CENTREINVEST GROUP

MRSKs: Betting on Higher Capitalization

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Investment Summary

The consolidation of RAO UES-owned electricity-distribution assets has yielded eleven large operating companies with $1.5 bn plus in average annual revenue and net assets. By volume of electricity transmitted and network length, the MRSK (interregional-grid) companies rank among the world's major power-distribution firms, and are quite comparable to the largest Russian generating companies in terms of capital spending-program volumes and financials.

Given the potential growth of these companies, we see the shares of these interregional grid companies as among the most interesting stories in the liberalized electric utilities sector. The forthcoming reform of the electric-grid complex should lead to improved financials and appreciating assets.

Although we see the possibility of growing market caps in the MRSK sector as real, we understand that the growth potential will likely be fully realized only once certain price-formation parameters are set. Based on RAB (regulatory asset base), this switch is due next year.

In anticipation, we have now determined the target values of eight of these companies as of the time of this move – which we take as January 1, 2009 for convenience sake. Our figures reveal the extent to which the MRSKs are undervalued, and we see average upside potential at 47%. As a hint for the future, we also estimated company values based on RAB (EV/RAB to be specific), although the results are not counted in calculating our current target prices.

The following details have a positive impact on the valuation:

- Large-scale capital investment programs will result in MRSK asset growth, both in terms of physical size and value. Capitalization will grow as their capex programs are realized.
- The new price-regulation system will instigate greater cash flows, as well as their improved stability and predictability.
- An average free float of $300 mn provides a sufficient level of liquidity. This should grow following consolidation of the MRSK share issues (for the moment, MRSK shares remain labeled according to the companies which were consolidated into them). This move is expected in late summer.
- RAO UES shareholders will receive shares of MRSK Holding, rather than interest in the individual MRSKs. This will avoid downward pressure on the stock prices as a result of excessive supply.

Negative pressure on the valuations comes from:

- The uncertainty concerning the implementation of the new RAB-based price-regulation system. Since the switch to it should lead to higher prices, the government may – in its efforts to fight inflation – attempt to restrict the benefits of RAB regulation. This is the outstanding risk for the MRSK group.
- The majority of MRSKs were established as operating companies but a few short months ago. Therefore, a lack of consolidated reporting and detailed growth strategies offers challenges to accurate analysis.

Our outlook on the prospects for capitalization growth of Russia's distribution-grid complex is positive, and we recommend the stock of each MRSK as a BUY. We estimate the average upside potential for the market value of the eight traded MRSKs at 63%.

MRSK Target Prices & Recommendations

MRSK	Ticker	Current Offer Price ($)	Target Price ($)*	Upside Potential (%)	Recommendation
Northwest	MRKZ	0.0102	0.01883	84	BUY
Center	MRKC	0.0500	0.06199	24	BUY
Center and Volga	MRKP	0.0154	0.02234	45	BUY
Volga	MRKV	0.0067	0.01392	108	BUY
Northern Caucasus	MRKK	9.4	18.50	97	BUY
South	MRKY	0.0161	0.02610	62	BUY
Urals	MRKU	0.017	0.02366	39	BUY
Siberia	MRKS	0.018	0.02614	45	BUY

Source: RTS, CiG Estimates

**as of beginning of 2009*

Unbundling and Restructuring Russian Distribution

Russia's electricity-distribution assets were spun off into separate companies as a result of restructuring the vertically-integrated 'energo' joint-stock companies in 2004–2006. Distribution networks were thus separated from the transmission grids and the sector's competitive (in terms of pricing that is) components – generation and supply.

At the same time, RAO UES – striving to improve the financial stability and investment attractiveness of the regional distributors – decided to consolidate them into 11 major interregional companies (MRSKs). The electric-grid assets of Russia's Far East did not become part of any MRSK, and were instead consolidated into the Far East Distribution Grid Company, part of the vertically-integrated Far East Energy Company holding.

At first, 8 out of 11 MRSKs were created as 100%-owned RAO UES subsidiaries, to which respective regional companies were later added. The other three took a slightly different route, with Lenenergo and Tyumenenergo formed as operating companies when the vertically-integrated 'energos' were broken up in 2005. The formation of Lenenergo will be completed next year; MRSK Moscow, being formed on the basis of two companies spun off from Mosenergo in 2005, will also be complete in 2009. Tyumenenrgo was a 100% subsidiary of UES, and became a 100% subsidiary of MRSK Holding on July 1, 2008.

