Renaissance Capital

Sector update
Equity Research
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Electricity Distribution
Russia

Russian electricity distribution
Trading around **SELL**s

Vladimir Sklyar
+7 (495) 641-4188
VSklyar@rencap.com

Anastasia Tikhonova
+7 (495) 604-4493
ATikhonova@rencap.com

In this report, we update our financial forecasts for the Russian electricity distributors and explore what drove their profits to record-high levels in 2015-2016. We believe this trend is set to continue in 2017 but see a steep drop in profitability as imminent thereafter. We revise our TPs on our updated forecasts (see Figure 1), and maintain SELL ratings on all companies in the sector – apart from Lenenergo preferred shares, which we upgrade to BUY (from Sell), on decent dividends and exposure (for pref holders) to increased profitability. Despite our negative stance on the sector, we believe short-term trading opportunities could exist on the back of dividend-driven share-price volatility.

Summary sector ratings and TPs

	Ticker	Old TP, RUB/ share	New TP, RUB/ share	CP, RUB/ share*	Rating
South MRSK	MRKY	0.00	0.01	0.05	**SELL**
Lenenergo	LSNG	0.25	0.38	5.36	**SELL**
Lenenergo pref	LSNGP	3.44	57.67	48.15	**BUY****
Siberia MRSK	MRKS	0.00	0.00	0.06	**SELL**
Urals MRSK	MRKU	0.00	0.00	0.16	**SELL**
Volga MRSK	MRKV	0.02	0.02	0.04	**SELL**
North Caucasus MRSK	MRKK	0.00	0.00	15.40	**SELL**
Moscow United DistCo	MSRS	0.56	0.08	0.87	**SELL**
Center MRSK	MRKC	0.10	0.27	0.33	**SELL**
North West MRSK	MRKZ	0.00	0.00	0.05	**SELL**
Kubanenergo	KUBE	0.00	29.20	74.80	**SELL**
Tomsk DistCo	TORS	0.05	0.03	0.38	**SELL**
Tomsk DistCo pref	TORSP	0.06	0.03	0.39	**SELL**
Center & Volga MRSK	MRKP	0.02	0.02	0.10	**SELL**
FSK	FEES	0.04	0.06	0.17	**SELL**
Rosseti	RSTI	0.03	0.30	1.02	**SELL**
Rosseti pref	RSTIP	0.10	0.50	2.28	**SELL**

*Prices as of market close on 1 November 2016.
**Previously Sell.

Source: Company data, Renaissance Capital estimates

Profitability growth – but not sustainable

We break down the profits of Russian distribution sector and find that 40-50% of reported NOPAT comes from non-recurring revenue lines such as grid connection fees and 'other revenue'. Our key conclusion is that this revenue is of questionable sustainability; the long-term predictability of sector profits is therefore low – we see significant downside potential and believe a profitability 'cliff' is imminent in 2018.

Fundamentally, the sector is a SELL for us…

Despite the recent share-price rally, profitability improvement and generally more positive stance of investors towards the sector, we remain committed **SELL**ers of the Russian distributors (barring Lenenergo prefs). The sector delivered RoIC of 6% in 2015 (falling to 3% by 2020E, on our estimates), vs a current WACC of 12%; investment likely troughed in 2016 and is set to grow in the future; current dividends place a burden on cash flows, forcing the companies to raise debt; while capex remains value-destructive, in our view. We are sceptical about the government decision to privatise individual regional grid companies (MRSK) by 2020 – similar statements have been being made since 2006, while the stake of Rosseti in the MRSKs has only grown. In this environment, and taking into account our view that the sector will likely be earning substantially less in two years, we rate each company in the sector **SELL** (with Lenenergo prefs being the only exception).

…but short-term trading opportunities could exist

Russian equities in general, and Russian utilities in particular, have recently been largely driven by dividend announcements. A dividend yield of government OFZ bond yields +1 ppt seems to be perceived by the market as 'fair', despite what we view as limited prospects for the sustainability of such yields. Taking into account the profitability peak we expect the sector to see in 2016-2017, we believe some stocks may offer attractive short-term trading opportunities before the investment case deteriorates. If companies replicate their 2015 dividend policy on the 2016 results (which is our base case, however, it is exposed to execution risk), we believe speculative pressure could push Federal Grids (FSK) shares up by as much as 60% before investors start pricing in the profitability cliff likely in 2017, while Rosseti common shares could more than double before the dip in profitability we expect in 2018 hits valuations. Lenenergo preferred shares deliver highest cumulative yield in 2016-20, according to our estimates. However, we warn investors that even though FSK's 2016E yield of 15% and Rosseti's 2017E yields of 14% (commons) and 10% (prefs) may seem attractive, there are few marginal buyers in these names and exiting such investments could be painful.

Investment summary

The Russian electricity distribution sector, represented by Russian Grid holding and its subsidiaries, controls the world's largest electricity network, with a total grid length of 2.3mn km. It operates under the regulatory asset base (RAB) system, but generates RoIC of only 5% in 2015; it is set to be privatised according to Russian electricity reform legislation, but the majority state-owned Rosseti has continued to increase its stake in the sector via numerous additional share issues (and the state has increased its stake in Rosseti itself using the same mechanism). Ostensibly it applies an economically rational tariff regime, but annual tariff increases are set by the Ministry of Economic Development taking into account social considerations. The sector has seen some of the highest share-price growth in the Russian market in 2016.

We are often blamed for overlooking this investment opportunity and we acknowledge that it may be an opportunity missed. At the same time, we note that the sector's recent profits have arisen from capex that has not fed, in our view, into additional sustainable profitability. We expect profits to be even higher in 2016 (and for some companies also in 2017), but our 2018 outlook is that sector-wide net profit will be 60% lower than the level we estimate for 2017. These profits feed into dividends that are not supported by cash flows, as the companies spend most of their operating cash flow on capex; dividend payments therefore have to be financed by borrowing.

We update our estimates for the Russian electricity distribution companies and revise our view of the short-term outlook, with an increased volume of one-off revenue already seen in 2015 and likely to continue in 2016-2017E. On our estimates, non-recurring grid connection fees and other revenue account for 40-50% of the companies' NOPAT, suggesting that as grid connection revenue tails off the companies could face a profitability cliff – something we expect to happen in 2018.

Grid connection revenue is highly volatile and dependent on the number of applications as well as the capacity requested. According to the business plans of the MRSKs and FSK, grid connection revenue is expected to contribute about RUB86mn to Rosseti's overall revenue in 2016E, vs just RUB34bn reported for 2015, and RUB66bn in 2017E, while in 2018E it could fall to RUB29bn, driving down the bottom line as well as potential dividends and RoIC. RoIC is often half the level of current WACC: on our estimates, Rosseti's RoIC was 6% in 2015, vs a 12% WACC, while in 2018 we expect RoIC of 5%, falling to 2% in the longer term. The same is true for FSK, where RoIC was 5% in 2015; despite an increase in 2016-2017E to 6-9%, we estimate it will subsequently decline to 3%.

In addition to high levels of one-off revenue in 2016-2017E, the companies continue to make large investments: although capex fell in 2015, we expect a new wave of investment in 2016-2017, with investments on average 20% higher than in 2015. The continuation of this value-destructive capex, in our view, is likely to be accompanied by new borrowing, increasing the sector's debt burden. Moreover, given the inability of some companies to raise further debt, additional share issues are still ongoing; we incorporate all ongoing and announced additional share issues in our valuations and derive post-money TPs.

Given the sector's high level of debt and investment, paying dividends might seem to be of questionable economic merit. However, as some companies paid out dividends for 2015 and will most likely be forced to do so in 2016-2017, in view of government rulings on this issue, we continue to assume dividend payouts for profit-making companies, and derive our TPs using a dividend discount model (DDM).

Figure 1: TPs and ratings for Russian electricity grids

Company	Ticker	CP, RUB/share	Fair value DCF-based, RUB/share	DDM-based TP, RUB/share	Upside/ downside potential	Rating	Previous TP, RUB/share	Previous rating
South MRSK	MRKY	0.05	0.00	0.01	-81%	**SELL**	0.00	Sell
Lenenergo	LSNG	5.36	1.55	0.38	-93%	**SELL**	0.25	Sell
Lenenergo pref	LSNGP	48.15	13.90	57.67	20%	**BUY**	3.44	Sell
Siberia MRSK	MRKS	0.06	0.00	0.00	-100%	**SELL**	0.00	Sell
Urals MRSK	MRKU	0.16	0.00	0.00	-100%	**SELL**	0.00	Sell
Volga MRSK	MRKV	0.04	0.04	0.02	-63%	**SELL**	0.02	Sell
North Caucasus MRSK	MRKK	15.40	0.00	0.00	-100%	**SELL**	0.00	Sell
Moscow United DistCo	MSRS	0.87	0.00	0.08	-91%	**SELL**	0.56	Sell
Center MRSK	MRKC	0.33	0.26	0.27	-18%	**SELL**	0.10	Sell
North West MRSK	MRKZ	0.05	0.00	0.00	-100%	**SELL**	0.00	Sell
Kubanenergo	KUBE	74.80	42.09	29.20	-61%	**SELL**	0.00	Sell
Tomsk DistCo	TORS	0.38	0.00	0.03	-92%	**SELL**	0.05	Sell
Tomsk DistCo pref	TORSP	0.39	0.00	0.03	-93%	**SELL**	0.06	Sell
Center & Volga MRSK	MRKP	0.10	0.00	0.02	-85%	**SELL**	0.02	Sell
FSK	FEES	0.17	0.00	0.06	-64%	**SELL**	0.04	Sell
Rosseti	RSTI	1.02	0.00	0.30	-71%	**SELL**	0.03	Sell
Rosseti pref	RSTIP	2.28	0.00	0.50	-78%	**SELL**	0.10	Sell

Source: Bloomberg, Renaissance Capital estimates

The large amount of one-off revenue and bad debt, as well as property, plant and equipment (PPE) impairment costs, makes it difficult to forecast the companies' bottom lines. Another uncertainty stems from dividend payouts: we have looked at multiple scenarios on the back of the 50% dividend that the government would like to see, but which the Ministry of Energy is opposing, saying it would lead to too much pressure on Rosseti. The companies themselves have a 25% dividend payout policy, based on RAS financials, but according to recent management guidance IFRS could become the basis for the calculation, with an adjustment for differences in depreciation according to RAS and IFRS.

Given these different scenarios, in our valuations we assume that the payout applied in 2015 will be maintained, while if no dividends were paid in 2015, we assume a payout of 25% of IFRS net income in total and 10% for prefs. Incorporating these assumptions, we arrive at **SELL** ratings for all of the companies in the sector except for Lenenergo prefs, which we upgrade to **BUY** (from Sell). The transfer of new assets to the company and the 56% YoY tariff hike in 2016 led to increased profitability, and a 10% dividend payout applies to prefs, meaning that pref holders are likely to benefit from exposure to this higher profitability. Common shareholders, however, have seen substantial dilution, stemming from additional Lenenergo share issue and Rosseti share issues in favour of Lenenergo.

