

Research  
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Telecommunications  
Russia

# MTS

3Q results.

**Recommendation: BUY**

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## Bullet moments

Thursday MTS summed up the results of company's operation in 3Q 2010 and 9 months of 2010 by US GAAP. Sales of the company within a quarter formed 2.9 bn USD, OIBDA – 1.3 bn USD, net profit – 475 mn USD.

Financial estimates of the company do not show significant changes any more – the saturated Russian telecommunication market does not provide for rapid climbing of income and profit. So, the participants' activities are a lot calmer and do not involve aggressive price policy and marketing. Note that in CIS states MTS' behavior becomes more deliberate.

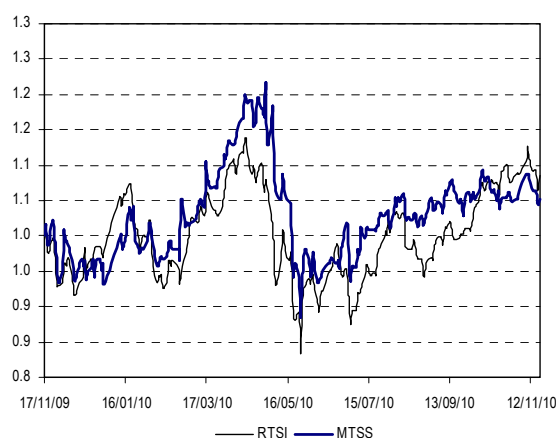
We consider continuing consolidation of telecommunication asses of AFK Sistema based on MTS being the investment idea in the shares of MTS. In particular, next year MTS might completely consolidate Comstar (in case minority of the company agrees on terms of MTS relating shares conversion).

We have revised our financial model of the company considering the intermediate results of MTS operation within 9 months of 2010. Besides, we superseded the estimation period of evaluation to late 2011.

Considering the changes we raise our fair estimation of MTS' shares cost from 9.88 USD to 13.49 USD. Considering the significant growth potential of the quotes growth, we confirm our recommendation BUY for the shares of the company.

## Principal estimates

Company's shares vs. the RTS index



### Information about MTS

MTSS / NYSE	MTSS / MBT
Market price, USD	8.20
Min / max price during last year, USD	6.90 / 9.50
Fair price at year end, USD	13.49
Fair price at year end (ADR), USD	26.98
Upside (downside), %	64.5
Total shares, units <sup>1</sup>	1,916,869,262
MC, mn USD	15,718
EV, mn USD	19,707

<sup>1</sup> Excluding treasury shares

Financial values (US GAAP)	2009 (E)	2010 (F)	2011 (F)
Sales, mn USD	8,667	11,267	12,266
EBITDA, mn USD	3,917	5,065	5,665
Net income, mn USD	691	1,740	2,140
EBITDA margin, %	45.2	45.0	46.2
Net income margin, %	8.0	15.4	17.5

Financial coefficients	2009 (E)	2010 (F)	2011 (F)
EV / S	2.27	1.75	1.61
EV / EBITDA	5.03	3.89	3.48
P / E	22.75	9.03	7.34
ROIC, %	14.1	22.0	27.9
ROE, %	17.6	34.9	33.9