The process of consolidating the various MRSKs has not always run smoothly, but we do not see any of the issues as affecting the value of any of the companies to a great extent. In particular, UES ran into problems while forming three of the companies:

- MRSK Urals: The controlling shareholder of Kurganenergo did not support the merger. Given Kurganenergo's size, its absence should not significantly impact operating or financial results.
- MRSK Siberia: The consolidation of Tomsk Distribution Company (TRK) is being appealed in court by Rosneft-affiliated Neft-Aktiv – a major minority holder.
- MRSK South: The consolidation of Kubanenergo is being appealed in court by Rosneft-affiliated Neft-Aktiv – a major minority holder.

In the latter two cases, although it is too early to speak of exact dates, we believe these companies will eventually enter their respective MRSKs. Contrary to the situation with Kurganenergo, Neft-Aktiv does not own controlling stakes in either TRK or Kubanenergo, and thus cannot directly influence consolidation-related decisions. Instead, Neft-Aktiv claims violations of formalities in the decision-making processes. We view these legal challenges as fairly straightforward to overcome.

Consolidation of the MRSKs

MRSK	Status	Companies Merged
Northwest	Completed	Arkhenergo, Vologdaenergo, Karelenergo, Kolenergo, Komienergo, Novgorodenergo, Pskovenergo
Center	Completed	Belgorodenergo, Bryanskenergo, Voronezhenergo, Kostromaenergo, Kurskenergo, Lipetskenergo, Orelenergo, Tambovenergo, Smolenskenergo, Tverenergo, Yarenergo
Center and Volga	Completed	Vladimirenergo, Ivenergo, Kalugaenergo, Kirovenergo, Marienergo, Nizhnovenergo, Ryazanenergo, Tulaenergo, Udmurtenergo
Volga	Completed	Mordovenergo, Orenburgenergo, Penzaenergo, Volga MRK, Chuvashenergo
Northern Caucasus	Completed	Dagenergo, Caucasus Energy Management Company (KEUK), Nurenergo, Stavropolenergo
South	Kubanenergo consolidation postponed	Astrakhanenergo, Volgogradenergo, Rostovenergo, Kalmenergo
Urals	Kurganenergo consolidation postponed indefinitely	Permenergo, Sverdlovenergo, Chelyabenergo
Siberia	Tomsk Distribution Company consolidation postponed	Altaienergo, Buryatenergo, Krasnoyarskenergo, Kuzbassenergo-RSK, Omskenergo, Tyvaenergo-Holding, Khakasenergo, Chitaenergo
Tyumenenergo	Completed	-
Moscow	The consolidation of the Moscow City Electric-Grid Company and the delivery of assets belonging to the Moscow Municipality is planned for July 2008 and mid-2009, respectively	-
Lenenergo	Delivery of assets belonging to the St. Petersburg Municipality is planned for late 2008	-

Source: Company Data

Since May, all MRSKs have been functioning as operating companies

Although five of the eleven companies have yet to complete their originally planned structures, one could say that the consolidation of Russia's electricity-distribution complex is on the home stretch. All MRSKs, without exception, are now functioning as operating companies, and many have sufficient experience in the management of the companies that have been consolidated. A substantial drawback, and one that makes the valuation of these companies difficult, is their scant corporate history, which means that certain MRSKs have neither consolidated reporting nor a detailed growth strategy.

Since the formation of the MRSKs was based on a principle of asset-value equality, all the companies (except MRSK Moscow and MRSK North Caucasus) are readily comparable along basic production and financial criteria. This is highly important from the point of view of regulator objectivity, as well as increasing management efficiency.

