

Research

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Sibirtelecom

On the edge of debt pit

**Recommendation: CS – BUY
PS – BUY**

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Bullet moments

Earlier this July Sibirtelecom issued a financial report under IAS-compliant financial year 2007. The results in general are quite strong – Sibirtelecom demonstrated one of the top rates of sales increase (among fellow IRCs). More to that – OIBDA margin growth rate has also proved to be highest, adding +9.1 p.p. to 33.6%.

Amongst companies annual achievements – we must point out the hard grip of cost management – the largest expenditure items, such as staff costs and materials & repairs have remained virtually the same over the past year. The reduction of staff costs came up from reduction of number of personnel. In addition to this – the optimization of personnel will continue through following years, positively affecting Sibirtelecom's general costs.

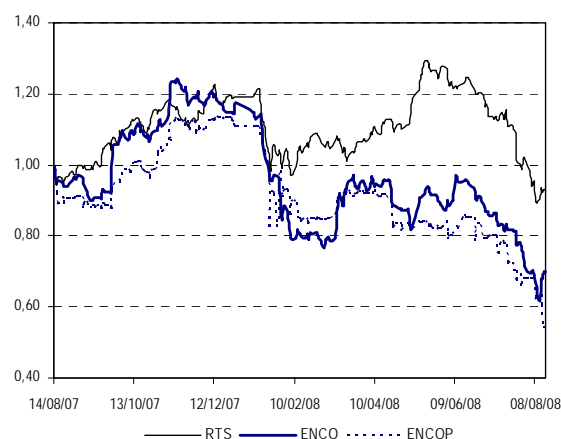
One of the most important negative facts of the company was negative cash flow by company, at which company ended the year. Not to mention last five years, all demonstrating similar dynamics. This year's negative result – debt increase, whereas during last two years the debt to own capital ratio is above value 1. This indicates that Sibirtelecom has all the chances to enter the “unsound” range of companies, considering IRCs debt load standpoint. Do note though, according to our estimates – in 2008 company's cash flow should once more sink into negative zone, confirming our fears regarding the worsening of Sibirtelecom's financial condition.

The primary reason for possible negative cash flow of 2008 – high CapEx: throughout 2008 Sibirtelecom plans to invest almost 480 mn USD – this is an absolute value for the company.

Now, considering the published report – we downgrade our estimate of fair price of Sibirtelecom's stock, down to 0.0902 USD per common and to 0.0676 USD per preferred stock. Whilst previous estimates formed – 0.1140 USD and 0.0855 USD respectively (-21% downgrade). The primary reason to cause the reduction of the estimate – aggressive investment program. Nevertheless, in despite such a significant decrease of Sibirtelecom's value – company still holds a considerable growth potential. This is still yet to be implemented fully, thanks to the market's general state. Therefore, we confirm “BUY” recommendation for Sibirtelecom's stocks.

Principal estimates

Company's shares vs RTS index



Info on Sibirtelecom

	ENCO / ENCO P
Ticker RTS	ENCO / ENCO P
Share price (com), USD	0.0715
Share price (pref), USD	0.0393
Min./max. share price for 52 weeks (com), USD	0.0630 / 0.1267
Min./max. share price for 52 weeks (pref), USD	0.0393 / 0.0825
Fair share price by the end of the year (com), USD	0.0902
Fair share price by the end of the year (pref), USD	0.0676
Growth potential (com), %	26.1
Growth potential (pref), %	72.3
Market capitalization, mn USD	1,012
EV, mn USD	2,338

Financial values (IAS)	2007	2008 (F)	2009 (F)
Sales, mn USD	1,379	1,531	1,678
EBITDA, mn USD	464	496	581
EAT, mn USD	104	57	78
OIBDA margin	33.6	32.4	34.6
EAT margin	7.5	3.7	4.7

Financial coefficients	2007	2008 (F)	2009 (F)
EV / S	1.69	1.53	1.39
EV / OIBDA	5.04	4.71	4.02
P / E	8.25	15.04	10.95
ROIC, %	11.3	7.6	8.8
ROE, %	17.1	7.6	9.8

