

Russian Oil Sector

Post-Oligarch Era

Russia's oil and gas sector is entering a new phase of its development, one where the old rules of the game will not apply any more. This could be seen as the end of the oligarch era. Oligarchs' incentives to maximize their own net worth, the driving force behind the post-1998 recovery, are no longer the dominant factor in the industry.

Sadly, in the post-oligarch era, the sector at large will, we believe, end up less cost-efficient, more highly taxed, prone to higher capital spending and less transparent for minority shareholders. This all implies that it will be less appealing to minority shareholders. Bearing this in mind, our neutral stance on the sector is being reinforced with a downgrade of fair values across the board.

We have also lowered our fair value for YUKOS to \$3.80 per share as the potential for a deal now looks more speculative than the likelihood of a forced sale of Yuganskneftegaz. The latter could trigger additional liabilities, erosion of operating performance and additional asset losses. The valuation of Yuganskneftegaz becomes a matter of almost secondary importance, as YUKOS will certainly get nowhere near the real price for its core subsidiary.

While it could be tempting to pick up YUKOS shares after the major sell-off, we cannot recommend the stock until the risk of Yuganskneftegaz being sold off has been alleviated. Valuation of YUKOS on any future multiples is irrelevant, in our view, when the very existence of the company is at risk.

Despite painting a gloomy picture, it should be noted that valuations have also adjusted downwards and Russia has missed out on the global re-rating of oil stocks that has been under way since end 2003. At today's prices, we believe, the sector offers selective value, with LUKoil and Gazprom locals, together with Surgutneftegaz preferreds, set to outperform the market in the medium term.

Oil sector re-rated, \$ per share

	Old fair value	New fair value	Upside	Recommendation
Gazprom	2.62	2.39	17%	BUY
LUKoil	31.73	30.10	11%	BUY
Sibneft	3.10	2.49	-4%	HOLD
Surgutneftegaz	0.61	0.60	-10%	HOLD
Tatneft	1.23	1.16	-2%	HOLD
YUKOS	6.40	3.80	-12%	HOLD
Transneft	1,050	948	18%	BUY

Source: Troika Dialog

Glancing Back, Weighing Up the Future

On the anniversary of Platon Lebedev's arrest and our downgrade of the sector, we are taking a step back and considering the changes that the industry has undergone over the last 12 months. The market was full of optimism a year ago, awaiting massive foreign direct investment. And YUKOS, the most successful Russian oil company, was benchmarked against ExxonMobil and BP. Today, the very same company is on the verge of bankruptcy.

This report provides an update on the YUKOS story, as well as that of the oil sector, and addresses the deteriorating operating and political background in which Russian oil companies operate. While the endgame in the YUKOS story will clearly be the dominant driver of the sector's and market's near-term performance, we look beyond this at the rules forming in what seems to be a new dawning era of state control.

At a time when the redistribution of wealth and social responsibility of business are themes being widely discussed, the government has reclaimed a higher share of cashflows from the oil and gas industry. This tax increase, although tolerable, limits the upside of oil companies from the attractive oil price environment. At the same time, concerns over property redistribution are mounting.

Deteriorating transparency and lower dividend distribution are the most likely implications of the change. We have already seen disclosure worsening in the sector, while high capital spending by government legacy companies will ultimately put pressure on free cashflows and dividend distributions.

As the YUKOS story draws to a close, many market players are trying to predict whether the government will allow the company to collapse despite presidential assurances to the contrary. It is important to realize, however, that YUKOS has already collapsed as far as its share price is concerned. To take the argument one step further, the government's only incentive for seeking a deal with Group MENATEP is to save the investment climate in Russia, assuming of course that it sees this as a priority. At the same time, it should be clear that if the government really wants to take over YUKOS' assets, it will. The further we go down the road of confrontation, the lesser therefore the incentive for the government to do a deal; after all, the damage to the investment environment has already been done. Moreover, there will, we think, come a point after which there will simply be no incentive left for the Kremlin to deal. Rather alarmingly, this point may already have been passed.

