

Abrau Durso: Double Upside for Winemaker to the Tsars

Investment Summary

We initiate coverage of Abrau Durso, a leading Russian producer of sparkling wine. We see large potential due to growing domestic demand, strong financials and company interest in developing its share market. We recommend Abrau Durso shares as a BUY with target price of \$318, offering 90% upside.

- ✓ Abrau Durso wine house, based near Russia's Black Sea coast, has an unbroken tradition of champagne-style winemaking from the Tsarist period, including current status as official supplier to the Kremlin. It is privately owned, has shown very rapid growth of financials in recent years, and can take advantage of the ongoing change in Russian alcohol consumption away from vodka and towards wine.
- ✓ The company is now in third place on the Russian market for sparkling wine with 6.4% share by value. Production in 2011 was about 16m bottles, and the company plans to nearly double the figure by 2015 as well as increasing the share of high-value 'champagne' style output (matured for up to 3 years in bottles) compared with output using the much faster Charmat process. Our DCF model is more conservative, assuming 10% CAGR to 23.5m bottles by 2016.
- ✓ Company revenues more than doubled from 2009 to 2011 as sales volume and prices increased. EBITDA surged by 78% in 2011 and EBITDA margin added 4pp to reach 33%. Managers do not expect further growth of profitability, and our forecast assumes a slight decline to 31% in 2016 due to higher marketing and advertising costs.
- ✓ Abrau Durso has fairly good distribution, including sales through all major supermarket chains, and is setting up its own regional branches to assist sales across Russia. This process and expansion of supermarket chains will be important growth drivers.
- ✓ Future plans include purchase of land for the company's own vineyards (at present all production is by second fermentation of wines bought in South Africa and from nearby vineyards in southern Russia) and further development of wine tourism (the company already operates a hotel and restaurants at its production site).
- ✓ Current free-float is less than 1%, but the owner (SVL Group, owned by Boris Titov, appointed last week as Russia's business ombudsman) intends to sell 10% to the market this year. A full IPO is possible in the future.
- ✓ We use DCF and comparative valuation (75-25) and value Abrau Durso at \$318 per share. We carried out a stress test for our DCF, assuming flat sales volumes and slower price growth, and found target price of \$227 per share. Our main valuation offers substantial 90% upside (stress case offers 35%) and we recommend to BUY the shares.

ABRD RX

BUY \$318 ▲90%

Current market cap, \$m	123
EV, \$m	171
Estimated free-float, %	0.7%

Common shares

- ticker (MICEX)	ABRD RX
- number, m	0.735
- last price, \$	168
- fair price, \$	318
- up/down, %	90%
- previous fair price,\$	N/R

Other stock exchanges

LSE	N/L
NYSE	N/L

market price as of 21.06.12

IFRS, \$m	10	11	12E	13E
Revenues	64.5	99.6	127.4	153.3
EBITDA	18.3	32.5	41.7	50.0
- margin, %	28.3%	32.6%	32.8%	32.6%
Op. income	16.5	29.7	38.8	47.1
Net income	8	18	22	28
- margin, %	11.8%	18.0%	17.2%	18.0%
EPS, \$	10	24	30	38

	10	11	12E	13E
EV/S	2.7	1.7	1.3	1.1
EV/EBITDA	9.4	5.3	4.1	3.4
P/E	16.3	6.9	5.6	4.5

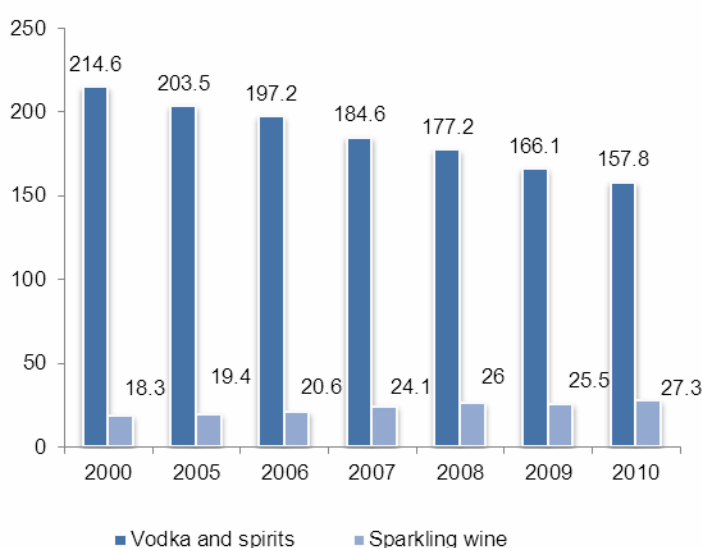
Market overview

Wine consumption in Russia is low by international standards...

