

GREAT GROWTH OUTLOOK, BUT LITTLE VALUE LEFT

Russia's constellation of seven regional telecoms turned in a stellar performance in 2003, rising an average 54% for the year, with the two brightest stars, Volga Telecom and Uralsvyazinform, up 115% and 103% respectively, nearly doubling the RTS's own impressive 58% gain. The question then is: are the companies' current prices justified by their fundamentals? This note re-examines regional telcos fundamentals to answer just that.

We updated our underlying assumptions to incorporate the latest available data. In particular, we revised up our ILD traffic/ALIS growth and mobile subscriber growth assumptions based on 9M03 statistics. We have also raised our capital expenditure projections based on regional telcos' average 50% higher than previously announced capex and their ambitious 2004 investment programs. We incorporated these changes into our models to generate new IAS-based estimates; yet, our model update did little to our target prices, which continue to suggest the sector is fully valued.

Our fundamental view on the sector has not changed much. We thus conclude that after the 2003 rally, the appreciation potential of regional telecoms' stock prices is almost exhausted. And despite exciting top line growth and attractive forward valuation multiples, regional telcos look poor in FCF terms, as the aforementioned capex increases eat up an increasing percentage of sales.

Svyazinvest sale the key potential catalyst in 2004. The heightened news flow late last year on Svyazinvest's privatization suggests the sale could finally happen in 2004. The biggest positive impact from a move to private ownership would be companies' receiving far greater freedom on capex allocations, allowing those with the biggest exposure to non-regulated services to benefit most. We see Sibir Telecom, Volga Telecom and Uralsvyazinform as the best exposure to the privatization play. In addition, we note that the resulting liquidity enhancements would also be a factor for an upgrade of our target prices.

Sibir Telecom downgraded to Hold; only Sibir and Volga pref shares appear attractive. Following this update, we downgrade our recommendation on our last top pick in the sector, Sibir Telecom, from Buy to Hold. We only see select preferred shares as attractive at current levels, with Volga Telecom and Sibir Telecom our top picks, with 23% and 8% upside respectively. Both have mobile exposure and are the least leveraged companies in the sector. Moreover, Volga boasts the highest profitability of the seven regional telcos and is expected to be first to break even at the FCF level.

	Common				Preferred				Mcap, \$ mln	Dividend yield	
	Current price, \$	Target price, \$	Upside	Rating	Current price, \$	Target price, \$	Upside	Rating		Common	Preferred
North-West Telecom	0.49	0.37	-24%	Sell	0.34	0.28	-18%	Sell	429	1.30%	5.70%
CenterTelecom	0.40	0.31	-23%	Sell	0.30	0.23	-23%	Sell	789	0.80%	3.20%
Volga Telecom	3.20	3.17	-1%	Hold	1.93	2.38	23%	Buy	945	0.60%	3.20%
South Telecom	0.110	0.084	-24%	Sell	0.088	0.060	-28%	Sell	411	1.40%	5.10%
Uralsvyazinform	0.043	0.038	-13%	Hold	0.027	0.029	7%	Hold	1,598	0.30%	1.10%
Sibir Telecom	0.046	0.046	0%	Hold	0.032	0.030	8%	Buy	678	0.90%	3.90%
Dalsvyaz	1.30	1.32	2%	Hold	0.90	0.99	10%	Buy	152	0.90%	3.90%

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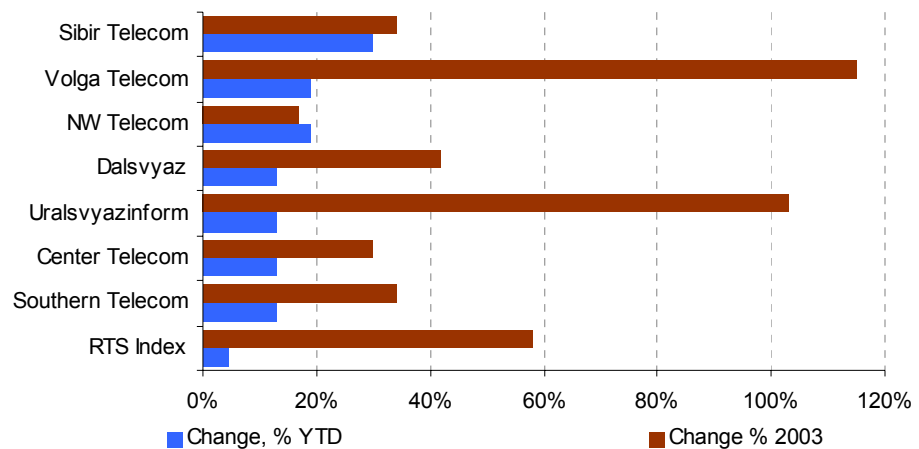
MODEL UPDATE DOES LITTLE TO CHANGE TARGET PRICES, OUR VIEWS