Today, the potential for a deal looks more speculative than the likelihood of a forced sale of assets. Admittedly, the break-up of YUKOS, Russia's largest vertically integrated oil company, will create many managerial problems for the Kremlin. How will a new owner market the oil? Where will it be refined? Will there be an undisrupted supply of oil products for the domestic market? And so on. However, the market was in denial and underestimated the Kremlin's ability to not blink in what initially seemed to be a poker game in which both parties were bluffing. If both parties are determined to play this game through to the bitter end, then the Kremlin undoubtedly has a better hand than Group MENATEP.

It would be useful, at this point, to recall the sequence of events, throughout which many investors (and us) believed that a peaceful resolution of the conflict was imminent. While the market was in denial, developments were taking the worst possible turns. A deal is still a possibility, but should be seen now as a far more speculative possibility than the break-up of the company.

YUKOS saga

Date	Event	Market in denial
July 2003	Platon Lebedev arrested.	Small problem with a shareholder. Will not affect the company.
October 2003	Mikhail Khodorkovsky arrested.	YUKOS loses "value of Khodorkovsky", but the company is safe and almost debt free at \$35/bbl oil. Only the MENATEP stake will be affected.
December 2003	Tax audit leads to tax evasion allegations dating back to 2000. YUKOS faces claim for \$3.44 bln.	Accusation is an informal letter with no legal weight. The charge will be negotiated by YUKOS.
March 2004	Tax Ministry files lawsuit against YUKOS.	The court will not rule in the ministry's favor. The verdict will anyway be prolonged, so that YUKOS has time to come up with the funds.
April 2004	Tax Ministry wins lower court ruling.	YUKOS will appeal and at least have the bill reduced.
May 2004	YUKOS loses appeal, debt becomes collectible.	The ministry, like any commercially-driven creditor, will allow YUKOS to restructure the debt.
June 2004	Tax Ministry refuses to restructure debt.	Non-core assets, such as the Sibneft stake, will be chosen for sale. YUKOS' operations will not be affected.
July 2004	Bailiff chooses Yuganskneftegaz, YUKOS' core asset, for sale.	The valuation of Yuganskneftegaz will be more or less reasonable. The loss of value from the firesale of assets will thus be contained...

YUKOS Valuation: Dostoyevsky Scenarios Revisited

Our approach to YUKOS' valuation since the company lost its tax case for 2000 has been scenario analysis, which is based on a four-stage process:

1. Valuation of YUKOS as a business: DCF valuation.
2. Estimate of break-up value of YUKOS' assets: sum-of-the-parts valuation (the difference between the DCF and break-up values we call the "value of the management").
3. Estimate of actual and potential tax liabilities.
4. Estimate of losses from sale of assets.

We no longer use a DCF model (or any forward-looking multiples) to derive a valuation for YUKOS' stock. This is tantamount to saying that the conflict between the Kremlin and YUKOS has gone so far that YUKOS will almost certainly be made to 'pay the price'.

At the same time, the company has not yet lost any of its assets and these are estimated to be worth at least \$27 bln, or around \$12.60 per share. This is the break-up value of the assets. To arrive at the figure, we applied a straight \$1.50/bbl reserve multiple to YUKOS' main E&P subsidiaries and a similar \$1.50/bbl multiple to the annual throughput of its refining assets. Acquisition prices are used where available, the market price for the 35% Sibneft stake and estimated values for other assets.

Valuation of YUKOS assets

	Stake	Production, '000 bpd	Reserves (SPE), mln bbl	Value, \$ mln
E&P, total		1,601	14,700	22,156
Yuganskneftegaz	100%	995	10,800	16,200
Tomskneft	100%	322	1,500	2,250
Samaraneftegaz	100%	246	1,550	2,325
East Siberian Oil Company	71%	1	400	142
Arctic Gas	100%	–	–	274
Rospan	56%	–	–	165
Urengoil	100%	–	–	75
Sakhaneftegaz	50%	–	–	50
Other		38	450	675
		Throughput, '000 bpd	Capacity, '000 bpd	
Refining, total		764	1,220	515
Angarsk Refinery	100%	168	384	92
Syzran Refinery	100%	93	213	51
Novokuibyshev Refinery	100%	141	192	77
Kuibyshev Refinery	100%	117	140	64
Achinsk Refinery	100%	103	131	56
Mazeikiu Refinery		142	160	175
Sibneft	35%			3,941
Transpetrol	49%			74
Other assets				440
Total				27,126

