

GDR	ETLN LI
Recommendation	BUY
Last price	\$3.15
Target price	\$4.70
Upside	49%
Free float	61%
Market cap	\$921 mln
Enterprise value	\$1,078 mln
ADT, 100 days	\$1.3 mln

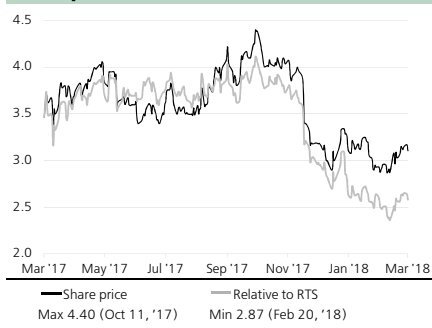
Prices as of March 9, 2018

Key data

	2016	2017E	2018E	2019E
Financials (IFRS), \$ mln				
Revenues	736	990	1,487	1,583
EBITDA	110	186	345	434
EBIT	75	119	238	318
Net income	74	100	188	248
Adjusted EPS, \$	0.25	0.34	0.64	0.85
Profitability				
EBITDA margin	15%	19%	23%	27%
EBIT margin	10%	12%	16%	20%
Net margin	10%	10%	13%	16%
Price ratios				
P/S	1.3	0.9	0.6	0.6
EV/EBITDA	9.5	6.0	3.1	2.5
P/E	12.5	9.2	4.9	3.7
P/CF	39.4	38.7	6.9	8.4
Growth				
Revenues	5%	35%	50%	6%
EBITDA	-13%	70%	85%	26%
Adjusted EPS	-17%	36%	89%	32%

Price performance, %

	1m	3m	6m	YTD
GDR	7.5	-0.9	-21.3	5.0
Relative to RTS	0.4	-12.7	-30.6	-4.6

Price performance, R


Source: Bloomberg, Sberbank CIB Investment Research

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Etalon Group

Construction Now Part of GAV

Etalon Group's 2017 year-end portfolio valuation was up 17% y-o-y to R135 bln (\$2.4 bln at the current exchange rate), but this time it included the R8.3 bln (\$146 mln) valuation of the construction business, which the company had not valued before. We believe the inclusion of the unit was likely an attempt to crystallize its value. Adjusted for the construction division, the GAV of the project portfolio increased 10% y-o-y to R127 bln (\$2.2 bln). Absent the 2017 financials, we estimate a year-end NAV of R125 bln (\$2.2 bln, equivalent to \$7.60 per share), which would imply that the stock trades at a 58% discount to NAV (or a 55% discount to the \$7.10 per share if construction is excluded). The valuation looks attractive, although our equity value estimate is more conservative at \$4.70 per share, as we think the assets would be unlikely to fetch such a high price were the company to be broken up today. Still, the stock could rise 51% from the current levels if the overhang concerns and succession issues clear up. We reiterate our BUY rating.

■ **Project portfolio: St Petersburg takes the lead again.** The 10% increase in value was completely attributable to a higher valuation per m², as the portfolio was flat y-o-y at 2.8 mln m², equivalent to roughly five years of construction volumes at the current pace of delivery. The portfolio was once again slightly skewed toward St Petersburg, due both to the addition of projects acquired last year and value erosion for most projects in the Moscow Metropolitan Area (MMA) on a decrease in NSA, lower selling prices and higher discount rates. The GAV per m² increase was driven by both the addition of three higher-end projects and the reassessment of selling prices for completed projects and projects under development (most notably commercial space in St Petersburg). Unsold inventory at completed projects was valued at R19 bln, translating into a "worst-case" NAV of \$0.54 per share on our estimates.

■ **An attempt to crystallize (and inflate) the value of the largely ignored construction unit.** This was the first time the company valued its construction division. It assigned an R8.3 bln value to the assets, which include a concrete plant, a small brick plant, 62 tower cranes, a number of contracting companies, a property management company and four office buildings. The assets are expected to generate R27.8 bln in revenues this year (R12.5 bln from third parties), along with R0.7 bln in net income. The total carrying value of these assets on the balance sheet was R3.3 bln on the last reporting date. Although it is indeed helpful to have the market valuation of balance sheet items carried at book value, especially when assessing P/NAV, we think the company's main goals in valuing the construction business were crystallizing its value and increasing the valuation of the group. While investors are likely to ignore the valuation of the construction business, as Etalon Group is perceived as mainly a developer, the management could attempt to sell or spin off the business to realize its value (we see this as unlikely). We doubt the unit would sell for the full R8.3 bln, which would imply a 2018E P/E of 8.9, nearly double the level Etalon currently trades at.

