Veles Capital

Investment company

Research
June 23, 2009

Telecommunications
Russia

Rostelecom

Good annual report

Recommendation: CS – BUY
PS – BUY

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Bullet moments

☎ Russia's largest long-distance communication operator – Rostelecom – summed up the results of the previous year by IAS. The sales of the company totaled 66.6 bn RUR, net profit – 12.2 bn RUR. The year 2008 might be called the most successful one for the company within the past 3 years after the liberalization of the long-distance communication market.

☎ Rostelecom showed significant upping of OIBDA margin – the value of the given estimate reached 21%. Partially that was defined by the regulating moments, such as cancellation of compensation adding. However, there was another negative moment of the regulating character – decrease of tariffs for the national communication. The cost of on minute lost 8% average.

☎ Nevertheless, the development of the non-regulated segments is another positive moment of the company. First of all we should outline gaining control over RTComm.ru, which allowed building up and diversifying the sales. Nevertheless, the diversification level remains relatively not high – almost 44% of income is gained by the company from the national communication, and about 70% comes from usual types of voice communication.

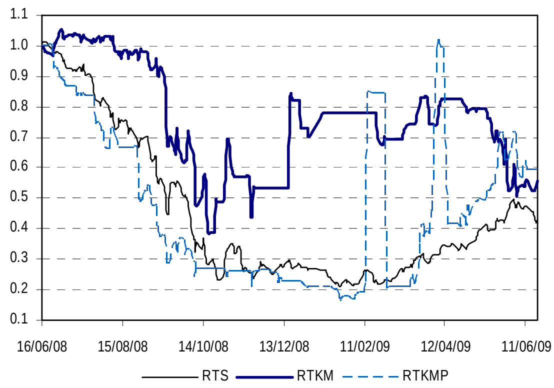
☎ Extremely low debt load of Rostelecom still is one of its incontestable bonuses. Cash assets minus the interest debts as of the end of the previous year formed 542 mn USD, and the cash flow from the operating activity is enough for financing the investment program.

☎ Despite the success of Rostelecom, the dynamics of its quotes does not depend on the fundamental factors. More to that, the situation is not to change soon – the coming reorganization of Svyazinvest might significantly raise the volatility of the company's share market.

☎ We revised our model of Rostelecom considering the new data and re-calculated the estimation of its shares' value. The new estimations form 3.44 USD per common share and 2.58 USD per preferred share (the former estimations were 3.63 USD and 2.72 USD respectively). Note that the given estimates do not account the possible change of company's structure. We confirm the former recommendations on the common and preferred shares of Rostelecom – SELL and BUY respectively.

Principal estimates

Company's shares vs. the RTS index



Information about Rostelecom	
Ticker RTS	RTKM / RTKMP
Market price (cs), USD	6.50
Market price (ps), USD	1.43
Min / max price during last year (cs), USD	4.50 / 12.30
Min / max price during last year (ps), USD	0.39 / 2.46
Fair price at year end (cs), USD	3.44
Fair price at year end (ps), USD	2.58
Upside (downside) (cs), %	*-47.1*
Upside (downside) (ps), %	*81.1*
Number of common shares, units	728,696,320
Number of preferred shares, units	242,831,469
MC, mn USD	5,083
EV, mn USD	4,579

Financial values (IAS)	2008	2009 (F)	2010 (F)
Sales, mn USD	2,679	2,112	1,929
OIBDA, mn USD	563	418	266
Net income, mn USD	490	149	62
OIBDA margin, %	*21.0*	*19.8*	*13.8*
Net income margin, %	*18.3*	*7.1*	*3.2*

Financial coefficients	2008	2009 (F)	2010 (F)
EV / S	1.71	2.17	2.37
EV / OIBDA	8.14	10.95	17.19
P / E	9.67	31.76	76.49
ROIC, %	*8.9*	*9.6*	*4.0*
ROE, %	*21.7*	*8.1*	*3.6*