MRSK Indicators (2008E)

MRSK	Transmission Volume (bn kW-h)	Length of Grids ('000 km)	Revenue ($ mn)	Net Assets ($ mn)
Northwest	45	163	1 150	957
Center	58	378	1 770	1 775
Center and Volga	56	264	1 490	1 712
Volga	62	230	1 450	1 724
Northern Caucasus	11	125	440	537
South*	49	242	1 410	1 310
Urals	83	170	1 860	1 086
Siberia**	103	267	1 520	1 472
Tyumenenergo	71	45	1 650	2 595
Moscow	69	78	3 620	3 550
Lenenergo	27	55	850	1 490
Average	*58*	*182*	*1 565*	1 655

Source: Federal Grid Company, Company Data, CiG Estimates

**including Kubanenergo*

***including Tomsk Distribution Company*

MRSK shares made their exchange debut in the spring, with market capitalizations ranging from $300 mn (MRSK Northern Caucasus) to $2.1 bn (MRSK Center). The average free float ($300 mn) translates into what is, in our opinion, a fairly sufficient level of liquidity. MRSK Holding will receive the UES-owned shares in all the consolidated companies, and will thus assume the responsibility of managing the entire Russian distribution-network complex.

Former RAO UES shareholders will not receive shares in individual MRSKs, but rather MRSK Holding, which is expected to debut on exchanges in September or October, and will likely become one of the sector's blue chips. Investors will thus have a choice between investing in the shares of individual MRSKs on the one hand, or in MRSK Holding stock, which can then be seen as an index for the entire distribution segment. The latter option should offer more risk-adverse investors more comfortable exposure to the segment.

Prospects for Asset Appreciation

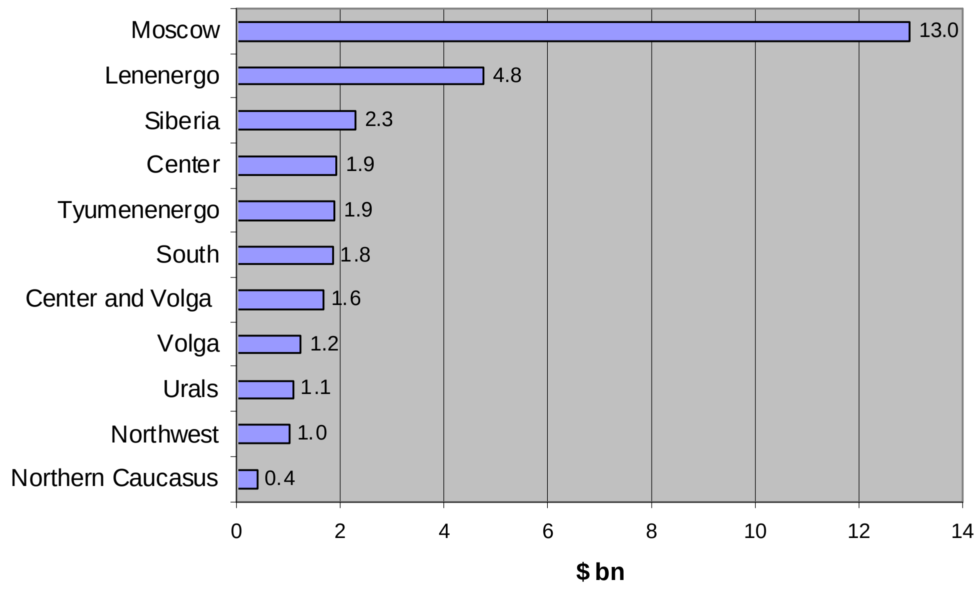
Appreciation of MRSK capitalization depends on the success of large-scale investment programs

The growing demand for electricity and the need to ensure the quality and reliability of delivery call for huge investment in upgrading and developing the country's grid infrastructure. Last year, the load on distribution networks in 16 of the country's regions approached maximum levels. The average depreciation of the electric-grid infrastructure is 65%. Data from the former Ministry of Industry and Energy suggests the cumulative volume of unsatisfied demand for connection to distribution networks has reached 10,000 MW.

According to estimates by the Federal Grid Company, in order to meet the needs of the economy (as well as the social sector) Russia must construct 70,000 km of distribution network, with transformer capacity of 200,000 MVA. At the same time, the total wear of the grid infrastructure must be reduced to 50% by 2015, at which point it would correspond to the EM average.

In order to transform these ambitions into reality, the UES 2008–2012 capital investment program for the distribution-grid complex demands a cumulative volume of $31 bn (RUB 728 bn). Implementation will grow the MRSKs' fixed assets, both in physical and value terms, and therefore trigger a re-valuation, with both the quality and size of their assets, as well as the increased revenue they will generate, contributing.