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Gross asset value now includes the construction services division

Etalon's estimate of the value of its assets increased 16.7% y-o-y to R135.2 bln, but this was inflated by the inclusion of the construction services division, which added R8.3 bln (6%) to the total. Excluding construction, the project portfolio expanded 9.6% y-o-y to R126.9 bln, thanks entirely to a higher valuation per m² of unsold space, whereas unsold net saleable area (NSA) was roughly flat y-o-y at 2.8 mln m². There were a number of factors contributing to the increase, including the change in the appraiser from JLL to Knight Frank. The latter is generally more conservative in valuing projects that have yet to receive permitting documents and more optimistic on completed projects and those still under construction. We noted, for example, a rise in estimated selling prices for commercial space in residential projects. Discount rates were also down about 1 pp on a like-for-like basis across the portfolio, according to the management, reflecting the decline in Russian interest rates.

Etalon Group's end-2017 portfolio valuation

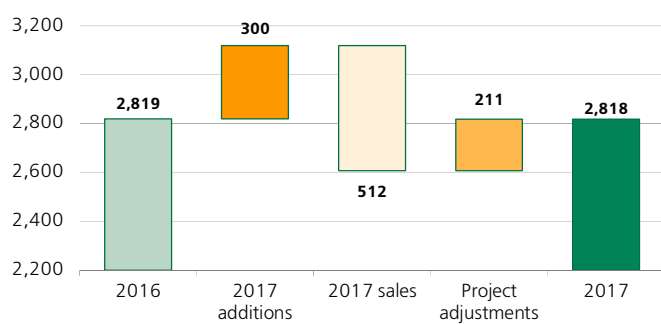
	Consolidated			St Petersburg			Moscow		
	2017	2016	y-o-y	2017	2016	y-o-y	2017	2016	y-o-y
Total GAV, R mln	135,197	115,818	16.7%	67,569	56,678	19.2%	59,356	59,140	0.4%
Total GAV, \$ mln	2,389	2,011	18.8%	1,194	984	21.3%	1,049	1,027	2.1%
Construction division, R mln	8,272	0	-	0	0	-	0	0	-
GAV of projects, R mln	126,925	115,818	9.6%	67,569	56,678	19.2%	59,356	59,140	0.4%
Projects in design and construction, R mln	108,226	97,109	11.4%	49,037	37,969	29.2%	59,189	59,140	0.1%
Completed inventory, R mln	18,699	18,709	-0.1%	18,532	18,709	-0.9%	167	0	n/m
Unsold NSA, '000 m²	2,818	2,819	0.0%	1,503	1,450	3.7%	1,315	1,369	-4.0%
Projects in design and construction, '000 m ²	2,562	2,506	2.2%	1,247	1,137	9.7%	1,314	1,369	-4.0%
Completed inventory, '000 m ²	257	313	-17.9%	256	313	-18.1%	1	0	n/m
Gross asset value, R/m²	45,041	41,085	9.6%	44,948	39,088	15.0%	45,147	43,199	4.5%
Projects in design and construction, R/m ²	42,243	38,751	9.0%	39,324	33,394	17.8%	45,045	43,199	4.3%
Completed inventory, R/m ²	72,759	59,773	21.7%	72,310	59,773	21.0%	233,919	0	n/m

Source: Company, Sberbank CIB Investment Research

Project portfolio: Moscow's projects were the weak spot

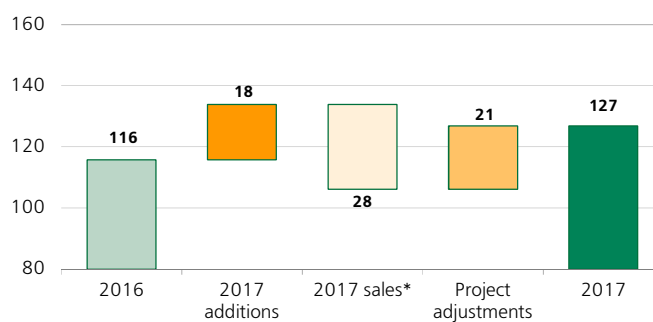
The company replaced its entire presold land bank through both new project purchases and NSA adjustments (in roughly equal proportions), leaving the total unsold NSA virtually unchanged at year end. The valuation adjustment, however, exceeded the value of presales thanks to the addition of higher-end projects and the increase in prices per m² for both completed and under-development projects. As a result, the company added R11 bln in value to its land bank (a 9.6% increase), all of which came from an increased value per m² of unsold NSA.

