

Sibneft – Consolidating The Profits

We were initially so cynical about Sibneft's motivation in announcing a stunningly high dividend of US\$612 million in August, that we downgraded our recommendation on the stock from Buy to Hold. After two weeks of further contemplation, it appears that although our initial caution was not entirely unjustified, our decision to downgrade our recommendation was. With the company appearing to have turned the corner in terms of profitability and potential dividend payouts, we are now recommending the shares as a **Buy**, and rate Sibneft a **Market Outperformer**.

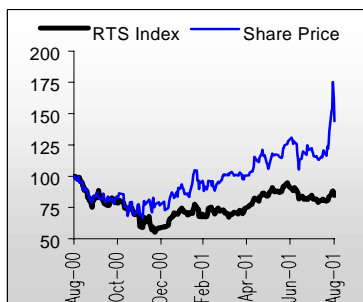
Back To A Buy

Sibneft - Recommendations

Short Term	Buy
Long Term	MO
Target Price (US\$)	US\$1.16
Ticker	SIBN

An Outperformer

Sibneft – Stock Performance Vs RTS



Cheap Valuations

Sibneft – Selected Market Data

Market Cap (US\$ mln)	1,811	
Free Float (%)	16%	
12 mo Hi/Lo (US\$)	0.52/0.27	
Share Price (US\$)	0.525	
RTS Level	209.57	
	PE	EV/EBITDA
2000	2.5	2.3
2001E	1.6	1.5
2002E	1.8	1.5

Consolidation Drives A Re-Rating ...

Our change of view on Sibneft has been inspired by a fuller understanding of the consolidation of its trading subsidiaries and how it will result in a doubling of the company's profits this year, despite a lower oil price and higher costs than 2000. This will mean that the company produces net income per barrel on a par with YUKOS and Surgutneftegas, rather than with LUKOIL and Tatneft, and as a result we believe that it deserves a rating higher than its current prospective P/E ratio of 1.6 times 2001 earnings. The statement by Sibneft management that its long-term goal is to pay out 50% of net income (with a 15% minimum level) also implies that, on our current forecast for 2001, the stock is trading on a prospective yield of between 7% and 23%, which clearly provides significant downside protection for investors.

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Operating Performance Will Improve ...

Sibneft's increased capital expenditure over the past 12 months and its ongoing alliance with Schlumberger are now bearing fruit. The company has increased its production forecast for 2001 to 20.5 million tonnes (150 million barrels), implying an increase of 19% compared to 2000. This is astonishing growth, which Sibneft expects to be repeated in 2002, before declining to the still impressive rate of 10% in 2003. By 2005 the company is looking for production of around 200 million barrels per annum, almost 60% higher than the level seen in 2000. Taking these new production forecasts and our fresh understanding of trading operations, into account, we now estimate that Sibneft has a fair value of US\$1.16 per share, almost exactly 100% above the current share price.

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... But Investment Risks Do Remain

Our one caveat continues to be the motivation of the majority shareholders. The reason for the recent change of heart has been the new tax laws which have made it much more difficult to use transfer pricing. It seems to us that the regime of President Vladimir Putin is clearly making its influence felt amongst the business elite and is forcing them to play by the rules. This is very positive for now, but begs the question as to what happens if the administration's grip ever loosens, and we have little doubt that should new loopholes emerge, they will be exploited by Sibneft's majority shareholders.

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Consolidation Drives The Re-Rating

The major change in our view of the company has been caused by the impact of the consolidation of two trading companies named Vester and Olivestra (Kalmykia-registered structures that trade Sibneft's oil and products). We believe that both companies made around US\$300 million in net profit during 2000 from arbitraging the transfer price between Sibneft's upstream subsidiaries and its refinery at Omsk (and perhaps also through involvement in its export sales). While it is important to note that the activity of both companies was not illegal under Russian law, it clearly transferred huge value away from Sibneft.

