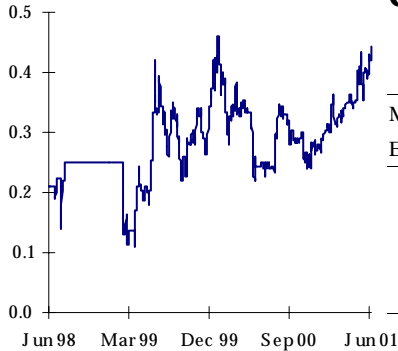


SIBNEFT

Share repurchase: another case of good intentions or can of worms?



Mcap: \$1.5bn*	Revenues (\$ mn)	EBITDA (\$ mn)	Net profit (\$ mn)	EPS (\$)	ch. yoy (%)	EV/EBITDA (x)	P/E (x)	EV/S (x)
EV: \$2.1bn								
1999	1746	547	287	0.06	n/a	3.8	7.3	1.2
2000	2398	1027	675	0.19	222%	2.0	2.3	0.9
2001F	2806	1156	590	0.17	-13%	1.8	2.6	0.7
2002F	3140	1217	625	0.18	6%	1.7	2.4	0.7

* This and other calculations are made adjusted for treasury shares (ie using 3.46bn shares outstanding)

INVESTMENT SUMMARY

Sibneft reported yesterday that it acquired 27% of its own stock from a group of controlling shareholders during last year. The company paid \$541mn, or \$0.42 a share, for the stake. Thus the price paid represents a 35% premium to last year's average share price. However, we find the premium justified, given the resulting improvements to the capital structure.

At face value the transaction seems beneficial to minority investors. First, at present, debt financing is clearly better than equity from the point of view of cost of capital - we estimate that Sibneft's WACC declined by 3.8% to 22% as a result of the buyback. We further estimate that reduction in WACC increases our target EV/Cash flow multiple from 5.8X to 7.6X, thus increasing our target equity value from \$4.65bn to \$5.85bn. Secondly, Sibneft says it plans to use these shares to raise additional funds, either by issuing a convertible bond or by selling equity, either of which would ultimately increase the free float and improve trading liquidity.

This said, the fact remains that management, which retains absolute control over Sibneft, has in a sense sold \$541mn worth of stock to itself. Although the price paid seems fair, we doubt that the primary reason for the transaction was to lower the cost of capital. A simpler, and maybe more accurate, way to look at this is that insiders simply chose to take some excess cash out of the company. This is fine, of course, but we are negatively surprised that minority investors were not offered a chance to participate in the buyback.

Thus we believe that the shares may come under pressure in the near term as some investors respond negatively to the news. Longer term, we remain supportive of the stock due to its excellent fundamentals, which were confirmed by the slightly better than expected 2000 results.

According to US GAAP numbers, released yesterday, the EBITDA of \$1bn was fully in line with our estimate, while net income of \$675mn was 22% above our estimate due to a lower than expected tax rate. The quality of the reported numbers was very high since Sibneft reports under US GAAP in US\$, compared to rubles of constant purchasing power at Yukos and Tatneft.

In our view, Sibneft remains the best defensive option in the sector due to its rapid production growth (up 17% in Jan-May 2000) and heavy exposure to the domestic market, where prices have remained firm despite falling export prices. As a result, we expect Sibneft to be the only Russian oil company to post EBITDA growth in 2001. We maintain our Buy recommendation on the stock.

The transaction

According to Sibneft, in 2000 it acquired 27% of its shares from a group of controlling shareholders. Based on a disclosed purchase value of \$541mn, we estimate that Sibneft paid \$0.42 a share, a premium of 35% to the average 2000 price of \$0.31 as posted on the RTS. We are not overly concerned about the dilutive implications of the premium. The average RTS price cannot really be used as the basis for pricing such a large block, which in effect constitutes a blocking minority stake. Also, repurchase of the stock has the effect of creating value for remaining shareholders, so it seems legitimate to pay at least some premium.

Finally, Sibneft explained to us that it chose to acquire its own shares due to their undervaluation, and that it now plans to use treasury stock to raise money, either by issuing a convertible bond or by selling the shares to investors. These plans imply a potential increase in free float, which is of course also good news.