## Financial and operating results

### MTS's operational results (wireless)

	1H2009	Chng., %	1H2010	3Q2009	Chng., %	4Q2009	Chng., %	1Q2010	Chng., %	2Q2010	Chng., %	3Q2010
<b>Subscriber base, th</b>	96,850	3.8	100,560	96,850	1.0	97,800	0.0	97,820	1.0	98,830	1.8	100,560
Russia	68,700	1.4	69,670	68,700	0.9	69,340	-0.4	69,080	0.5	69,420	0.4	69,670
Ukraine	17,780	2.1	18,150	17,780	-1.2	17,560	-1.2	17,350	1.0	17,520	3.6	18,150
Uzbekistan	6,790	20.2	8,160	6,790	4.1	7,070	4.4	7,380	2.8	7,590	7.5	8,160
Turkmenistan	1,500	59.3	2,390	1,500	17.3	1,760	8.0	1,900	14.2	2,170	10.1	2,390
Armenia	2,080	5.3	2,190	2,080	-0.5	2,070	1.9	2,110	0.9	2,130	2.8	2,190
<b>Churn rate, %</b>												
Russia	n/d	n/m	n/d	10.7	1.7	12.4	-2.0	10.4	-0.6	9.8	3.7	13.5
Ukraine	n/d	n/m	n/d	10.4	-0.7	9.7	-0.3	9.4	-2.2	7.2	-0.6	6.6
Uzbekistan	n/d	n/m	n/d	8.1	-0.1	8.0	-2.1	5.9	0.2	6.1	1.1	7.2
Turkmenistan	n/d	n/m	n/d	4.5	1.2	5.7	4.2	9.9	-6.9	3.0	3.1	6.1
Armenia	n/d	n/m	n/d	11.3	1.4	12.7	-4.1	8.6	-0.1	8.5	-0.8	7.7
<b>ARPU, USD</b>												
Russia	7.5	11.0	8.4	8.2	3.2	8.4	-5.9	7.9	5.8	8.4	4.8	8.8
Ukraine	4.5	8.0	4.9	4.9	-6.2	4.6	-4.7	4.4	13.5	5.0	5.3	5.3
Uzbekistan	5.4	-9.0	4.9	5.1	-2.0	5.0	-4.0	4.8	4.2	5.0	-4.0	4.8
Turkmenistan	10.5	-18.5	8.6	10.4	-6.8	9.7	-8.9	8.8	-0.8	8.8	-6.8	8.2
Armenia	9.0	-11.0	8.0	9.5	-8.4	8.7	-15.7	7.3	7.3	7.8	11.7	8.8
<b>MOU, minutes</b>												
Russia	211	8.0	228	213	2.8	219	-3.7	211	9.0	230	6.1	244
Ukraine	449	19.6	536	478	5.9	506	4.2	527	2.7	541	0.0	541
Uzbekistan	475	9.7	520	500	6.8	534	-2.6	520	2.7	534	-4.9	508
Turkmenistan	236	25.5	296	241	3.7	250	6.8	267	8.2	289	12.5	325
Armenia	190	34.8	257	217	9.2	237	-7.2	220	15.9	255	15.3	294

Note 1: margin changes are given in percentage points, ARPU was recalculated using average exchanges rates to USD for proper period

Note 2: ARPU and MOU for 9M - are own estimates

Source: company's data, Estimates: Veles Capital

### MTS's US GAAP financial results, mn USD

	9M2009	Chng., %	9M2010	3Q2009	Chng., %	4Q2009	Chng., %	1Q2010	Chng., %	2Q2010	Chng., %	3Q2010
<b>Sales</b>	6,099	36.1	8,298	2,268	19.9	2,719	-3.8	2,614	6.0	2,772	5.0	2,911
Wireless	6,099	11.3	6,787	2,268	-3.6	2,187	-5.2	2,072	7.5	2,228	11.6	2,487
Fixed	0	n/m	1,244	0	n/m	413	-1.0	408	1.1	413	2.7	424
<b>Expenses</b>	(4,448)	36.5	(6,072)	(1,629)	29.5	(2,110)	-8.1	(1,938)	4.1	(2,017)	4.8	(2,115)
incl. amortization	(1,197)	23.0	(1,472)	(424)	17.3	(497)	-4.0	(478)	0.5	(480)	7.0	(514)
<b>Operating income</b>	1,651	34.8	2,226	638	-4.6	609	11.0	676	11.6	755	5.4	796
<b>Operating income margin, %</b>	27.1	-0.2	26.8	28.2	-5.7	22.4	3.5	25.9	1.4	27.2	0.1	27.3
<b>OIBDA</b>	2,848	29.9	3,698	1,063	4.1	1,107	4.3	1,154	7.0	1,235	6.1	1,309
<b>OIBDA margin, %</b>	46.7	-2.1	44.6	46.9	-6.2	40.7	3.4	44.1	0.4	44.5	0.4	45.0
<b>Non-recurrent items</b>	0	n/m	0	0	n/m	(368)	n/m	0	n/m	0	n/m	0
<b>Interest expenses</b>	(255)	147.3	(631)	(121)	87.6	(226)	0.8	(228)	-6.4	(213)	-11.2	(190)
<b>Non operating incomes/losses</b>	(117)	n/m	124	105	-71.0	30	238.4	103	n/m	(32)	n/m	54
<b>EBT</b>	1,278	34.4	1,718	623	-92.8	45	1125.5	551	-7.6	509	29.6	660
<b>EBT margin, %</b>	21.0	-0.3	20.7	27.5	-25.8	1.7	19.4	21.1	-2.7	18.4	4.3	22.7
<b>Income tax</b>	(278)	36.8	(380)	(128)	39.2	(178)	-29.9	(125)	-10.3	(112)	25.6	(141)
<b>Minority interest</b>	(1)	9387.7	(129)	(0)	n/m	107	n/m	(45)	-3.3	(43)	0.7	(43)
<b>Net income</b>	999	21.0	1,209	494	n/m	(26)	n/m	381	-7.2	354	34.3	475
<b>Net income margin, %</b>	16.4	-1.8	14.6	21.8	-22.8	Omp.	15.5	14.6	-1.8	12.8	3.6	16.3
<b>Average RUR/USD exchange ratio</b>	32.58	-7.1	30.26	31.34	-5.9	29.48	1.2	29.84	1.4	30.25	1.2	30.62