Financial model

Income statements of Rostelecom, mn USD

	2005	2006	2007	2008	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)	2014 (F)	2015 (F)
Sales	1,448	2,269	2,528	2,679	2,112	1,929	1,889	2,011	2,196	2,364	2,536
Costs	(1,181)	(1,911)	(2,112)	(2,116)	(1,694)	(1,662)	(1,647)	(1,702)	(1,761)	(1,864)	(1,934)
OIBDA	266	358	417	563	418	266	241	309	435	500	602
OIBDA margin, %	*18.4*	*15.8*	*16.5*	*21.0*	*19.8*	*13.8*	*12.8*	*15.3*	*19.8*	*21.2*	*23.7*
Amortization	(252)	(310)	(298)	(288)	(223)	(196)	(180)	(170)	(166)	(163)	(159)
EBIT	14	48	119	274	195	71	62	138	268	337	442
EBIT margin, %	*1.0*	*2.1*	*4.7*	*10.2*	*9.2*	*3.7*	*3.3*	*6.9*	*12.2*	*14.3*	*17.4*
Interest expenses	0	0	0	0	0	0	0	0	0	0	0
Non-operating income (losses)	45	42	38	372	(8)	7	5	6	8	12	18
EBT	59	90	157	646	187	78	67	145	276	350	460
EBT margin, %	*4.1*	*4.0*	*6.2*	*24.1*	*8.9*	*4.0*	*3.5*	*7.2*	*12.6*	*14.8*	*18.2*
Income tax	(25)	(36)	(47)	(156)	(38)	(16)	(13)	(29)	(55)	(70)	(92)
Minority interest	0	0	(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)
Loss from discontinued operations	0	0	0	0	0	0	0	0	0	0	0
Net income	35	54	110	490	149	62	53	115	220	279	368
Net income margin, %	*2.4*	*2.4*	*4.3*	*18.3*	*7.1*	*3.2*	*2.8*	*5.7*	*10.0*	*11.8*	*14.5*

Source: company's data, Estimation: Veles Capital

Balance sheets of Rostelecom, mn USD

	2005	2006	2007	2008	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)	2014 (F)	2015 (F)
ASSETS											
Non-current assets											
PPE and intangible assets	1,412	1,594	1,680	1,479	1,267	1,189	1,103	1,094	1,090	1,071	1,058
Other non-current assets	128	233	504	18	16	16	15	16	16	16	17
Total non-current assets	1,540	1,827	2,184	1,497	1,283	1,205	1,118	1,110	1,105	1,087	1,075
Current assets											
Inventories	221	362	393	407	350	339	330	363	397	428	460
Short-term investments	425	323	282	298	177	198	209	268	410	603	864
Cash and equivalents	83	89	134	408	350	338	328	360	393	423	454
Total current assets	730	774	809	1,114	877	875	868	991	1,200	1,455	1,778
Total assets	2,270	2,602	2,993	2,611	2,159	2,080	1,986	2,100	2,305	2,542	2,853
LIABILITIES											
Shareholder's equity											
Authorised capital	3	4	4	3	3	3	3	2	2	2	2
Retained earnings	1,723	1,930	2,283	2,018	1,770	1,707	1,626	1,712	1,887	2,094	2,372
Total shareholder's equity	1,727	1,934	2,287	2,021	1,773	1,709	1,628	1,715	1,890	2,096	2,375
Minority interest	0	1	1	1	1	1	1	1	2	2	2
Non-current liabilities											
Long-term borrowings	215	214	201	164	17	12	10	9	8	6	5
Other non-current liabilities	158	157	179	62	52	50	46	46	45	45	44
Total non-current liabilities	373	370	380	227	69	61	56	55	53	51	49
Current liabilities											
Accounts payable	170	296	325	362	316	308	300	329	361	393	427
Total current liabilities	170	296	325	362	316	308	300	329	361	393	427
Total liabilities	2,270	2,602	2,993	2,611	2,159	2,080	1,986	2,100	2,305	2,542	2,853

Source: company's data, Estimation: Veles Capital

Statements of cash flow of Rostelecom, mn USD

	2005	2006	2007	2008	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)	2014 (F)	2015 (F)
Cash flows from operating activities											
Income before tax	59	90	157	646	187	78	67	145	276	350	460
Amortization	252	310	298	288	223	196	180	170	166	163	159
Other	174	(5)	12	(362)	27	6	4	(1)	(5)	(11)	(17)
Changes in working capital	(12)	(59)	(19)	31	(1)	(1)	(2)	(4)	(4)	(4)	(4)
Interest expenses	20	13	31	39	3	6	5	6	7	12	18
Income tax	(107)	(76)	(96)	(191)	(38)	(16)	(13)	(29)	(55)	(70)	(92)
Net cash provided by operating activities	387	274	383	453	402	269	240	287	385	439	524
Cash flows from investing activities											
CapEx	(275)	(265)	(280)	(307)	(270)	(198)	(186)	(179)	(177)	(158)	(159)
Gains from sales associates and subsidiaries	5	(55)	(1)	399	0	0	0	0	0	0	0
Other	(86)	155	37	(52)	80	(30)	(27)	(60)	(146)	(198)	(268)
Net cash provided by investing activities	(356)	(164)	(244)	40	(191)	(228)	(212)	(239)	(323)	(356)	(427)
Cash flows from financing activities											
Proceeds from borrowings	0	0	0	0	0	0	0	0	0	0	0
Repayments of borrowings	(41)	(76)	(55)	(72)	(144)	(4)	(1)	(1)	(1)	(1)	(1)
Other	51	(35)	(48)	(67)	(60)	(29)	(13)	(11)	(25)	(48)	(61)
Net cash provided by financial activities	10	(111)	(102)	(139)	(203)	(34)	(14)	(12)	(26)	(49)	(62)
Other items	0	(0)	(0)	(4)	0	0	0	0	0	0	0
Currency rates corrections	(2)	8	8	(76)	(66)	(18)	(24)	(3)	(4)	(4)	(4)
Net change of cash	38	6	44	274	(59)	(12)	(10)	32	33	30	31
Cash at the beginning of period	45	83	89	134	408	350	338	328	360	393	423
Cash at the end of period	83	89	134	408	350	338	328	360	393	423	454