Russia has a large market for alcoholic drinks. According to Rosstat data, the value of retail sales of alcoholic beverages in 2010 was larger than value of clothes retail. Alcoholic beverages are the fastest growing segment of the food and drink market (8-9% per year) and were worth more than R1.2 trillion (\$49b) in 2010.

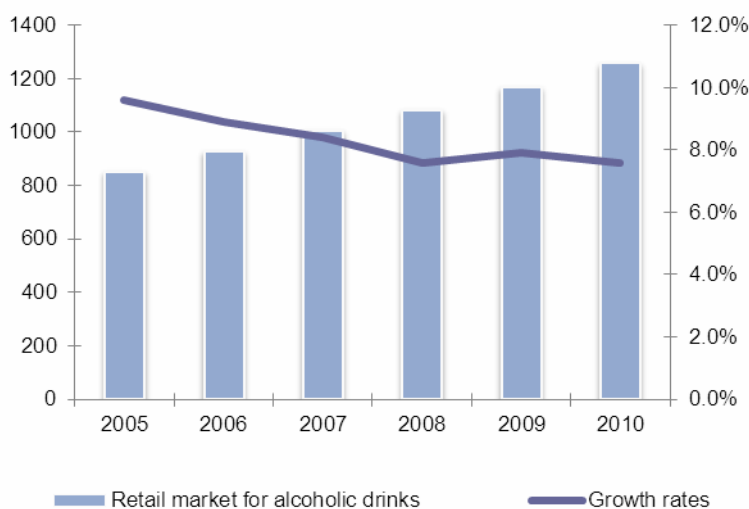
However, consumption of wine is at an early stage of development in Russia. According to the World Health Organization, wine accounts for only 1% of alcohol consumption, while 63% of alcohol is consumed in spirits and 33% in beer. For comparison, wine represents 62% of alcohol consumption in France, where only 20% is consumed in spirits.

Spirits and wine consumption in Russia (million deciliters)



Source: Rosstat

Value of alcoholic beverage market in Russia (R bln)



Source: Rosstat

...but is steadily increasing

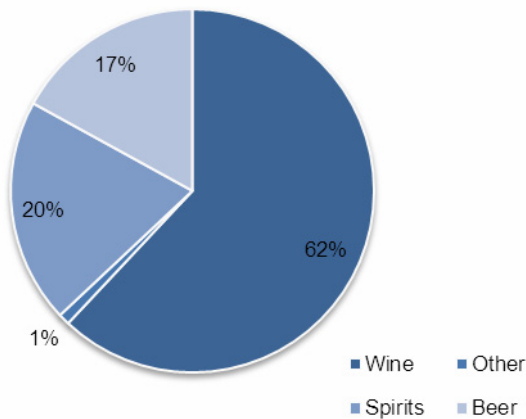
Structure of the Russian alcohol market is gradually changing in favor of wine (including sparkling wine), i.e. towards a European model. According to Rosstat, sales of sparkling wines in Russia increased by 50% from 2000 to 2010, while sales of vodka and other spirits fell by 26%. The share of sparkling wine in total alcohol consumption also increased during this period by more than 1pp to 2.1%.

Russian sparkling wine consumption is focused at New Year

A remarkable feature of Russian sparkling wine consumption is its seasonality. Sales peak in the fourth quarter when people stock up for New Year celebrations. This is in contrast with Europe, where sales peak in the summer due to perception of sparkling wine as a 'warm-weather' beverage.

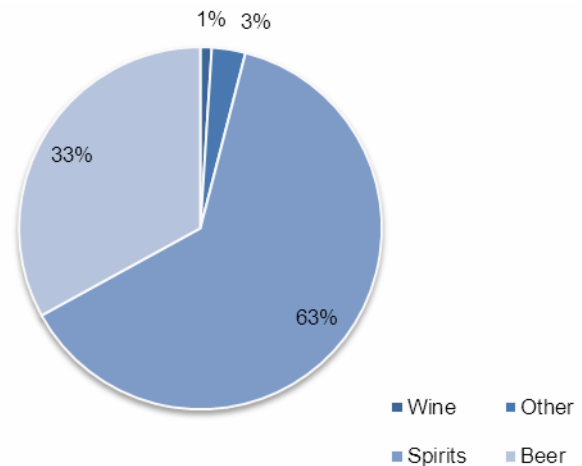
We see major growth potential for sparkling wine sales in Russia, as improving living standards and changing lifestyles reduce dominance of vodka in overall alcohol intake. In particular, we expect that concentration of sparkling wine consumption at New Year will become less marked, and consumption in the rest of the year, particularly in the summer, will grow strongly.