After a dramatic restructuring-inspired rally in 2003, regional telecoms intuitively appear close to full value at present. To check this thesis, we have updated our valuation models by incorporating the most recent results from the telcos themselves and the latest industry statistics in order to develop new IAS-based estimates and re-evaluate target prices. Our analysis, however, confirmed our view that most sector shares (with the exception of several preferred names) are fully valued or even overvalued at current levels.

Telco stocks reach for the stars in 2003 - early 2004; prompt us to revisit the fundamentals

Russia's seven regional telecoms turned in a stellar performance in 2003, rising an average 54% for the year, with the two brightest stars (and our 2003 top picks), Volga Telecom and Uralsvyazinform, soaring 115% and 103% respectively, nearly doubling the RTS's own 58% increase. Meanwhile, in the first two weeks of 2004, telcos have surged 10%-31% against a modest 5% for the index. The question then is: are the companies' current prices justified by their fundamentals? We have updated our models and looked again at the sector to answer this question.

Regional telecoms' price performance in 2003 and this year, %

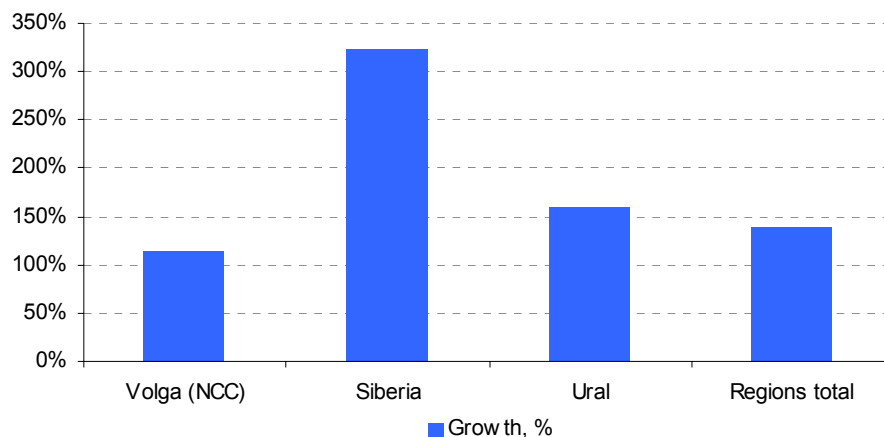


Source: RTS

We updated our estimates for LD traffic/ALIS, mobile subscribers and capex in line with 9M03 data (the latest available) and companies most recent capex guidance, with the key adjustments being the following:

- While DLD traffic/ALIS generally grew in line with our expectations in 9M03, with the exception of Far East Telecom (better than expected) and Center Telecom (worse). In contrast, ILD traffic/ALIS in Russia grew more rapidly in 2003 than forecast: 8% y-o-y vs. 4%, leading us to raise our 2004-2010 assumptions.
- We also revised up our mobile subscriber forecast following stronger than expected 2003 uptake in Russia mobile subscribers and lower than expected loss of market share by Svyazinvest regional operators with cellular exposure. This translated into an upgrade of Uralsvyazinform's financials (though part of its cellular business is consolidated to RAS) and a higher value for Sibir Telecom's and Volga Telecom's cellular businesses.

Regional telecoms subscriber base growth in 2003



Sources: ACM, Aton estimates

We increased Svyazinvest regional operators' capex assumptions through 2004-2007

following significantly higher capex in 2003, which turned out to be 50% greater – for a total \$1.2bn – than expected. The result suggests the government, through the agency of Svyazinvest, is using regional companies' improving operating performance to increase investment (including on socially important projects).

