

Gazprom Neft: Strong Downstream, Strong Owner

Investment Summary

We revise our DCF model for Gazprom Neft to reflect new oil price forecasts, production corrections and revised capex targets. Our fair price is \$4.20 per share. We see Gazprom Neft as an attractive entry point to the export-oriented oil business with large share of downstream and political muscle of the main shareholder, Gazprom. We recommend investors to BUY its shares.

- ✓ We expect margins of Russian oil companies to decline significantly in 2009 due to world economic slowdown. Chances of any rapid recovery are slim, so we prefer companies with high levels of own refining and distribution outlets.
- ✓ Gazprom Neft has a strong downstream business and intends to develop it further. Despite oil output decline in 2008 the company could double output by 2020 by launch of the second phase of the Priobskoye field and development of deposits, to which its main owner, Gazprom, owns rights.
- ✓ Company debt levels are lower than at other Russian majors. Net debt is \$1.3b and expected net debt-to-EBITDA should only be 0.2 in 2008. Affiliation with Gazprom ensures favorable credit conditions, and the company's maturity profile is unproblematic.
- ✓ Gazprom will exercise an option to buy Eni's 20% stake in Gazprom Neft this April 2009, after which the gas giant intends to place more Gazprom Neft shares on the stock market.
- ✓ Gazprom Neft is likely to pay high annual dividends (20-25% of net income under GAAP), since Gazprom is eager to receive more cash, so we expect the dividends to be \$0.26 per share in 2008, but we do not expect them to be announced before the share option has been exercised.
- ✓ We valued Gazprom Neft by DCF and find the company to be undervalued at current market prices. Our fair price for Gazprom Neft at end-2009 is \$4.20 per share, offering upside of 116%.
- ✓ We view Gazprom Neft as an excellent investment in export-oriented oil business with a large share of downstream and Gazprom patronage. Our recommendation is BUY.

SIBN BUY \$4.20 ▲ 116%*

Current market cap, \$m	9 198
EV, \$m	10 474
Estimated free-float, %	4.3%
Common shares	
- ticker (RTS)	SIBN
- number, m	4 741
- bid-ask range, \$	1.50-2.60
- fair price, \$	4.20
- up/down, %	116%
- previous fair price, \$	U/R
Preferred shares	
- ticker (RTS)	no
- number, m	0
- bid-ask range, \$	n/a
- fair price, \$	n/a
- up/down, %	n/a
- previous fair price, \$	n/a
Other stock exchanges	
LSE (1 ADR = 5 shares)	GAZ
NYSE	N/L

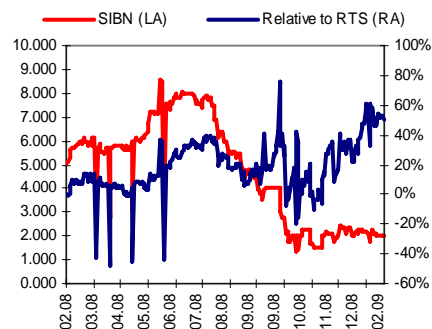
*based on last deal price (\$1.94 per share)

IFRS, \$m	07	08E	09E	10E
Revenues	21 100	31 547	10 801	14 450
EBITDA	5 828	6 817	1 990	4 210
- margin, %	28%	22%	18%	29%
Op. income	4 899	5 561	608	2 659
Net income	4 143	4 861	556	2 430
- margin, %	20%	15%	5%	17%
EPS, \$	0.87	1.03	0.12	0.51

	07	08E	09E	10E
EV/S	0.50	0.33	0.97	0.72
EV/EBITDA	1.80	1.54	5.26	2.49
P/E	2.22	1.89	16.55	3.78

Previous RMG reports on this company

[Gazprom Neft: Fair Price Revision](#) from May 8, 2008



View on sector

We expect 2009 to be a tough year for Russian oil companies. Bursting of the commodity bubble and world economic slowdown have lowered oil prices from over \$140 per barrel in July 2008 to the current level of \$40.

Margins of all oil companies will be significantly reduced and there is little likelihood of fast recovery. In this situation we prefer companies with high levels of own refining and distribution, which will help to maintain margins through the recession.