Alcohol consumption structure in France, %



Source: WHO

Alcohol consumption structure in Russia, %



Source: WHO

Company overview

The estate of Abrau Durso was founded in 1870 by decree of Tsar Alexander II near Russia's Black Sea coast, at a location where the soil is particular suited for cultivation of Champagne-style grapes. During the Soviet era Abrau Durso was the country's leading sparkling wine producer. The company is presently in third place on the market by sales.

The company makes standard and champagne-style sparkling wines

The company produces 16 varieties of sparkling wine using two main methods: traditional method (formally called 'champagne method') when the blended and bottled wine is stored for a second fermentation lasting up to 3 years (the company uses 6km of mountain tunnels, created at its production site in Tsarist times), and the cheaper and faster Charmat process, in which the wine undergoes a second fermentation in bulk tanks for 2-3 weeks.

The company has production capacity of over 17m bottles per year of Charmat and 3m bottles of traditional wine. In 2011 the company produced about 16mn bottles of sparkling wine, including 800,000 by the traditional method.

It does not have its own vineyards

Abrau Durso does not own vineyards. Its Charmat production uses wine from South Africa imported to nearby Novorossiysk port, and its traditional output uses raw wine from neighboring vineyards in Krasnodar Region. Management notes that Abrau Durso can exert significant price pressure on local suppliers. However, the company intends to acquire 500 hectares of land for its own vineyards in the near year, and expects to be fully self-sufficient in raw wine for its traditional production within 5 years.

Company is also developing wine tourism

Abrau Durso is developing wine tourism as a second source of income and a useful advertising tool. The company already operates a hotel, three restaurants and four retail outlets at its production site. Tourism accounted for about 4% of total revenues in 2010, and visitor numbers in 2011 reached 129,000. There are plans for construction of a second hotel and the company is seeking investors to build an upscale gated settlement, whose residents would use the tourist infrastructure. We assume that revenue from these businesses will grow in line with revenue from sparkling wine sales.

Owners, share market and IPO prospects

The company has a single private owner

SVL Group, which is owned by the businessman Boris Titov, acquired 58% of Abrau Durso in 2006. In 2011 SUE of Krasnodar Region, controlled by the administration of Krasnodar Region sold SVL the remaining 42% of the company. Last week Titov was appointed by the Russian President as business ombudsman.

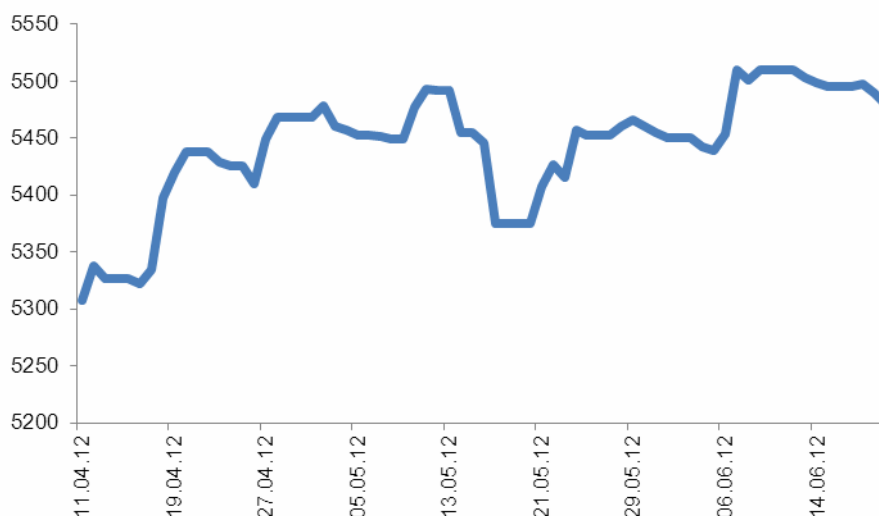
Abrau Durso made a softly-softly entry to the stock market at the end of March 2012, listing its shares on the MICEX at R5200 (\$168) per share. SVL sold 0.5% of its shares over a number of days. The shares have been more or less actively traded since then and have risen in value by 5-6%, resisting the downward trend on the overall market.