Despite possible double-digit dividend yields in 2016-2017E for some companies, we continue to see little value in the sector, given the profitability cliff we expect to see from 2018E. However, as investment in utilities is often dividend-driven, we cannot rule out short-term trading opportunities in stocks such as FSK, Rosseti, Center MRSK and Lenenergo prefs. For this reason, we also calculate fair values for the companies on the back of what we believe investors might view as a fair dividend yield (the "reference yield" in Figure 2) – calculated as Russian government OFZ yields plus a premium (a 1-ppt premium for Rosseti and FSK, and an additional 2-ppt liquidity premium for MRSKs, making a 3-ppt premium for them in total).

Figure 2: Reference yield fair valuation summary

	DPS, RUB		Dividend yield		Reference	Fair value per share, RUB		Current	Upside	
	2016E	2017E	2016E	2017E	yield	2016E	2017E	price, RUB	2016E	2017E
South MRSK	-	0.00	0%	7%	11%	-	0.03	0.05	-100%	-37%
Lenenergo	0.09	0.15	2%	3%	11%	0.81	1.36	5.36	-85%	-75%
Lenenergo pref	**13.56**	**22.73**	**28%**	**47%**	**11%**	**119.46**	**200.25**	**48.15**	**148%**	**316%**
Siberia MRSK	-	-	0%	0%	11%	-	-	0.06	-100%	-100%
Urals MRSK	0.03	-	17%	0%	11%	0.25	-	0.16	54%	-100%
Volga MRSK	0.00	0.00	5%	7%	11%	0.02	0.02	0.04	-57%	-39%
North Caucasus MRSK	-	-	0%	0%	11%	-	-	15.40	-100%	-100%
Moscow United DistCo	0.05	0.05	6%	6%	11%	0.48	0.47	0.87	-46%	-46%
Center MRSK	**0.04**	**0.06**	**11%**	**17%**	**11%**	**0.33**	**0.49**	**0.33**	**-1%**	**47%**
North West MRSK	0.00	-	8%	0%	11%	0.03	-	0.05	-27%	-100%
Kubanenergo	5.80	12.65	8%	17%	11%	51.06	111.42	74.80	-32%	49%
Tomsk DistCo	0.04	0.02	10%	6%	11%	0.32	0.19	0.38	-16%	-50%
Tomsk DistCo pref	0.04	0.02	9%	5%	11%	0.32	0.19	0.39	-19%	-52%
Center & Volga MRSK	0.01	0.01	8%	8%	11%	0.07	0.07	0.10	-34%	-31%
FSK	**0.03**	**0.02**	**15%**	**10%**	**9%**	**0.28**	**0.18**	**0.17**	**63%**	**9%**
Rosseti	**0.21**	**0.14**	**21%**	**14%**	**9%**	**2.27**	**1.48**	**1.02**	**123%**	**45%**
Rosseti pref	**0.34**	**0.22**	**15%**	**10%**	**9%**	**3.65**	**2.38**	**2.28**	**60%**	**4%**

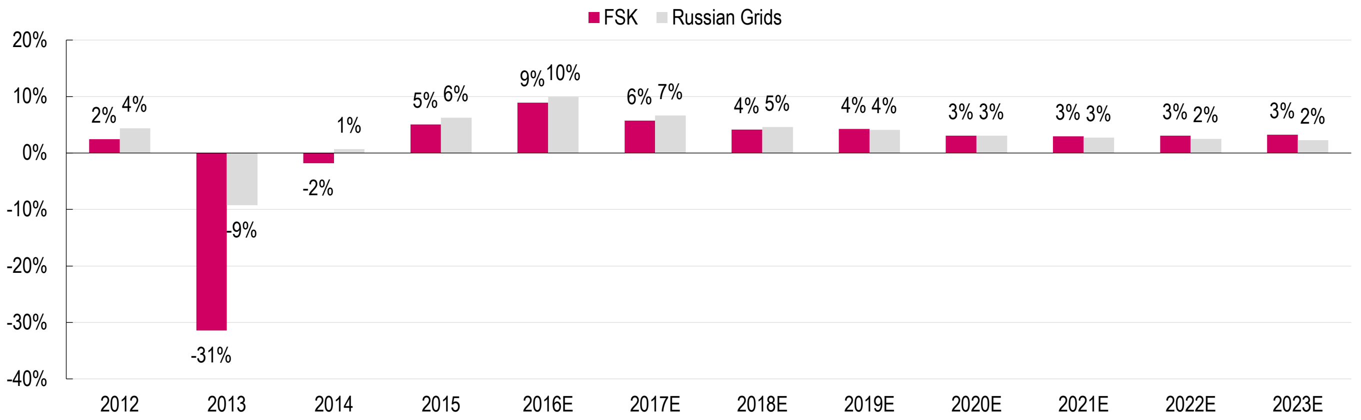
Source: Bloomberg, Renaissance Capital estimates

On these fair value estimates, we see potential upside for four companies in the sector (Figure 2), while for most stocks we still see significant downside. However, given what we view as the unsustainability of current profits, as well as uncertainty around dividend payouts, we highlight the substantial risks associated with such investments and believe our **SELL** rating for most of the stocks is fully justified.

RoIC

Despite the recent share-price rally for both FSK and Rosseti, as well as the robust 2015 and 1H16 performance, we note that RoIC was 5-6% in 2015 and we estimate it at 9-10% in 2016E, while since the introduction of RAB it had not previously exceeded 4%; in the future we see it in the 2-5% range. This suggests to us that the increase in RoIC in 2015-2016 was largely driven by one-off revenue, such as grid connection fees. Moreover, although the 2015-2016E RoIC numbers might be seen as fairly attractive, they are still below WACC, which is in the range of 11-13% even following a fall in the risk-free rate and the favourable effects of the tax shield.

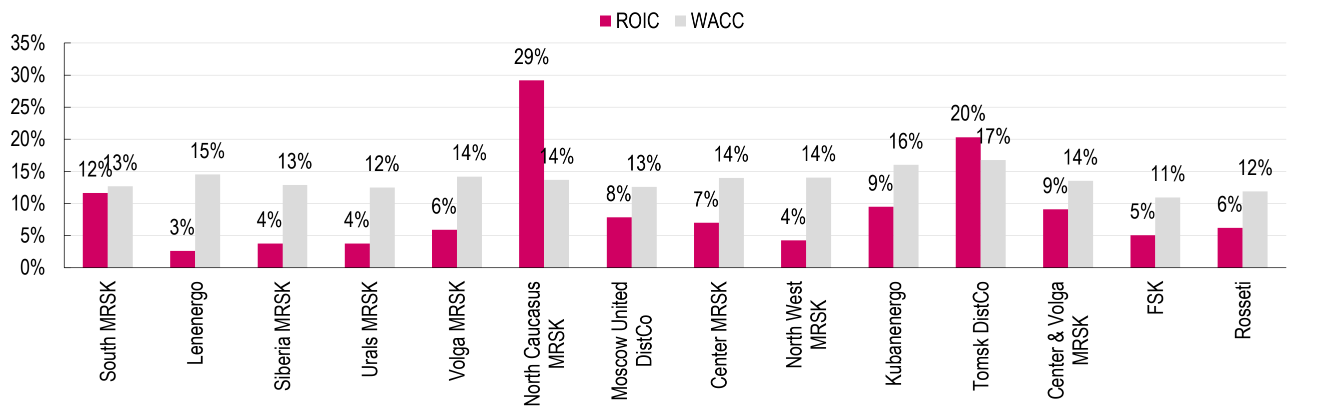
Figure 3: FSK and Rosseti RoIC



Source: Company data, Renaissance Capital estimates

In 2015, WACC for all MRSKs was on average twice as high as RoIC, with RoIC exceeding WACC only for North Caucasus MRSK and Tomsk DistCo. However, for North Caucasus MRSK this stemmed from RUB13.6bn of proceeds recorded due to the termination of operations of one of its subsidiaries; adjusting for this, RoIC would have been negative. A similar situation applies for Tomsk DistCo, as RUB550mn of 'other operating income' came from the recovery of reserves; excluding this one-off, RoIC would have been about 4%. In reality, therefore, none of the companies was able to deliver RoIC higher than WACC.

Figure 4: Russian grid companies – RoIC and WACC in 2015



Source: Company data, Renaissance Capital

One-off revenue

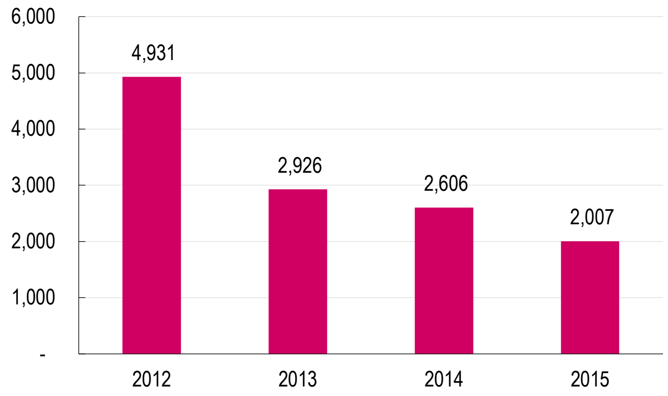
1. Revenue and other operating income at the Russian grid companies includes many one-offs, the dynamics of which lead to high income volatility. For Rosseti, **retail revenue** amounted to RUB42bn in 2012 and RUB127bn in 2013, followed by reductions to RUB87bn in 2014 and RUB56bn in 2015. This trend suggests that in future these revenue lines could either disappear or decrease to substantially lower levels, with one-off income also threatened by the sale of supply companies and transfers of guaranteed-supplier status from subsidiaries.

Figure 5: Rosseti revenue and other operating income flow, RUBbn

Source: Company data, Renaissance Capital estimates

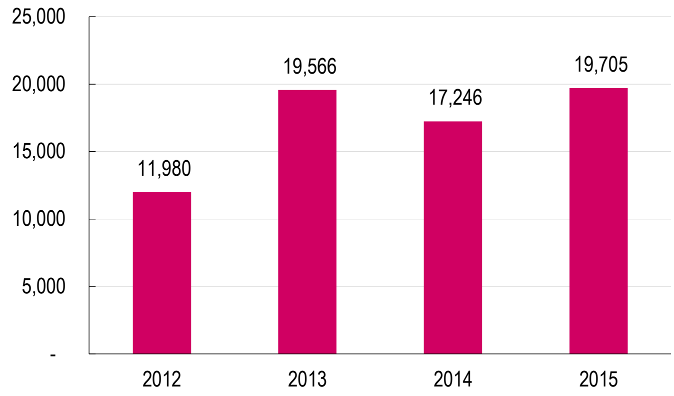
2. **Grid connection revenue** is also highly volatile, depending on the number and size of applications received, as well as the number of actually finalised connections. Since 2012, Rosseti has seen a continuous decline in grid connection revenue, from RUB46bn in 2012 to RUB37bn, RUB36bn and RUB34bn in 2013-2015, respectively. The number of connections actually carried out is also highly volatile, rising by 63% YoY in 2013, falling by 12% in 2014 and rising again by 14% in 2015. The average tariff for grid connections has declined steadily: according to the company, it fell by 41% in 2013, 11% in 2014 and 23% in 2015. This suggests that Rosseti's grid connection revenue is highly dependent on volumes, which we view as unsustainable (as the proportion of customers connected to the grid increases) and unable to offset the reduction in tariffs.

