80.8
Last-mile*	14%

Source: company data, Gazprombank estimates

*Share of revenue received under last-mile agreements

Market data

Ticker	MRKP
Market price, rub	0,17
Market Cap, USD mln	609
TP (ordinary), rub	0,25
Upside	47%
Recommendation	OVERWEIGHT

Source: Bloomberg, Gazprombank estimates

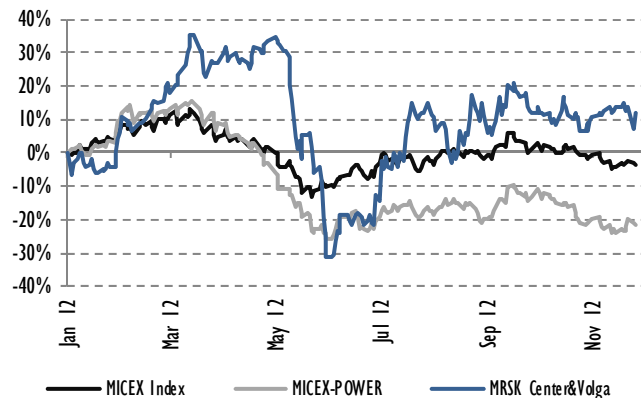
Ratios and valuation

EV/RAB	0.51
P/E 2013F	4.7
CAPEX/RAB*	1.05
Expected RoR 2012F	4.0%
RoR/WACC	0.31
Fair EV/RAB 2012F	0.63

Source: Bloomberg, Gazprombank estimates

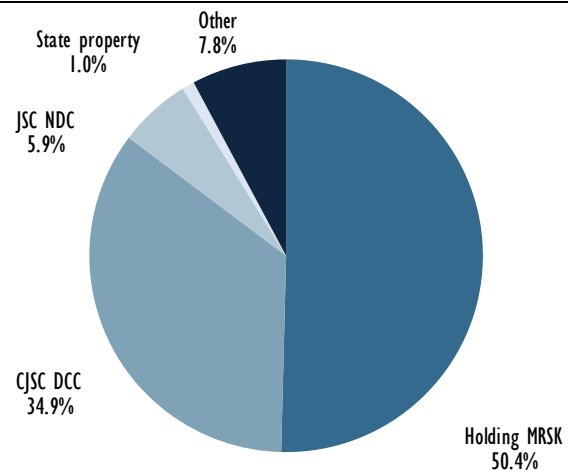
*6-year capex plan for 2012-2017

YTD stock performance against main indices



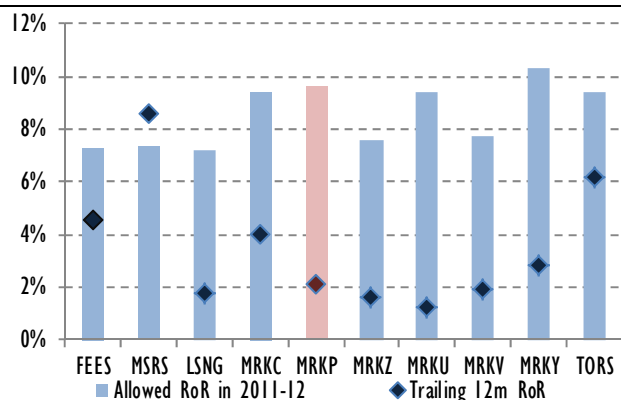
Source: company data

Shareholders breakdown



Source: company data

Actual return on RAB v allowed rate of return



Source: company data

DCF valuation results, RUB mln

	2012	2013	2014	2015	2016	2017	2018	2019	2020
EBIT	5,037	7,020	7,606	10,163	11,576	12,292	13,025	13,548	13,672
Taxes	-1,007	-1,404	-1,521	-2,033	-2,315	-2,458	-2,605	-2,710	-2,734
NOPAT	4,030	5,616	6,085	8,130	9,261	9,833	10,420	10,838	10,937
D&A	4,979	5,636	6,411	7,360	8,487	9,801	11,226	12,698	14,267
Changes in working capital	583	-183	98	-238	-270	-300	-351	-84	-54
Operating cash flow	9,592	11,069	12,594	15,252	17,478	19,335	21,294	23,452	25,151
CAPEX	-9,074	-9,671	-11,949	-14,129	-16,050	-17,934	-16,589	-15,345	-14,194
Free cash flow	518	1,399	645	1,123	1,429	1,401	4,705	8,107	10,957
Terminal growth rate	0.0%								
WACC	12.9%								
DFCF	14,286								
DTV	31,568								
Enterprise value	45,854								
Net debt	20,794								
Non-controlling interest	0								
Capitalization	25,059								
Number of shares, mln	112,698								
Target price, RUB	0.25								