Land bank bridge, '000 m²



Source: Company, Sberbank CIB Investment Research

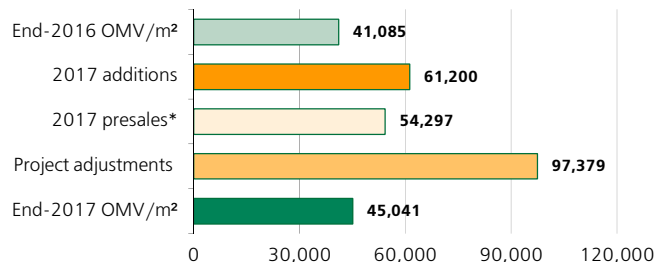
Market value bridge, R bln



* the outstanding market value (OMV) for 2017 sales was calculated as end-2016 OMV per m² multiplied by the number of m² sold on a project-by-project basis, where data was available; for projects where a sales breakdown was not available, a weighted average for the portfolio was used

Source: Company, Sberbank CIB Investment Research

Implied value per m² across market value bridge, R per m²

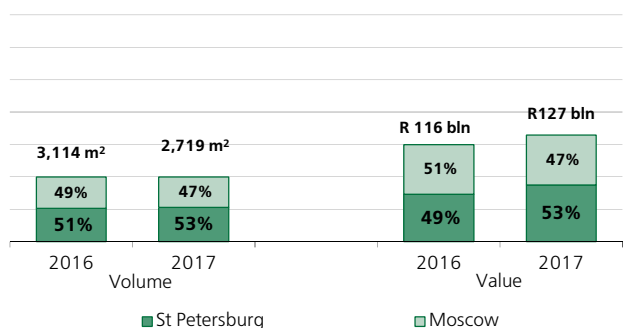


* the outstanding market value (OMV) for 2017 presales was calculated as end-2016 OMV per m² multiplied by the number of m² sold on a project-by-project basis, where data was available; for projects where a sales breakdown was not available, a weighted average for the portfolio was used

Source: Company, Sberbank CIB Investment Research

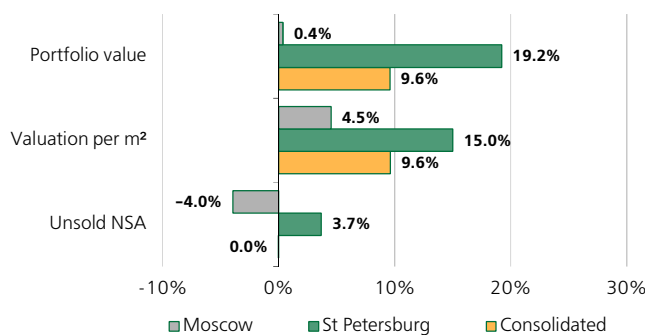
The portfolio was once again skewed toward St Petersburg, as the new land bank additions last year were mostly in Russia’s northern capital. The company added four plots in St Petersburg with a total NSA of 225,000 m² and value of R10.2 bln, while Moscow saw just one addition – albeit a more profitable one – of 75,000 m² in NSA and R8.2 bln in value. Moreover, project adjustments – a significant factor behind the valuation increase last year – were mainly value-accretive in St Petersburg, but not in Moscow. Eight of the ten projects in Moscow saw their market value decline due to decreases in NSA, lower selling prices and higher discount rates. As a result, the valuation of St Petersburg projects increased 19.2% y-o-y to R67.6 bln, while the valuation of projects in the Moscow Metropolitan Area remained flat at R59.4 bln. Moreover, St Petersburg nearly caught up to Moscow in value per m² of unsold NSA (R44,948/m² in St Petersburg versus R45,147/m² in Moscow).