Company strategy and opportunities

Gazprom Neft has the highest refining ratio in Russia

Gazprom Neft has a strong downstream business and highest throughput-to-production ratio in the sector (near 60%). Downstream business is being further improved by modernization of the company's own Omsk Refinery and refineries of equity companies, Slavneft (YaNOS) and Moscow Refinery. Also, at the end of 2008 Gazprom Neft closed a deal for purchase of 51% of NIS, the Serbian VIC, with 7.3mt annual refining throughput, which will enable sale of high-margin petroleum products on the East European market.

The company can increase crude output rapidly

The main driver for upstream business is launch of the second phase of the Priobskoye field, which will increase annual oil output at Priobskoye from about 6mt to 12.3mt by 2012.

Gazprom Neft will also be able to rapidly increase oil production by developing fields of its main shareholder, Gazprom, in the Yamal-Nenets Peninsula. In 2009 Gazprom Neft will start developing the Tazovskoye and Novoportovskoye fields, which are the most promising in Yamal-Nenets.

Latest financial and operational keys

9M 2008 financials were very good

Gazprom Neft published strong 9M 2008 financial results under GAAP. Revenue grew by 86% y-o-y to \$27.3b, adjusted EBITDA (Gazprom Neft EBITDA + share in EBITDA of equities) was 74% higher y-o-y at \$8.2b and net income rose by 84% to \$5.2b.

Margins were slightly down: adjusted EBITDA margin fell by 2 p.p. to 30%, while operating and net margins were steady at 23% and 19%, respectively.

Gazprom Neft consolidated 9M 2008 BS (GAAP)

	9M 08, \$m	FY 07, \$m	Change, %
Current assets	7 884.0	4 760.0	66%
- cash & cash equivalents	2 663.0	733.0	263%
- accounts receivable	2 801.0	2 264.0	24%
- inventories	1 556.0	1 083.0	44%
Non-current assets	14 117.0	11 849.0	19%
- PP&E	8 218.0	6 634.0	24%
ST liabilities	4 948.0	3 625.0	36%
- accounts payable	2 803.0	2 269.0	24%
- ST debt	2 105.0	1 339.0	57%
LT liabilities	2 366.0	2 548.0	-7%
- LT debt	1 818.0	2 083.0	-13%
Minority interest	147.0	3.0	4800%
Equity	14 540.0	10 433.0	39%

Source: Company data, RMG estimates

Gazprom Neft consolidated 9M 2008 P&L (GAAP)

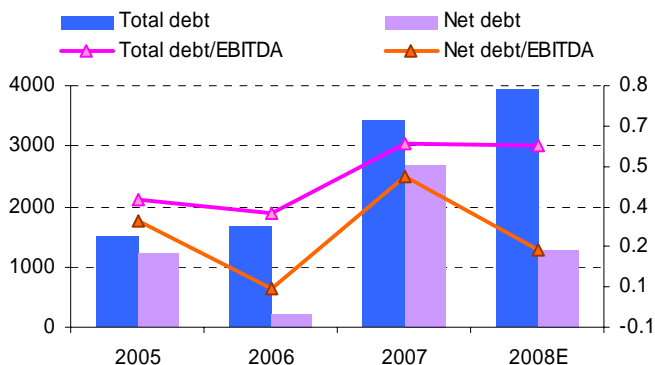
	9M 08, \$m	9M 07, \$m	Change, %
Revenues	27 315.0	14 678.0	86%
Operating costs	21 060.0	11 338.0	86%
Operating income	6 255.0	3 340.0	87%
- Operating margin	23%	23%	
Adj. EBITDA	8 151.0	4 687.0	74%
- Adj. EBITDA margin	30%	32%	
Income before tax	6 800.0	3 729.0	82%
Income tax	1 551.0	910.0	70%
- Effective tax rate	23%	24%	
Minority interest	48.0	n/a	n/a
Net income	5 201.0	2 819.0	84%
- Net margin	19%	19%	

Source: Company data, RMG estimates

Debt levels are lower than at other Russian VICs Total debt increased by 15% in 9M 2008 to \$3923m and share of LT debt declined from 61% to 46%, but net debt fell by \$535m y-o-y to \$1276m due to rapid increase of cash & cash equivalents from \$721m to \$2634m. Management says that cash stayed almost unchanged at the end of 2008.