According to Sibneft and various media sources, the deal was structured as follows:

- each member of a group of controlling shareholders, who jointly own approximately 88% of the company, transferred a proportionate part of his/her stake to Runicom SA, Sibneft’s trader. As a result, Runicom’ ownership increased to 28.5%.
- Runicom then sold 27% out of the total to a group of offshore companies owned by Sibneft. The new equity holders are fully consolidated in Sibneft’s US GAAP reporting.

Under Russian legislation, a company cannot hold more than 10% of its own equity on its books for more than one year. Any larger stake, or any treasury stock held for more than a year, must be retired. This explains why Sibneft, just like Lukoil, Yukos and Gazprom, uses fully consolidated subsidiaries to hold treasury stock.

Technically, however, although this 27% stake was dubbed “treasury stock,” these shares are not treasury shares in the original meaning of the word. They will maintain voting and dividend rights, and under Russian law they are considered outstanding equity. Thus, Sibneft’s treasury share structure now closely resembles that of Surgutneftegaz. However, since these shares have been classified as “treasury” under US GAAP, we will treat them as such for valuation purposes and reduce share count accordingly.

Excluding this 27% of equity, we estimate that management and insiders now own 84% of the remaining 3.46bn shares, while minorities own 16%. Thus, the controlling group of shareholders maintains a supermajority in Sibneft even after the repurchase.

There is solid financial rationale for the deal...

Looking at the transaction from a purely financial standpoint, the deal makes sense for Sibneft. For Russian oils, debt financing is cheaper than equity, so it is profitable for shareholders to increase debt at the expense of equity, to a reasonable degree, of course. We calculate that Sibneft reduced its WACC by 3.8% to 22.1% as a result of replacing debt with equity.

Replacing equity with debt reduces WACC...

	Before repurchase			After repurchase		
	Equity	Debt	Total	Equity	Debt	Total
Market value, in \$mn	2086.04	211.74	2297.78	1522.84	592.55	2115.39
Weighting in total capital	91%	9%	100%	72%	28%	100%
After-tax cost	27.7%	7.2%	25.8%	27.7%	7.2%	22.0%

Source: Company data; Aton estimates

Also, by reducing the number of shares outstanding, Sibneft increases the value per share for remaining shareholders. Excluding “treasury” stock, Sibneft’s 2000 EPS were \$0.20 vs \$0.14 on a fully diluted basis, which effectively led to a 27% decline in the trailing multiple. Also, we calculate that Sibneft’s EV/EBITDA multiple has declined by 8% as a result of the share buyback.

...and EV/EBITDA multiple

Price (June 26,01), \$	0.44
MCap, full share count, \$mn.	2086.04
MCap, ex. treasury stock, \$mn.	1522.84
Net debt (excl. 2000 change in debt), \$mn.	211.74
Net debt (incl. 2000 change in debt), \$mn.	592.55
EV (ex. treasury stock), \$mn.	2297.78
EV (with treasury stock), \$mn.	2115.39
2000 EBITDA, in \$mn.	1027.42
EV/EBITDA (ex.treasury stock)	2.24
EV/EBITDA (with treasury stock)	2.06
Reduction in EV/EBITDA multiple	-8%

Source: Company data

...but was it the real raison d’etre?

We believe that desire of controlling shareholders to raise cash was the preeminent reason for the transaction. In 2000, Sibneft’s major shareholders engaged in a number of new business ventures, most notably the creation of Russia’s largest aluminum holding RusAl, which is likely to have required additional financing.

If Russia’s capital markets were more developed, or demand for Russian equities had been stronger in 2000, Mr. Abramovich and his partners could have exited their investment via a secondary offering. However, in the absence of these circumstances, the only investor with the means to acquire the stake and to have a full understanding of the company was...the company itself.

However, Sibneft’s balance sheet appears to represent a transition stage for these shares. According to the company, Sibneft plans to use them for capital raising purposes, either by issuing a convertible bond or undertaking a secondary equity offering.

If these developments were to take place, 27% of Sibneft shares could eventually flow into the market. Along with the current free float of 12%, it would imply that 39% of Sibneft stock might possibly be held by minority investors, the second highest degree of minority ownership in the sector after Lukoil.