10% of shares should be sold to the market in 2012

Management told us that it purposely limited sales to avoid over-supply (free float is now less than 1%), but that up to 10% will be placed by the end of 2012. Managers say that fund raising is not a priority goal of share placement at present. The intention is to encourage investors to assess the business ahead of an IPO, planned in the future.

Abrau Durso also plans to split its shares by 100 times this summer, which will improve share liquidity and may boost price levels.

Abrau Durso share price, rubles



Source: MICEX

Market position

The company has a strong competitive position against both domestic and foreign competitors

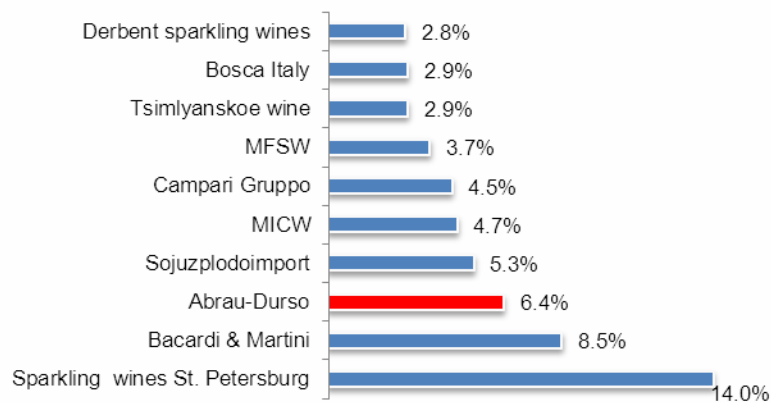
The company has occupied a unique, top-end niche among domestic producers of sparkling wine, offering its Charmat-method wines in a price range of R250-400 (\$8-13) per bottle compared with R120-200 per bottle for other main Russian producers.

Abrau Durso offers its traditional-method wines in the sub-premium and premium price segments at R600-900 (\$20-30), in which its only competitors are foreign Asti manufacturers. The Russian company has an advantage, since Asti wines are produced using the inferior Charmat method.

The long history of Abrau Durso gives it very high levels of recognition in Russia, and it is perceived as the best national brand in the sparkling wine segment, For example, Abrau Durso is the official supplier to the Kremlin and its wines were served at the recent inauguration ceremony for Vladimir Putin’s new term as President.

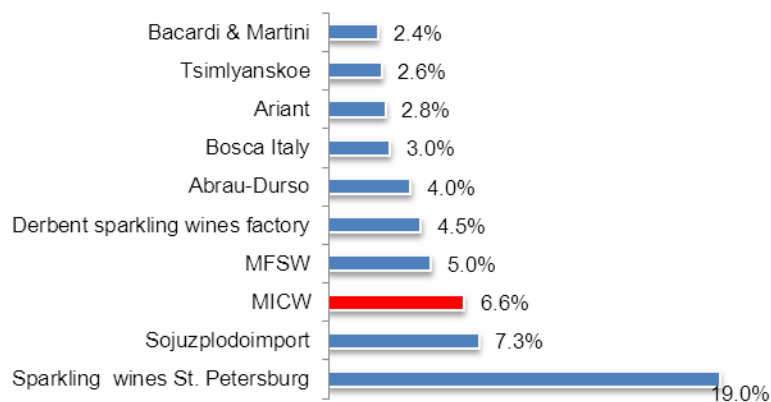
AC Nielsen recently found that Abrau Durso has 6.4% market share by value and 4% share by volumes in Russia’s 15 largest Russian cities.

Leading sparkling wines producers by market share in 15 largest Russian cities (2011, value terms),%



Source: AC Nielsen, company data

Top sparkling wines producers by market share in 15 largest cities in Russia (2011, volume terms),%



Source: AC Nielsen, company data

Distribution

There is still much potential for regional expansion

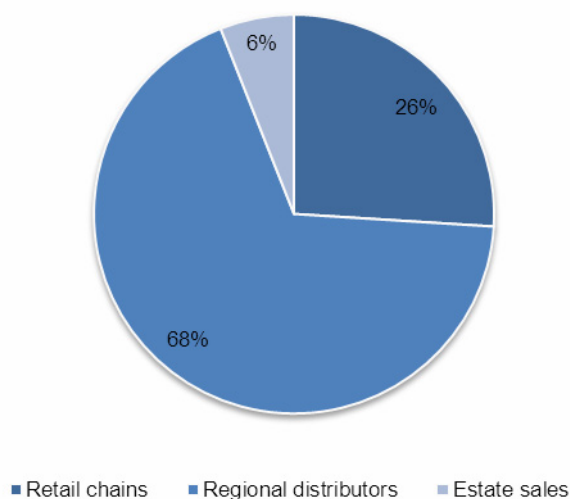
Abrau Durso has a fairly strong distribution model with potential for further development. Its products are offered by all main national retail chains, which account for about 26% of total sales, while 68% are through regional distributors, and 6% directly from the factory.