Regional telecoms capex/sales ratio

	2002	2003F	2004F
North-West Telecom	22%	24%	20%
Center Telecom	22%	33%	27%
Volga Telecom	32%	26%	22%
Southern Telecom	22%	64%	42%
Uralsvyazinform	24%	33%	26%
Sibir Telecom	17%	32%	35%
Dalsvyaz	9%	27%	27%
Telecoms average/total	22%	34%	29%

Source: Company data; Aton estimates

Change in settlement rules with Rostelecom affects margin but not EBITDA. From Aug. 1, 2003, a new settlement system with Rostelecom for DLD traffic was introduced. The system has new provisions for reflecting termination revenues from incoming traffic and payment for outgoing traffic termination, where previously only the net balance was reflected. In addition, the new system moves to real-time monitoring of the traffic balance instead of simply using the previous year's. As a result of the new system, regional telcos' top line increase by the amount of revenue from the termination of incoming traffic – estimated at 7% on an annual basis – while costs grow by the amount of payments for traffic termination at other regional telcos. However, unless the traffic balance changes significantly compared to the previous year, EBITDA will remain almost unaffected, though the EBITDA margin will be squeezed.

Finally, we have switched our models to IAS based, in accordance with regional telecoms' move to international standards in reporting their financials. Apart from the fact that IAS accounts better reflect a company's financial position, they also allow us to more accurately value those telcos with significant exposure to cellular revenues through subsidiaries – Uralsvyazinform, VolgaTelecom and SibirTelecom – which were previously valued on a multiples basis (subsidiaries are not consolidated under RAS). For the remaining companies the switch to IAS did not lead to any substantial changes in P&L, as cash flows were essentially the same. The reason for this is that the main difference between IAS and RAS lies in depreciation, which does not affect cash flows, and in turn, companies' DCF values.

Regional telecoms' forecast financials, IAS, \$ mn

	Revenues				EBITDA				Net income				Operating cash flow			
	2002	2003F	2004F	2005F	2002	2003F	2004F	2005F	2002	2003F	2004F	2005F	2002	2003F	2004F	2005F
North-West Telecom	326	412	529	624	88	107	137	163	15	28	40	51	73	82	101	120
Center Telecom	529	694	911	1 079	151	190	243	286	2	28	42	50	104	141	171	198
Volga Telecom	399	553	744	892	127	188	253	301	26	67	91	103	119	123	157	183
Southern Telecom	359	498	660	812	104	150	192	248	27	34	20	25	62	119	131	158
Uralsvyazinform	535	737	1 028	1 254	160	234	356	444	33	70	125	160	91	129	188	247
Sibir Telecom	423	562	757	914	115	157	223	273	20	74	82	96	78	120	136	163
Dalsvyaz	171	232	305	381	32	49	69	96	1	17	24	37	22	40	52	68
Total	2 743	3 688	4 935	5 956	777	1 075	1 474	1 810	124	318	423	522	550	755	937	1 136

Source: Company data; Aton estimates

We have also raised WACC to reflect a rise in the base cost of equity for Russian stocks from 12.3% to 12.4%, as a falling risk-free rate is more than offset by the Russian equity market's increased volatility following the Yukos case (please see our Jan. 16, 2004, strategy report *Much ado about little* for more details).

New and old cost of equity assumptions

Assumptions	Previous	New	Comment
Long-term risk free rate, %	6	5.7	Based on 5-yr. trailing average yield of LT US govt. bond futures
Russian country risk premium, %	1.5	1.7	Spread of LT Russian Eurobonds over US govt. bonds
Russian risk-free rate, %	7.5	7.4	
Standard equity premium, %	4.00	4.00	Historic difference between stocks and bonds
Excess RTS volatility factor	1.2	1.25	Increased forecast excess volatility due to recent upsurge
Russian equity market premium, %	4.8	5.00	
Base cost of equity*, %	12.3	12.4	Barely changed

Source: Company data; Aton estimates

Valuation: Little value left despite model changes

The changes we incorporated did not, on balance, dramatically increase the attraction of Syazinvest regional operators and we reiterate our view that telcos' valuations are demanding at present.