We tend to believe the company on this issue. After all, if controlling shareholders really wanted to, they could have found a way of raising half a billion dollars from Sibneft without disclosing it or reducing their economic interest. Also, Sibneft was one of the first companies in the sector to significantly improve its corporate governance practices in 1999, and it is altogether plausible that it now wishes to leverage this for financing purposes.

There are several other versions of why Sibneft decided to buy its own shares. One is accumulation of a blocking stake for a prospective strategic buyer - a possible prelude to a fully-fledged sale. Another is the company’s decision to buy out shareholders who did not want to be affiliated to the company any longer. This list might possibly include controversial businessman Boris Berezovsky and/or Dart Management. However, our main version of why the deal took place is still fund-raising by the main controlling shareholders.

Risks

The transaction creates several new risks for investors. First, the company is becoming more leveraged at what appears to be the top of the earnings cycle. While debt coverage ratios are more than adequate, the rationale for buying back stock with borrowed money is clearly less convincing than doing it from excess free cash flow.

Secondly, the transaction introduces a risk that treasury shares might not be used as originally intended. For instance, Sibneft may transfer or sell these shares to related parties without receiving appropriate compensation. Sibneft executives already stated that these shares might be used to compensate management through stock options.

Conclusions

On balance, we do believe that Sibneft's purchase of 27% of its equity represents a beneficial transaction for minority investors as it reduces cost of capital and improves valuation multiples. Share buyback represents a reasonable and tax-efficient way to return cash to shareholders.

However, three fundamental issues prevent us from wholeheartedly approving the transaction. First, Sibneft did not extend its buy-back offer to minority shareholders. Although it was not required under Russian law, one could expect it from a company which has solid corporate governance. Second, share buybacks in their pure form are made from excess cash. The rationale for buying back shares with borrowed money, especially at the top of the earnings cycle is of a more debatable nature.

Income statement

Sibneft reported 2000 US GAAP numbers which surpassed our expectations. Net income of \$675mn was 22% above our forecast, mainly due to a lower than expected effective tax rate (10% vs 30%). Reported EBITDA of \$1.03bn was up 90% y-o-y and fully in line with our \$1.04bn forecast.

Revenue of \$2.4bn was 37% above the 1999 level and 19% below our forecast. This difference is explained by the fact that Sibneft uses export price net of export duties and some other taxes for revenue calculation, while we assumed prices gross of export duties in our forecasting.

EBITDA margin of 43% was below 62% at Yukos, a company Sibneft is often compared with. The better margin results the higher export ratio at Yukos. Yukos derived approximately 74% of its revenues from exports last year, compared with 38% for Sibneft. Export sales were far more profitable than domestic in 2000.

However, comparing Yukos to Sibneft on the basis of their US GAAP results is like comparing apples to oranges. As we explained in a recent note, Yukos reports its results in rubles of constant purchasing power, which inflate results (including EBITDA) expressed in dollars in periods of high inflation and stable exchange rates. Sibneft, in contrast, reports its numbers in US\$, which makes them far more relevant for investors.

Cash flow and balance sheet

Operating cash flow was \$920.5mn, 43% above our forecast. Capital expenditures were \$268mn. Investments were made to acquire a 40% stake in Orenburgneft and 1.5% of Onaco, totaling \$480mn.

Considering that after the full consolidation of Onaco, Sibneft will own 33% of the combined company, Sibneft appears to have paid slightly less for its shareholding than TNK, a future 67% owner. Based on TNK's auction bid last year, it valued the entire group at \$1.6bn vs the \$1.45bn, implied by Sibneft's price.