Source: company's data, Estimation: Veles Capital

Price estimation

Discount rate (WACC) of Rostelecom, %

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Cost of equity (k_s)	13.24	13.42	13.44	13.39	13.38	13.14	13.13	13.13	13.13	13.12	13.12
Risk-free rate	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4
Stock market risk	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Coefficient β	0.7	0.8	0.8	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Corporate risk	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Share of equity, %	*95.2*	*88.9*	*90.1*	*91.9*	*92.5*	*99.1*	*99.3*	*99.4*	*99.5*	*99.6*	*99.7*
Cost of debt (k_d)	17.41	17.41	17.41	17.41	17.41	17.41	17.41	17.41	17.41	17.41	17.41
Risk-free rate	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4
Debt premium	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Tax rate	41.5	40.4	29.9	24.2	20.2	20.1	20.1	20.0	20.0	20.0	20.0
Share of debt, %	*4.8*	*11.1*	*9.9*	*8.1*	*7.5*	*0.9*	*0.7*	*0.6*	*0.5*	*0.4*	*0.3*
WACC	13.09	13.08	13.31	13.37	13.42	13.15	13.14	13.14	13.13	13.13	13.12

Estimation: Veles Capital

Cash flows of Rostelecom, mn USD

	2005	2006	2007	2008	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)	2014 (F)	2015 (F)
Net income (corr.)	108	32	73	196	153	55	47	102	193	244	322
Depreciation and amortization	252	310	298	288	223	196	180	170	166	163	159
CapEx	(270)	(319)	(281)	(307)	(270)	(198)	(186)	(179)	(177)	(158)	(159)
Changes in working capital	(12)	(59)	(19)	31	(1)	(1)	(2)	(4)	(4)	(4)	(4)
Free cash flow	78	(35)	71	209	105	52	40	89	179	246	318
Discount rate, %					*13.4*	*13.1*	*13.1*	*13.1*	*13.1*	*13.1*	*13.1*
Dicount coefficient					1.00	0.88	0.78	0.69	0.61	0.54	0.48
Discounted cash flow					105	46	31	62	109	133	152

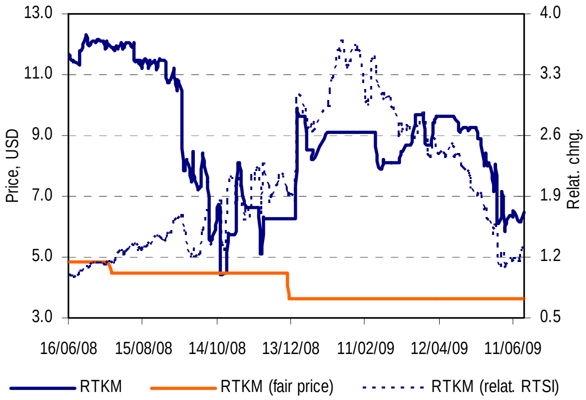
Source: company's data, Estimation: Veles Capital