Abrau Durso itself owns two distribution companies: Kuban Artel Wine, which mainly sells in Krasnodar and other regions of the Southern Federal District (close to Abrau Durso production facilities); and Abrau Trade House, which is based in Moscow and works with main national retail chains and regional distributors.

Management says that recent growth of sales volumes were difficult to achieve, due to limited distribution capacities, but the company is now investing more in marketing and promotional activities. A key problem is lack of motivation among regional distributors to maximize presence of company products on store shelves. Abrau Durso is therefore setting up its own network of regional branches, which will cooperate with local retail chains and single stores to boost sales volumes.

Ongoing regional expansion by the national retail chains is also a good driver for increase of sales volumes.

Abrau Durso distribution structure



Source: Company data

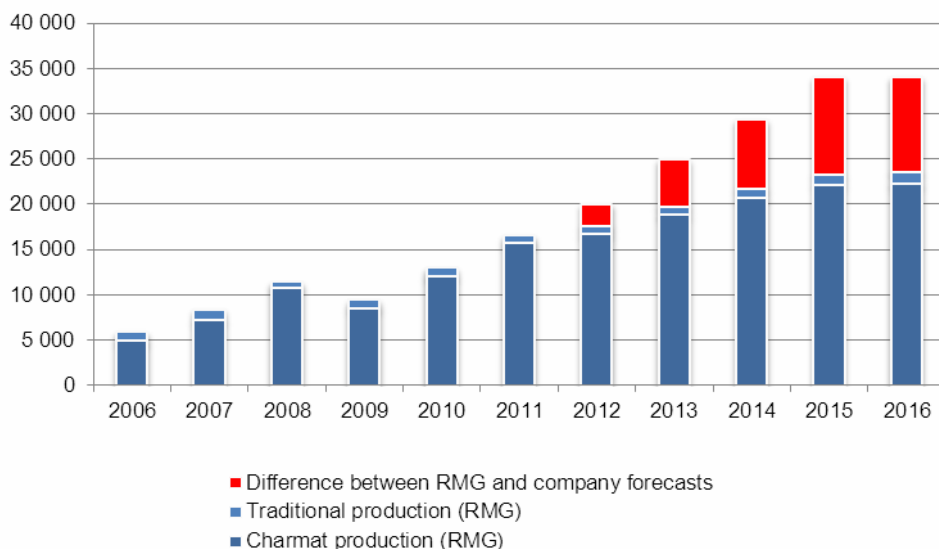
Growth prospects

Our growth forecast is more conservative than that of the company

The company plans to increase total capacity from current 20m bottles per year to 34m by 2015 for an investment of about \$14m. Sales volumes should reach 29.3m bottles in 2014, including 2.2m bottles of more profitable traditional wine (7.5% of total volumes compared with 5% at present). Based on increasing consumption of sparkling wines and of household incomes in Russia, we view the company target as realistic, particularly if backed by strong development of distribution. However, we use a more conservative scenario and assume that sales will grow with 10% CAGR to 23.5m bottles by 2016, of which 22.2m bottles of Charmat sparkling wine and 1.3m of traditional-method wine.

The company also plans to begin production and sale of its own still wine in the long term, and is already looking for possible acquisitions. Such diversification will boost production and sales, as well as smoothing seasonality of the business (Abrau Durso currently generates more than 40% of its revenues in the fourth quarter, due to the seasonality of Russian demand for sparkling wine (see 'Market Overview' above)).

Production profile



Source: Company data, RMG estimates

Financials

The company published its first financials for 2011 (the figures are from management reporting, and an audited IFRS version has been promised by July this year). The company plans to disclose operating results quarterly in the future.

Revenues doubled in 2009-2011 and EBITDA growth was close behind

Revenues doubled in 2009-2011 as sales volumes and selling prices rose, including increase by 55% y-o-y to \$100m in 2011. EBITDA has also risen quickly: by more than 90% in 2010 and by 78% y-o-y in 2011. EBITDA margin has seen very rapid growth, by 5pp and 4pp in 2010 and 2011, respectively, to a level of 32.6%.