Portfolio breakdown



Source: Company

Geographical performance of Etalon’s project portfolio



Source: Company, Sberbank CIB Investment Research

Digging slightly deeper into the changes, we highlight the following:

- New projects boosted the market value per m².** Etalon Group acquired five new projects last year: Botanica, Petrovsky Island, Obukhovskoy Oborony and Morskaya Zvezda in St Petersburg, and Letnikovskaya in Moscow. The aforementioned projects added 300,000 m² of NSA to the portfolio (11%) worth R18.4 bln (14%), implying an average value of R61,200 per m², a 50% premium to the end-2016 average value per m². Most of these projects (the exceptions being Obukhovskoy Oborony and Morskaya Zvezda) are more centrally located and should demand higher selling prices than the rest of the portfolio. For example, Petrovsky Island in St Petersburg is expected to sell at R195,221/m² and Letnikovskaya in Moscow at R326,373/m² over their lifespans, while the average selling price for the entire portfolio now stands at R93,305/m².
- Selling prices for commercial space in St Petersburg increased.** Commercial space (mainly on the ground floors) saw a significant boost in selling prices across most of Etalon’s projects in St Petersburg. The range of the increases was wide – from 10% to 125%. This was one of the most notable changes in the valuation. It likely reflected the new appraiser’s optimism on recovering economic activity and trade in St Petersburg.

- **The Moscow acquisitions from 2016 were seen as 23% less valuable.** The biggest disappointment in the valuation was Moscow. Seven out of ten projects in the Moscow Metropolitan Area (MMA) saw their average value per m² decline despite increased prices. This owed to a combination of higher capex, downward revisions to potential NSA and higher discount rates. All four MMA projects acquired in 2016 had their market value revised downward.
 - ▶ **Revision of NSA and higher discount rates.** Higher sales prices per m² were not able to offset declines in potential NSA for projects like Perovo (NSA declined by 6%) and Ryazanskiy Prospekt (22%) as feasibility studies on these projects moved forward. In addition, the new appraiser assigned higher discount rates for the 2016 acquisitions that had yet to receive permitting documents, bringing down the GAV of the projects.
 - ▶ **Lower selling prices.** The average price for Moscow’s satellite Mytishi project (also bought in 2016), which is still in the design stage, was lowered 13% to R73,806/m² on a reassessment of the market situation. The selling price at the flagship Emerald Hills project in Moscow Region’s Krasnogorsk saw a 4% reduction driven by a steep decline for residential units (down 23% to R74,149/m²).
 - ▶ **Higher capex.** Silver Fountain, Etalon’s upscale project under construction within Moscow’s old city limits, saw its capex more than double last year. While the increase was driven in part by higher NSA (up 23%), it was also due to higher costs per m² (up 78%), as the project was upgraded from “comfort” to “business” class.

Completed and unsold inventory is worth \$0.54–1.65 in equity value

A crucial factor when examining a development company is the “floor” valuation – the equity value of its assets if it were to cease to exist today. Hence, one of the important metrics to look at is the valuation of unsold inventory on the company’s balance sheet and the implied equity value.

Knight Frank assessed Etalon’s unsold and completed inventory of 475,000 m² at R36.9 bln, with 210,000 m² of residential space valued at R25.4 bln. This includes inventory in projects that are still under development and may be difficult to sell if Etalon were to run into trouble. (After all, who wants to buy a flat in a development that may end up unfinished?) We look at inventory at fully completed projects only (some of which, granted, may be totally illiquid and unsellable) to assess the “worst-case” NAV, but we also provide analysis based on the company’s definition of “completed and available-for-sale” inventory in order to give our readers a choice in defining the stock’s theoretical floor. Since the 2017 IFRS financials have yet to be published, we were only able to adjust the inventory value by the previously reported net debt level. Adjustments for other assets and liabilities, including the construction division’s fixed assets, were not made. We urge our readers to take these estimates as merely an indication of whether the stock value is attractive rather than as the actual liquidation value of the developer’s equity. If things were to turn sour, we are afraid there would be little, if any, residual value remaining for minority shareholders.

“Worst-case” back-of-the-envelope NAV estimate			
Inventory definition	Completed inventory, incl. unfinished projects	Completed inventory of apartments only, incl. unfinished projects	Completed inventory in finished projects only
Valuation, R mln	36,939	25,381	18,699
Valuation, \$ mln	653	448	330
Inventory value per share, \$	2.24	1.54	1.13
Net debt, end 2017, R mln	(9,712)	(9,712)	(9,712)
NAV, R mln	27,227	15,669	8,987
NAV, \$ mln	481	277	159
NAV per share, \$	1.65	0.95	0.54

Source: Company, Sberbank CIB Investment Research

Construction services: What's in the bag?