MRSK Capital Investment Program, 2008–2012



Source: RAO UES, CiG Estimates

Sources of Growth – RAB in the Driver's Seat

RAB regulation will allow for the necessary investment component to be made a part of new regulated price of electricity

Unlike generating companies, MRSKs cannot use additional share issues as sources of capital, as legislation stipulates that the government must hold a controlling stake. At the same time, widespread privatization of the MRSKs via strategic investment is unlikely until at least 2011, when the move to RAB regulation should be complete. That said, we do not exclude the possibility of MRSKs Moscow, Volga, and Tyumenenergo placing an additional share issue to raise funds for capex purposes.

For the most part then, the capital demands that MRSKs face must be satisfied almost exclusively via changes to price regulation. The 'cost plus' price-regulation system currently in effect sees the regulator striving first to cover current costs and unforeseen expenditures, while capital expenditures are financed from whatever funds remain. As a result, capital investment is often insufficient to support even a minimal level of system maintenance.

The new RAB-based system will see the regulator set a price that will allow the company to attract the funds to make its investment program a reality. Specifically, the price assumes the recovery of capital invested into the company's assets (the regulatory asset base) over their service life, while also guaranteeing a certain rate of return. Thus in the regulator's calculations, company revenue targets (and therefore the regulated price) will consist of the following elements:

RAB Based Revenue = Operating Expenses + Capital Base Recovery + Return on Capital Base

The new regulation system will also allow companies to become more active on the debt markets, as their revenues will allow them to take on loan-servicing costs. The Federal Grid Company estimates that the MRSKs' loan volume could reach 40–50% of RAB, from the current maximum of 10%.

Independent appraisers are currently calculating initial RAB for the MRSKs. Meanwhile, we have conducted our own estimates for the eight companies we value here, with RAB estimated as of the time at which the switch to the new regulation system will be made (sometime in early 2009). We believe that initially RAB will be broadly defined as the sum of working capital, plus fixed assets on the balance sheet, plus new capital investment committed in 2008.

We performed a valuation of the initial Regulated Asset Base for eight MRSKs

Our estimation of RAB is likely to be on the conservative side, as on the eve of the switch to the new regulation system, the companies' assets will be re-valued, whereas we base our forecasts on current accounting data. Therefore, while we have no choice but to use these current RAB calculations in our guiding estimates, it's worth bearing this conservative bent in mind.

Calculating RAB

MRSK	Estimated Fixed Assets + Working Capital ($ bn)*	2008E Capital Investment ($ bn)	RAB ($ bn)
Northwest	1.30	0.16	1.46
Center	2.20	0.36	2.56
Center and Volga	2.07	0.28	2.35
Volga	1.97	0.23	2.20
Northern Caucasus	0.69	0.09	0.78
South	1.93	0.31	2.24
Urals	1.45	0.23	1.68
Siberia	1.81	0.22	2.03

