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Buy
$0.415

SIBNEFT
On a more transparent path?

Two corporate events that took place at Sibneft on Friday make us significantly more optimistic about the outlook for its shares.

Consolidation of trading subsidiaries boosts transparency.

First, Sibneft's EGM approved acquisition of two trading companies, Vester and Olivesta, registered in the Russian offshore zone of Kalmykia. Sibneft acquired control over these companies in exchange for 4,000 shares, worth a total of $1,680. This appears a small price to pay considering that, according to Sibneft's board member and Naufor chairman Ivan Tirishkin, just one of these companies had retained earnings of $300mn prior to consolidation. The consolidation of Olivesta and Vester follows a similar step last year, when Sibneft replaced its long-term trader Runicom with the fully consolidated Sibneft Oil Trade. We view consolidation of trading subsidiaries as a key step in increasing corporate transparency and thus a major positive for the stock.

Record dividend payout…

Sibneft also announced Friday that it would pay $612mn in interim dividends, the largest dividend ever paid by a Russian company. Per share dividend will be $0.13, implying a dividend yield of 32%. The dividend will be payable on 17 September to shareholders of record on 3 August. Although it has been called interim, the payment effectively represents a dividend for the full year 2000.

During a conference call with analysts Friday, Sibneft said that the dividend payment would apply to treasury shares as well, which account for 27% of total shares outstanding. Treasury shares are not considered as such for statutory accounting proposes, since they are held by Sibneft's fully owned subsidiaries and not the company itself. Sibneft executives said that the dividend on treasury shares would be paid in a way to avoid a tax withholding charge.

Sibneft shares rallied 15% in response to the news Friday, but gave back nearly all of their gains by the end of the day, closing just 1% higher. It is our opinion, however, that the dividend should not have had any impact on the share price, both because the record date has already passed and because the dividend was clearly extraordinary in nature.

In fact, we view the dividend payment as a major long-term positive development for the stock. It is as an indication that, in the future, majority shareholders may continue to seek maximum returns from their investment in Sibneft via large dividend payments, which will benefit all investors alike. Sibneft has a formal dividend policy of paying at least 15% of net income as dividends, but company executives indicated during Friday's conference call that the dividend payout ratio might be closer to 50%-60% over the long-term earnings cycle.

… may represent distribution of past profits

One may speculate endlessly as to the reasons for such a sizeable dividend payment. The most obvious idea is that Sibneft's major shareholders want to raise cash for some other business venture. We, however, find another senario more realistic - the dividend could well represent distribution of retained earnings from the newly consolidated trading subsidiaries, which would have easily amounted to $500mn - $600mn. If our theory is true, it would mean Sibneft is returning to all

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minority shareholders profits that accrued outside the company during the past several years, a revolutionary step in Russian corporate governance.

Our theory is supported by the statement of Eugene Tenenbaum, an adviser to Sibneft's CEO, who said that the company's debt will not change materially from the current $600mn level. According to our estimates, Sibneft's 2001 operating cash flow of $900mn - $1bn is insufficient to cover the $612mn dividend payment and planned $600mn-$700mn in capex. Thus, in order for debt levels to remain unchanged, cash must be coming from somewhere else - and this "somewhere else" could easily be the accounts of trading subsidiaries.

From another perspective, , combining the estimated 2000 dividend of $100mn with the probable $500mn - $600mn of retained earnings at Vester and Olivesta yields a number remarkably close to the announced dividend payment of $612mn.

In any event, Sibneft's controlling shareholders clearly chose to return cash to themselves; but they did so in the most transparent and legitimate way possible - via dividends.The fact that the payment has been made available to all of Sibneft's investors speaks volumes for management's determination to include minority investors in the profit distribution process.

Borrowing to pay dividends - Finance 101 revisited.

In our opinion, that even if Sibneft had to borrow $150mn - $200mn for dividend payment, it would represent a positive development due to a subsequent reduction in the company's weighted average cost of capital.

Basic finance theory dictates that, as long as debt is cheaper than equity, replacing the latter with the former makes perfect sense. A reasonable investor would want to increase leverage in order to generate higher returns on invested capital, similar to buying stock on margin.

Sibneft's COO Alexander Korsik said that the company does not invest in projects that carry a return below 20%, assuming a core Urals price of $16.5/bbl. We estimate that Sibneft pays around 10% interest on its debt. At the same time, the cost of equity for Sibneft shareholders has to be at least 20%. Under such conditions, replacing debt with equity clearly makes sense.

The strategy becomes risky, of course, if the company over-leverages itself and then oil prices fall. We are not worried about such a scenario in Sibneft's case, however, as the company appears to have a solid financial position. Assuming a $200mn increase in debt, the $800mn total debt would amount to 68% of estimated 2001 EBITDA of $1.1bn and 120% of expected net income of $670mn. The interest coverage ratio, assuming a 10% interest rate, would be around 11x. Debt per barrel of production would be $5.2, versus $9.3 at TNK, $4.85 at Tatneft and $4.2 at Lukoil.

Comparison with peers - we like Sibneft better

At $0.41 a share, Sibneft trades at FY01 EV/EBITDA of 2.1X including treasury shares and 1.7X excluding them. While this represents a slight premium to Yukos (which is often used as a benchmark for Sibneft), we believe that Sibneft may rightfully deserve a premium.

First, its US GAAP numbers are of much higher quality than those of Yukos. Second, Sibneft reports in US dollars, versus rubles of constant purchasing power at Yukos, which often greatly distort actual performance. Finally, Sibneft's growth rate also appears superior to Yukos. According to the COO, Sibneft will produce 20.5mn tons (410mbpd) of crude oil in 2001 and 26mn tons (520mbpd in 2002). This implies 19% growth in 2001 and 27% growth in 2002, by far the fastest growth rate in the sector.

We continue to favor Sibneft as perhaps the most attractive investment in the sector and maintain our Buy recommendation.

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