Financial model

Income statements of Sibirtelecom, mn USD

	2004	2005	2006	2007	2008 (F)	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)
Sales	785	970	1,111	1,379	1,531	1,678	1,761	1,867	1,999	2,124
Operating expenses	(579)	(743)	(839)	(916)	(1,035)	(1,097)	(1,133)	(1,220)	(1,294)	(1,366)
OIBDA	205	227	272	464	496	581	627	648	706	758
<i>OIBDA margin, %</i>	<i>26.2</i>	<i>23.4</i>	<i>24.5</i>	<i>33.6</i>	<i>32.4</i>	<i>34.6</i>	<i>35.6</i>	<i>34.7</i>	<i>35.3</i>	<i>35.7</i>
Amortization	(86)	(115)	(153)	(240)	(317)	(368)	(408)	(435)	(454)	(469)
EBIT	120	113	119	224	179	213	219	212	252	289
<i>EBIT margin, %</i>	<i>15.3</i>	<i>11.6</i>	<i>10.7</i>	<i>16.2</i>	<i>11.7</i>	<i>12.7</i>	<i>12.5</i>	<i>11.4</i>	<i>12.6</i>	<i>13.6</i>
Interest expense	(29)	(39)	(50)	(67)	(93)	(99)	(97)	(78)	(69)	(35)
Other non-operating income and expense	7	5	6	6	0	0	0	1	6	6
Income before tax	98	79	76	163	86	114	123	135	188	261
<i>Income before tax margin, %</i>	<i>12.5</i>	<i>8.1</i>	<i>6.8</i>	<i>11.8</i>	<i>5.6</i>	<i>6.8</i>	<i>7.0</i>	<i>7.2</i>	<i>9.4</i>	<i>12.3</i>
Income tax	(33)	(27)	(41)	(59)	(29)	(36)	(35)	(36)	(45)	(63)
Minority interest	(0)	0	1	0	0	0	0	0	0	0
Net income	66	52	36	104	57	78	87	99	143	198
<i>Net income margin, %</i>	<i>8.4</i>	<i>5.4</i>	<i>3.2</i>	<i>7.5</i>	<i>3.7</i>	<i>4.7</i>	<i>5.0</i>	<i>5.3</i>	<i>7.2</i>	<i>9.3</i>

Source: company's data, Estimation: Veles Capital

Balance sheets of Sibirtelecom, mn USD

	2004	2005	2006	2007	2008 (Π)	2009 (Π)	2010 (Π)	2011 (Π)	2012 (Π)	2013 (Π)
ASSETS										
Non-current assets										
PPE and intangible assets	1,002	1,159	1,452	1,814	1,938	1,949	1,879	1,748	1,639	1,565
Other non-current assets	22	34	40	24	24	24	24	25	25	25
Total non-current assets	1,024	1,193	1,492	1,838	1,962	1,974	1,904	1,773	1,664	1,591
Current assets										
Inventories	20	19	21	22	24	26	28	29	31	33
Accounts receivable	63	65	79	88	97	107	112	119	127	135
Other current assets	71	76	66	73	81	89	93	99	106	113
Short-term investments	6	5	5	5	0	0	0	128	89	114
Cash and equivalents	16	19	18	56	35	33	28	76	82	87
Total current assets	176	184	189	244	238	255	261	451	435	482
Total assets	1,199	1,377	1,681	2,082	2,200	2,229	2,165	2,224	2,099	2,072
LIABILITIES										
Shareholder's equity										
Authorised capital	127	123	134	144	144	144	144	144	144	144
Retained earnings	436	456	473	603	655	726	804	894	1,023	1,202
Total shareholder's equity	563	579	608	748	799	870	949	1,038	1,167	1,346
Minority interest	0	2	0	0	0	0	0	0	0	0
Non-current liabilities										
Long-term borrowings	331	483	635	848	881	807	645	591	308	74
Other non-current liabilities	105	124	157	178	178	178	178	178	178	178
Total non-current liabilities	436	607	791	1,025	1,058	984	823	769	485	252
Current liabilities										
Accounts payable	99	130	231	266	295	323	339	359	385	409
Other current liabilities	42	34	16	21	23	25	26	27	29	31
Short-term borrowings	59	26	34	22	25	27	29	30	32	34
Total current liabilities	200	189	282	309	342	375	393	417	446	474
Total liabilities	1,199	1,377	1,681	2,082	2,200	2,229	2,165	2,224	2,099	2,072