As a result of the consolidation of these companies into the Sibneft holding structure, which has been almost entirely motivated by the new tax legislation that makes transfer pricing much more difficult, the profitability of the holding company will increase dramatically. We estimate that in 2000 the trading companies had revenues of around US\$7 per barrel, which will effectively be added straight back into the net revenues of Sibneft as a result of the consolidation at minimal cost (Sibneft is paying around US\$2,000 for both companies).

Clearly the suspicion is that the trading companies were formerly owned by the majority shareholders of Sibneft, who are now transferring profitability back to the holding company rather than keeping it for themselves in the trading companies. This is clearly good news for Sibneft's minority shareholders going forward, despite the annoyance of realising how much they have missed out on in the past.

2001 Net Income Forecast Implies A 70% Y-O-Y Rise In Profitability

Prior to the dividend announcement, our profit forecast for Sibneft in 2001 had been just below US\$600 million. The dividend payout of US\$612 million clearly showed this to be wrong, as the dividend has been officially classified as an interim payment, implying that profits for H1 2001 cannot be less than US\$612 million.

Taking this into consideration, and having re-evaluated the full impact of the consolidation of the trading companies, we have increased our net income forecast for 2001 to US\$1.15 billion, implying EPS of US\$0.33 and a 70% increase in profitability over the previous year. It should be noted that we have treated the shares that the company re-purchased at the end of 2000 as treasury stock, despite the fact that they are being held in a 100% subsidiary (similar to the structure at Surgutneftegas). This is the treatment that Arthur Andersen used in the 2000 US GAAP accounts.

Going forward into 2002 and beyond, the impact of the consolidation will clearly remain, albeit at lower oil prices on our current assumptions. Nevertheless, it will put Sibneft into a different league of profitability when compared with its Russian peer group, as shown in the table below. It will rank with the leaders such as Surgutneftegas and YUKOS, and will leave LUKOIL and Tatneft needing to upgrade their short-term profitability to compete.

Sibneft To Move Up Into The Next League

Table Of Per Barrel Profitability For 2001

	2001 Net Income Estimate	2001 Production Estimate	Profit Per Barrel
LUKOIL	2456	510	4.82
Surgutneftegas	2195	318	6.90
YUKOS	2732	418	6.54
Sibneft	1148	151	7.60
Tatneft	599	186	3.22

Source: Company data, Renaissance Capital estimates

Consolidation Drives The Re-Rating – continued from page 2

Management Policy Is To Pay Out 50% Of Net Income In Dividends

This new level of profitability has clear implications for future dividend payments, given Sibneft's new commitment to a payout policy. Although we continue to believe that the recent huge payout was motivated by the majority shareholders' need for cash in the short-term, the company has outlined a policy which sees it competing with the international majors in paying out an average of 50% of net income, with a minimum level set at 15% on an annual basis. In the table below we show the implication of a 15% payout as well as a 50% payout ratio, and it is clear that even at the lower level there is significant support for the current share price given the implied yield of 7%.

Sibneft To Up The Ante

Table Of Different Dividend Payouts

	2000	2001	2002	2003	2004	2005
Net Income (US\$'000)	674,845	1,148,232	1,024,602	1,077,720	1,187,674	1,310,483
15% payout (US\$'000)	612,000	172,235	153,690	161,658	178,151	196,573
Dividend per share (cents)	12.9	3.6	3.2	3.4	3.8	4.1
Yield (%)	24.6%	6.9%	6.2%	6.5%	7.2%	7.9%
50% payout (US\$'000)	337,423	574,116	512,301	538,860	593,837	655,242
Dividend per share (cents)	7.1	12.1	10.8	11.4	12.5	13.8
Yield (%)	13.6%	23.1%	20.6%	21.7%	23.9%	26.3%
Share price (cents)	52.5					

Source: Company data, Renaissance Capital estimates

Increased Profitability Provides Protection For The Balance Sheet

Having bought back 27% of the company's shares for US\$541 million at the end of 2000, Sibneft ended the year with net debt of US\$565 million. Prior to the dividend announcement we had anticipated the company reaching net cash position by the end of 2001, but we now expect that Sibneft will have net debt of US\$467 million by the end of this year. The company has stated that it expects net debt to be around US\$500-600 million, but that this will in no way inhibit its development plans, which include spending approximately US\$650 million on capital expenditure this year.