DCF-based valuation summary for regional operators

	North-West	Center	Volga	South	Ural	Siberia	Far East
DCF Assumptions							
Russian risk-free rate	7.40%	7.40%	7.40%	7.40%	7.40%	7.40%	7.40%
Russian equity market premium	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
Forecast beta	2.0	1.5	1.5	1.5	1.3	1.5	2.0
Levered forecast beta	2.6	2.1	1.8	2.2	1.6	2.0	2.8
Cost of equity	20.6%	17.7%	16.2%	18.5%	15.5%	17.3%	21.2%
Cost of debt	9.1%	11.4%	11.4%	12.9%	9.9%	12.9%	10.6%
Equity as % of capitalization	24%	27%	14%	33%	23%	24%	27%
WACC	17.82%	16.00%	15.48%	16.70%	14.22%	16.24%	18.29%
Terminal growth	5%	5%	5%	5%	5%	5%	5%
Total NPV of future FCF, \$mn	442	856	1083	471	1801	817	197
Net Debt, end 03F, \$mn	-115	-242	-108	-161	-344	-135	-51
Total equity value, \$mn	326	613	975	310	1457	682	146
Fair value per com share, \$	0.37	0.31	3.17	0.08	0.04	0.05	1.32
Fair value per pref share, \$	0.28	0.23	2.38	0.06	0.03	0.03	0.99
Current price, common, \$	0.49	0.40	3.20	0.11	0.04	0.05	1.30
Current price, common, \$	0.34	0.30	1.93	0.09	0.03	0.03	0.90
Upside, common	-25%	-22%	-1%	-24%	-11%	-1%	1%
Upside, preferred	-19%	-22%	23%	-28%	7%	8%	10%

Source: Aton estimates

And while for many companies IAS-based financial multiples still look attractive, we must note that the companies' strong top line outlook, a 19% CAGR through 2004-07, does not translate into similar growth at the free cash flow level, due to their very aggressive capex plans. The government, via Svyazinvest, appears to be pushing companies to hike capex ratios in 2004. At the same time, the margin improvement that failed to eventuate in 2003 (going on RAS) seems to represent an even greater challenge in 2004.

Profitability failed to improve in 2003

	9M03	9M02	Y-o-Y change, p.p.
NW Telecom	28%	28%	0.0%
Center Telecom	27%	26%	0.9%
Volga Telecom	29%	30%	-0.9%
Southern Telecom	25%	25%	0.0%
Uralsvyazinform	27%	27%	0.6%
Sibir Telecom	23%	24%	-0.9%
Dalsvyaz	17%	18%	-1.0%

Source: Company data; Aton estimates

Comparative valuation of regional telecoms and EM peers (as of January, 17 close)

	EV/S		EV / EBITDA		P/E	
	2003F	2004F	2003F	2004F	2003F	2004F
North-West Telecom	1.4	1.1	5.3	4.1	13.1	9.0
Center Telecom	1.5	1.1	5.3	4.2	22.4	15.2
Volga Telecom	1.9	1.4	5.4	4.0	11.8	8.7
Southern Telecom	1.1	0.8	3.7	2.9	9.4	16.3
Uralsvyazinform	2.6	1.9	8.3	5.4	19.9	11.1
Sibir Telecom	1.4	1.1	5.2	3.6	7.5	6.7
Dalsvyaz	0.9	0.7	4.1	2.9	7.3	5.1
Average	1.5	1.1	5.3	3.9	13.0	10.3
Emerging markets — fixed line						
Bezeq Israeli Telecom	2.1	2.1	5.2	5.3	54.0	33.0
Cesky Telecom	2.4	2.2	5.0	4.6	29.0	21.4
Hellenic Telecom	2.9	2.8	7.0	6.7	15.4	14.8
Matav	2.5	2.2	6.1	5.6	14.4	11.9
Telecom Malaysia	3.7	3.3	8.2	7.3	24.9	21.2
Telekomunikacja Polska	2.2	2.1	5.3	5.3	18.0	16.7
Total/Weighted average	2.7	2.5	6.3	6.0	20.1	17.5

Source: Company data; Aton estimates

The seven telcos' potential for costs reduction, and hence profitability improvement, lies in personnel cuts, the scope for which is limited by agreements with trade unions. Other major cost items such as maintenance costs and payments to Rostelecom, which are beyond companies' control, are building rapidly due to inflation and the steady re-balancing of revenue sharing with Rostelecom in the latter's favor.