Source: company's data, Estimation: Veles Capital

Statements of cash flow of Sibirtelecom mn USD

	2004	2005	2006	2007	2008 (F)	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)
Cash flows from operating activities										
EBT and shares	98	79	76	163	86	114	123	135	188	261
Amortization/Depreciation	86	115	153	240	317	368	408	435	454	469
Change in working capital	(31)	58	59	9	11	11	6	8	10	9
Interest paid	(40)	(49)	(67)	(73)	(93)	(99)	(97)	(78)	(69)	(35)
Income tax	(32)	(41)	(57)	(68)	(29)	(36)	(35)	(36)	(45)	(63)
Other	34	41	101	90	128	146	149	125	95	35
Net cash provided by operating activities	116	202	265	361	420	505	553	589	633	677
Cash flows from investing activities										
Purchase of non-operating assets	(252)	(318)	(357)	(440)	(476)	(427)	(389)	(351)	(375)	(399)
Other	10	8	13	20	5	0	0	(128)	43	(22)
Net cash provided by investing activities	(242)	(311)	(344)	(420)	(471)	(427)	(389)	(478)	(332)	(421)
Cash flows from financing activities										
Proceeds from borrowings	279	339	389	478	298	177	99	30	32	34
Repayments of borrowings	(151)	(219)	(303)	(371)	(263)	(249)	(258)	(83)	(314)	(266)
Other	(8)	(9)	(9)	(13)	(6)	(8)	(9)	(10)	(14)	(19)
Net cash provided by financial activities	120	112	77	93	30	(79)	(168)	(62)	(295)	(251)
Net change of cash	(6)	3	(2)	35	(21)	(2)	(5)	48	5	5
Cash at the beginning of period	21	16	19	18	56	35	33	28	76	82
Cash at the end of period	16	19	18	56	35	33	28	76	82	87

Source: company's data, Estimation: Veles Capital

Price estimation

Discount rate (WACC) of Sibirtelecom, %											
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Cost of equity (k_e)	11.62	12.07	12.71	12.52	13.60	13.85	13.88	13.53	12.95	12.70	11.85
Risk-free rate	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2
10 year US Treasures yield	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Russia risk	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Stock market risk	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Coefficient β	0.8	0.9	1.1	1.0	1.2	1.3	1.3	1.2	1.1	1.1	0.9
Corporate risk	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Share of equity, %	81.4	70.3	59.7	53.3	47.6	46.2	46.9	51.7	58.5	62.6	77.4
Cost of debt (k_d)	7.49	7.49	7.49	7.49	7.49	7.49	7.49	7.49	7.49	7.49	7.49
Risk-free rate	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2
Debt premium	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Tax rate	30.8	33.2	34.1	53.6	36.2	33.8	31.3	28.9	26.4	24.0	24.0
Share of debt, %	18.6	29.7	40.9	46.7	52.4	53.8	53.1	48.9	41.5	37.4	22.6
WACC	10.42	9.97	9.53	8.30	8.98	9.07	9.24	9.51	9.86	10.08	10.46

Estimation: Veles Capital

Cash flows of Sibirtelecom mn USD										
	2004	2005	2006	2007	2008 (F)	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)
Net income (corr.)	92	88	80	161	143	137	126	110	140	179
Depreciation and amortization	86	115	153	240	317	368	408	435	454	469
CapEx	(253)	(324)	(361)	(440)	(476)	(427)	(389)	(351)	(375)	(399)
Changes in working capital	(31)	58	59	9	11	11	6	8	10	9
Free cash flow	(106)	(64)	(69)	(30)	(6)	90	150	203	229	258
Discount rate, %					9.1	9.2	9.5	9.9	10.1	10.5
Discount coefficient					1.00	0.92	0.84	0.76	0.69	0.63
Discounted cash flow					(6)	82	126	154	158	162

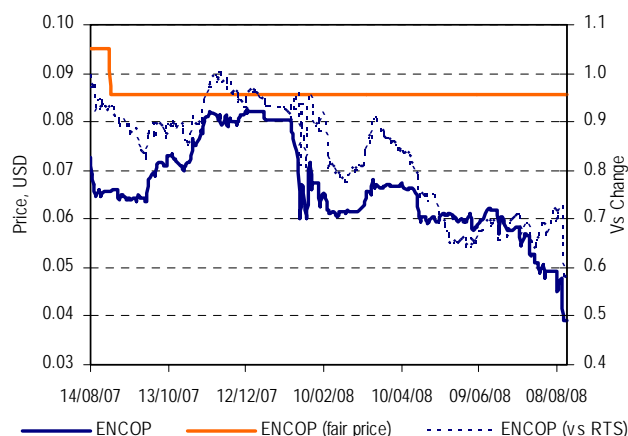
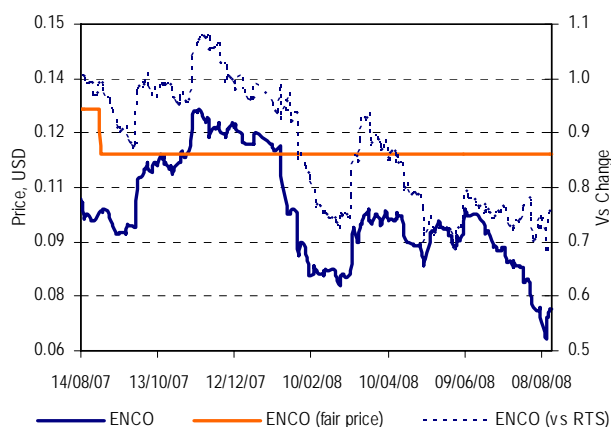
Source: company's data, Estimation: Veles Capital