Income statement, RUB mln

	2011	2012	2013	2014	2015	2016	2017
Revenue	64,590	61,090	68,459	72,500	79,920	85,963	91,184
Operating expenses	58,127	56,193	63,431	68,649	74,116	79,763	84,477
Depreciation and amortization	4,270	4,979	5,636	6,411	7,360	8,487	9,801
EBITDA	11,058	10,016	12,656	14,017	17,523	20,063	22,093
EBIT	6,788	5,037	7,020	7,606	10,163	11,576	12,292
Net income	4,524	2,186	4,042	4,419	6,841	8,119	7,946
Non-controlling interest	1	1	2	3	7	12	14
EBITDA margin	17.1%	16.4%	18.5%	19.3%	21.9%	23.3%	24.2%
EBIT margin	10.5%	8.2%	10.3%	10.5%	12.7%	13.5%	13.5%
Net margin	7.0%	3.6%	5.9%	6.1%	8.6%	9.4%	8.7%
EPS, rub	0.04	0.02	0.04	0.04	0.06	0.07	0.07

Source: MRSK Center and Volga, Gazprombank forecasts

Balance sheet, RUB mln

RUB mln	2011	2012	2013	2014	2015	2016	2017
ASSETS							
Non-current assets							
Property, plant & equipment	54,292	58,574	62,876	68,791	76,085	84,371	93,497
Intangible assets	472	525	581	641	707	779	862
Other investments	539	546	559	574	594	631	669
Other non-current assets	77	77	77	77	77	77	77
Total non-current assets	55,380	59,722	64,093	70,083	77,462	85,859	95,105
Current assets							
Inventories	995	871	878	932	989	1,049	1,102
Other current assets	2,622	2,622	2,622	2,622	2,622	2,622	2,622
Income tax receivable	548	548	548	548	548	548	548
Trade and other receivables	5,591	5,033	5,640	5,973	6,585	7,083	7,513
Cash and cash equivalents	3,928	1,079	1,508	2,665	4,073	9,278	6,781
Total current assets	13,684	10,153	11,197	12,739	14,816	20,579	18,565
TOTAL ASSETS	69,064	69,876	75,290	82,822	92,278	106,438	113,670
EQUITY AND LIABILITIES							
Equity							
Share capital	11,270	11,270	11,270	11,270	11,270	11,270	11,270
Reserves	27	27	27	27	27	27	27
Retained earnings	21,825	24,010	27,847	32,042	38,534	46,235	53,770
Total equity to shareholders	33,121	35,306	39,144	43,339	49,831	57,532	65,066
Non-controlling interest	11	12	14	17	24	36	50
TOTAL EQUITY	33,132	35,318	39,158	43,356	49,855	57,568	65,116
Non-current liabilities							
Loans and borrowings	21,374	18,017	20,866	19,394	19,552	34,052	29,052
Trade and other payables	809	809	809	809	809	809	809
Employee benefits	1,382	1,382	1,382	1,382	1,382	1,382	1,382
Deferred tax liabilities	3,215	3,215	3,215	3,215	3,215	3,215	3,215
Total non-current liabilities	26,780	23,423	26,273	24,800	24,958	39,458	34,458
Current liabilities							
Loans and borrowings	1,776	3,857	2,150	6,473	8,842	500	5,000
Trade and other payables	6,706	6,609	7,040	7,524	7,954	8,243	8,427
Current tax liabilities	669	669	669	669	669	669	669
Total current liabilities	9,151	11,134	9,859	14,666	17,465	9,411	14,095
TOTAL LIABILITIES	35,931	34,557	36,132	39,466	42,423	48,870	48,554
TOTAL EQUITY AND LIABILITIES	69,064	69,876	75,290	82,822	92,278	106,438	113,670

Source: MRSK Center and Volga, Gazprombank forecasts

Cash flow statement, RUB mln

	2011	2012	2013	2014	2015	2016	2017
Operating cash flows before w/c changes and income tax paid	10,620	10,016	12,656	14,017	17,523	20,063	22,093
Working capital changes	154	583	-183	98	-238	-270	-300
Income tax paid	-1,010	-1,007	-1,404	-1,521	-2,033	-2,315	-2,458
Net cash generated by operating activities	8,435	7,505	9,418	10,822	13,782	16,055	16,853
Cash flow from investing activities	-15,110	-9,078	-9,930	-12,295	-14,559	-16,602	-18,453
Cash flow from financing activities	7,424	-1,276	941	2,629	2,185	5,752	-897
Increase/(decrease) in cash	750	-2,849	429	1,156	1,409	5,205	-2,498
Cash at the beginning of the year	3,179	3,928	1,079	1,508	2,665	4,073	9,278
Cash at the end of the year	3,928	1,079	1,508	2,665	4,073	9,278	6,781

Source: MRSK Center and Volga, Gazprombank forecasts

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