Alfa-Bank

Equity Market

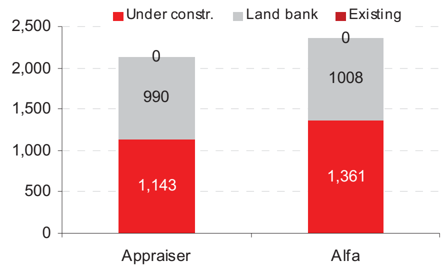
PIK Initiation (O/W)

Overleveraged and Overlooked

Russian Equity Research
Real Estate
February 2, 2012

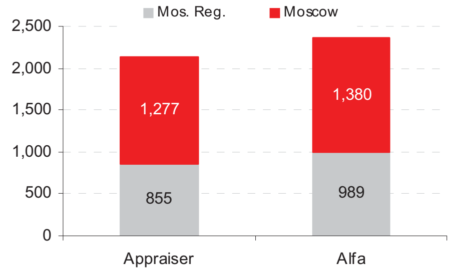
BB Ticker	PIK LI
Rating	O/W
Target price (DRs)	3.64
Closing price (DRs)	2.57
Return to TP	42%
Market cap, $m	1,267
Est. free float, %	43.7%
Shares outstanding, m	493.3
Daily volume, $ m (3M Ø)	0.4

Portfolio value by project status, $ m



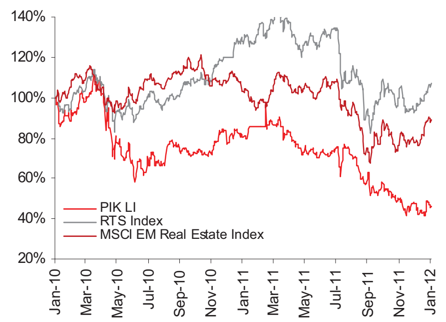
Source: PIK, Alfa Research

Portfolio value by location, $ m



Source: PIK, Alfa Research

GDR price performance (dollar-based)



Source: Bloomberg, Alfa Research

Summary

While negative sentiment toward PIK is understandable due to the company's heavy debt burden, we believe that its operational strength as a leader in the mass-market residential segment in MMA makes it an intriguing investment opportunity. While dilutive, we would view a successful placement of shares to reduce leverage as a positive catalyst. We initiate coverage with an O/W rating and a TP of $3.64/GDR, implying 42% upside.

Investment Case

Reducing leverage is a primary challenge: PIK has demonstrated an ability to survive with a heavy debt burden, not only relying on financing from state and private, but also sourcing funding from private and state customers, as well as suppliers. Yet PIK barely managed to emerge from a negative equity position as of 1H11 and is not assured of near-term profitability due largely to debt costs. While PIK likely will require refinancing with repayments exceeding adjusted EBITDA in 2012E-2014E, we expect state banks to provide adequate funds, as PIK was declared strategically important by the Russian government in 2008.

A successful share capital increase could be a positive catalyst: A reduction of leverage would help PIK argue for lower rates on its loans after it reported an average cost of debt of 12.2% in 1H11. It would also provide management with flexibility through project timing based on RE markets rather than funding availability. Our hypothetical capital injection scenario raising RUB9.1bn through a 20%-discounted offering implied a TP that was only 13% lower than our actual TP, before considering the significant potential benefits coming from further project developments.

Historical mass-market MMA focus a key advantage: While LSR and Etalon face operational and political challenges in expanding operations away from their home SPMA market, PIK is already an established player with experience and vertical integration in MMA, where some key developers have reduced production.

Valuation and Risks

We initiate on PIK with an O/W rating and a TP of $3.64/GDR (1 GDR equals 1 share), implying 42% upside. We believe that expected state funding support mitigates the substantial capital and funding risks facing PIK, whose established position in MMA mass-market residential we consider a key strength. As PIK's near-zero equity makes typical valuation multiples less useful in our view, we rely on our DCF approach, which applies a WACC of just 11.7% as we assumed 75% debt/(debt+equity).

Debt burden is PIK's primary risk: With 2012E debt/adj.EBITDA of 8.2x and repayments exceeding EBITDA in 2012E-2013E, PIK's debt will continue to drag heavily on earnings until the company can increase capital significantly, in our view. While we believe that state banks will provide any necessary medium-term refinancing, we cannot exclude near-term refinancing problems. We also cannot ignore other risks, including governance issues and a lack of share liquidity.