Essentially then, the company is using the dividend payment to leave it with some leverage within its capital structure. It certainly has had no trouble in raising financing when needed, as the US\$175 million loan from ING Barings and Societe Generale received in March this year demonstrated. Current plans include US\$250 million of trade financing which is currently being syndicated by ABN AMRO as well as a potential US\$250 million Eurobond which is planned for Q4. Although the latter could be delayed if market conditions for emerging market debt deteriorate, we currently estimate that Sibneft will have just less than US\$700 million of total debt by year-end, and that the company will have a net debt to equity ratio of 11%.

Although one might debate the wisdom of borrowing to finance a huge dividend payment, there is certainly an argument for leaving the company with a certain level of gearing while returning cash to shareholders if projects cannot be found to generate an adequate rate of return. The boost to profitability provided by the consolidation of the trading companies has certainly provided a cushion of prospective net income that should protect the company's balance sheet against the risk of anything but a catastrophic oil price decline. In addition, given the criticisms leveled at Surgutneftegas over the past two years over its inability to find a use for its cash pile, Sibneft's policy has some logic and the company plans to maintain its debt levels at around current levels for the foreseeable future.

Operational Performance Will Improve

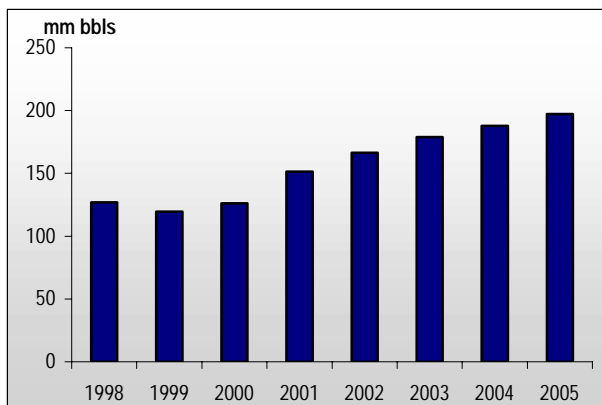
Sibneft's increased capital expenditure over the past 12 months and its ongoing alliance with Schlumberger are now bearing fruit. The company has increased its production forecast for 2001 to 20.5 million tonnes (150 million barrels) implying an increase of 19% compared to 2000. This is an astonishing rate of growth that Sibneft expects to be repeated in 2000, before declining to the still impressive rate of 10% in 2003. By 2005 the company is looking for production of around 200 million barrels per annum, almost 60% higher than the level seen in 2000.

Production Levels To Increase Almost 60% By 2005

Upstream capital expenditure in 2001 is forecast to be US\$595 million, meaning that although the forecasts for future growth are aggressive they are realistic. This is mainly due to the fact that a number of projects, such as the development of the Sugmutskiye field, are only now reaching fruition, with output set to rise sharply over the next 18 months. In addition the company's new joint venture with Sibir Energy will also see development of the southern part of the huge Priobskoye field. This development should help increase not only production but also well productivity, which reached over 80 tonnes per day from new wells in Q1 2001, well above the industry average and a reflection of the quality of the upstream assets at Sibneft's disposal.

Sibneft Puts All Hands To The Pumps

Production Profile



Source: Sibneft

Sibneft Headed Higher?

