Veles Capital

EQUITY RESEARCH
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RusHydro

Target: 0.87 RUB, BUY

Disappointing Capital Markets Day

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- We updated our DCF model and incorporated latest operating and financial data. As a result, our 12M target price was cut down from RUB 1.0 to RUB 0.87, with a BUY recommendation unchanged. We do not see any positive triggers for HYDR within next 6 months. Still, **after a recent 14% plunge in the HYDR shares we assume there is no potential for any further decline.**

- **Financial results**

In the end of December the company presented unimpressive results for 9M2017: core revenue (ex-government grants) grew by 1.4% YoY; EBITDA grew by 4.6%. Net income decreased by 15.2%. Operating expenses grew up by 5.5%.

IFRS results were broadly in line with our guidance. However, we note a net income decrease, which was mainly due to change of fair value of forward contract and various impairments. This a negative for us because it implies that dividends for 2017 will be less than in 2016.

- **Capital markets day**

The company held an Investor Day on December 19th where the management commented on the latest financial results and presented a short-term outlook. Our key takeaways are the following:

- The management plans an additional share issue of RUB 13-14 bn in short-term.

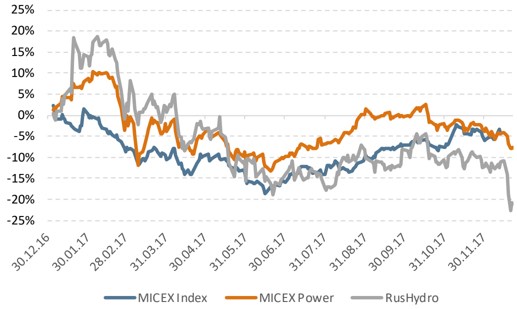
- Zagorskaya PSPP-2 reconstruction is suspended until 2020

- Dividend policy remains unchanged (50% payout ratio)

- Capital expenditures till 2022 are 3.1% above the previous plan

We also note that from July of 2017 RusHydro started to receive government grants to subsidize electricity tariffs in Far East region. The base tariff in that regions will be is 4.3 RUB/kWh in 2018 and subsidies will reach RUB 35 bn. Receivables overdue should decrease but the effect should be limited, in our view.

RusHydro share performance vs Indices



Source: market data; Veles Capital estimates

Price targets and recommendations

Company	Rating		PT, RUB		Upside	TSR
	New	Old	New	Old		
HYDR	BUY	BUY	0.87	1.0	19.5%	24.3%

Company Information

Ticker	HYDR
Share price, RUB	0.73
Min / max price during last year, RUB	0.57 / 1.10
Target price (12m), RUB	**0.87**
Upside (downside), %	*19.5*
Total shares[1]	426 288 813 551
MC, mn RUB	311 873
EV, mn RUB	458 796

Source: company, market data; Veles Capital estimates

RusHydro: IFRS 9M 2017

mn RUB	9M 2016	9M 2017	+/-
Revenue incl. subsidies	255 362	266 158	4.2%
COGS	226 954	216 218	-4.7%
EBITDA	68 428	66 184	-3.3%
Net Income	36 323	29 181	-19.7%

Source: company data; Veles Capital estimates

The fact that 50% IFRS payout is kept unchanged is a **negative** because net income on the background of forward contract with VTB Bank will be very volatile in the nearest future. We expect a modest dividend yield of 4.9% for 2017. Due to a negative effect of forward contract, **FCF dividend base** would be more attractive for shareholders.

- Among **positive** moments we see an intention of the management to cut down on operating expenses up to RUB 15 bn per annum and a possible introduction of a 3rd price zone in Far East. Also, due to an additional share issue for VTB Bank and a reasonable borrowing policy HYDR has a **comfortable** Net Debt/EBITDA ratio of 1.4x.

Valuation

We updated our DCF model and decreased RusHydro target price by 13% to 0.87 RUB/share. This implies an upside of 19.7% so we keep our “BUY” recommendation unchanged. TSR within next 12 months is 24.3%. We also included a RUB 5 bn additional share issue, which is planned in 2018 according to the latest CEO comments.