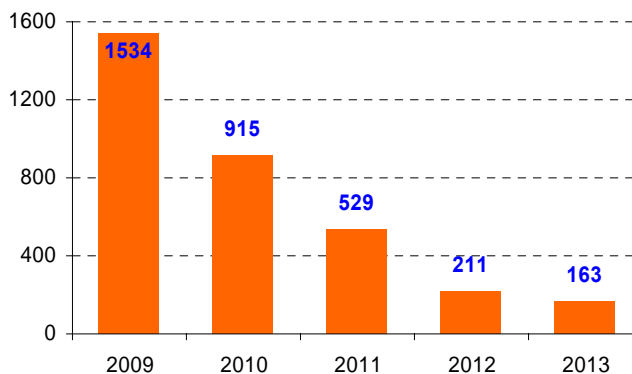
Expected net debt-to-EBITDA ratio in 2008 should be very low at about 0.2, but we expect the indicator to rise in 2009-2012 due to oil price drops, before stabilizing in 2013. The company has sustainable positive cash flow to cover debt servicing.

Gazprom Neft solvency



Source: Company data, RMG estimates

Maturity profile of Gazprom Neft, \$m



Source: Company data, RMG estimates

Comparison with main Russian peers

We compare Gazprom Neft with main Russian oil VICs, Lukoil and Rosneft. Comparison with Surgutneftegaz is inappropriate (because the company does not have financial reports under international statements), TNK-BP did not publish 9M 2008 results, and Tatneft has not stated clear figures for total oil production.

9M 2008 financial and operational results of main Russian oil VICs

	Sales, \$m		EBITDA, \$m		Net income, \$m		Capex, \$m	Net debt, \$m
	9M 2008	Change*, %	9M 2008	Change*, %	9M 2008	Change*, %		
Lukoil	89 727	56.46%	16 652	60.58%	10 765	70.93%	7 770	6 011
Rosneft	58 192	77.70%	17 076	81.68%	10 345	139.02%	6 426	19 388
Gazprom Neft	27 315	86.09%	8 151	73.91%	5 201	84.50%	2 442	1 276

	MC**, \$m	EV**, \$m	EV/S***	EV/EBITDA***	P/E***
Lukoil	26 367	32 378	0.35	1.39	1.89
Rosneft	32 854	52 242	0.70	2.37	2.47
Gazprom Neft	9 198	10 474	0.31	1.18	1.41

	Production, mb	EBITDA per barrel	NI per barrel	Capex per barrel	MC per barrel	EV per barrel
Lukoil	499.8	33.3	21.5	15.5	52.8	64.8
Rosneft	580.9	29.4	17.8	11.1	56.6	89.9
Gazprom Neft	253.5	32.2	20.5	9.6	36.3	41.3

* y-o-y change

** based on 03.02.09 bid price

*** based on 4Q2007-9M2008 financials

Source: Bloomberg, Companies data, RMG estimates

Gazprom Neft is nearly the cheapest among domestic oil majors

Rosneft is the most expensive of the three by financial multiples (EV/S, EV/EBITDA and P/E). Gazprom Neft is cheaper than Lukoil by all these indicators. Rosneft has the lowest return per barrel, while Lukoil and Gazprom Neft have almost the same level of return, but Gazprom Neft's barrel is 30% undervalued by the market to a Lukoil barrel.

Share option exercise

Gazprom will buy out Eni and then make a public placement

Gazprom has a call option for Eni's 20% stake in the company and intends to exercise it in April 2009, as the result of which the stake of the gas monopoly will rise above 95%. Russian law does not require Gazprom to make any offer to minorities in connection with exercise of the option, but ownership of 95% gives Gazprom the right to buy out remaining minorities. However the gas monopoly has said that it will not take advantage of this right and that it wants to increase free-float of Gazprom Neft by placing some of its shares on the stock exchange. We take a very positive view of this.