Fair Value Calculation

Fair Value Calculation	Scenario 1	Scenario 2
Future EBITDA (US\$mIn)	1,973	1,973
EV/EBITDA Multiple	6	8
Implied EV (US\$mIn)	11836	15781
Net Debt at end 2005 E	-1997	-1997
Future Equity Value	9839	13784
Discount Factor (@20% rate)	2.07	2.07
Implied Equity Value	4745	6647
Implied Price Per Share (US\$)	1.38	1.93
Discount for Liquidity	30%	30%
Fair Value (US\$)	0.96	1.35
Average Fair Value (US\$)	1.16	

Source: Renaissance Capital estimates

Sibneft's Fair Value Is 100% Higher Than Its Current Share Price

Taking this production forecast, as well as our new understanding of trading operations, into account, we have re-calculated our fair value for Sibneft. Using a discounted cash flow approach that involves calculating the companies enterprise and equity values in 2005 and discounting them back to today at a rate of 20%, we now estimate that Sibneft has a fair value of US\$1.16 per share, almost exactly 100% above the current share price.

One of the ways in which this value could be realized is if Sibneft is sold to a domestic or international competitor. The company has made little secret of the fact that if the right price were to be offered a sale could be made, with the hint that the right price would be around US\$5 billion. However, we do not believe that this is currently realistic, and indeed the majority shareholders at the company seem to realise this too.

On the one hand, we believe that it is highly unlikely that any company would make a bid for Sibneft at a point near the top of the oil price cycle, despite the company's low valuations. On the other hand, we think it equally unlikely that the majority shareholders would be sellers at anything close to the current share price, especially as such huge dividend yields can be generated at present. Now that a commitment to invest in the company's upstream assets has been made, we believe that a more likely scenario is that a sale could occur in 18-24 months time, when Sibneft has established a higher production plateau and when the oil price is likely to have fallen back towards the long run average oil price of US\$20 per barrel. Under this scenario, buyers may be more inclined to pay up for established production and shareholders may be more inclined to cash out if valuations have increased.

But Investment Risks Do Remain

Our one caveat with Sibneft continues to be the motivation of the majority shareholders. The reason for the recent change of heart has been the new tax laws which have made it much more difficult to use transfer pricing. It seems to us that the regime of President Vladimir Putin is clearly making its influence felt amongst the business elite and is forcing them to play by the rules. This is very positive for now, but begs the question as to what happens if the administration's grip ever loosens, and we have little doubt that Sibneft management and shareholders would exploit any new loopholes they could find.

Would All Shareholders Benefit From A Sale?

Another major issue is what will happen to the minority shareholders if the majority shareholders decide to sell? In the scenario where the majority shareholders sell their shares in Sibneft, the buyer would only be obliged to buy out the minority at the average price over the previous six months, meaning that not everyone would necessarily reap the full benefit. This risk is somewhat mitigated, however, by the fact the upside to any possible sale price is large enough to mean that the price over any six-month period is likely to be significantly higher than today's levels.

What Would Happen If The Assets Were To Be Sold?

Perhaps a more worrying scenario is what would happen if the assets of the company, rather than the shares, were to be sold. It is perfectly possible that any buyer might want only to buy the underlying assets of the company rather than the holding structure. In this case, the holding company would receive large amounts of cash or shares, which should obviously be added to the assets on its balance sheet. The question would then be how these would be distributed to shareholders. In an ideal world they would of course be distributed pro rata to the benefit of all shareholders, as the recent dividend was. The risk is clearly that given the Russian legal system this would not necessarily happen.

And Where Will The US\$140 Million Cash Pile Go?

This issue raises another concern that Sibneft has yet to resolve. The company has repurchased 1.3 billion of its own shares that are currently sitting in a 100%-owned subsidiary. However, because of various Federal Security Commission and tax regulations they have not been cancelled and have received a dividend payment. As such, the company currently has around US\$140 million of cash (the dividend minus withholding tax of 15%) in it, which is theoretically owned by all shareholders but is of course controlled by the majority group. The plans for this cash, and even the shares themselves, are very unclear, but should clearly be monitored very carefully to ensure that minority investors are not disadvantaged by their disposal.