The construction services division was included in Etalon's portfolio valuation for the first time in 2017. While we understand the company's desire to value assets that were previously largely ignored by the market and we recognize that this is a much smaller set of assets than for either LSR Group or PIK Group, neither of these companies has ever included construction services, materials or any other assets into a valuation of a land bank.

So what's included in the R8.3 bln figure that represents 6% of the reported GAV? Besides the land bank, the company owns a concrete plant with annual capacity of 180,000 m³ of ready-mix and 40,000 m³ of concrete products, a small brick plant with annual production capacity of 42 mln units, 62 tower cranes that the company either uses itself or leases out to third parties, four office buildings with GLA of 20,000 m², a property management company with 4.3 mln m² under management, a real estate broker, and numerous contractor companies that perform design, construction and fit-out services for Etalon Group and may be contracted out to third parties.

Etalon Group's construction division assets

Asset	Capacity
Concrete plant	180,000 m ³ of ready-mix 40,000 m ³ of concrete products
Brick plant	42 mln units
Tower cranes	62
Commercial property	4 office buildings with 20,000 m ² of GLA
Property management company	4.3 mln m ² of residential and commercial area, 17,100 parking spaces
Real estate broker	
Contractor companies	Design, construction, fit-out works

Source: Company

The division is certainly instrumental in controlling the quality and timing of Etalon's projects, but does not make much of a profit contribution to the group: the management projects the division's total revenues this year at R27.8 bln, of which only R12.5 bln will come from outside the company (the rest will be from the development business) with a 7% gross margin at the consolidated level and R742 mln in net income. Sales to other companies make up just 22% of 2018E revenues and 7% of net income for the whole group. Of course, some value has been transferred away over the last two years to the real estate development division to maximize profit margins in the company's core business, but it ultimately does not matter where the profits are booked if the business stays in one piece. The published valuation of R8.3 bln, adjusted for the R1.7 bln GAV of four office buildings for the company's own use, implies that the construction division was valued at a 2018E P/E of 8.9, a high multiple for a construction business and nearly twice Etalon Group's current 2018E P/E of 4.9.

Construction division financials and valuation, R mln		
	2018E	2023E
Total revenues	27,756	38,122
<i>External revenues</i>	12,488	15,682
Gross income	2,020	2,918
<i>Gross income from external revenues</i>	1,153	1,644
Gross margin	7%	8%
<i>Gross margin for external business</i>	9%	10%
Net income	742	1,276
Valuation (assuming no debt*)	8,300	
GAV of four office buildings	(1,668)	
Standalone valuation of construction division	6,632	
Implied P/E	8.9	
Etalon Group's current P/E	4.9	

* the construction division has no debt, according to the management

Note: The discount rate used in valuing the construction division was circa 14%, according to the management.

Source: Company, Sberbank CIB Investment Research

Ownership structure

Zarenkov family	30.7%
Baring Vostok Capital Partners	5.7%
Treasury	2.2%
Others	61.4%