Sibirtelecom stocks valuation

TGR, %	3.0
Sum of cash flows, mn USD	1,089
Terminal value, mn USD	3,441
Discounted terminal value, mn USD	1,348
Enterprise value, mn USD	2,436
Net debt, mn USD	1,089
Shareholder's equity (incl. minority interest), mn USD	1,347
Minority interest, mn USD	0
Shareholder's equity, mn USD	1,347
Number of shares, mn units	12,011
Fair value of common stock at the year end, USD	0.0902
Discount preferred stocks to common stock, %	25.0
Fair value of preferred stock at the year end, USD	0.0676
Upside (downside) of common stock, %	26.1
Upside (downside) of preferred stock, %	72.3

Source: company's data, Estimation: Veles Capital

Fair price history



Source: RTS; Estimation: Veles Capital

Sector recommendations

Our recommendations

Share	Tiker	Current price, USD	Target for year end, USD	Current growth potential, %	Recommendation	Date of recommendation revision	Investment idea
Traditional telephony							
Volgatelecom, cs	NNSI	3.3000	6.0110	82.2	BUY	3/14/2008	High effectiveness and low debt make company into an attractive subject for investing
Volgatelecom, ps	NNSIP	2.1000	4.5083	114.7	BUY	8/28/2007	
Dalsvyaz, cs	ESPK	3.2000	7.4457	132.7	BUY	8/28/2007	Prospects of improving the effectiveness of activity due to the new services
Dalsvyaz, ps	ESPKP	2.6500	5.5842	110.7	BUY	8/28/2007	
NWT, cs	SPTL	0.9600	1.3290	38.4	HOLD	6/18/2008	Company's management gets maximum out of regulated services, however CapEx limits the growth prospects
NWT, ps	SPTLP	0.7500	0.9967	32.9	ACCUMULATE	6/18/2008	
Sibirtelecom, cs	ENCO	0.0715	0.0902	26.1	BUY	8/18/2008	The drop of quotes earlier this year, allows to hope for a significant growth potential
Sibirtelecom, ps	ENCOP	0.0450	0.0676	50.3	BUY	8/18/2008	
Uralsvyazinform, cs	URSI	0.0412	0.0573	39.2	BUY	3/13/2008	High debt load limits growth potential
Uralsvyazinform, ps	URSI	0.0260	0.0430	65.4	ACCUMULATE	8/28/2007	
Centrtelecom, cs	ESMO	0.5000	0.9018	80.4	BUY	7/7/2008	The fall of quotes, in spite of aggressive investment program, makes company's shares attractive.
Centrtelecom, ps	ESMOP	0.3000	0.6763	125.4	BUY	7/7/2008	
STC, cs	KUBN	0.1210	0.2526	108.8	BUY	7/15/2008	Significant fall of quotes after year's start intends a growth potential up to fair price
STC, ps	KUBNP	0.0810	0.1895	134.0	BUY	7/15/2008	
Alternative telephony							
Comstar-UTS	CMST	8.6000	13.4790	56.7	BUY	4/24/2008	Growth potential due to development of regional markets
Long-distance communication							
Rostelecom, cs	RTKM	11.2000	4.4800	-60.0	SELL	7/21/2008	An extremely high market price, resulted from buyup of shares, yet unsupported by fundamental factors
Rostelecom, ps	RTKMP	1.6000	3.3600	110.0	BUY	7/21/2008	
Cellular communication							
Vimpelcom	VIMP	24.43	39.99	63.7	BUY	6/6/2008	Change of marketing policy intending growth of profitability, possible transformation into a universal operator (carrier)
MTS	MTSS	11.35	19.59	72.6	BUY	8/13/2008	Sound financial results, prospects of 3G technology use, fundamental underestimation of shares
Media							
CTC Media	CTCM	22.73	32.60	43.4	BUY	7/30/2008	Growth of ad market, prices and spread business, due to merger with other companies
RBC	RBCI	7.85	9.86	25.6	BUY	10/2/2007	Separation of IT business and improvement of primary business' effectiveness
Other							
Sitronics	SITR	0.1170	0.0854	-27.0	SELL	5/6/2008	Company demonstrates record losses and low effectiveness, determining its low fundamental value