Note 1: financials are given without retrospective consolidation of Comstar and Multiregion

Note 2: margin changes are given in percentage points

Source: company's data, Estimates: Veles Capital

## Financial model

	2009 (E)	2010 (F)	2011 (F)	2012 (F)	2013 (F)		2009 (E)	2010 (F)	2011 (F)	2012 (F)	2013 (F)			
<b>P&amp;L statement</b>						<b>WACC</b>								
Sales	8,667	11,267	12,266	12,904	13,686	Risk-free rate, %			8.1	7.2	6.3			
Operating expenses (excl. Amortization & EBITDA)	(4,750)	(6,202)	(6,600)	(7,041)	(7,704)	Income tax rate, %			21.6	21.2	20.8			
EBITDA	3,917	5,065	5,665	5,863	5,982	Cost of equity (cs), %			17.3	15.1	13.8			
Amortization and depreciation	(1,689)	(2,099)	(2,215)	(2,211)	(2,203)	Market risk, %			5.0	5.0	5.0			
EBIT	2,228	2,966	3,450	3,652	3,779	Beta leveraged			1.5	1.3	1.2			
Non-recurrent items	(422)	0	0	0	0	Specific risk, %			1.6	1.6	1.6			
Interest expenses	(472)	(795)	(733)	(565)	(389)	Cost of debt, %			10.6	9.5	8.6			
Non-operation expenses	(92)	207	27	142	50	Specific risk, %			2.5	2.3	2.3			
EBT	1,242	2,378	2,744	3,228	3,440	WACC, %			17.3	15.1	13.8			
Income tax	(451)	(523)	(593)	(684)	(716)	<b>Free cash flow estimate</b>								
Minority interest	(101)	(114)	(11)	(13)	(14)	NOPAT	1,908	2,512	2,912	3,038	3,123			
Net income	691	1,740	2,140	2,531	2,711	Amortization and depreciation	1,689	2,099	2,215	2,211	2,203			
<b>Balance sheets</b>						CapEx	(3,590)	(2,419)	(1,644)	(1,500)	(1,838)			
Non-current assets	11,386	12,025	11,239	11,122	10,720	Changes in working capital	62	138	42	28	35			
PPE & IA	9,981	10,860	10,023	9,780	9,323	Free cash flow	70	2,329	3,525	3,777	3,523			
Other non-current assets	1,405	1,165	1,216	1,342	1,397	WACC, %			17.3	15.1	13.8			
Current assets	4,395	5,134	5,725	5,870	6,545	Discount factor			1.00	0.89	0.80			
Current assets	1,655	2,126	2,216	2,402	2,476	Discounted free cash flow			3,525	3,363	2,804			
Short-term investments	217	0	130	0	295	<b>Common stock valuation</b>								
Cash and equivalents	2,523	3,008	3,379	3,468	3,774	TGR, %			3.0					
Total assets	15,781	17,159	16,964	16,992	17,264	Discount cash flow sum (+)			20,833					
Shareholder's equity	4,485	5,311	6,352	8,149	9,499	Discounted terminal value (+)			8,298					
Shareholder's capital	3,377	4,318	6,317	8,100	9,436	EV			29,131					
Minority interest	1,108	992	35	50	63	Net debt (-)			3,329					
Long-term liabilities	7,037	7,633	5,350	4,379	3,725	Minority interest (-)			142					
Long-term debt	6,328	6,890	4,616	3,610	2,963	Financial investments (+)			124					
Other long-term liabilities	710	743	734	770	762	MC			25,783					
Current liabilities	4,258	4,216	5,262	4,463	4,041	Fair value of common stock, USD			13,488					
Short-term debt	2,002	1,307	2,221	1,158	622	<b>Sensitivity, %</b>								
Current liabilities	2,256	2,908	3,041	3,306	3,419	TGR	WACC	-3.0	-2.0	-1.0	curr.	1.0	2.0	3.0
Total liabilities and shareholder's equity	15,781	17,159	16,964	16,992	17,264	1.0	+22%	+11%	+2%	-6%	-12%	-18%	-23%	
<b>Cash flow statement</b>						2.0	+28%	+15%	+5%	-3%	-10%	-16%	-21%	
Operating activity	3,230	3,890	4,371	4,646	4,905	3.0	+36%	+21%	+9%	+0%	-8%	-14%	-20%	
Net income	691	1,740	2,140	2,531	2,711	4.0	+47%	+29%	+15%	+4%	-5%	-12%	-18%	
Amortization and depreciation	1,689	2,099	2,215	2,211	2,203	5.0	+62%	+39%	+22%	+9%	-1%	-9%	-16%	
Changes in working capital	62	138	42	28	35	<b>Multipliers, 1x</b>								
Other cashflows from operating activity	788	(87)	(27)	(124)	(44)	EV / Sales			2.3	1.7	1.6	1.5	1.4	
Investment activity	(3,629)	(2,200)	(1,774)	(1,367)	(2,135)	EV / EBITDA			5.0	3.9	3.5	3.4	3.3	
CapEx	(2,231)	(2,500)	(1,500)	(1,500)	(1,500)	EV / EBIT			8.8	6.6	5.7	5.4	5.2	
Purchase/sale of subsidiaries and affiliates	(1,088)	(276)	(144)	0	(338)	P / E			22.7	9.0	7.3	6.2	5.8	
Other cashflows from investing activity	(310)	576	(131)	133	(297)	P / BV			3.5	3.0	2.5	1.9	1.7	
Financial activity	1,799	(1,335)	(2,189)	(3,352)	(2,429)	EV / FCF			282.5	8.5	5.6	5.2	5.6	
Changes in debt	3,060	(361)	(1,300)	(2,274)	(1,152)	<b>Waterfall chart</b>								
Changes in shareholder's equity	0	0	0	0	0	Previous price								
Dividends paid	(1,262)	(974)	(889)	(1,078)	(1,277)	Debt changes			+ 112					
Other cashflows from financing activity	0	0	0	0	0	9M10 results			+ 1,874					
Changes in cash and equivalents	1,400	355	408	(73)	341	Offset of horizon			+ 1,927					
<b>Ratios</b>						M&A			- 307					
EBITDA margin, %	45.2	45.0	46.2	45.4	43.7	New price								
Net income margin, %	8.0	15.4	17.5	19.6	19.8	Source: company, estimates: Veles Capital								
EBITDA / interest expenses, 1x	8.3	6.4	7.7	10.4	15.4									
CapEx / Sales, %	25.7	22.2	12.2	11.6	11.0									
ROE, %	17.6	34.9	33.9	31.2	28.7									
ROIC, %	14.1	22.0	27.9	30.5	33.2									
Debt / EBITDA	2.1	1.6	1.2	0.8	0.6									
Net debt / EBITDA	1.4	1.0	0.6	0.2	n/m									
Debt / Shareholder's equity	1.9	1.5	1.1	0.6	0.4									