Figure 6: Rosseti average grid connection tariff, RUB/kWh



Source: Company data

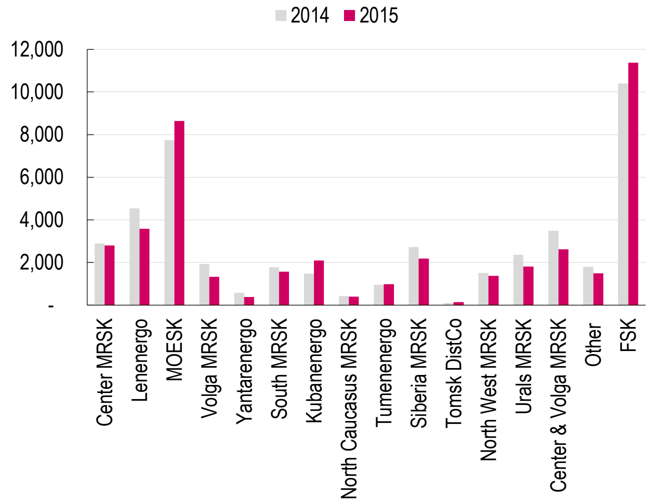
Figure 7: Rosseti grid connections, MW



Source: Company data

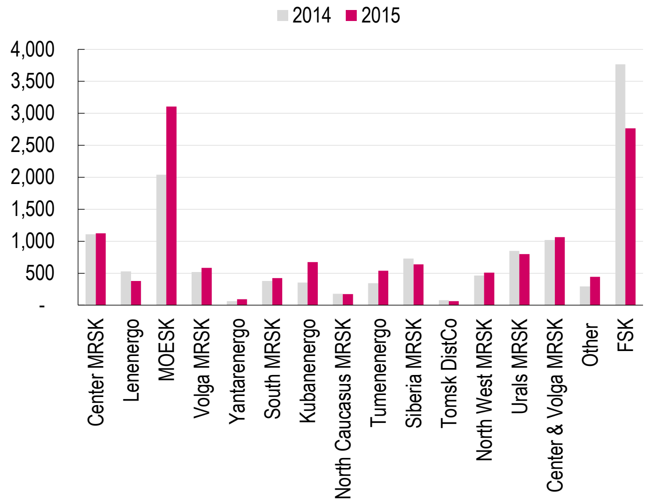
This volatility is true for all the Rosseti subsidiary companies. Moreover, the number of grid connection applications received tends to substantially exceed the number of actual grid connections of equipment made, although some companies saw a significant improvement on this metric in 2015. Another issue is the size of each application in terms of capacity, which can substantially distort the overall revenue picture.

Figure 8: Applications for grid connections, MW



Source: Company data

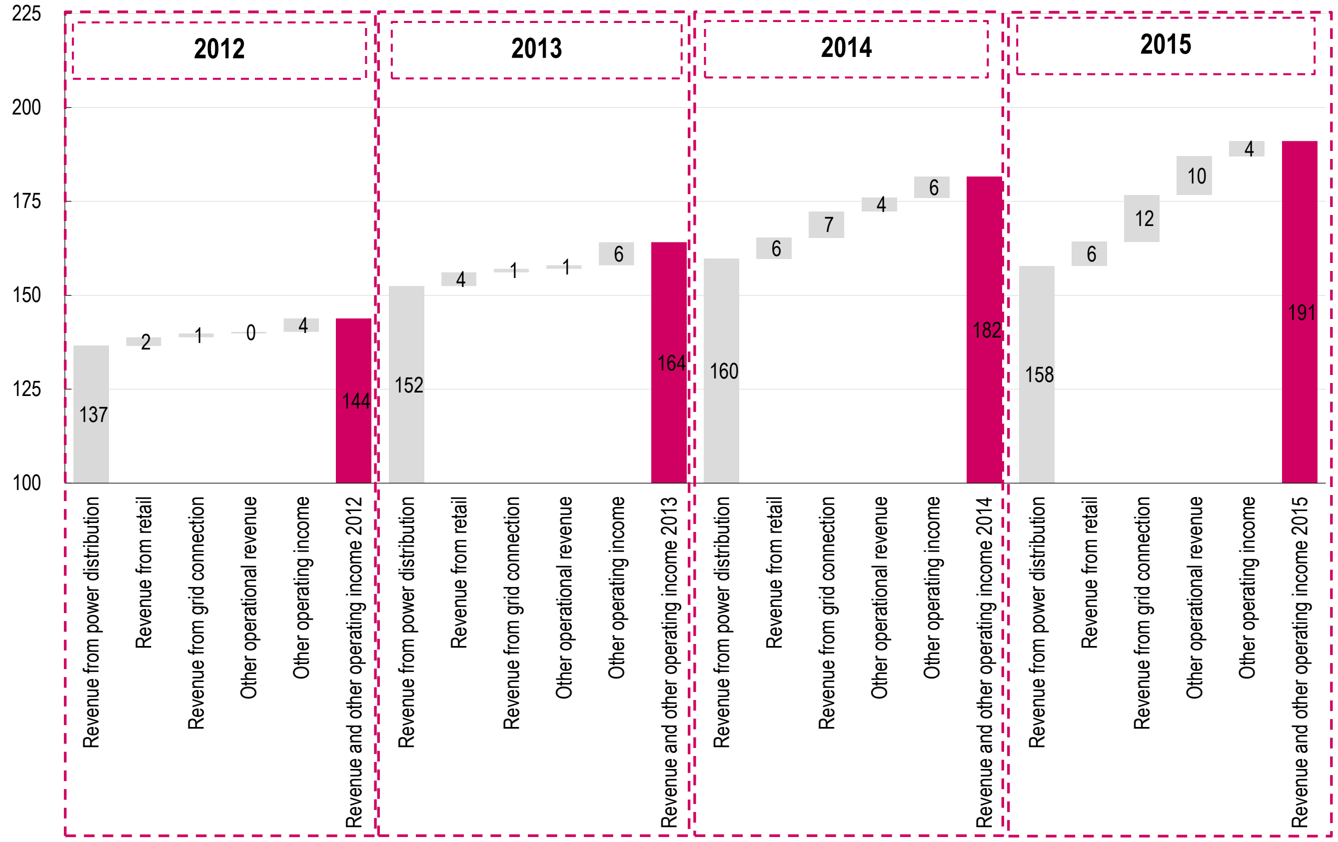
Figure 9: Signed grid connection documents for the connection of equipment, MW



Source: Company data

For FSK, revenue is even more distorted by revenue from grid connections than for Rosseti, with the connection of generating units making a significant difference. In 2012 and 2013, annual grid connection revenue was just RUB1bn, while in 2014 and 2015 it rose to RUB7bn and RUB12bn, respectively, owing to large power stations being connected to the grid. Grid connection revenue is the second-largest contributor to FSK's top line, followed by 'other revenue' and revenue from retail operations.

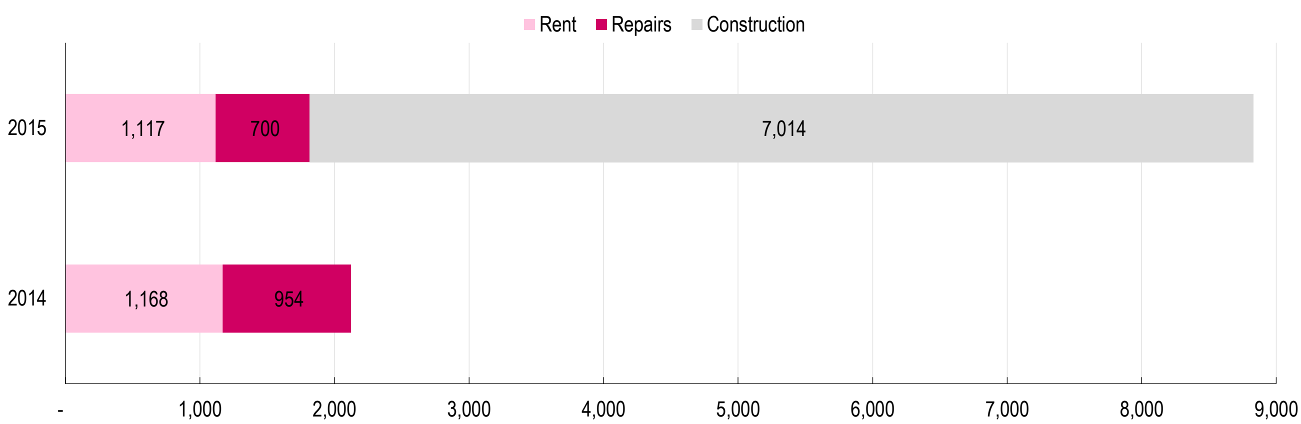
Figure 10: FSK revenue and other operating income flow, RUBbn



Source: Company data, Renaissance Capital estimates

3. In terms of volatility, we also highlight **other operating revenue**, which comprises a wide range of revenue lines, such as revenue from rent, construction and repairs and government subsidies, all of which can vary widely. For example, for Rosseti government subsidies amounted to RUB4bn in 2014, while in 2015 they were just RUB1bn; 'other revenue' increased to RUB25.3bn in 2015, vs RUB12.5bn in 2014. Construction revenue also increased quite substantially, but this also increases costs in what is a low-margin business. Of FSK's RUB10bn in 'other revenue' in 2015, RUB7bn came from construction; in 2012-2013 'other revenue' was less than RUB1bn in total, while in 2014-2015 rent revenue alone exceeded RUB1bn annually.

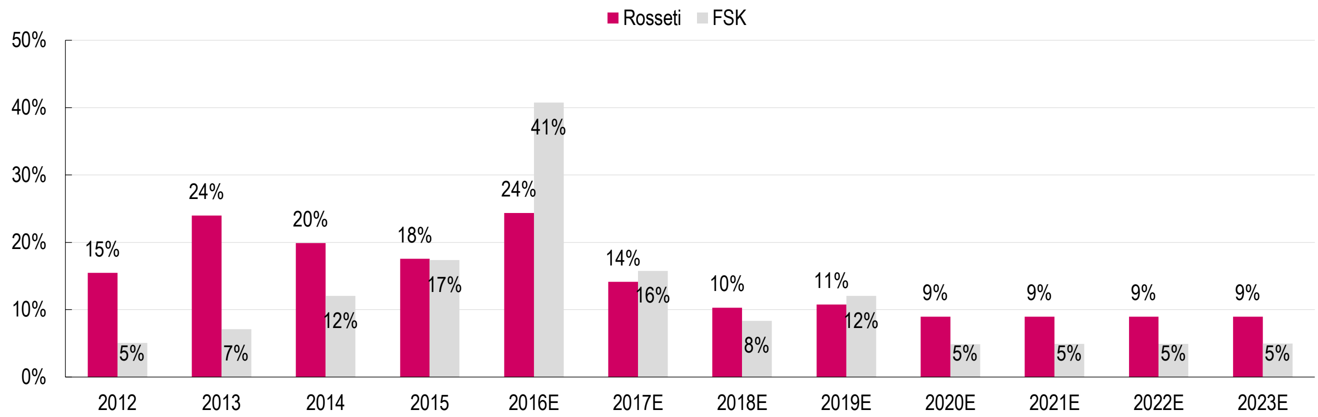
Figure 11: FSK other revenue structure in 2014-2015, RUBmn



Source: Company data

4. **Other operating income** includes the recovery of fines, insurance proceeds, subsidies (if not included in revenue), reversals and proceeds from the termination of participation in subsidiaries. All of these can vary, but the termination of participation in subsidiaries can make a significant contribution to income. For example, in 2015 North Caucasus MRSK reported RUB13bn of such revenue, which was the sole reason it was not loss-making in 2015, after constant losses in 2012-2014. In 1H16, FSK and Rosseti also both recorded about RUB11-12bn of such revenue.
5. **In total**, we can see that these various categories of volatile, one-off revenue amounted to 15-24% of Rosseti's total revenue in 2012-2015, while for FSK the proportion fell in a range of 5-17%. This might be viewed as not particularly high, but given that grid connection revenue, for example, is not associated with any costs, its contribution to operating profit and the bottom line is direct and therefore significant both for returns on investment and dividends, which are derived from the bottom line. Given the increase we expect in grid connection revenue in 2016-2017, we believe overall performance will be substantially affected by this revenue, which is likely to colour the entire short term investment story of both Rossetti and FSK.