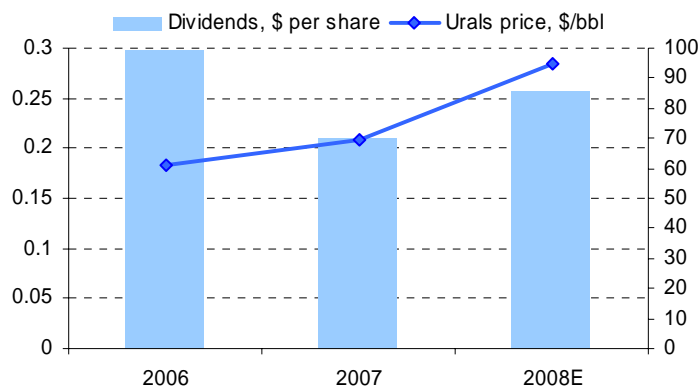
Dividends

Dividends for 2008 should stay high

The company is likely to pay high dividends every year because the main shareholder, Gazprom, wants to receive more cash. According to management, Gazprom Neft will continue to pay dividends equal to 20-25% of net income under GAAP. We therefore expect the dividend to be \$0.26 per share in 2008. We assume that payment will not be made before Gazprom has exercised its option, so that dividends are not paid out to Eni.

We see a possibility that Gazprom Neft may not pay any dividends to shareholders in 2009-2010 if low oil prices lead to very low net income levels.

Dividend payments



Source: Company data, RMG estimates

Reasons for revision

Our revisions reflect oil prices, production delays, and lower capex

We made several significant changes to our DCF model for Gazprom Neft:

- new macroeconomic assumptions (see our report [Macroeconomics: Weaker Currency for Stronger Economy](#));
- new oil price forecast (see our report [Oil prices: Return to Trend](#));
- delays in development by the company of new Russian oil fields with high-viscosity oil and of foreign projects;
- capex cuts (mainly reduction of drilling work), and tight cost control;
- expected downward corrections of output, despite new licenses from Gazprom.

DCF valuation

Adjusted management guidance suggests 90-100mt annual output by 2020. Our DCF model is based on a figure of 85mt. We expect the company to use its downstream division to the maximum in order to maintain margins in the face of a crude oil price slump through 2009-2011. We therefore forecast that throughput-to-production will be no lower than 60% (the highest figure among Russian oil companies).

Operational review

	2007	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Upstream division										
Total oil, mt	43.2	45.4	46.8	47.6	51.6	55.6	59.4	63.1	66.7	70.4
Growth, %	0.6%	5.2%	3.0%	1.8%	8.4%	7.7%	6.7%	6.3%	5.8%	5.5%
Oil production, mt	32.7	30.8	32.0	32.7	36.6	40.6	44.5	48.4	52.3	56.3
Share in Slavneft, mt	10.5	9.3	9.2	9.1	8.9	8.7	8.6	8.4	8.2	8.1
Share in Tomskneft, mt	-	5.4	5.6	5.8	6.1	6.3	6.3	6.3	6.2	6.1
Share in NIS, mt	-	-	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Downstream division										
Total throughput, mt	26.2	28.4	32.4	33.4	34.4	35.4	36.3	37.9	40.0	42.2
Total product output, mt	20.8	24.0	26.7	27.6	28.9	30.1	31.3	33.0	35.4	37.5
Overall efficiency, %	79.4%	84.4%	82.3%	82.7%	83.9%	85.1%	86.2%	87.2%	88.4%	88.7%
Gasoline, mt	5.7	7.4	8.7	9.4	10.3	11.2	12.1	13.3	14.8	16.3
Diesel, mt	8.1	9.0	10.1	10.5	11.1	11.6	12.2	13.0	14.0	14.9
Fuel oil, mt	5.3	5.7	5.9	5.7	5.4	5.1	4.7	4.4	4.1	3.7
Jet fuel, mt	1.8	1.8	2.0	2.1	2.1	2.2	2.3	2.4	2.5	2.6
Distribution of crude oil										
Total crude oil sales, mt	19.2	20.4	16.4	16.2	19.2	22.2	25.0	27.2	28.7	30.2
Crude oil for export, mt	14.6	14.2	12.0	12.4	15.4	17.8	20.0	21.8	23.0	24.1
Crude oil for CIS sales, mt	2.5	3.3	2.6	2.5	2.9	3.3	3.8	4.1	4.3	4.5
Crude oil domestic sales, mt	2.1	2.8	1.8	1.3	1.0	1.1	1.3	1.4	1.4	1.5
Additional purchases, mt	2.3	3.4	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Distribution of product										
Total product sales, mt	24.8	28.5	31.3	32.2	33.4	34.6	35.9	37.6	40.0	42.0
Product export, mt	9.7	11.2	12.4	12.8	13.4	13.9	14.3	15.0	16.0	16.8
CIS product sales, mt	1.9	2.0	2.0	1.8	1.7	1.7	1.8	1.9	2.0	2.1
Domestic product sales, mt	13.2	15.3	16.9	17.6	18.4	19.1	19.7	20.7	22.0	23.1
Additional purchases, mt	3.9	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5