Data: Bloomberg; Estimation: Veles Capital

Brief investor's guide

Methods, used for company's share evaluation				
Income approach		Comparables approach	Expenses approach	
	DCF method	EVA method	Multiplicative method	Net assets method
Concept of evaluating the unified object (EV) *	FCFF discounting	EVA discounting		
Shareholders' value direct calculation (SV) **	FCFE discounting	EVA for shareholders discounting (Edwards-Bell-Ohlson method)		

*

Debt cost is calculated separately and then subtracted from the sum total cost of business (target EV), formed considering the cash flows/ economic profits of firm.

**

Debt is accounted integrated -via annual coverage. So the fair cost of shareholders' value (target SV) is formed directly - considering the cash flow / economic profits for holders.

Note:

DCF methods differ from the methods of economic profit by the way of investments calculation. The methods of unified object evaluation concept differ from these methods of direct calculation of shareholders' value costs - by the way of accounting cost and maintenance of debt liabilities.

Cost calculation within the frames of income approach:

	Business cost calculation (EV) within the frames of united object cost evaluation	Shareholders' capital value calculation (SV)
DCF method (FCFF)	$EV = \sum_{i=1}^n \frac{FCFF_i}{(1+WACC_1)^i} + \frac{TV}{(1+WACC_1)^n} + NA$	$SV = EV - D$
DCF method (FCFE)		$SV = \sum_{i=1}^n \frac{FCFE_i}{(1+k_{s1})^i} + \frac{TV}{(1+k_{s1})^n} + \text{Cash} + NA$
EVA method	$EV = IC_1 + \sum_{i=1}^n \frac{EVA_i}{(1+WACC_1)^i} + \frac{TV}{(1+WACC_1)^n} + NA$	$SV = EV - D$
EBO method		$SV = BV_1 + \sum_{i=1}^n \frac{SVA_i}{(1+k_{s1})^i} + \frac{TV}{(1+k_{s1})^n} + \text{Cash} + NA$

Signs:

- EV - Enterprise Value
- SV - Shareholders Value
- TV - Terminal Value
- Cagr - development rates within the target period
- BV, E - Balance Value, Equity
- EBIT - operational profit from selling, profit before payments of credit interest and income tax
- EBITDA - operational profit before payment of credit interest, income tax and amortization
- EBT - Earnings Before Tax
- EAT - Earnings After Tax
- EPS - Earnings Per Share
- NOPAT - net operational profit, free from effects of debt financing
NOPAT = EBIT * (1- income tax effective rate)
- FCFF - Free Cash Flow to Firm
FCFF = gross cash flow - gross investments
Gross cash flow = NOPAT + amortization
- FCFE - Free Cash Flow to Equity
FCFE = gross shareholders' cash flow - gross investments
Gross shareholders' cash flow = EAT of operational profit (including interest payoffs) - annual debt coverage + attracted borrowed assets + amortization
- EVA - Economic Value Added
EVA = economic profit spread * IC = (ROIC - WACC) * IC
- SVA - Shareholders Value Added
SVA = spread * E = (ROE - k_s) * E
- WACC - Weighted Average Cost of Capital
- k_s - required shareholders' yield
- D - fair (market) cost of net debt
- Cash - cash assets, along with market securities on thee balance
- NA - non-operational assets
- IC - Invested Capital
- ROIC - Return on Invested Capital
ROIC = NOPAT / IC
- ROE - Return on Equity
- ROA - Return on Assets

Information disclosure

The statement of an analyst and confirmation of the responsibility withdrawal

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The principle of recommendation assignment

The 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.

At the present moment 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 15% or more.

ACCUMULATE – corresponds to the growth potential of the shares within the nearest 12 months for 5-15%.

HOLD – corresponds to the growth (reduction) potential of the shares within the nearest 12 months from -5% to 5%.

REDUCE – corresponds to the reduction potential of the shares within the nearest 12 months from 15% to 5%.

SELL – corresponds to the reduction potential of the shares within the nearest 12 months by 15% or more.

In some cases the deviations from the evaluation scale given above, based on which the recommendations are assigned, are possible. That fact relates to the high volatility of some securities in particular, and market in the whole, and also to the individual characteristics of one or another issuer.

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