Figure 12: Share of revenue and other operating income, excluding revenue from power distribution, in total revenue and other operating income

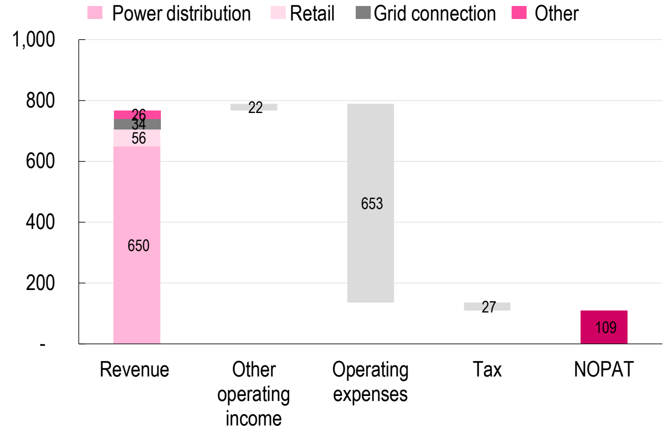


Source: Renaissance Capital estimates

Why do one-offs matter?

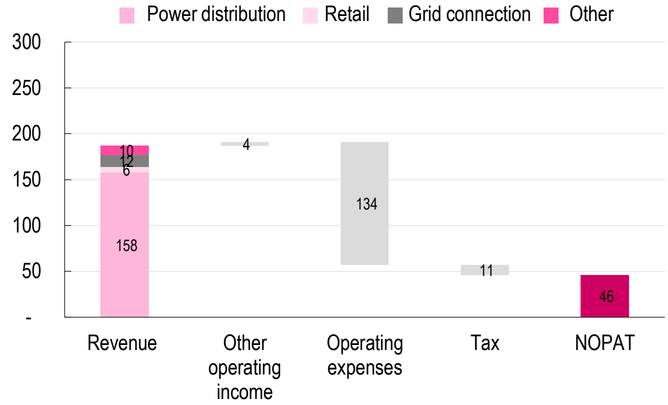
To illustrate why we view one-off revenue as so important, below we provide NOPAT waterfall charts for Rosseti and FSK in 2015 and 2016E (Figures 13-16). We can see that grid connection fees – the most significant of these one-off revenue lines – makes a substantial contribution to NOPAT, given its zero contribution to costs. Grid connection revenue of RUB34bn for Rosseti, adjusted for tax, accounted for 25% of NOPAT in 2015, while the aggregated effect of grid connection revenue and other income amounted to 41% of NOPAT. For FSK, the situation is similar: in 2015, grid connection revenue, adjusted for tax, accounted for 22% of NOPAT, while grid connection revenue and other income represented 40% of 2015 NOPAT.

Figure 13: Rosseti NOPAT 2015, RUBbn



Source: Company data, Renaissance Capital

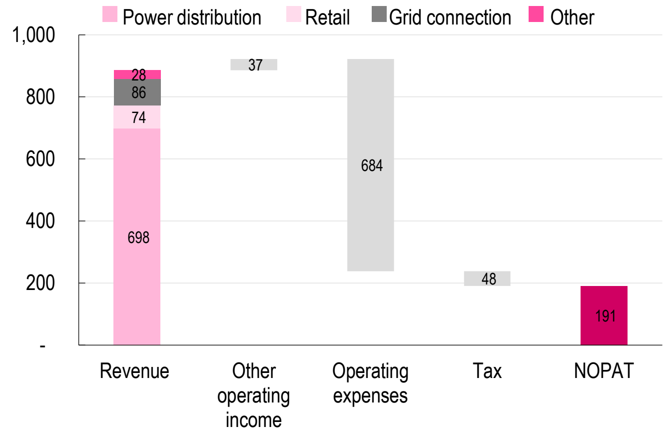
Figure 14: FSK NOPAT 2015, RUBbn



Source: Company data, Renaissance Capital

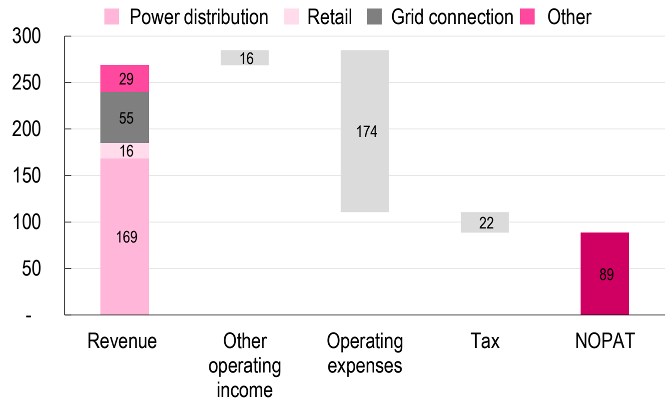
In 2016E, these one-off revenue lines are likely to make an even higher contribution to NOPAT. For Rosseti, grid connection revenue could reach RUB86bn; excluding tax, this would account for 36% of NOPAT, on our estimates, and including other operating income (boosted by the end of participation in subsidiaries) would imply a 48% contribution to NOPAT. On our estimates, FSK's grid connection revenue will account for 50% of NOPAT, while including other operating income the total contribution would amount to 75%. This suggests to us that 48% of Rosseti's 2016E NOPAT and 75% of FSK's is completely unsustainable.

Figure 15: Rosseti NOPAT 2016E, RUBbn



Source: Renaissance Capital estimates

Figure 16: FSK NOPAT 2016E, RUBbn



Source: Renaissance Capital estimates

Sunny 2016-2017 outlook followed by a cliff

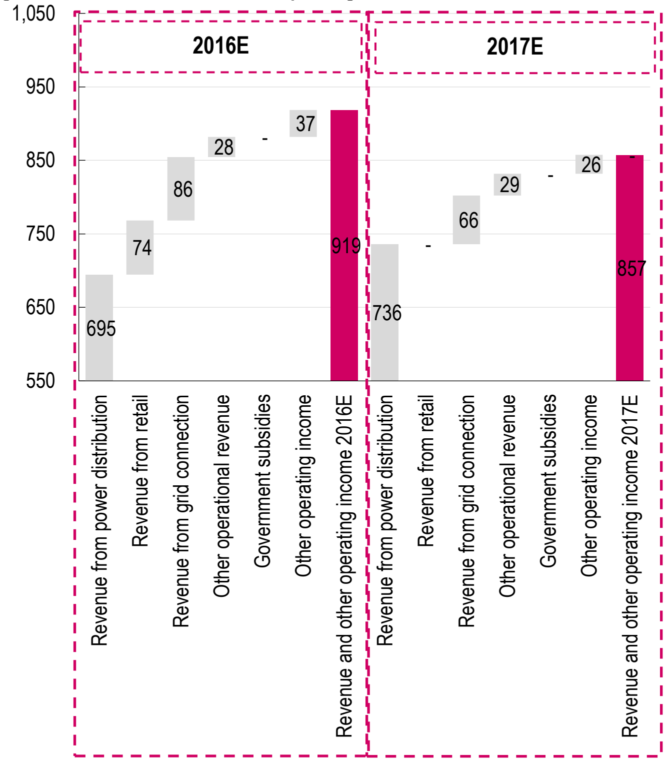
Unsustainable revenue to distort 2016-2017 performance

We expect 2016 and 2017 to be robust years for both Rosseti and FSK, although we expect a moderation in 2017E. Given the high level of one-offs in the top line, it is difficult to forecast revenue with great conviction.

On our estimates, Rosseti's revenue from operating activities will increase by 15% YoY to RUB881,929mn, with a 7% increase in revenue from power distribution (mainly driven by tariff indexation) and as much as a 32% YoY increase in revenue from retail on the back of an already reported YoY improvement in 1H16. Grid connection revenue could amount to RUB86bn in 2016E, vs RUB34bn in 2015, while in 2017E it could fall to RUB66bn (largely driven by grid connection revenue at subsidiaries, for which, given the forecasting difficulties, we use the companies' guidance taken from their business plans prepared for the Ministry of Energy). We estimate other operating revenue to grow at par with inflation, amounting to RUB28bn and RUB29bn in 2016E and 2017E, respectively. We do not incorporate any additional revenue from subsidies in our forecasts due to their high volatility, ranging from RUB73bn in 2013 to RUB4bn in 2014 and RUB1bn in 2015. In addition, on the back of 1H16 dynamics, we adjust our FY16 expectations for other operating income, and estimate it at RUB37bn in 2016E and RUB26bn in 2017E. Much of this operating income is inflation-driven, while in 2016E an additional RUB12.6bn comes from the end of operations at one of the subsidiaries (reported in 1H16). Incorporating these numbers, we estimate total revenue at RUB881,929mn in 2016. In 2017 we expect a decrease by 6% YoY to RUB831,794mn, on the back of lower retail revenue (certain of the company's supply assets are for sale, while some could be deprived of their guaranteed supplier status), a decrease in grid connection revenue (in line with company guidance) and a fall in other income due to the lack of income from the end of subsidiaries' operations.

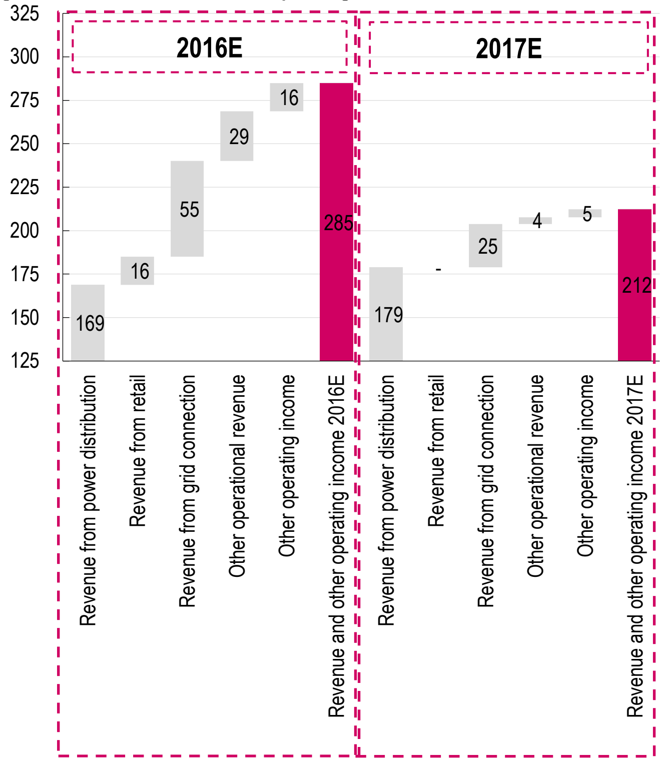
For FSK we apply similar assumptions, and estimate its operating revenue will increase by 43% YoY to RUB207,734mn in 2016E, and then decrease by 23% YoY to RUB198,250mn in 2017E. These dynamics are explained, first of all, by grid connection revenue, which we expect at RUB55bn in 2016E and around RUB25bn in 2017E, compared with RUB12bn in 2015. We also expect retail revenue, at RUB16bn, on our estimates, to make a significant contribution in 2016E, but to decline to zero in 2017E. Other revenue and other operating income in 2016E are likely to be distorted by a rise in construction revenue as well as from discontinued operations: we expect other revenue of RUB29bn in 2016E and other operating income of RUB16bn, vs RB10bn and RUB4bn, respectively, in 2015. We expect a decline in 2017E, with only grid connection revenue (among the one-off revenue lines) likely to support the 2017E results.