Source: YUKOS, Troika Dialog estimates

The reserve valuation of \$1.50/bbl is average for Russia's first-tier oil companies, Tatneft and Surgutneftegaz included. This means that we no longer apply a premium to YUKOS for the quality of its assets and/or management. The difference between the DCF (\$41.7 bln with no risk) and break-up values of YUKOS, i.e. the "value of the management" is \$14.6 bln. Again, we believe that this is now irretrievably lost. No matter how the YUKOS story ends (and control will likely change hands), we do not see the company being managed in the same "aggressive" manner as it has been over the last three years.

We are increasing our assumption for YUKOS' total liabilities in back taxes from \$7.0 bln to \$8.8 bln. This is composed of the already enforceable \$3.4 bln for 2000 and \$5.4 bln for 2001-03 (the Tax Ministry has already indicated a \$3.4 bln charge for 2001 and is looking into records for 2002). Since 2002, oil taxes (export duties and the newly introduced unified production tax) have been linked to the international oil price, thus eradicating the potential for tax minimization schemes. Any claims for 2002-03 would therefore relate to avoidance of profit taxes and, perhaps, fuel excise taxes.

Asset losses: sale of Yuganskneftegaz could be death knell for YUKOS

The Justice Ministry's announcement that the bailiff's office has picked Yuganskneftegaz, the company's largest subsidiary, for sale means that the YUKOS affair has now taken the worst possible turn. Sale of this asset, which we value at not less than \$16.2 bln, would imply a loss of value as there will be no global oil majors willing to take part in such an auction or Russian bidders with anything approaching that purchasing power.

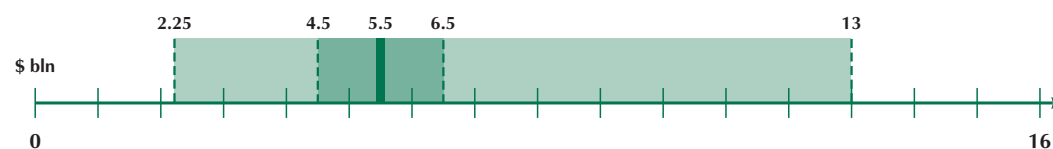
The decision to start collection at the very core of YUKOS' production potential reveals the government's true motives; unless this is a bluff, it is after YUKOS' assets, rather than collection of a debt. Had the government been purely commercially-driven, it would have allowed the tax debt to be restructured (at a very attractive interest rate) or else picked the stake in Sibneft for sale.

Second-guessing the government on the valuation of Yuganskneftegaz is a purely speculative exercise. Still, based on more or less sensible assumptions, we could derive an indicative range for the valuation. The assumptions are the following:

- 1. Proceeds from the sale are likely to be at least \$2.25 bln, but not more than \$6.5 bln.** The first figure is the balance of the \$3.44 bln tax debt for 2000 after YUKOS makes its promised payment of \$1.2 bln. It would be strikingly "ugly" if the sale of Yuganskneftegaz could not cover the 2000 tax liability. At the same time, we are equally unlikely to see proceeds above \$6.5 bln, what the highest bidder, Surgutneftegaz, can afford to pay at short notice without tapping the debt market, which it has not done in the past.
- 2. Between 50%+1 share and a 100% stake in Yuganskneftegaz is likely to be sold.** The Justice Ministry's statement mentioned that "a stake" in Yuganskneftegaz would be transferred to a special organization for sale. This does not necessarily mean that the entire 100% would be sold. However, considering that the government would be looking to take control out of YUKOS' hands and that almost any bidder would only be interested in a controlling stake, we can assume that at least 50%+1 share of the company would be sold. In the worst case, of course, YUKOS could lose the company entirely.
- 3. For simplicity's sake, we assume the minority stake in Yuganskneftegaz to be worth the same as the sale price at auction.** This would be significantly less than the fair value of the stake. Nevertheless, taking into account that potential buyers (Rosneft and Surgutneftegaz) have a poor track record of treating minority shareholders fairly, the assumption is sensible, in our view.