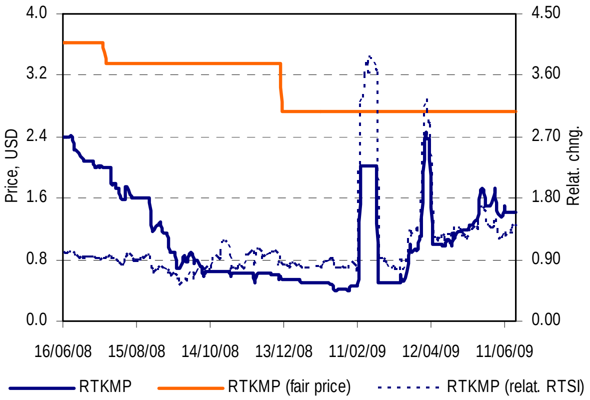
Rostelecom's stocks valuation

TGR, %	*3.0*
Sum of cash flows, mn USD	792
Termimal value, mn USD	3,738
Discounted terminal value, mn USD	1,393
Enterprise value, mn USD	2,185
Net debt, mn USD	-949
Shareholer's equity (incl. minority interest), mn USD	3,134
Minority interest, mn USD	0
Shareholer's equity, mn USD	3,134
Number of common shares, mn units	729
Number of preferred shares, mn units	243
Fair value of common stock at the year end, USD	3.44
Discount preferred stocks to common stock, %	*25.0*
Fair value of preferred stock at the year end, USD	2.58
Upside (downside) of common stock, %	*(47.1)*
Upside (downside) of preferred stock, %	*81.1*

Source: company's data, Estimation: Veles Capital

Rostelecom' fair price history





Source: RTS, Estimates: Veles Capital

Sector coverage

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	1.2500	2.5993	*107.9*	BUY	4/20/2009	
Volgatelecom, ps	NNSIP	0.9200	1.9495	*111.9*	BUY	4/20/2009	
Dalsvyaz, cs	ESPK	1.5400	3.4860	*126.4*	BUY	6/18/2009	
Dalsvyaz, ps	ESPKP	1.0000	2.6145	*161.4*	BUY	6/18/2009	
NWT, cs	SPTL	0.2920	0.3008	*3.0*	BUY	4/20/2009	
NWT, ps	SPTLP	0.3350	0.2256	*-32.7*	HOLD	4/20/2009	Rapidly fall quotes last year intends considerable potencial of growth despite of negative moments
Sibirtelecom, cs	ENCO	0.0235	0.0392	*66.8*	BUY	4/20/2009	
Sibirtelecom, ps	ENCOP	0.0223	0.0294	*32.2*	BUY	4/20/2009	
Uralsvyazinform, cs	URSI	0.0146	0.0295	*102.3*	BUY	4/20/2009	
Uralsvyazinform, ps	URSIP	0.0088	0.0221	*151.7*	BUY	4/20/2009	
Centrtelecom, cs	ESMO	0.2300	0.3083	*34.0*	BUY	4/20/2009	
Centrtelecom, ps	ESMOP	0.1500	0.2312	*54.2*	BUY	4/20/2009	
STC, cs	KUBN	0.0335	0.0191	*-43.0*	REDUCE	4/20/2009	High debt level carries highly risks of investments in this shares
STC, ps	KUBNP	0.0220	0.0143	*-34.9*	SELL	4/20/2009	
Alternative telephony							
Comstar-UTS	CMST	4.1000	5.6700	*38.3*	BUY	5/27/2009	Company has all chances to live out crisis with minimum losses
Long-distance communication							
Rostelecom, cs	RTKM	6.3000	3.4406	*-45.4*	SELL	6/22/2009	An extremely high market price, resulted from buyup of shares, yet unsupported by fundamental factors
Rostelecom, ps	RTKMP	1.5000	2.5805	*72.0*	BUY	6/22/2009	
Cellular communication							
Vimpelcom	VIMP	11.30	10.59	*-6.3*	SELL	5/29/2009	High debts cuts up development
MTS	MTSS	5.53	10.29	*86.1*	BUY	5/25/2009	Fundamental underestimation of shares
Media							
CTC Media	CTCM	10.59	11.06	*4.4*	BUY	5/8/2009	Rapidly fall quotes last year intends considerable potencial of growth

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 thee 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 calcculation (**SV**)*
DCF method (FCFF)	$EV=\sum_{i=1}^{n}\frac{FCFF_i}{(1+WACC_i)^i}+\frac{TV}{(1+WACC_i)^n}+NA$	$SV = EV - D$
DCF method (FCFE)		$SV=\sum_{i=1}^{n}\frac{FCFE_i}{(1+k_{si})^i}+\frac{TV}{(1+k_{si})^n}+Cash+NA$
EVA method	$EV=IC_1+\sum_{i=1}^{n}\frac{EVA_i}{(1+WACC_i)^i}+\frac{TV}{(1+WACC_i)^n}+NA$	$SV = EV - D$
EBO method		$SV=BV_1+\sum_{i=1}^{n}\frac{SVA_i}{(1+k_{si})^i}+\frac{TV}{(1+k_{si})^n}+Cash+NA$

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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