Figure 17: Rosseti revenue and other operating income flow in 2016-2017E, RUBbn



Source: Company data, Renaissance Capital estimates

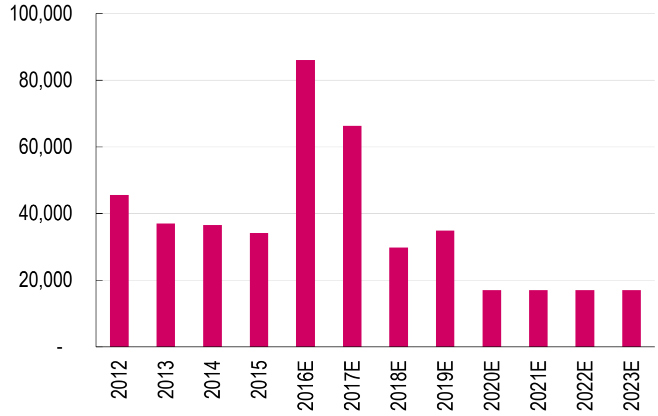
Figure 18: FSK revenue and other operating income flow in 2016-2017E, RUBbn



Source: Company data, Renaissance Capital estimates

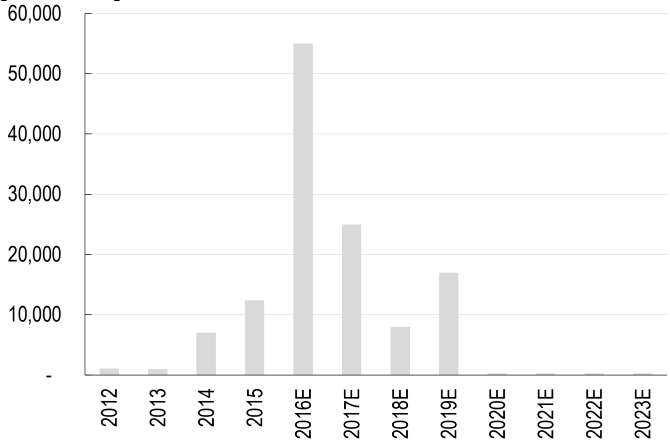
Given that we believe the outlook for grid connection revenue is key for our investment case, we show our expectations for this revenue below: we expect 2016E and 2017E to be outliers, and see a small upturn in 2019E, with a subsequent reduction to levels far below those seen in 2015 and earlier. We expect annual grid connection revenue at Rosseti of around RUB17bn from 2020E, while for FSK it could fall to around RUB300mn, with this revenue line making a more significant contribution to the MRSKs rather than to FSK in the long term.

Figure 19: Rosseti grid connection revenue outlook, RUBbn



Source: Company data, Renaissance Capital estimates

Figure 20: FSK grid connection revenue, RUBbn

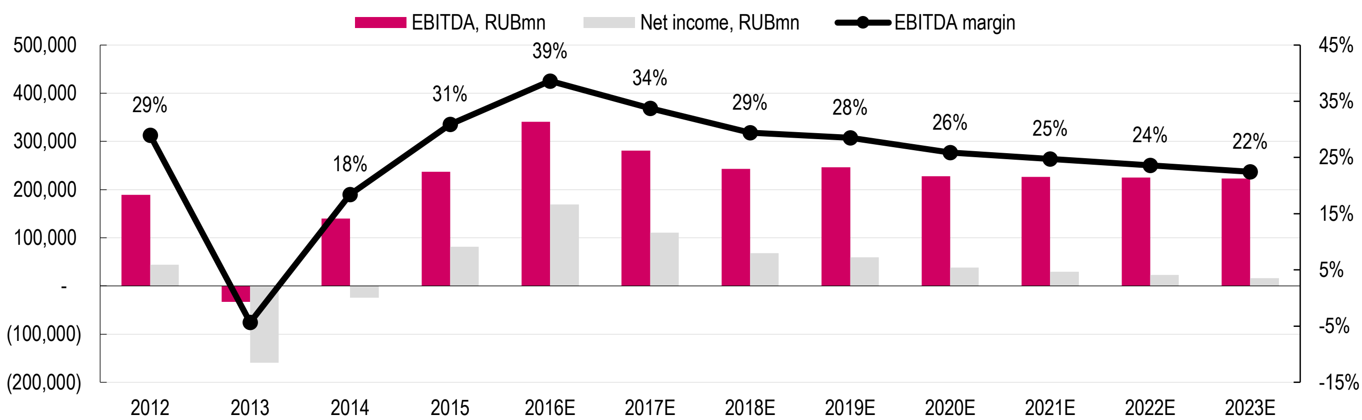


Source: Company data, Renaissance Capital estimates

Profitability cliff is inevitable

Along with the deterioration in the top line that we expect (due to a fall in grid connection revenue, a lack of retail revenue and long-term tariff indexation of only 3%, as expected by the Ministry of Economic Development) and an increase in costs, we forecast a decline in profitability for both Rosseti and FSK. The bottom line and operating profit could be substantially distorted by bad debt and the recognition of PPE impairments. We also expect a moderation in the cost of debt as interest rates come down. On our estimates, Rosseti's EBITDA in 2016E could amount to RUB340,568mn, up by 44% YoY, but we see an 18% reduction in 2017E and a further decline thereafter. We forecast net income of RUB169,131mn in 2016E and RUB110,271mn in 2017E, falling to RUB16,209mn in 2023E.

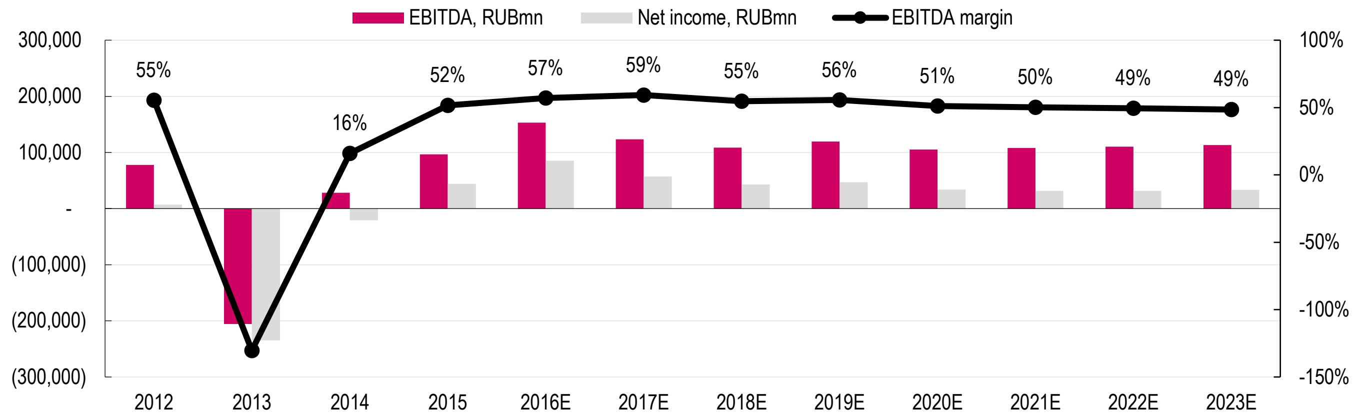
Figure 21: Rosseti profitability outlook, RUBmn (unless otherwise stated)



Source: Company data, Renaissance Capital estimates

We forecast FSK's EBITDA at RUB153,275mn in 2016E, up by 59% YoY, followed by a 20% reduction in 2017E to RUB123,180mn, while in 2020E we estimate it at RUB113,042mn. We expect net income to rise by 93% YoY in 2016E, to RUB85,247mn, falling to RUB56,980 in 2017E (-33% YoY) and RUB33,352mn in 2023E.

Figure 22: FSK profitability outlook, RUBmn (unless otherwise stated)

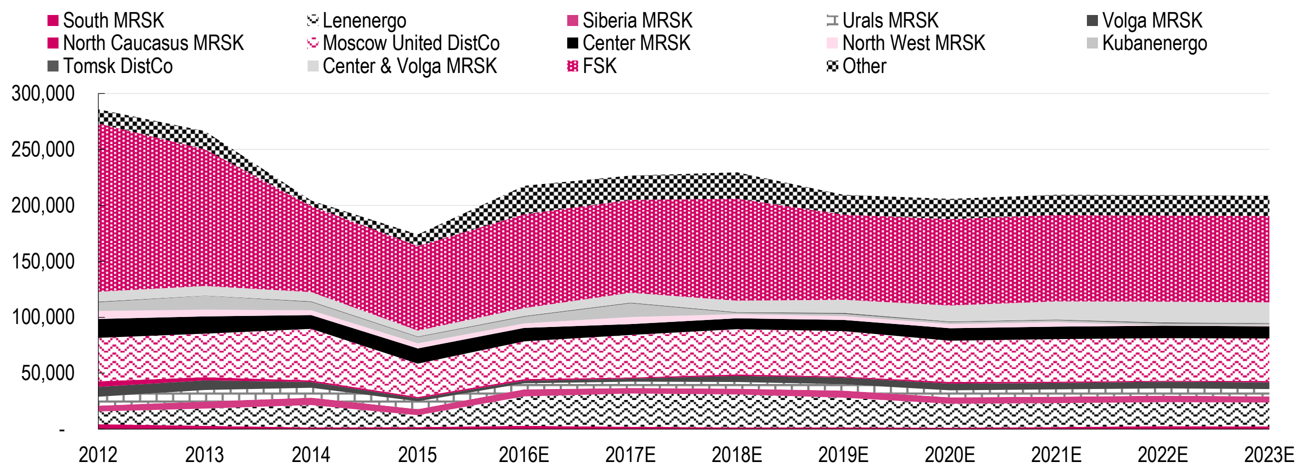


Source: Company data, Renaissance Capital estimates

Capex reduction? Investments to continue…

Despite the distribution companies claiming to have achieved a substantial reduction in capex, with a declining or flat trend since 2012, according to their new proposed investment programmes (where available), capex for most grid companies will show an upward trend from 2015 to 2019, stabilising thereafter. Some companies have proposed plans until 2022, while for others we assume flat capex if there is no guidance – which seems reasonable to us given that the companies claimed intention of achieving capex at maintenance levels.