Etalon Group IFRS financials, \$ mln

	2014	2015	2016	2017E	2018E	2019E	2020E
INCOME STATEMENT							
Revenues	1,364	699	736	990	1,487	1,583	1,659
COGS	(945)	(485)	(553)	(735)	(1,099)	(1,114)	(1,164)
Gross income	419	214	183	255	388	470	495
Gross margin	30.7%	30.7%	24.9%	25.7%	26.1%	29.7%	29.8%
SG&A	(150)	(95)	(97)	(122)	(136)	(137)	(144)
EBITDA	283	125	100	157	297	382	404
Adjusted EBITDA	281	127	110	186	345	434	458
EBITDA margin	20.6%	18.1%	14.9%	18.8%	23.2%	27.4%	27.6%
DD&A	(11)	(7)	(7)	(9)	(11)	(13)	(14)
EBIT	245	103	75	119	238	318	336
Interest income	31	22	24	14	14	13	13
Forex gain	–	(2)	(1)	–	–	–	–
Revaluation gain	–	–	–	–	–	–	–
Other gains	–	–	–	–	–	–	–
Exceptionals	–	–	–	–	–	–	–
EBT	275	123	98	133	252	332	349
Income tax	(54)	(33)	(25)	(34)	(63)	(84)	(88)
Minority interest	(1)	(0)	–	–	–	–	–
Discontinued operations	–	–	–	–	–	–	–
Net income	221	89	74	100	188	248	261
Adjusted net income	221	89	74	100	188	248	261
Net margin	16.2%	12.7%	10.0%	10.1%	12.7%	15.7%	15.7%
EPS, \$	0.76	0.30	0.25	0.34	0.64	0.85	0.89
Adjusted EPS, \$	0.76	0.30	0.25	0.34	0.64	0.85	0.89
BALANCE SHEET							
Assets							
Cash and equivalents	272	169	179	79	86	59	71
Receivables	259	251	348	453	493	546	518
Inventories	988	934	1,158	1,483	1,361	1,256	1,130
Other current assets	1	–	–	52	57	45	37
Total current assets	1,520	1,354	1,685	2,067	1,997	1,906	1,755
Total non-current assets	133	111	170	181	183	184	186
Total assets	1,653	1,466	1,855	2,247	2,180	2,090	1,941
Liabilities							
Short-term borrowings	67	87	92	26	26	68	114
Payables	368	353	547	850	714	530	350
Other current liabilities	38	49	28	33	36	39	38
Total current liabilities	473	489	667	910	776	637	502
Long-term borrowings	213	181	202	240	216	148	34
Other non-current liabilities	76	39	41	47	51	44	40
Total non-current liabilities	289	220	243	287	267	193	74
Total liabilities	763	709	910	1,197	1,044	830	577
Minority interest	12	4	1	1	1	1	1
Equity	885	754	944	1,050	1,136	1,260	1,364
Total liabilities and equity	1,653	1,466	1,855	2,247	2,180	2,090	1,941
Net debt/(cash)	8	99	115	188	156	158	77
CASH FLOW STATEMENT							
Net income	221	89	74	100	188	248	261
Minority interest	1	0	–	–	–	–	–
DD&A	11	7	7	9	11	13	14
Working capital change	(189)	(162)	34	(60)	(43)	(132)	(24)
Other assets change	(30)	(30)	(93)	(25)	(21)	(19)	(19)
Operating cash flow	14	(96)	22	24	134	110	232
Maintenance capex	(7)	(6)	(2)	(9)	(11)	(13)	(14)
Expansionary capex	(10)	–	(8)	(9)	(10)	(10)	(10)
Other investments	104	43	16	5	5	5	5
Investing cash flow	87	37	6	(14)	(16)	(17)	(19)
Change in debt	60	53	(21)	(47)	(26)	(26)	(68)
Dividends paid	(30)	(40)	(23)	(40)	(62)	(112)	(124)
Share issues/(purchases)	0	0	–	–	–	–	–
Other	(2)	(0)	(1)	–	–	–	–
Financing cash flow	28	12	(45)	(87)	(88)	(139)	(192)
Forex effects	43	(4)	(2)	–	–	–	–
Net change in cash	172	(51)	(20)	(78)	31	(47)	21
RATIOS							
P/E	4.2	10.3	12.5	9.2	4.9	3.7	3.5
EV/EBITDA	3.3	8.1	9.5	6.0	3.1	2.5	2.2
P/BV	1.0	1.2	1.0	0.9	0.8	0.7	0.7
Net debt/EBITDA	0.0	0.8	1.0	1.0	0.5	0.4	0.2
Total debt/EBITDA	1.0	2.1	2.7	1.4	0.7	0.5	0.3
ROE	19.8%	10.9%	8.7%	10.0%	17.2%	20.7%	19.9%
ROIC	16.8%	7.1%	4.5%	6.8%	12.9%	16.1%	16.6%
Dividend per share, USD	0.15	0.08	0.14	0.20	0.37	0.40	0.51
Dividend yield based on USD value	4.9%	2.6%	4.3%	6.4%	11.6%	12.8%	16.1%
P/S	0.7	1.3	1.3	0.9	0.6	0.6	0.6
P/CF	>100	neg	39.4	38.7	6.9	8.4	4.0
Revenue growth	9%	-49%	5%	35%	50%	6%	5%
EBITDA growth	-5%	-55%	-13%	70%	85%	26%	6%
EPS growth	6%	-60%	-17%	36%	89%	32%	5%

Source: Company, Sberbank CIB Investment Research

Analyst certification

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