Source: Company data, RMG estimates

Net profit will approach \$556m in 2009

We expect company revenue to drop in 2009 mainly due to oil price falls, but believe that recovery will be fast thanks to further development of downstream projects and cost control.

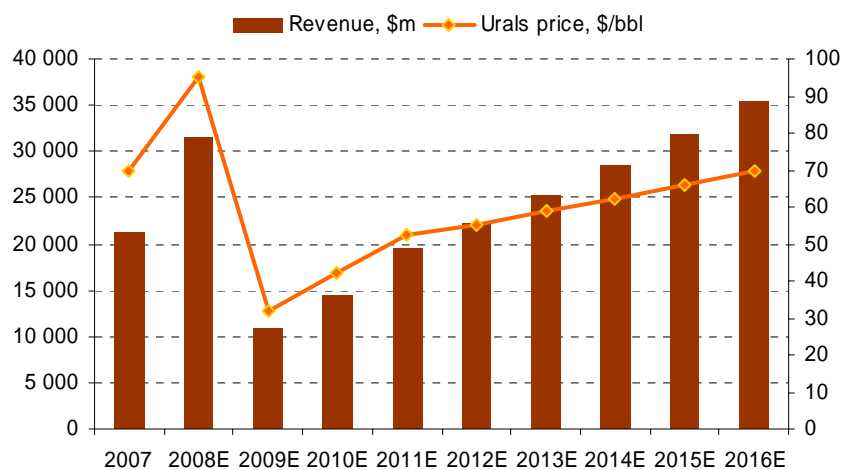
There is a risk that Gazprom Neft will show a net loss in 2009, due to revaluation of debt, which is mainly in dollars.

Income statement, \$m

	2007	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Total revenue	21 100	31 547	10 801	14 450	19 502	22 294	25 288	28 444	31 846	35 446
Transportation costs	1 367	1 849	1 263	1 015	1 351	1 667	1 914	2 187	2 486	2 778
Purchases	3 928	7 455	2 680	3 543	4 433	4 750	5 048	5 336	5 632	5 951
Non-income taxes	6 702	11 899	2 275	3 315	5 538	6 760	8 126	9 571	11 079	12 755
Operating costs	2 395	2 514	2 066	1 887	2 145	2 435	2 748	3 100	3 496	3 925
DD&A	929	1 256	1 382	1 551	1 747	1 971	2 229	2 526	2 823	3 120
SG&A	536	571	375	302	331	364	400	440	484	533
Other expenses	344	442	153	177	237	273	312	353	396	443
Total costs	16 201	25 986	10 193	11 791	15 782	18 220	20 777	23 514	26 396	29 505
EBITDA	5 828	6 817	1 990	4 210	5 467	6 045	6 740	7 457	8 273	9 062
EBITDA margin, %	28%	22%	18%	29%	28%	27%	27%	26%	26%	26%
EBIT	4 899	5 561	608	2 659	3 720	4 074	4 511	4 930	5 449	5 942
EBIT margin, %	23%	18%	6%	18%	19%	18%	18%	17%	17%	17%
Net income	4 143	4 861	556	2 430	3 401	3 724	4 124	4 507	4 981	5 431
Net margin, %	20%	15%	5%	17%	17%	17%	16%	16%	16%	15%