Figure 23: FSK and MRSK capex, total capex of Rosseti, RUBmn



Source: Company data, Renaissance Capital estimates

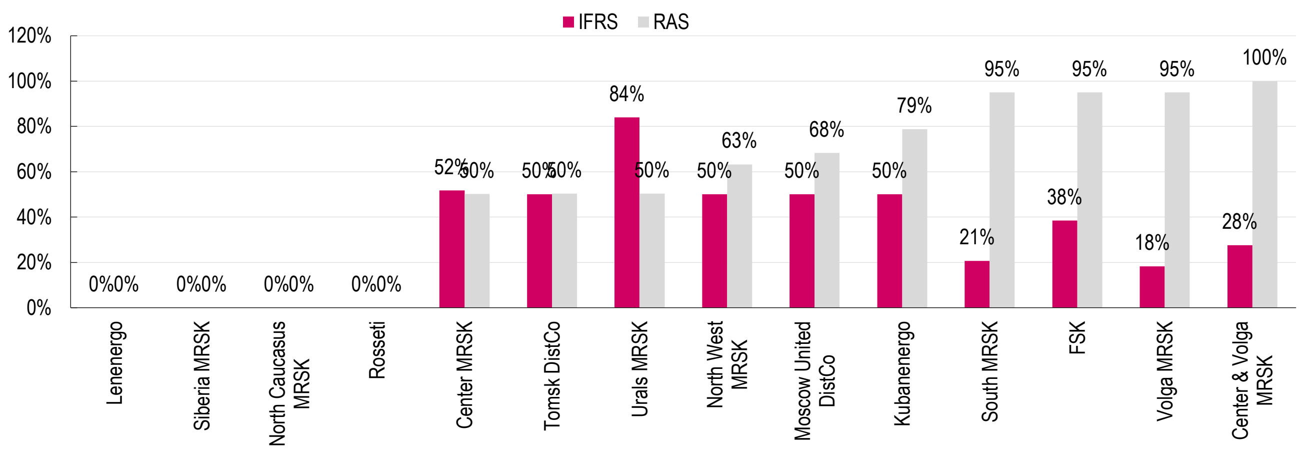
We estimate that capex for Rosseti could stand at around RUB217.4bn (excluding VAT) in 2016E (a 25% YoY increase and higher than the previous programme by about 6%, on our estimates), RUB226.7bn in 2017E and RUB229.6bn in 2018E, with a subsequent decrease to RUB208-RUB209bn. For FSK, the largest contributor, we expect total capex of about RUB84bn (excluding VAT, RUB99bn otherwise) in 2016E, RUB83bn (RUB98bn with VAT) in 2017E, a peak of RUB91bn (RUB107.6bn) in 2018E and RUB-77bn thereafter. Apart from FSK, the three subsidiaries with the largest levels of capex, on our estimates, are Moscow United DistCo (with capex of RUB33.7bn for 2016E), Lenenergo (RUB26.3bn) and Center MRSK (RUB12bn); We expect Tomsk DistCo to have the lowest capex in 2016E, at RUB551mn.

Is there still room for dividends?

Given the improved results in 2015, Rosseti forced its subsidiaries to pay out dividends for that year, in line with a government decree. However, we believe it is a common misperception among investors that this is something that is sustainable. Given our detailed analysis of one-off revenue for Rosseti and FSK, we highlight that not only is there uncertainty about dividend payouts, there is little certainty around profits themselves, with high levels of one-off revenue and accounting costs such as bad debt and PPE impairment.

Looking at payout ratios for 2015, there is a significant difference between payouts based on RAS and IFRS results for most companies. Apart from Rosseti itself, three of its subsidiaries – Lenenergo, Siberia MRSK and North Caucasus MRSK – also did not pay dividends, although they did have positive net income according to IFRS (except for Siberia MRSK), vs a loss according to RAS. Dividend policy is based on RAS results, not IFRS, and usually incorporates a 25% payout of net income (excluding investment plans and adjusting for various accounting issues). This creates a big discrepancy, as RAS financials are often half the level of IFRS, suggesting a lower potential dividend base. For some companies the two accounting systems are comparable: dividends at Center MRSK and Tomsk DistCo as a percentage of RAS and IFRS net income were both around 50% in 2015. However, for all other subsidiaries the difference is more significant – at Center & Volga MRSK, even a 100% payout on RAS amounted to just 28% of net income according to IFRS.

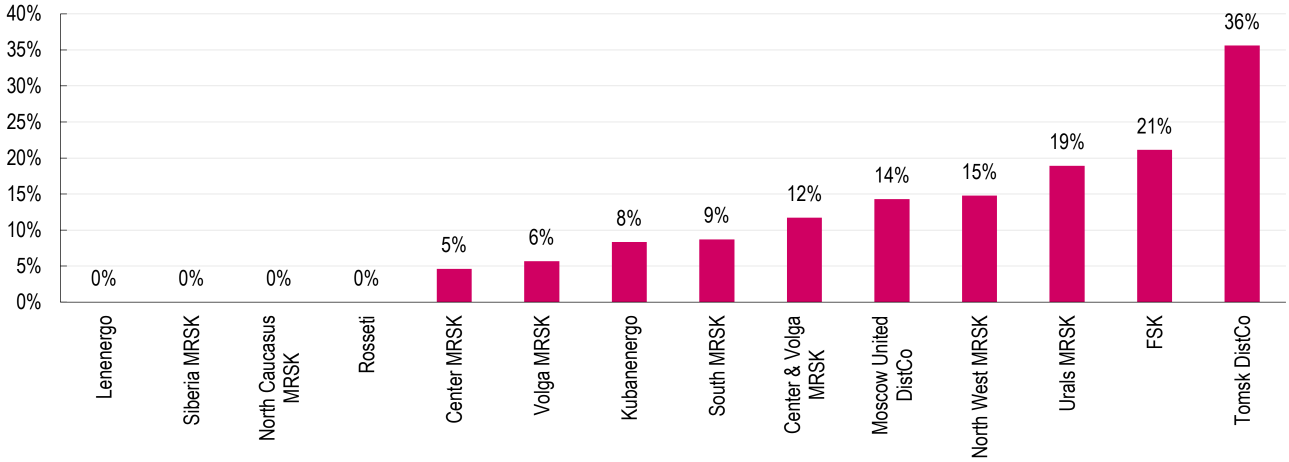
Figure 24: Russian grid companies – dividend payout as % of IFRS and RAS bottom line in 2015



Source: Company data, Renaissance Capital estimates

The 50% payout for certain subsidiaries translated into what we view as attractive dividend yields, although this is partially explained by the low share prices of most companies. The delivered yields, ranging from 6% to 36%, surprised us, but we view the key question to be whether they will continue.

Figure 25: Russian grid companies dividend yield range for 2015, %



Source: Company data, Renaissance Capital estimates

The better-than-expected performance in 2015 (as outlined above, largely driven by grid connection revenue) pushed up net income, and although we expect revenue to remain at a high level in 2016-2017E, we forecast a decline thereafter. Dividends and dividend payout ratios appear uncertain to us, as the companies continue to accumulate substantial debt; capitalising part of the interest improves net income, but aggravates the debt burden. In addition, we expect extensive additional debt to be needed to fund the companies' investment programmes (which in many cases are more extensive than in 2015), and the inability of some companies to raise new debt means additional share issues will dilute existing shareholders – we have incorporated all planned equity raises in our forecasts (new share issues are usually fully bought by Rosseti).

Given these uncertainties and the current dividend payout policy, based on RAS results, in our valuations we use 2015 payout ratios if the companies paid dividends, and if not we apply a 25% payout assumption in total and 10% for preferred stock. For Rosseti, we apply the 25% total payout ratio and 10% for the preferred stock using the IFRS bottom line as the base. The company's latest guidance is for a possible 25% payout of IFRS net income (adjusted for the difference in deprecation based on RAS and IFRS numbers) for 2016-2017E.

Having analysed in detail various dividend scenarios for Rosseti and FSK, as well as several other subsidiaries that we think could pay dividends for 2016-2017E, we conclude the following. Applying the assumptions outlined above leads to the highest yields for Lenenergo prefs, on the back of a rise in profits due to tariff growth, grid connection revenue and the transfer of new assets to the company as part of an additional share issue – which has led to a substantial dilution for common shareholders but does not affect the number of prefs. We see yields potentially reaching 28% and 47% in 2016E and 2017E, respectively, assuming the 10% payout for prefs, falling to 30% in 2018E. Among other potential high-yield companies we see Center MRSK, Kubanenergo and most importantly FSK and Rosseti. For Center MRSK, we see yields at 11% in 2016E, 17% in 2017E and falling to 14% in 2018E; for Urals MRSK we expect a yield of 17% in 2016E, with no dividends thereafter. For Kubanenergo we expect 8% in 2016E and 17% in 2017E, due to a rise in grid connection revenue in 2017, in line with the company's business plan, and then falling to just 3% in 2018E. According to thes eestimates, Rosseti could deliver yields of 21% in 2016E and 14% in 2017E for commons and 15% and 10%, respectively, for prefs. However, in 2018E we expect yields to fall to 8% for commons and 6% for prefs, as one-off revenue declines. FSK's yield could reach 15%, 10% and 8% in 2016-2018E, respectively, with the decline due to the same reason.

Figure 26: Key indicators for the Russian grid companies

	Dividend yield 2016E	Dividend yield 2017E	Dividend yield 2018E	FCF yield 2017E	FCF yield 2018E	EV/sales, 2017E, x	EV/EBITDA, 2017E, x	P/E, 2017E, x
South MRSK	0%	7%	6%	11%	14%	0.79	4.32	2.88
Lenenergo	**2%**	**3%**	**2%**	-6%	-13%	0.65	1.71	5.40
Lenenergo pref	**28%**	**47%**	**28%**					
Siberia MRSK	0%	0%	0%	-9%	-9%	0.69	19.28	neg
Urals MRSK	17%	0%	0%	-14%	-9%	0.43	7.38	neg
Volga MRSK	5%	7%	7%	53%	19%	0.16	1.05	2.62
North Caucasus MRSK	0%	0%	0%	-4%	-5%	4.02	neg	neg
Moscow United DistCo	6%	6%	3%	-2%	-3%	0.93	3.83	8.23
Center MRSK	**11%**	**17%**	**14%**	**11%**	**11%**	**0.64**	**3.01**	**3.10**
North West MRSK	8%	0%	0%	-8%	-4%	0.54	4.98	-neg
Kubanenergo	**8%**	**17%**	**3%**	**-3%**	**21%**	**0.80**	**3.86**	**6.45**
Tomsk DistCo	10%	6%	2%	-5%	-7%	0.19	2.03	8.91
Tomsk DistCo pref	9%	5%	2%					
Center & Volga MRSK	8%	8%	6%	6%	1%	0.45	2.81	3.54
FSK	**15%**	**10%**	**8%**	**8%**	**3%**	**2.29**	**3.86**	**3.79**
Rosseti	**21%**	**14%**	**8%**	**3%**	**1%**	**0.84**	**2.50**	**1.85**
Rosseti pref	**15%**	**10%**	**6%**	**11%**	**14%**			

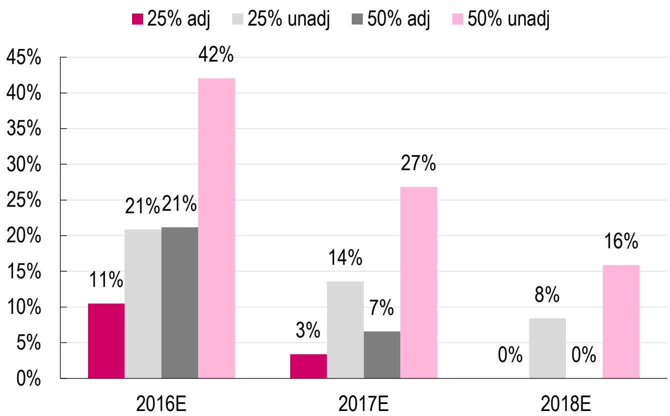
Source: Renaissance Capital estimates

Given that Rosseti and FSK are the most liquid stocks in the sector, we believe attractive yields would be likely to be of interest to investors only for these stocks. However, despite management's claims that the company could pay out 50% of net income and a statement that this should be included in tariffs, something the Ministry of Energy disagrees with, we are doubtful that Rosseti will pay any dividends, given its track record, high levels of debt and capex and the need to support loss-making subsidiaries (although we assume the payment of some dividends in our base case). FSK could still pay out dividends, in our view, and despite it becoming more expensive on multiples due to its 185% YtD share-price run, we see more certainty in the stock than in Rosseti. For this reason, we analyse different payout scenarios for these two stocks.