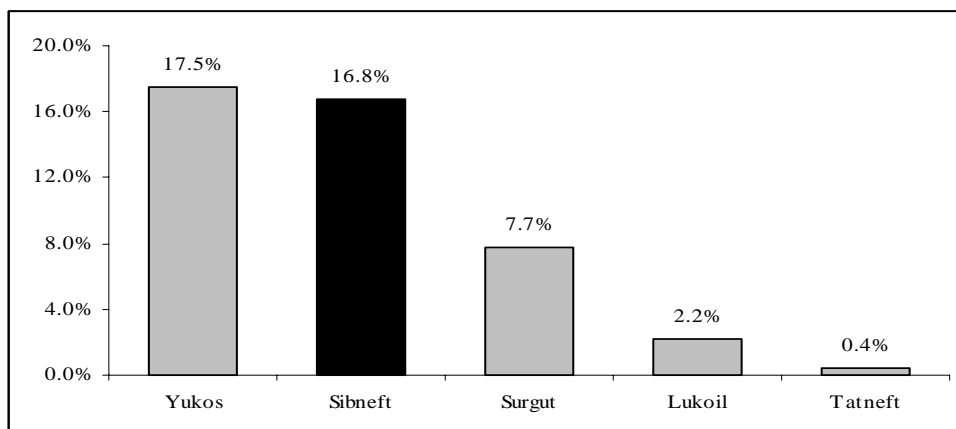
However, the number was well above our purchase price forecast of \$200-250mn.

Despite generating free cash flow of \$170mn, Sibneft total debt increased by \$381mn. At the same time, cash has risen by just \$11.4mn as the company spent \$541mn to buy back from its majority shareholders.

Production forecast revised upwards

Sibneft revised its production forecast for 2001 upward by 5% to 405bpd (20.5mn tons), which implies 19% growth y-o-y. While the projected growth may seem overly optimistic, we think that the estimate is realistic, considering that Sibneft has already delivered 17% growth rate in January-May 2001 and its production volumes are rising.

Sibneft daily output rises 17% y-o-y in January-May 2001



Source: Company data

Utilization of enhanced recovery and horizontal drilling allowed Sibneft to improve average well flow 7% in 2000 y-o-y to 86.24bpd, which is 44% above the industry average.

By 2003, Sibneft plans to reach a production level of 209mn bbl, which will be the major value driver for the company and is expected to offset weakness in crude oil prices and rising production costs. The major part of growth will be from new fields, which will be contributing around half of total output by 2003, according to Sibneft's plans.

Corporate governance

Sibneft's management recommended its BoD to adopt a formal dividend policy, which envisions payment of 15% of net income as dividends over the long-term earnings cycle. If approved, this would be the first formal dividend policy adopted by a Russian oil/gas company.

Sibneft said that it would announce its 2000 dividend during the AGM, scheduled for 29 June. Using the 15% payout ratio and US GAAP net income of \$675mn, implied dividend is \$0.021 per share, which represents the higher end of our \$0.015-\$0.02 range.

The upcoming AGM may bring another positive improvement to corporate governance practices. According to Vedomosti, minority shareholder representatives are likely to gather two seats on Sibneft's board, the highest minority representation ever.

Aton Capital Group

27 Pokrovka Street, Bldg. 6
Moscow, Russia 103062

7 (095) 777-8877
7 (095) 777-8876, fax

www.aton.ru
aton@aton.ru

ATON <GO> (Bloomberg)

Trading

saltrad@aton.ru
7 (095) 777-8872

International Sales

istrd@aton.ru
7 (095) 777-8845

Nick Betsky
Ryan Dodd
Kevin Dougherty
Bobby Lowe
Richard Stevenson

Domestic Sales

sales@aton.ru
7 (095) 777-8873

Albert Gavrikov, Department Head
Alexei Kaminski
Konstantin Khaydukow
Denis Piskunov
Alexei Primak
Valery Tolkachev

Research

atonres@aton.ru

Jim Nail, Department Head

Economics

Peter Westin
westin@aton.ru
7 (095) 777-8877, x3117

Utilities

Michael P. Fogarty, CFA
mfogarty@aton.ru
7 (095) 777-8833

Telecoms/Technology

Nadezhda Goloubeva
nadia@aton.ru
7 (095) 777-8834

Oil/Gas

Steven Dashevsky, CFA
steven@aton.ru
7 (095) 777-8832

Industrials/Transport

Brian Chipman
chipman@aton.ru
7 (095) 777-8837

Editor

Vadim Kotikov
kotikov@aton.ru
7 (095) 777-8877, x3121

Vladislav Metnev
metnev@aton.ru
7 (095) 777-8836

Helen Sakhnova
sakhnova@aton.ru
7 (095) 777-8835

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