Source: Company Data, CiG Estimates

**as of January 1, 2009*

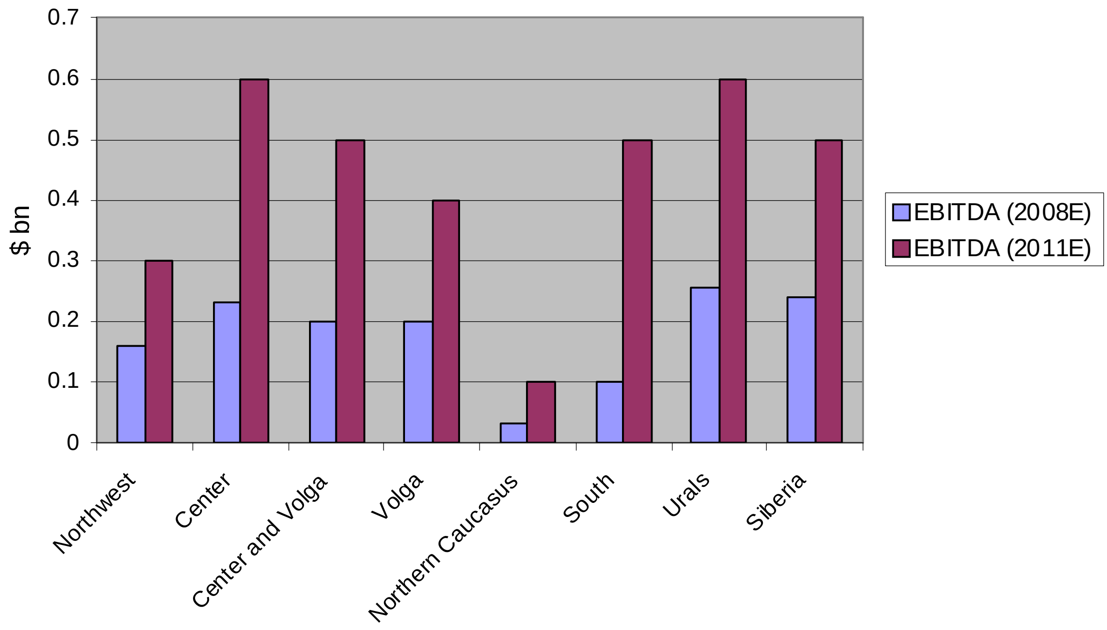
Widespread use of RAB regulation in the electricity-distribution grid system will start in 2009

In subsequent years, RAB will increase by the amount of capital invested (investment plus changes in working capital,) minus depreciation. The pre-tax return on existing RAB will start at 6% in 2009, changing to 12% in 2011. Return on new investments will be 12% from 2009 onwards. We note that all new investments will need approval from the regulator in order to enter calculated RAB.

RAB regulation is due to be implemented starting in 2009 in most MRSKs, and from 2010 in the remainder – definite information is not yet available. Pilot schemes to test the parameters of the system begin this month in five regions: Perm (MRSK Urals), Orenburg (MRSK Volga), Astrakhan (MRSK South), Tver and Belgorod (MRSK Center). Although the actual prices in these regions will be determined, as before, according to the 'cost plus' method, the regulator will also simultaneously calculate RAB-regulated prices.

The new system should lead to greater cash flows and increased margins. We calculate average EBITDA growth in 2008–2012 for the eight MRSKs we cover in this report at 170%.

RAB Regulation Boost to EBITDA



Source: Federal Grid Company, CiG Projections

Fees collected for connecting customers to the distribution network provide another avenue for financing capital investment programs. After the Russian government allowed the inclusion of an investment component in the make-up of the fee early last year (connection fees are also set by the regulator), the fees gained wide implementation in most of the country's regions. Although connection fees do not solve the question of grid wear outright, they do attract investment that could solve the problem of connecting new users to the system. Connection fees should generate $6 bn for the distribution sector by 2012.

In order to avoid double-counting, investments originating from connection fees will not be included in RAB. After the sector switches over to the new system entirely (sometime after 2011), connection fees will be eliminated countrywide, except for those regions where the size of the companies' investment programs is too large to be fully accounted for in the electricity-transmission price.

Valuation & Recommendation

In this report, we arrive at target prices for the shares of eight out of eleven MRSKs, leaving only Moscow Unified Electric-Grid Company (which will serve as the basis for MRSK Moscow), Lenenergo and Tyumenenergo without coverage. As for MRSK Moscow and Lenenergo, the formation of these companies will be complete once electric-grid assets belonging to the Moscow and St. Petersburg municipalities (valuation as yet unknown) are delivered into these MRSKs' equity. Tyumenenergo shares will not be traded in the near future; its sole shareholder from July 2008 on will be MRSK Holding.
We value the shares of Siberia and South MRSKs without accounting for the companies that have yet to be merged into them, i.e. Tomsk Distribution Company and Kubanenergo, respectively.

As discussed, the sector is on the cusp of crucial changes which should lead to improvements in revenue and EBITDA, and increased asset value. This, in turn, should lead to a substantial re-valuation of the entire segment. At the same time, given that certain crucial elements of the new regulation system (such as the size of RAB at certain MRSKs) are still not fully clear, we feel it imprudent to base our valuation on its parameters. Therefore, although we include EV/RAB ratios, it is for illustrative purposes only.