Outlook and stock drivers

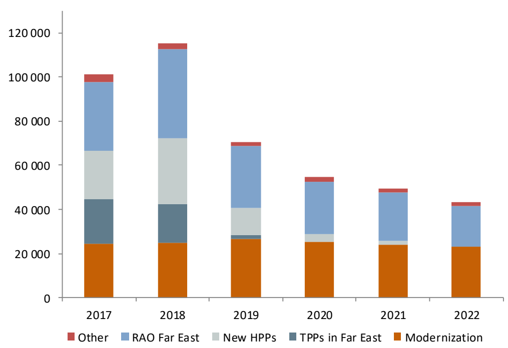
Next year promises to be challenging for RusHydro due to an all-time-high CAPEX, additional share issue and a decrease of generation. We hope to see OPEX cuts, Far East regulation change and a start of DPM-like modernization wave. Regulatory risks are still an integral part of this investment case, but we are optimistic about HYDR shares due to an efficient hydro business, commissioning of new capacities and high generation that is expected in 2017.

Financial forecasts

mn RUB	2016 (A)	2017 (F)	2018 (F)
Sales ex. subs.	374 072	363 588	387 592
EBITDA	99 747	80 918	93 445
Net income	39 751	30 639	37 258
EBITDA margin, %	*26.7*	*22.3*	*24.1*
%	*10.6*	*8.4*	*9.6*
EV / S	1.12	1.05	1.00
EV / EBITDA	5.04	4.36	3.92
P / E	10.18	8.37	6.81
ROIC, %	*7.0*	*5.0*	*5.5*
ROE, %	*6.1*	*4.2*	*4.9*

Source: company data; Veles Capital estimates

CAPEX split till 2022, RUB bn



Source: company data; Veles Capital estimates

Financial forecasts: RusHydro

P&L statement	2016	2017 (F)	2018 (F)	2019 (F)
Sales	374 072	363 588	387 592	407 890
Operating expenses (excl. Amortization &	(291 575)	(324 265)	(347 094)	(357 224)
EBITDA	**99 747**	**80 918**	**93 445**	**103 971**
Amortization and depreciation	(24 130)	(26 082)	(28 588)	(28 565)
EBIT	**75 617**	**54 836**	**64 857**	**75 406**
Non-recurrent items	(28 078)	(10 000)	(10 000)	(10 000)
Interest expenses	(6 813)	(5 219)	(5 416)	(4 595)
Non-operation expenses	0	0	0	0
EBT	**55 123**	**40 852**	**49 677**	**61 047**
Income tax	(15 372)	(10 213)	(12 419)	(15 262)
Net income	**39 751**	**30 639**	**37 258**	**45 785**

Balance sheets				
Non-current assets	**834 993**	**879 115**	**948 154**	**979 505**
PPE &IA	765 047	815 809	884 848	916 199
Other non-current assets	69 946	63 306	63 306	63 306
Current assets	**148 000**	**147 571**	**125 392**	**111 422**
Current assets	71 113	76 648	81 820	85 471
Short-term investments	0	0	0	0
Cash and equivalents	66 901	60 938	25 974	30 952
Total assets	**982 993**	**1 026 686**	**1 073 547**	**1 090 927**
Shareholder's equity	**650 932**	**729 695**	**761 633**	**798 789**
Shareholder's capital	646 669	725 432	757 370	794 526
Minority interest	4 263	4 263	4 263	4 263
Long-term liabilities	**215 858**	**156 211**	**180 160**	**162 392**
Long-term debt	158 046	99 495	120 935	101 047
Other long-term liabilities	57 812	56 717	59 225	61 346
Current liabilities	**116 656**	**140 780**	**131 754**	**129 745**
Short-term debt	41 757	58 647	43 161	38 193
Current liabilities	74 899	82 133	88 593	91 552
Total liabilities and shareholder's equity	**983 446**	**1 026 686**	**1 073 547**	**1 090 927**