We calculate potential dividend yields for Rosseti commons and prefs with a total payout of 50% and 25%, and 10% for prefs, as well as the same payout ratios with the bottom line adjusted for the difference in depreciation according to RAS and IFRS. For FSK, we look at payouts of 25%, 50% and 38%. These scenarios are based on management guidance for 25% of IFRS net income, adjusted for differences in depreciation; the 50% scenario is based on a potential government ruling on a 50% payout from the larger of RAS or IFRS net income, as well as news reports citing the CEO of Rosseti; and the 38% scenario is based on the payout ratio used for 2015.

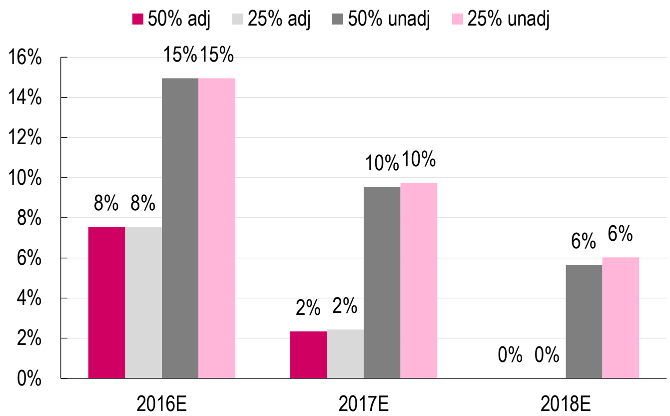
On this assessment, we arrive at a dividend yield ranging from 11% to 42% in 2016E for Rosseti commons, and a 3-27% range for 2017E, with the highest yields coming from a 50% payout of unadjusted net income and the lowest from a 25% payout of adjusted net income. Our base case (25% of unadjusted net income) leads to yields of 21% for 2016E and 14% for 2017E. For prefs, we see a range of 8-15% in 2016E and 2-10% in 2017E, with our base case implying 15% and 10% in 2016E and 2017E, respectively. FSK's dividend yield could range from 6% to 20% in 2016E and 3% to 13% in 2017E, with the 50% of unadjusted net income implying the largest yields; our base case implies yields of 15% in 2016E and 10% in 2017E.

Figure 27: RSTI common stock dividend yield scenarios



Source: Company data, Renaissance Capital estimates

Figure 28: RSTI preferred stock dividend yield scenarios

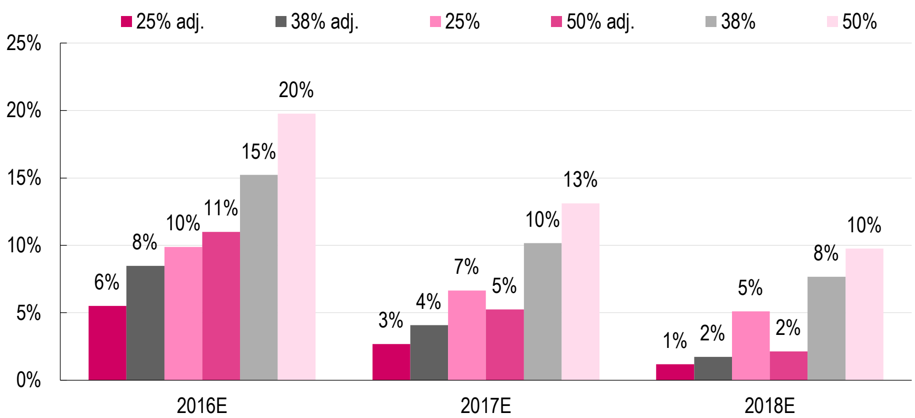


Source: Company data, Renaissance Capital estimates

However, again we highlight that despite the fact that the robust performance we expect in 2016-2017E for most MRSKs, FSK and Rosseti could lead to attractive dividend yields, performance is likely to be driven by one-offs; dividend payouts are in any case highly uncertain; we would expect a dramatical fall in line with a drop-off in unsustainable revenue; paying out dividends would like mean that debt levels would rise; and financing expenses for some companies would be likely to lead to net losses in the long term.

Even in 2018E, under all the scenarios outlined above, we would expect yields to decline. For Rosseti, we expect they could even fall to 0% due to the depreciation adjustment being higher than the IFRS bottom line. Using a 25% unadjusted payout we estimate a 8% yield, and one of 16% using 50% of the unadjusted bottom line. Looking at all our scenarios together, we would expect 2018E yields to be around half their level in 2017E. We see a similar situation for the prefs, with a potential maximum yield of 6%, vs 10% in 2017E. The scenarios imply similar dynamics for FSK, with a potential 3-13% yield for 2017E falling to 1-10% for 2018E.

Figure 29: FSK dividend yield scenarios



Source: Company data, Renaissance Capital estimates

Valuation

Given that investors in utilities are traditionally seeking dividends, we value the Russia distribution companies on a DDM basis. However, we also carry out a DCF valuation as a sanity check. Our DCF valuations imply that eight of the 14 companies on our list have a negative fair equity value, which we then set at zero due to low operating cash flows and still-high capex. The exceptions are FSK, Rosseti, Kubanenergo, Center MRSK, Volga MRSK and South MRSK, for which we calculate a positive discounted terminal value. However, for only four companies do we arrive at a positive fair equity value, given that substantial debt burdens wipe out the equity value for FSK and South MRSK. We therefore arrive at positive DCF-based fair share values for only Lenenergo, Volga MRSK, Center MRSK and Kubanenergo. However, these fair values still imply downside vs the current price.

Figure 30: DCF-based fair value calculation

	South MRSK	Lenenergo	Siberia MRSK	Urals MRSK	Volga MRSK	North Caucasus MRSK	Moscow United DistCo	Center MRSK	North West MRSK	Kubanenergo	Tomsk DistCo	Center & Volga MRSK	FSK	Rosseti
Terminal value growth, %	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%
PV(Terminal value), RUBmn	6,844	(9,473)	(46,273)	(24,849)	354	(15,113)	(2,123)	26,777	(7,640)	10,410	(1,390)	(40,329)	116,631	61,925
PV(Present value), RUBmn	14,060	(22,368)	(24,495)	(15,388)	7,481	(16,929)	(10,123)	28,930	(11,052)	16,818	(703)	(10,676)	125,857	82,421
EV, RUBmn	20,904	(31,841)	(70,768)	(40,237)	7,835	(32,042)	(12,246)	55,706	(18,693)	27,228	(2,093)	(51,006)	242,487	144,346
Net debt 2017, RUBmn	24,059	(64,901)	28,078	12,536	796	11,415	94,776	44,645	18,391	12,902	(425)	23,593	260,384	496,339
Fair equity value, RUBmn	(3,155)	33,060	(98,846)	(52,773)	7,039	(43,457)	(107,022)	11,061	(37,084)	14,326	(1,668)	(74,599)	(17,896)	(351,993)
Total shares, common	69,038	20,541	94,815	87,430	190,091	3,413	48,707	42,218	95,786	340	3,819	112,698	1,274,665	195,996
Total shares, pref		93	5,071								576.693			2,075
Fair per share price, RUB	0.00	1.55	0.00	0.00	0.04	0.00	0.00	0.26	0.00	42.09	0.00	0.00	0.00	0.00
Fair per share price pref, RUB		13.90									0.00			0.00
Current price, RUB	0.05	5.36	0.06	0.16	0.04	15.40	0.87	0.33	0.05	74.80	0.38	0.10	0.17	1.02
Current price pref, RUB		48.15									0.39			2.28
Upside/downside potential	na	-71%	na	na	-9%	na	na	-20%	na	-44%	na	na	na	na
Upside/downside potential pref		-71%									na			na

Source: Bloomberg, Company data, Renaissance Capital estimates

Our DDM valuations are highly dependent on dividend payout assumptions. As outlined above, given the uncertainties around payout ratios, current payout policies based on RAS results and various management statements, we apply payout ratios equal to those used in 2015 if the companies paid dividends, and if not we apply a 25% payout assumption in total and one of 10% for prefs. We show our TP calculations in Figure 31, where it can be seen that four companies have a TP of zero. This is explained by the fact that we expect these companies to deliver negative net income due to a decrease in grid connection revenue, low tariff indexation in the long term and high interest payments as they accumulate debt accumulation; we therefore expect them to be unable to pay any dividends. Our TPs for the other companies – with one exception – imply downside potential vs the current price, usually of more than 60%. The exception is Lenenergo prefs: additional Lenenergo share issues and Rosseti share issues in favour of Lenenergo have led to a substantial dilution for common shareholders. However, numbers of prefs have not been affected, and the 10% dividend payout for prefs remains in place. Pref stock holders should therefore be able to benefit from the increased profitability brought about by the transfer of new assets to the company and the 56% YoY tariff hike in 2016.