Regional telecoms outlook: 2004-2007

Driver	Outlook	04-07F Risks CAGR	
Revenue			
Local tariffs	Positive	14%	Slowdown in tariff hikes in 2004 due to presidential election
ALIS growth	Mildly positive	4%	Falling demand due to mobile cannibalization
DLD traffic/ ALIS	Positive	11%	Mobile and VoIP competition
ILD traffic/ALIS	Positive	4%	VoIP competition
Mobile	Positive	8%	Competition from the Big 3
VAS	Positive	42%	Competition from CLECs, uptake rates unclear
Costs			
Staff cuts	Neutral	-3%	Restriction on personnel cuts due to social considerations
Maintenance costs	Neutral	13%	Potentially up on higher than expected PPI
Payments to Rostelecom	Negative	19%	Revenue sharing with Rostelecom shifting in the latter's favor
Capex			
	Negative	7%	Regional telecoms might be forced to invest more in non-economically viable projects

Breakeven at the FCF level is expected in 2005 at the earliest (bar Volga Telecom)

Source: Company data; Aton estimates

Conclusion and recommendation

Following this update, we downgrade our recommendation on our last top pick in the sector, Sibir Telecom, from Buy to Hold. Only select preferred shares look attractive at current levels, with Volga Telecom and Sibir Telecom being our top picks, with 23% and 8% upside respectively. Both companies have mobile exposure and they are the two least leveraged in the sector. Volga Telecom also boasts the highest profitability of the seven regional telcos and is expected to be the first to break even at the FCF level, and hence has the biggest potential for upgrade.

2003F dividend yields: additional benefit for preferred holders

	Dividend 2003F, \$		Dividend Yield 2003F	
	Common	Preferred	Common	Preferred
North-West Telecom	0.006	0.019	1.3%	5.7%
Center Telecom	0.003	0.010	0.8%	3.2%
Volga Telecom	0.021	0.062	0.6%	3.2%
Southern Telecom	0.001	0.0045	1.4%	5.1%
Uralsvyazinform	0.000	0.0003	0.3%	1.1%
Sibir Telecom	0.0004	0.0013	0.9%	3.9%
Dalsvyaz	0.012	0.035	0.9%	3.9%
Average			0.90%	3.70%

Source: Company data; Aton estimates

Svyazinvest sale the key potential catalyst for the sector in 2004. The intensification of the news flow in relation to Svyazinvest's privatization suggests it could well happen this year, though a private owner's potential to dramatically increase the value of regional telcos should not be overestimated. Svyazinvest's buyer will likely be bound by social obligations for several years to come, while the schedule for local tariff hikes is unlikely to change much, either, as the potential social disruption of radical hikes is too great. The biggest positive impact of the sale, in our view, would be that companies would acquire greater freedom in capex allocation, meaning those with the biggest exposure to non-regulated services would likely benefit. As a result, we see Sibir Telecom, Volga Telecom and Uralsvyazinform as the best instruments for the privatization play.

Likely improvements in liquidity also a potential factor for an upgrade of our target prices. The beta for our WACC calculation is set according to stocks' average trading volume over the past three months.

Forecast beta calculation

Avg. monthly trading volume* (com. + pref.), \$mn	Forecast beta
> 100	1
10-100	1.25
1-10	1.5
0.1-1	2
< 0.1	3

*Based on trailing three month total dollar volume on RTS, MICEX and ADR markets

Source: Company data; Aton estimates

Therefore, an increase in liquidity over time will lead to a lower WACC and higher target prices. One of the factors limiting the liquidity of most regional telcos is their lack of a full MICEX listing (with the exception of Uralsvyazinform), which would improve accessibility for domestic investors (although Sibir Telecom, Center Telecom, North-West Telecom and Southern Telecom are traded on the MICEX OTC). The table below summarizes the companies' target price sensitivity to a beta change by one category, and shows Dalsvyaz's and North-West Telecom's values would benefit most from better liquidity.

Sensitivity of regional telcos' fair values to beta changes

	Applied Beta	Fair value, \$	Fair value at Beta changed by 1 category, \$	Potential fair value upgrade
North-West Telecom	2,0	0,37	0,51	38%
Center Telecom	1,5	0,31	0,38	23%
Volga Telecom	1,5	3,17	3,7	17%
Southern Telecom	1,5	0,084	0,11	31%
Uralsvyazinform	1,25	0,038	0,047	24%
Sibir Telecom	1,5	0,046	0,055	20%
Dalsvyaz	2,0	1,32	2,02	53%

Source: Aton estimates

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