Overall Conclusion On Sibneft

Overall, it is hard to be anything but positive on Sibneft going forward. The consolidation of the two trading companies does raise questions about previous transfer pricing to the detriment of minority shareholders, but now it would seem that all shareholders are set to reap equal benefits from the company's increased profitability. Production is increasing at a record rate, and looks set to continue to do so for another two years. Over that period even a minimum dividend payout ratio will provide an attractive yield, with the prospect of the company eventually being bought out at a significant premium to today's price or continuing to generate healthy income for all shareholders. There are of course risks, not the least of which is that the majority shareholders may find new loopholes in the tax and legal system that encourage them to return to their former ways. However, with the stock on a PE ratio of 1.6 for 2001 and an EV/EBITDA of 1.5 we consider that these risks are fully accounted for in the price and recommend the shares as a **Buy** and **Market Outperformer**.

	1998	1999	2000	2001	2002	2003	2004	2005
Income Statement (US\$ 000)								
Net Revenues	1,781,023	1,746,448	2,397,922	3,367,457	3,642,009	3,968,541	4,350,218	4,768,283
Operating Costs	(1,886,271)	(1,489,104)	(1,670,505)	(2,125,805)	(2,457,117)	(2,725,510)	(2,981,390)	(3,258,681)
Operating Profit	(105,248)	257,344	727,417	1,241,652	1,184,892	1,243,031	1,368,828	1,509,602
EBITDA	211,386	547,149	1,027,417	1,558,894	1,535,905	1,631,031	1,794,125	1,972,646
Financial Items	158,738	66,259	25,793	93,501	95,860	104,119	115,765	128,502
Pre-tax Profit	53,490	323,603	753,210	1,335,153	1,280,752	1,347,150	1,484,593	1,638,104
Profit Tax	(17,345)	(8,497)	(78,365)	(186,921)	(256,150)	(269,430)	(296,919)	(327,621)
Net Income	36,145	315,106	674,845	1,148,232	1,024,602	1,077,720	1,187,674	1,310,483
Earnings per Share	0.01	0.07	0.21	0.33	0.30	0.31	0.34	0.38

Margins								
EBITDA	12%	31%	43%	46%	42%	41%	41%	41%
Operating	-6%	15%	30%	37%	33%	31%	31%	32%
Pre-tax	3%	19%	31%	40%	35%	34%	34%	34%
Net	2%	18%	28%	34%	28%	27%	27%	27%

# Ordinary Shares (mln)	3,450
# Preferred Shares (mln)	0
Ordinary Price (US\$)	0.525
Preferred Price (US\$)	0
Market Cap. (US\$ mln)	1811
Net Debt (US\$ mln)	565
Ent. Value (US\$ mln)	2377

	1998	1999	2000	2001	2002	2003	2004	2005
Ratios								
P.E. Ratio	65.6	7.9	2.5	1.6	1.8	1.7	1.5	1.4
EV/EBITDA	11.2	4.3	2.3	1.5	1.5	1.5	1.3	1.2
Price / Operating Cflow								
Net Debt / Equity	22.6%	6.4%	17.8%	10.8%	-1.9%	-10.1%	-16.7%	-22.4%
Net Debt / MCAP	24.1%	10.8%	31.2%	25.8%	-5.6%	-35.7%	-70.1%	-110.3%

Balance Sheet (US\$ 000)								
Receivables	384,590	326,405	448,695	630,113	661,042	698,700	742,921	789,887
Current Assets	539,382	472,531	667,711	1,125,973	1,382,812	1,827,687	2,484,217	3,261,044
P.P.& E.	4,426,890	3,782,005	3,362,377	3,692,135	4,085,172	4,515,627	4,949,707	5,389,010
Long-term Assets	4,454,714	3,807,421	3,904,858	4,453,954	4,909,102	5,413,429	5,933,856	6,467,737
Total Assets	4,994,096	4,279,952	4,572,569	5,579,926	6,291,914	7,241,116	8,418,073	9,728,781
Short-term Debt	320,371	61,741	405,025	506,281	329,083	164,541	123,406	92,555
Current Liabilities	797,089	451,283	841,705	1,191,972	871,906	735,226	716,279	708,175
Long-term Debt	150,000	150,000	187,528	187,528	0	0	0	0
Long-term Liabilities	2,270,450	778,699	561,139	69,998	77,450	85,611	93,840	102,169
Total Liabilities	3,067,539	1,229,982	1,402,844	1,261,970	949,356	820,837	810,120	810,344
Stockholders' Equity	1,926,557	3,049,970	3,169,725	4,317,957	5,342,559	6,420,279	7,607,953	8,918,437
Total Liabilities & Equity	4,994,096	4,279,952	4,572,569	5,579,927	6,291,914	7,241,116	8,418,073	9,728,781
Net Debt	436,284	196,010	565,467	467,481	(101,181)	(646,804)	(1,269,698)	(1,996,948)

