

## Rostelecom Prefs May Be a Buying Target

The market price of Rostelecom commons fell by 50% from April levels, but has stayed unchanged for more than two months and remains much too high by fundamentals. Company prefs are traded with a large discount of 60-70% to commons, contrasting with 10-30% pref/com discount at RTOs. But since RTOs are to be merged with Rostelecom, all prefs should be valued by an appraiser with a single discount to commons. This could be achieved via artificial increase of the Rostelecom pref price to a level of "normal" discount to company commons, most probably via an open-market buying spree.

Recent remarkable growth of RTO stocks is strong evidence that plans to reorganize Svyazinvest will go ahead. Until now the only certainty about reorganization was that all assets would be united on the basis of Rostelecom, the national LD operator, and growth of RTO share prices has probably been a play on conversion coefficients.

Our estimates suggest that most RTO shares have nearly reached fair value. However, this cannot be said of Rostelecom: while current prices for its prefs look more or less adequate to fundamentals, the price for common shares of the operator is greatly inflated. This is due to purchase of 40% of common shares by KIT Finance before the crisis and its further transfer to the government. As a result prefs of Rostelecom are traded with a 60-70% discount to its commons, while the ratio of prefs to commons at RTOs is 10-30%. We believe that the pref discount at RTOs is much fairer.

### Rostelecom commons price is evidently inflated

	Common shares			Preferred shares			EV/EBITDA (09E)	Pref/com discount, %
	market price, \$	target, \$	up/ down, %	market price, \$	target, \$	up/ down, %		
Rostelecom	5.15	N/R		1.75	4.00	128%	<b>10.2 *</b>	<b>66%</b>
Ural Svyazinform	0.023	0.023	2%	0.017	0.015	-10%	3.4	26%
Siberia Telecom	0.034	0.038	13%	0.026	0.027	6%	2.6	24%
Center Telecom	0.540	0.600	11%	0.455	0.450	-1%	3.2	16%
Volga Telecom	1.87	2.63	41%	1.54	1.84	19%	2.4	17%
North-West Telecom	0.430	0.440	2%	0.340	0.310	-9%	3.1	21%
South Telecom	0.073	0.075	3%	0.065	0.057	-12%	3.7	10%
Far-East Telecom	2.56	2.90	13%	1.80	2.17	21%	2.3	30%

\* Rostelecom 2009E EBITDA based on 1H results (as we have no valuation for the stock)

Source: RTS; RMG estimates

Whatever method is eventually used to set conversion coefficients for merger, there cannot be a difference in discounts between preferred and common shares of the uniting parties. So either prefs of RTOs will be valued with a 60-70% discount to commons, or prefs of Rostelecom will be valued at a 10-30% discount to its common share price. We view the former as much less likely than the latter (certainly, investors have shown no willingness to stretch the common-pref discount for RTOs).

Squeezing of the Rostelecom pref/com discount could be achieved either by pushing down prices for common shares by or setting fair value of company prefs at a much higher level.

Until now we have been betting on a fall of the Rostelecom common share price to a level, at which its prefs would have a "normal" discount. These anticipations have been realized, but only partially. After the sharp fall from April levels, Rostelecom common shares have been flat for more than two months, and are still far above their fundamental value. The reason may be that the government, being the key shareholder, is not willing to see further price falls and is supporting the price (this is not hard to do, as free-float for common shares is very low).

We therefore see it as most likely that Rostelecom prefs will be valued with a 10-30% discount to the current (or near to current) value of its common shares. This would be hard to justify using a fundamental approach to valuation. But if the market price of prefs grows for some reason to the level of a "normal" discount and stays there for at least 6 months, consequent valuation by an appraiser based on market quotes could give the desired result.

So we suggest a bet on artificial growth of the Rostelecom pref share price. Based on the current Rostelecom common share price (\$5.15) and assuming fair discount of 25%, the indicative target price for Rostelecom prefs would be about \$4.0, which is 130% above their current price.

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