Debt stood at \$49m by the end of 2011, of which more than 50% was owed to the controlling shareholder, SVL Group. Total debt-to-EBITDA was unthreatening at 1.5x.

Our estimates, using a conservative forecast for output growth and assuming price increase in line with inflation, suggests revenue growth by 17% CAGR in 2012-2016.

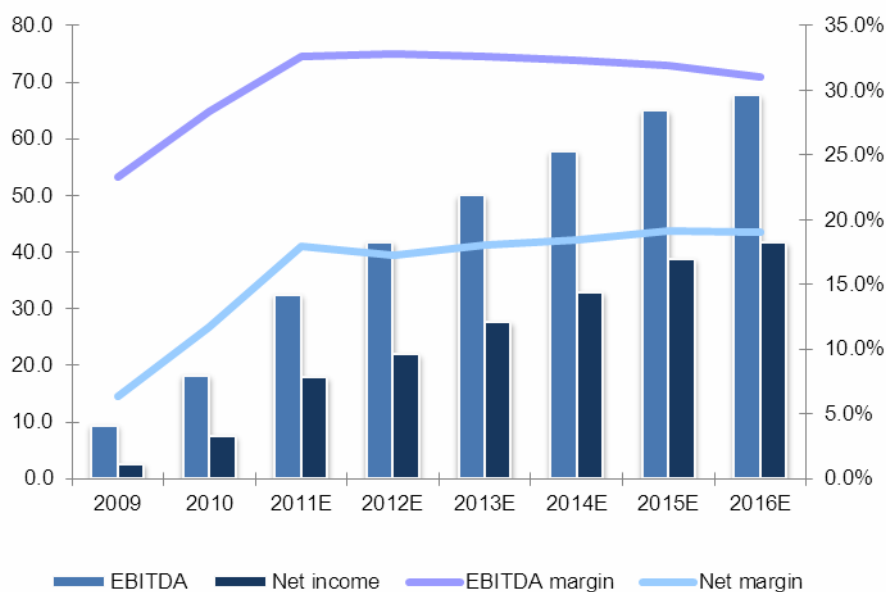
Management says that it does not expect any major increase of profitability in the future, and we forecast a slight decline of EBITDA margin to 31% in 2016 due to higher marketing and advertising costs.

The company plans to invest about \$5m in production facilities and more than \$2m in land acquisition for its vineyard in 2012. Capex will then be at lower levels of \$2.4m up to 2015. We expect the company to finance its capex internally thanks to strong margins.

Debt levels are comfortable

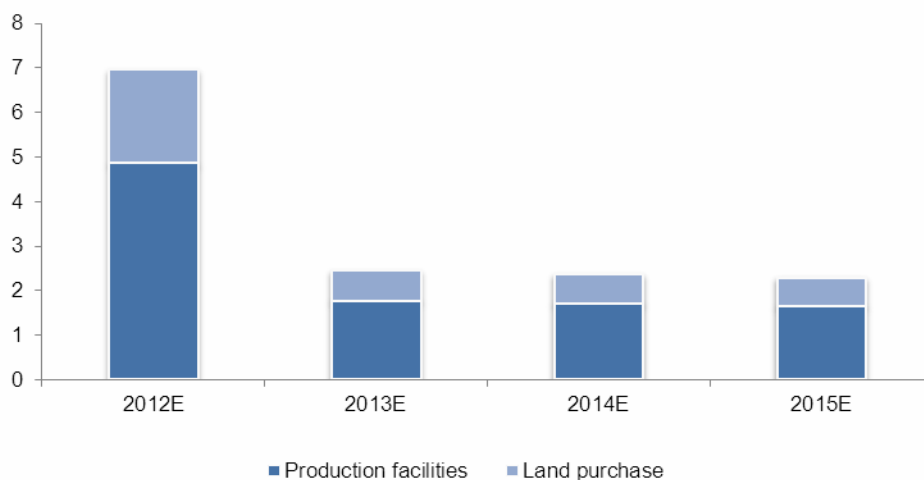
We also expect the company to gradually reduce its debt levels and forecast net debt-to-EBITDA ratio of 1.4x by the end of 2012, which is a comfortable level.

Financials, \$m (RMG forecast)



Source: Company data, RMG estimates

CAPEX breakdown, \$m



Source: Company data, RMG estimates

Risks

We do not see serious risk from the government clampdown on alcohol abuse

The Russian government has announced a long-term policy to reduce alcohol consumption, which currently takes a heavy toll on the country's public health. Limitations have been placed on sale of alcohol at night and levels of excise tax on alcoholic beverages are being increased. The measures are primarily directed against consumption of spirits and beer, and Abrau Durso says that excise duty rates for sparkling wines will only experience a 13.5% increase (to R25 per liter) in 2014. However, we expect some negative impact on the market for sparkling wine.