Thus, we can derive a quite wide valuation range for Yuganskneftegaz of between \$2.25 bln and \$13.00 bln (\$6.5 bln for 50%). This range could be narrowed to what we believe a more likely range of between \$4.5 bln (\$2.25 bln for 50%) and \$6.5 bln.

Valuation range for Yuganskneftegaz



Source: Troika Dialog estimates

In our analysis, we assume that Yuganskneftegaz is sold for \$5.5 bln, the average of the narrower range, compared with our valuation of \$16.2 bln, implying a loss of \$10.7 bln.

Base case Dostoyevsky scenario: The Possessed

	\$ mln
YUKOS valuation as problem-free company	38,927
Loss of 'value of the management'	(14,600)
Sibneft 35% stake	3,941
Tax liability: 2000	(3,441)
Tax liability: 2001-03	(5,400)
Firesale discount	(10,700)
Equity value	8,728
Value, \$ per share	4.00

Sensitivity of YUKOS value, \$ per share

Sale price for Yuganskneftegaz, \$ bln	2000-03 tax bill, \$ bln							
	3.4	5.0	6.0	7.0	8.0	8.8	9.0	10.0
2.0	4.9	4.2	3.7	3.3	2.8	2.4	2.3	1.9
4.0	5.9	5.1	4.7	4.2	3.7	3.3	3.3	2.8
5.5	6.6	5.8	5.4	4.9	4.4	4.0	4.0	3.5
6.0	6.8	6.0	5.6	5.1	4.7	4.3	4.2	3.7
8.0	7.7	7.0	6.5	6.0	5.6	5.2	5.1	4.7
10.0	8.6	7.9	7.4	7.0	6.5	6.1	6.0	5.6
12.0	9.6	8.8	8.4	7.9	7.4	7.0	7.0	6.5
14.0	10.5	9.8	9.3	8.8	8.4	8.0	7.9	7.4
16.0	11.4	10.7	10.2	9.8	9.3	8.9	8.8	8.4

Source: Troika Dialog estimates

Beyond sale of Yuganskneftegaz: zero visibility

Sale of Yuganskneftegaz, which is now our base case scenario, would not only cause the company's valuation to suffer, but also introduce a high level of uncertainty over the company's overall future.

- Potential additional liabilities could arise, which cannot be quantified at this stage. For example, YUKOS itself stated that without oil flows from Yuganskneftegaz, the company will not be able to meet its long-term oil supply contracts.

- The company's operational performance and incentives for profit maximization could deteriorate. We fear that we are already seeing signs of this development, as the company, which the market expects to generate at least \$4 bln in free cashflow this year, stated that it can pay off less than \$1 bln of the tax debt. Moreover, YUKOS has announced that it would be making only \$100 mln per month in free cashflow over July-August, a third of what we would expect given current oil prices.
- Perhaps most importantly, the company could incur future asset losses in order to meet its potential 2001-03 tax liabilities. While it can be assumed that two 50% Yuganskneftegaz stakes would cover the tax debt for 2000 and 2001, YUKOS may be forced to sell additional assets to cover liabilities for 2002 and 2003.

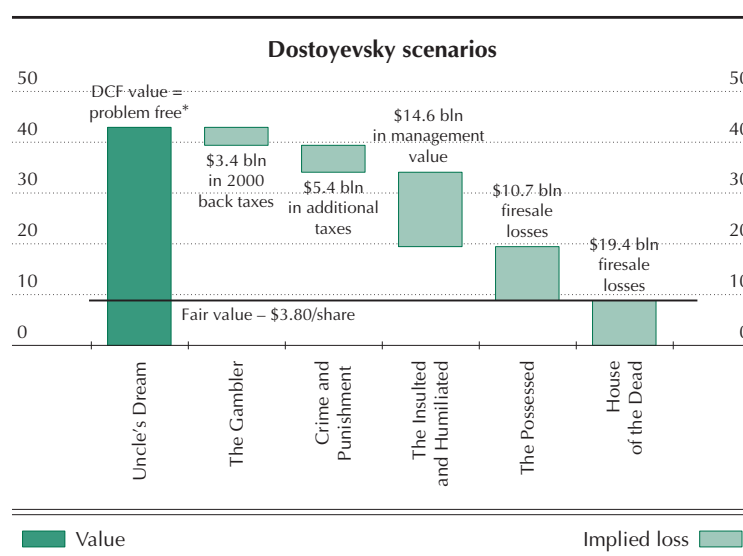
So the very sale of Yuganskneftegaz could trigger bankruptcy and liquidation, our "House of the Dead" scenario, which would only justify the option price for YUKOS shares.