Therefore, seeking to estimate the target value of the MRSKs as of the start of 2009, we use a comparison with emerging-market peers along two basic ratios: EV/EBITDA and P/B. We see EBITDA as crucial when valuing electric-grid companies, regardless of the regulation system used, while looking at the size of the companies' equity capital, we thus take into account the size of their net assets. It's important to note that the net asset value of Russian electric-grid companies is not so far from that of fixed assets, which is of course, a major element in RAB. We give each ratio a 50% weight in the final valuation.

Since we believe that the introduction of the new price-regulation system will lead to significant growth of EBITDA and net assets, our valuation of the MRSKs based on current data remains conservative. We will review it once the main parameters of RAB regulation become known.

Comparative Valuation (2008E)

Company	EV ($ mn)	EBITDA ($ mn)	EV/ EBITDA	MCAP ($ mn)	Book Value ($ mn)	P/B
Vakaru Skirstomieji Tinklai (Lithuania)	1 389	133	10.4	1 349	752	1.7
ELMU NyRt (Hungary)	1 019	167	5.8	873	470	1.7
EMASZ Rt. (Hungary)	479	61	7.8	409	215	1.9
Prazska Energetika (Czech Republic)	1 633	157	10.4	1 679	482	3.3
Rytu Skirstomieji Tinklai (Lithuania)	976	90	10.8	898	1 003	1.3
Manila Electric Co. (Philippines)	1 823	213	8.6	1 251	1 000	1.0
Empresa Distribuidora y Comercializadora Norte (Argentina)	750	207	3.6	450	676	0.8
Luz del Sur SA (Peru)	970	120	8.1	755	267	2.9
Equatorial Energia Sa (Brazil)	1 923	131	14.7	1 113	372	2.8
Eletropaulo Metropolitana Eletricidade de Sao Paulo SA (Brazil)	3 996	684	5.8	3 629	1 365	2.7
Average	*1 496*	*196*	*8.6*	*1 241*	*660*	*2.0*

Source: Bloomberg

Taking into account a probable delay at MRSK North Caucasus in switching to RAB-based regulation (having to do with the company's financial instability), we discount the target ratio values by 20%. Although we rate the chances of TRK merging into MRSK Siberia and Kubanenergo joining MRSK South as high, we value the pair without these consolidations.

Although we do not base our valuation on the size of RAB, we did calculate on its basis all the same, arriving at an average EV/RAB (the ratio of enterprise value to the forecast size of initial RAB) of 1.13x. To put this in context, some emerging-market peers see this ratio rise as high as 1.5x.

However, in our view, the resulting 25% discount is fully justified while the continued uncertainty over the forthcoming system persists. That said, once it lifts, so too will the valuations of the MRSKs.

MRSK Valuation

MRSK	2008E EBITDA ($ mn)	Target EV/EBITDA	Book Value at 01.01.09 ($ mn)	Target P/B	Target EV at 01.01.09 ($ mn)	RAB at 01.01.09 ($ mn)	EV/RAB
Northwest	160	8.6	957	2.0	1 694	1 496	1.13
Center	228	8.6	1 775	2.0	2 919	2 535	1.15
Center and Volga	204	8.6	1 712	2.0	2 676	2 330	1.15
Volga	194	8.6	1 724	2.0	2 651	2 242	1.18
Northern Caucasus	27	6.9	430	1.6	548	795	0.69
South*	107	8.6	919	2.0	1 469	1 354*	1.08
Urals	255	8.6	1 086	2.0	2 309	1 681	1.37
Siberia**	244	8.6	1 368	2.0	2 513	1 902**	1.32

Source: CiG Calculations

**excluding Kubanenergo*

***excluding Tomsk Distribution Company*

As uncertainty having to do with the implementation of RAB regulation abates, MRSK valuations should rise

In our view, MRSK sector stocks are attractive on the strength not only of their current undervaluation by the market, but also the significant propects for growth of their asset value and profitability once the new regulation system is introduced. We recommend the stock of each MRSK as a BUY, and estimate average upside potential at 63%, although on an individual basis, this ranges from 24% to 108%.

Target Prices and Recommendations for MRSK Shares

MRSK	Ticker	Current Offer Price ($)	Target Price ($)*	Upside Potential (%)	Recommendation
Northwest	MRKZ	0.0102	0.0188	84	BUY
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Source: RTS, CiG Estimates

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