Source: company, estimates: 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)	$EV = \sum_{i=1}^n \frac{FCFF_i}{(1+WACC_i)^i} + \frac{TV}{(1+WACC_1)^n} + NA$	$SV = EV - D$
DCF method (FCFE)		$SV = \sum_{i=1}^n \frac{FCFE_i}{(1+k_{si})^i} + \frac{TV}{(1+k_{si})^n} + \text{Cash} + NA$
EVA method	$EV = IC_1 + \sum_{i=1}^n \frac{EVA_i}{(1+WACC_i)^i} + \frac{TV}{(1+WACC_1)^n} + NA$	$SV = EV - D$
EBO method		$SV = BV_1 + \sum_{i=1}^n \frac{SVA_i}{(1+k_{si})^i} + \frac{TV}{(1+k_{si})^n} + \text{Cash} + NA$

### 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  

$$NOPAT = EBIT * (1 - \text{income tax effective rate})$$
- FCFF - Free Cash Flow to Firm  

$$FCFF = \text{gross cash flow} - \text{gross investments}$$

$$\text{Gross cash flow} = NOPAT + \text{amortization}$$
- FCFE - Free Cash Flow to Equity  

$$FCFE = \text{gross shareholders' cash flow} - \text{gross investments}$$

$$\text{Gross shareholders' cash flow} = \text{EAT of operational profit (including interest payoffs)} - \text{annual debt coverage} + \text{attracted borrowed assets} + \text{amortization}$$
- EVA - Economic Value Added  

$$EVA = \text{economic profit spread} * IC = (ROIC - WACC) * IC$$
- SVA - Shareholders Value Added  

$$SVA = \text{spread} * E = (ROE - k_s) * E$$
- 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  

$$ROIC = \frac{NOPAT}{IC}$$
- 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.

In order to get additional information and specifications please contact the Research Department of the Investment Company Veles Capital.

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