Figure 31: DDM-based TP calculation

	South MRSK	Lenenergo	Siberia MRSK	Urals MRSK	Volga MRSK	North Caucasus MRSK	Moscow United DistCo	Center MRSK	North West MRSK	Kubanenergo	Tomsk DistCo	Center & Volga MRSK	FSK	Rosseti
Terminal value growth	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%
PV(Terminal value), RUBmn	31	1,146	0	0	862	0	0	3,100	0	2,861	0	0	15,399	2,233
PV(Present value), RUBmn	622	6,622	0	0	1,993	0	3,850	8,360	0	7,077	109	1,806	62,198	56,309
Fair equity value, RUBmn	653	7,769	0	0	2,856	0	3,850	11,460	0	9,938	109	1,806	77,596	58,543
Total shares, common	69,038	20,541	94,815	87,430	190,091	3,413	48,707	42,218	95,786	340	3,819	112,698	1,274,665	195,996
Total shares, pref		93	5,071								577			2,075
TP per share, RUB	0.01	0.38	0.00	0.00	0.02	0.00	0.08	0.27	0.00	29.20	0.03	0.02	0.06	0.30
TP per pref share, RUB		57.67									0.03			0.50
Current price, RUB	0.05	5.36	0.06	0.16	0.04	0.87	0.33	0.05	74.80	0.38	0.38	0.10	0.17	1.02
Current price pref, RUB		48.15									0.39			2.28
Upside/downside potential	-81%	-93%	-100%	-100%	-63%	-100%	-91%	-18%	-100%	-61%	-92%	-85%	-64%	-71%
Upside/downside potential pref		20%									-93%			-78%

Source: Bloomberg, Company data, Renaissance Capital estimates

With the exception of Lenenergo prefs, which we upgrade to **BUY** (from Sell) for the reasons outlined above, we maintain our **SELL** ratings on all Russian distribution company stocks. Fundamentally we see now value in the sector, with capex likely to stay at high levels and a significant debt burden leading us to calculate DCF- and DDM-based fair values that are at or close to zero for many stocks. However, we highlight that certain companies, such as FSK, will probably deliver attractive dividend yields in 2016-2017E on the back of one-off revenue. Although we assume that Rosseti will pay dividends in our base csae, we see significant risks to this assumption, as the company will need funds to finance capex, repay debt and support loss-making subsidiaries with the dividends that it receives from subsidiaries that can afford to pay them. Moreover, even with certain MRSKs likely being able to deliver double-digit dividend yields in 2016-2017E, we are concerned about the lack of liquidity in the shares and what we expect to be an imminent sharp fall in profitability.

Risks to our TPs (both upside and downside) include the high level of uncertainty around dividend payouts and the difficulties (as outlined above) in forecasting net income given the volatile nature of one-off sources of revenue, as well as high debt burdens and further increases in capex.

Figure 32: TPs and ratings for Russian electricity distributors

Company	Ticker	Current price, RUB/share	DDM-based TP, RUB/share	Upside/downside potential	Rating
South MRSK	MRKY	0.05	0.01	-81%	**SELL**
Lenenergo	LSNG	5.36	0.38	-93%	**SELL**
Lenenergo pref	LSNGP	48.15	57.67	20%	**BUY**
Siberia MRSK	MRKS	0.06	0.00	-100%	**SELL**
Urals MRSK	MRKU	0.16	0.00	-100%	**SELL**
Volga MRSK	MRKV	0.04	0.02	-63%	**SELL**
North Caucasus MRSK	MRKK	15.40	0.00	-100%	**SELL**
Moscow United DistCo	MSRS	0.87	0.08	-91%	**SELL**
Center MRSK	MRKC	0.33	0.27	-18%	**SELL**
North West MRSK	MRKZ	0.05	0.00	-100%	**SELL**
Kubanenergo	KUBE	74.80	29.20	-61%	**SELL**
Tomsk DistCo	TORS	0.38	0.03	-92%	**SELL**
Tomsk DistCo pref	TORSP	0.39	0.03	-93%	**SELL**
Center & Volga MRSK	MRKP	0.10	0.02	-85%	**SELL**
FSK	FEES	0.17	0.06	-64%	**SELL**
Rosseti	RSTI	1.02	0.30	-71%	**SELL**
Rosseti pref	RSTIP	2.28	0.50	-78%	**SELL**

Source: Bloomberg, Renaissance Capital estimates

Nevertheless, given that some investors tend to focus on the short term and make investment decisions depending on dividends, we think the potentially attractive yields for

2016-2017E could provide certain short-term trading opportunities. We therefore analyse what the fair value of these stocks might be if they offered dividend yields that investors are likely to view as making them a worthwhile investment. As a benchmark, we use a 10-year OFZ with a yield of 8.35%, adding a 1-ppt premium to the risk-free rate for Rosseti and FSK, i.e. 9.35%. For the MRSKs we add another 2 ppts as a liquidity premium, implying a yield of 11.35% would make these stocks worth investing in. From this approach, we derive the fair values shown in Figure 33, using our 2016 and 2017 DPS forecasts.

Figure 33: Reference yield fair valuation summary

	DPS		Dividend yield		Reference	Fair value per share, RUB		Current	Upside	
	2016E	2017E	2016E	2017E	yield	2016E	2017E	price	2016E	2017E
South MRSK	-	0.00	0%	7%	11%	-	0.03	0.05	-100%	-37%
Lenenergo	0.09	0.15	2%	3%	11%	0.81	1.36	5.36	-85%	-75%
Lenenergo pref	**13.56**	**22.73**	**28%**	**47%**	**11%**	**119.46**	**200.25**	**48.15**	**148%**	**316%**
Siberia MRSK	-	-	0%	0%	11%	-	-	0.06	-100%	-100%
Urals MRSK	0.03	-	17%	0%	11%	0.25	-	0.16	54%	-100%
Volga MRSK	0.00	0.00	5%	7%	11%	0.02	0.02	0.04	-57%	-39%
North Caucasus MRSK	-	-	0%	0%	11%	-	-	15.40	-100%	-100%
Moscow United DistCo	0.05	0.05	6%	6%	11%	0.48	0.47	0.87	-46%	-46%
Center MRSK	**0.04**	**0.06**	**11%**	**17%**	**11%**	**0.33**	**0.49**	**0.33**	**-1%**	**47%**
North West MRSK	0.00	-	8%	0%	11%	0.03	-	0.05	-27%	-100%
Kubanenergo	5.80	12.65	8%	17%	11%	51.06	111.42	74.80	-32%	49%
Tomsk DistCo	0.04	0.02	10%	6%	11%	0.32	0.19	0.38	-16%	-50%
Tomsk DistCo pref	0.04	0.02	9%	5%	11%	0.32	0.19	0.39	-19%	-52%
Center & Volga MRSK	0.01	0.01	8%	8%	11%	0.07	0.07	0.10	-34%	-31%
FSK	**0.03**	**0.02**	**15%**	**10%**	**9%**	**0.28**	**0.18**	**0.17**	**63%**	**9%**
Rosseti	**0.21**	**0.14**	**21%**	**14%**	**9%**	**2.27**	**1.48**	**1.02**	**123%**	**45%**
Rosseti pref	**0.34**	**0.22**	**15%**	**10%**	**9%**	**3.65**	**2.38**	**2.28**	**60%**	**4%**

Source: Bloomberg, Renaissance Capital estimates

As shown in Figure 33, in both 2016E and 2017E, our fair values for FSK, Rosseti (both commons and prefs), Center MRSK and Lenenergo prefs imply upside to current levels, suggesting that, according to this approach, investors could be able to recover the risk-free rate return with a premium. However, for most of these stocks the upside potential in 2017E is lower – although there are some exceptions, such as Kubanenergo, which we expect to see a successful 2017, with DPS exceeding 2016 levels. Regardless, even on this approach, our fair value estimates for 10 of the 14 companies still imply no upside vs current levels.

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Renaissance Capital

Renaissance Capital research team

Head of Research & Turkish Product	Michael Harris	+44 (207)	005-7982	MHarris2@rencap.com
Deputy Head of Research	David Ferguson	+7 (495)	641-4189	DFerguson@rencap.com
Head of South African Research	Johann Pretorius	+27 (11)	750-1450	JPretorius2@rencap.com

Name	Telephone number		Coverage
Macro			
Charles Robertson	+44 (207)	005-7835	Global
Yvonne Mhango	+27 (11)	750-1488	Sub-Saharan Africa
Oleg Kouzmin	+7 (495)	258-7770 x4506	Russia/CIS
Equity strategy			
Daniel Salter	+44 (207)	005-7824	Global
Michael Harris	+44 (207)	005-7982	Turkey
Charles Robertson	+44 (207)	005-7835	Global
Vikram Lopez	+44 (207)	005-7974	Global
Financials			
Armen Gasparyan	+7 (495)	783-5673	Russia/CIS, CEE
Ilan Stermer	+27 (11)	750-1482	South Africa
Francois Du Toit	+27 (11)	750-1162	South Africa
Olamipo Ogunsanya	+234 (1)	448-5300 x5368	Sub-Saharan Africa
Seki Mutukwa	+44 (207)	005-7736	Sub-Saharan Africa/MENA
Balram Ramesh	+971 (4)	409-2054	MENA
Consumer/Retail/Agriculture			
David Ferguson	+7 (495)	641-4189	Russia/CIS, Africa
Kirill Panarin	+7 (495)	258-7770 x4009	Russia/CIS, Africa
Zaheer Joosub	+27 (11)	750-1427	South Africa
Olaloye Oyawoye	+234 (1)	448-5300 x5377	Sub-Saharan Africa/CEE
Robyn Collins	+27 (11)	750-1480	South Africa
Mohamed Zein	+971 (4)	409-2032	MENA
Seki Mutukwa	+44 (207)	005-7736	Sub-Saharan Africa/MENA
Amine Wafy	+971 (4)	409-2052	MENA
Media/Technology/			
David Ferguson	+7 (495)	641-4189	Russia/CIS, Africa
Kirill Panarin	+7 (495)	258-7770 x4009	Russia/CIS, Africa

Name	Telephone number		Coverage
Oil and gas			
Ildar Davletshin	+44 (207)	005-7954	EMEA
Temilade Aduroja	+234 (1)	448-5300 x5363	Sub-Saharan Africa
Evgeny Stroinov	+7 (495)	258-7770 x4046	Russia/CIS
Metals and mining			
Johann Pretorius	+27 (11)	750-1450	South Africa
Steven Friedman	+27 (11)	750-1481	South Africa
Kabelo Moshesha	+27 (11)	750-1472	South Africa
Vladimir Sklyar	+7 (495)	641-4188	Russia/CIS
Anastasia Burkhanova	+7 (495)	258-7770 x4594	Russia/CIS
Real estate			
Seki Mutukwa	+44 (207)	005-7736	Sub-Saharan Africa/MENA
Telecoms/Transportation			
Alexander Kazbegi	+41 (78)	883-4527	Global
Artem Yamschikov	+7 (495)	258-7770 x7511	Russia/CIS
Amine Wafy	+971 (4)	409-2052	MENA
Utilities/Electric Equipment			
Vladimir Sklyar	+7 (495)	641-4188	Russia/CIS/SSA/Pakistan
Anastasia Tikhonova	+7 (495)	604-4493	Russia/CIS/SSA/Pakistan
Fertilisers			
Vladimir Sklyar	+7 (495)	641-4188	Russia/CIS/MENA/Pakistan
Anastasia Burkhanova	+7 (495)	258-7770 x4594	Russia/CIS/MENA/Pakistan
Diversified/Industrials			
Seki Mutukwa	+44 (207)	005-7736	Sub-Saharan Africa/MENA
Brent Madel	+27 (11)	750-1160	South Africa
Metin Esendal	+44 (207)	005-7925	Turkey

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Renaissance Capital

Renaissance Capital
Moscow
T + 7 (495) 258-7777

Renaissance Capital Ltd.
London
T + 44 (203) 379-7777

Renaissance Capital
Johannesburg
T +27 (11) 750-1400

Renaissance Securities (Cyprus) Ltd.
Nicosia
T + 357 (22) 505-800

Renaissance Securities (Nigeria) Ltd.
Lagos
T +234 (1) 448-5300

Renaissance Capital
Nairobi
T +254 (20) 368-2000

Renaissance Capital
Dubai
T +971 (4) 409-2000

Renaissance Capital
Cape Town
T +27 (11) 750-1164