We also see some risk in the lag between production development and development of distribution capacities. But the company is already taking steps to address distribution bottlenecks (see above).

Valuation

Our DCF model for Abrau Durso uses a relatively high beta rate compared with other food and drink companies, as highly priced goods of Abrau Durso create risk of cyclical demand. We also gave 3% risk premium for low free float and relatively low transparency. Our WACC level is therefore 15.1% with 17% cost of equity and 11% cost of debt.

We also carried out comparative valuation, which finds substantial 40% discount to multiples of foreign peers. This can be explained by the fact that Abrau Durso does not have substantial land ownership and is not present on international global markets, unlike other leading wine houses.

We find 90% upside and 35% in a (unlikely) stress case

Using 75-25 balance between DCF (\$304) and comparative methods (\$359), we value Abrau Durso at \$318 per share, offering considerable upside of 90% from current levels. We recommend to BUY Abrau Durso shares.

We also carried out a stress test for our DCF target price, supposing that sparkling wine sales volumes remain at the current level of 15m bottles until 2014 and only increase to 17m bottles in 2015 and 2016. In the stress case, we also reduce our capex forecast and assume more modest annual price growth of 4.5%. The result is to lower our DCF target price from \$318 to \$227, offering 35% upside from current levels. However, we find the stress-case scenario little probable due to expansion of the Russian sparkling wines market and large potential for sales expansion.

Financial summary

	2009	2010	2011	2012E	2013E	2014E	2015E	2016E
Summary								
EPS, \$	3.5	10.3	24.4	29.8	37.6	44.8	52.8	56.6
EV/S	4.2	2.7	1.7	1.3	1.1	1.0	0.8	0.8
EV/EBITDA	18.2	9.4	5.3	4.1	3.4	3.0	2.6	2.5
P/E	47.9	16.3	6.9	5.6	4.5	3.7	3.2	3.0
P/BV	1.3	1.2	1.0	0.9	0.7	0.6	0.5	0.4
Income Statement, \$m								
Revenue	40.4	64.5	99.6	127.4	153.3	178.8	203.2	218.0
Gross profit	20.1	34.8	57.4	76.7	92.6	107.9	122.3	130.4
EBITDA	9.4	18.3	32.5	41.7	50.0	57.8	65.0	67.7
EBIT	8.2	16.5	29.7	38.8	47.1	54.7	61.9	64.6
Net income, adj.	2.6	7.6	17.9	21.9	27.6	33.0	38.8	41.6
Profitability, %								
EBITDA margin, %	23.3%	28.3%	32.6%	32.8%	32.6%	32.3%	32.0%	31.1%
Net margin, %	6.4%	11.8%	18.0%	17.2%	18.0%	18.4%	19.1%	19.1%

Source: Company data, RMG estimates

FCFF calculation

	2012E	2013E	2014E	2015E	2016E
EBIT, \$m	38.8	47.1	54.7	61.9	64.6
- Cash taxes on EBIT, \$m	9.7	12.3	14.6	17.2	18.5
NOPLAT, \$m	29.1	34.8	40.1	44.7	46.1
+ Depreciation & amortization, \$m	2.9	3.0	3.0	3.1	3.1
- Capex, \$m	7.0	2.5	2.4	2.3	2.2
- Changes in net working capital, \$m	26.5	21.1	21.0	20.4	12.4
Free cash flow to firm, \$m	-1.48	14.23	19.79	25.04	34.58
Discount factor	1.00	0.87	0.75	0.66	0.57
Discounted FCFF, \$m	-1.48	12.36	14.93	16.41	19.68

Source: RMG estimates

WACC calculation

Risk-free rate, %	7.0%
Leveraged beta	1.37
Standart risk premium, %	5.0%
Specific company premium, %	3.0%
Cost of equity, %	16.8%
Cost of debt (after tax), %	10.6%
Weight of debt	0.3
WACC, %	15.1%

Source: Bloomberg, RMG estimates

DCF fair price calculation

Terminal growth rate, %	1.5%
EBIT margin in terminal period, %	29.6%
EBIT in 2017, \$m	69.8
Cash flow in 2017, \$m	52
Discounted value 2012-2016, \$m	81
PV of terminal value, \$m	190
Fair EV, \$m	271
Net debt, \$m	48
Fair MCap, \$m	224
Number of shares, m	0.735
Fair price per share, \$	304