Source: Company data, RMG estimates

Gazprom Neft revenue vs. Urals price



Source: Company data, RMG estimates

FCFF calculation, \$m

	2007	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
EBIT	4 899	5 561	608	2 659	3 720	4 074	4 511	4 930	5 449	5 942
Less: non-operating expences	-559	-634	-69	-303	-424	-465	-515	-563	-622	-678
Less: cash taxes on EBIT	1 315	1 335	122	532	744	815	902	986	1 090	1 188
Add: DD&A	929	1 256	1 382	1 551	1 747	1 971	2 229	2 526	2 823	3 120
Less: Capex	2 210	3 500	2 100	2 829	3 254	3 742	4 303	4 948	4 948	4 948
Less: Changes in NWC	-316	654	-1 484	312	432	238	256	270	291	308
FCFF	3 178	1 963	1 322	841	1 462	1 715	1 794	1 815	2 565	3 295
Discount factor			1.00	0.87	0.76	0.66	0.58	0.50	0.44	0.38
Discounted FCFF	-	-	1 322	733	1 111	1 136	1 037	914	1 127	1 262

Source: RMG estimates

We use WACC of 14.7%

We forecast strong, positive cash flows from 2009. We use WACC of 14.7%, assuming 16.3% cost of equity, leveraged beta of 1.16, 8.5% risk-free rate, standard equity risk of 5%, liquidity risk of 1.5% (free-float is only 4.3%) and specific company risk of 0.5%. We estimate after-tax cost of debt at 8.8% based on corporate bond rates and most recent credits from Russian and foreign banks.

WACC calculation

Cost of debt	8.8%
Leveraged beta	1.16
Risk free rate	8.5%
Standard risk premium	5.0%
Specific company premium	2.0%
Cost of equity	16.3%
Share of debt, %	21.2%
Share of equity, %	78.8%
WACC	14.7%

Source: RMG estimates

Fair price calculation

Terminal growth rate, %	2.5%
Terminal value, \$m	38 124.5
PV of terminal value, \$m	12 727.5
Discounted value for 2008-2011, \$m	8 641.9
Fair EV, \$m	21 369.5
Net debt, \$m	1 276.0
Fair MC, \$m	20 093.5
Number of common shares, m	4 741.3
Fair price per common share, \$	4.2

We estimate fair market cap at \$20.1b

For calculation of terminal value we use a terminal growth rate of 2.5% and EBIT margin of 16%. We estimate fair EV of Gazprom Neft at \$21.4b., assuming \$1.3b net debt as of 9M08 GAAP statements. That implies fair market cap of \$20.1b.

Sensitivity matrix for common shares (fair price in \$)

Terminal growth rate, %	WACC, %						
	13.5%	14.0%	14.5%	14.7%	15.0%	15.5%	16.0%
1.5%	4.6	4.3	4.1	4.0	3.9	3.7	3.5
2.0%	4.7	4.4	4.2	4.1	4.0	3.8	3.6
2.5%	4.9	4.6	4.3	4.2	4.1	3.9	3.7
3.0%	5.0	4.7	4.5	4.4	4.2	4.0	3.8
3.5%	5.2	4.9	4.6	4.5	4.4	4.1	3.9

Source: RMG estimates

Final valuation and recommendation

We rate Gazprom Neft as BUY with fair price of \$4.20 per share

Our DCF approach suggests fair market cap of \$20.1b, which represents \$4.20 per share, offering 116% upside from current market levels.

We believe that Gazprom Neft is one of the best investment ideas on the Russian stock market, since it offers an attractive entry point to the export-oriented oil business with large share of downstream and political muscle of the main shareholder, Gazprom. We recommend to BUY company shares, but draw attention to the low free-float. As mentioned above, Gazprom has said that it will expand free-float through a share placement after exercising its call option on the Eni stake.

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