Cash flow statement				
Operating activity	**70 919**	**73 729**	**86 322**	**90 240**
Net income before tax payments	55 123	40 852	49 677	61 047
Amortization and depreciation	24 130	26 082	28 588	28 565
Changes in working capital	2 191	1 700	1 288	(691)
Other cashflows from operating activity	(10 525)	5 095	6 770	1 320
Investment activity	**(24 918)**	**(77 847)**	**(88 527)**	**(49 415)**
CapEx	(60 957)	(85 847)	(97 627)	(59 915)
Purchase/sale of subsidiaries and	3 559	0	0	0
Other cashflows from investing activity	32 480	8 000	9 100	10 500
Financial activity	**(26 837)**	**(1 845)**	**(25 146)**	**(58 446)**
Changes in debt	8 393	(11 986)	5 954	(24 856)
Changes in shareholder's equity	0	55 000	0	0
Dividends paid	(14 462)	(19 876)	(15 320)	(18 629)
Other cashflows from financing activity	(20 768)	(24 983)	(15 781)	(14 960)
Changes in cash and equivalents	**18 876**	**(5 963)**	**(27 351)**	**(17 621)**

WACC	2016
Risk-free rate	*7.8%*
Cost of Debt	*9.0%*
Income tax rate	*20.0%*
Cost of equity	*14.8%*
Beta	*93.0%*
Debt weight	*23.6%*
Equity weight	*76.4%*
WACC	**13%**

Free cash flow	2016	2017 (F)	2018 (F)	2019 (F)
NOPAT	**60 494**	**43 868**	**51 886**	**60 325**
Amortization and depreciation	24 130	26 082	28 588	**28 565**
CapEx	2 191	1 700	1 288	**(691)**
Changes in working capital	(60 957)	(85 847)	(97 627)	**(59 915)**
Free cash flow	**25 858**	**(14 197)**	**(15 866)**	**28 284**
WACC, %			*13.0%*	
Discount factor			0.00	
Discounted free cash flow			**202 860**	

Common stock valuation	
TGR, %	*2.0%*
Discount cash flow sum (+)	202 860
Discounted terminal value (+)	288 784
EV	**439 926**
Net debt (-)	(132 902)
Minority interest (-)	(4 263)
Financial investments (+)	41 459
MC	**376 920**
Fair value of common stock, RUB	**0.87**

Multiples, 1x	2016	2017 (F)	2018 (F)	2019 (F)
EV / Sales	1.1	1.1	1.1	
EV / EBITDA	4.1	5.0	4.4	
EV / EBIT	5.4	7.4	6.3	
P / E	7.8	10.2	8.4	
P / BV	0.5	0.4	0.4	
EV / FCF	15.8	neg.	neg.	

Ratios	2016	2017 (F)	2018 (F)	2019 (F)
EBITDA margin, %	*26.7*	*22.3*	*24.1*	*25.5*
Net income margin, %	*10.6*	*8.4*	*9.6*	*11.2*
EBITDA / interest expenses, 1x	14.6	15.5	17.3	22.6
CapEx / Sales, %	*16.3*	*23.6*	*25.2*	*14.7*
ROE, %	*6.1*	*4.2*	*4.9*	*5.7*
ROIC, %	*7.0*	*5.0*	*5.5*	*6.1*
Debt / EBITDA	2.0	2.0	1.8	1.3
Net debt / EBITDA	1.3	1.2	1.4	1.2
Debt / Shareholder's equity	0.3	0.2	0.2	0.2

Source: company data, Veles Capital estimates

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Investment recommendations are given based on the evaluation of the company's share yield. The basis for the calculation of the expected company's cost is the evaluation by the discounted cash flows method (DCF). In some estimations the method of comparable coefficients, and also the mixed estimation (by DCF method and by comparable coefficients method) are applied. All recommendations are assigned based on the determined by us the fair cost of the shares within the nearest 12 months.

The investment scale of the Investment Company Veles Capital is the following:

BUY – corresponds to the growth potential of the shares within the nearest 12 months by 10% or more.

HOLD – corresponds to the growth (reduction) potential of the shares within the nearest 12 months from -10% to 10%.

SELL – corresponds to the reduction potential of the shares within the nearest 12 months by 10% or more.

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