Cash Flow (US\$ mln)								
Net Income	36,145	315,106	674,845	1,148,232	1,024,602	1,077,720	1,187,674	1,310,483
Depreciation	316,634	289,805	300,000	317,242	351,013	388,000	425,297	463,044
Movements in Working Capital	(269,711)	(235,535)	(54,376)	(302,976)	(108,607)	(141,234)	(168,550)	(185,572)
Operating Cash Flow	83,068	369,376	920,469	1,162,498	1,267,008	1,324,486	1,444,422	1,587,955
Capital Expenditure	(184,589)	(120,402)	(230,935)	(647,000)	(744,050)	(818,455)	(859,378)	(902,347)
Other Investment Activity	30,720	(8,700)	(517,278)	(215,729)	(61,090)	(72,656)	(84,926)	(93,023)
Free Cash Flow	(70,801)	240,274	172,256	299,769	461,868	433,375	500,118	592,586

Source: Company data, Renaissance Capital estimates

Renaissance Capital

22/13 Voznesensky Pereulok, Moscow 103009, Russia
tel. (7 501) 258 7777, fax (7 501) 258 7778
www.rencap.com

Renaissance Capital Limited
One Angel Court
Cophthall Avenue
London EC2R 7HJ, United Kingdom
Telephone: + 44 (20) 7367 7777
Fax: + 44 (20) 7367 7778

RC Securities, Inc.
780 Third Avenue, Fifth Floor
New York, New York 10017
Telephone: + (212) 451 9100
Fax: + (212) 451 9101

RENAISSANCE CAPITAL RESEARCH

Head of Research
James Henderson
7 (501) 725 5257
Jhenderson@rencap.com

Strategy – Politics, Economics
Roland Nash 7 (501) 258 7916; Rnash@rencap.com
Alexei Moisseev

Deputy Head of Research
Kim Iskyan 7 (501) 258 7907; Kiskyan@rencap.com

Corporate Sectors

Oil & Gas 7 (501) 725 5257
James Henderson Jhenderson@rencap.com
Vladislav Metnev

Telecommunications 7 (501) 258 7745
Andrey Braginski Abraginski@rencap.com
Viacheslav Nikolaev

Utilities 7 (501) 258 7774
Hartmut Jacob Hjacob@rencap.com

Banking / Media 7 (501) 258 7907
Kim Iskyan Kiskyan@rencap.com
Andrey Besedin

Retail / Consumer Goods 7 (501) 258 7907
Kim Iskyan Kiskyan@rencap.com
Andrey Besedin / Natasha Zagvozdina

Airlines / Metals & Mining / Steel & Pipes 7 (501) 258 7743
Vladimir Titkov Vtitkov@rencap.com

Autos / Machinery / Shipping 7 (501) 258 7912
Kim Iskyan Kiskyan@rencap.com
Andrey Besedin

Russian Language Research 7 (501) 258 7703
Katya Malofeeva Kmalopheeva@rencap.com
Ekaterina Malakhova
Alexander Beskov
Maria Sulima

Research Editors 7 (501) 258 7908
Simon Watkins Swatkins@rencap.com
Patricia Somerville
Mark S. Bradford

Administrative Assistant 7 (501) 725 5216
Anna Martynova Amartynova@rencap.com

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