Source: RMG estimates

Comparative multiples of peers, 2011E

	Country	MCap, \$m	EV, \$m	EV / S	EV / EBITDA	P / E	P / BV	EBITDA margin, %	Net margin, %
Emerging markets									
United Spirits	India	1 918	3 233	1.9	13.3	28.8	2.0	14%	4%
CEDC	Poland	311	1 541	1.7	10.8	19.1	1.2	16%	2%
Vina Concha Y Toro SA	Chile	1 601	1 989	2.1	12.6	17.6	2.1	17%	10%
Median, all EM peers				1.9	12.6	19.1	2.0	16%	4%
Developed markets									
Diageo PLC	Britain	63 929	74 551	4.3	13.1	17.2	6.6	33%	21%
Pernod-Ricard SA	France	27 395	40 479	3.8	13.5	17.0	2.0	28%	15%
Constellation brands INC	United States	4 244	7 471	2.8	8.6	10.0	1.7	33%	16%
Remy Cointreau	France	5 294	5 760	4.3	20.3	30.8	3.5	21%	13%
Davide campari	Italy	3 956	4 780	2.7	10.5	16.5	2.2	26%	13%
Median, all DM peers				3.8	13.1	17.0	2.2	28%	15%
Median for all foreign peers				2.8	12.8	18.1	2.1	22%	9%
Abrau-Durso	Russia	123	171	1.3	4.1	5.6	0.9	33%	18%
Premium/discount to:									
DM peers				-64%	-69%	-67%	-61%		
EM peers				-30%	-67%	-71%	-57%		

Source: Bloomberg, RMG estimates

Comparative valuation (2012E)

	EV / S	EV / EBITDA	P / E	P / BV
Median for peers	2.8	12.8	18.1	2.1
Applied premium/discount, %	40%	40%	40%	40%
Implied multiples for valuation	1.7	7.7	10.8	1.3
MCap based on multiples, \$m	218	321	238	180
Weight, %	10%	40%	40%	10%
Weighted fair market cap, \$m		264		
# of shares outstanding		735 000		
Fair price, \$		359		

Source: Bloomberg, RMG estimates

Final valuation

	DCF	Comparative
Fair price per share, \$	304	359
Weight in final fair price, %	75%	25%
Final fair price per share, \$	318	

Source: RMG estimates

Any information and opinions contained in this analytical document (hereinafter – the “Analytical Materials”) are published solely for informational purposes and are not and should not be construed as an offer or a solicitation of an offer to buy or sell any securities or other financial instruments mentioned herein.

Any investments in securities or other financial instruments may be related to significant risks, appear inefficient or unacceptable for this or that category of investors. Any decision on investments in the securities and other instruments requires significant experience and knowledge in financial matters, and in issues of evaluation of risks and benefits related to investments in this or that financial instrument.

The Analytical Materials may be used by investors in the Russian Federation subject to the laws of the Russian Federation. The Analytical Materials are not addressed to residents of the USA, UK, Canada, Australia, Japan and to investors in other jurisdictions, unless this is permitted to particular investors in special circumstances provided for by the laws of their home jurisdiction. Rye, Man and Gor Securities accepts no liability for use of the Analytical Materials by investors, who are not permitted to do so under the laws of their home jurisdiction.

Information has been obtained from reliable sources and any opinions herein are based on sources believed to be reliable, but no representation or warranty, either expressed or implied, is provided in relation to the accuracy, completeness or reliability of such information.

Any opinions expressed are the opinion of specialists of Rye, Man and Gor Securities and subject to change without notice. Rye, Man and Gor Securities is under no obligation to update or correct any inaccuracies contained in the Analytical Materials.

Neither Rye, Man and Gor Securities nor any of its directors, employees, agents, affiliates or licensees accept any liability for any loss or damage arising from use of the Analytical Materials.

Investors should assume that Rye, Man and Gor Securities does or seeks to do investment business with any of the companies mentioned herein. Rye, Man and Gor Securities and its directors, employees, agents, affiliates or licensees may, from time to time, have long or short positions in, and buy, sell, make a market or otherwise act as principal or as agents in transactions on securities or other financial instruments related to companies mentioned in the Analytical Materials.

The Analytical Materials may not be reproduced, redistributed or any other way used, in whole or in part, without the written permission of Rye, Man and Gor Securities.

All rights reserved © [Rye, Man & Gor Securities](http://Rye.Man&GorSecurities.com), 2012