Below is a summary of our Dostoyevsky scenarios, derived based on our understating of the current situation and near-term expectations. We value YUKOS shares at \$3.80, the weighted average price in the three most pessimistic scenarios, and reiterate our HOLD recommendation on the stock. While it could be tempting to pick up shares after the major sell-off, we cannot recommend the stock until the risk of Yuganskneftegaz being sold off has been alleviated. Valuation of YUKOS on any future multiples is irrelevant, in our view, when the very existence of the company is at risk.

Dostoyevsky scenarios

	Assumptions	Equity value, \$ bln	Value per share, \$	Probability
Uncle's Dream	DCF value = no risk	42.87	19.80	0%
The Gambler	\$3.4 bln taxes paid	39.43	18.30	0%
Crime and Punishment	Additional \$5.4 bln taxes paid	34.03	15.80	0%
The Insulted and Humiliated	Loss of management value	19.43	9.00	20%
The Possessed	\$10.7 bln firesale losses	8.73	4.00	50%
House of the Dead	\$19.4 bln firesale losses	–	–	30%
Weighted average		8.25	3.80	100%

Source: Troika Dialog



* includes 35% stake in Sibneft

Source: Troika Dialog estimates

Post-Oligarch Era: Change in the Balance of Power

Russia's oil and gas sector is entering a new phase of development, where the old rules of the game, the most important of which was "what is good for oil companies is good for the country", may not necessarily apply any more. This new post-oligarch phase could culminate, we believe, in a massive shift in the balance of cashflow distribution away from companies (or their owners and minorities) towards the government.

The government has clearly been changing the rules under which oil companies operate over the last few months. While this process appears still to be evolving, the government's key policies towards the sector have already been revealed. However, until these new policies are fully in place, we believe that investors are exposed to an unpredictable environment.

Sadly, when the industry re-emerges from the post-oligarch era, the sector at large will, we believe, end up less cost-efficient, more highly taxed, prone to higher capital spending and even less transparent for minority shareholders. This implies that it would be less appealing to minority shareholders who, in turn, should demand lower valuation multiples sector-wide.

The people's oil

Perhaps the most profound shift in the government's oil and gas policy is that the previously stable state of coexistence among the three parties who have a claim on sector cashflows (the state, core owners and minority shareholders) has been destroyed. From now on, the government is to take a higher share of cashflows from this mainly private sector using two approaches:

- **Growing indirect involvement.** The tax collection rate levied on the industry is likely to increase. This may be achieved either via a higher tax base or through "voluntary contributions" as the government increasingly pursues a policy of making businesses more socially responsible.
- **Emerging direct involvement.** The government's currently limited role as a regulator in the oil and gas sector may be expanded to include considerable, direct involvement in the hydrocarbon production business. The state would thus go from being a marginal producer to a major one and may also pursue a long-term ambition of managing price along, but not necessarily in conjunction, with other global owners of hydrocarbon reserves.

The concept of the "people's oil" emerged at the beginning of the year in the form of plans to increase the tax burden on the industry. Assuming flat oil prices, the government's tax take in 2005 (when all the new taxes have been introduced) will increase to 49% of total industry proceeds, up from an estimated 45% in 2004. In 2001, the figure was a mere 33%. The increase in taxation and operating costs will translate into a drop in the industry's 2005 free cashflow by an estimated \$3 bln versus 2004.

Industry cashflow, \$ mln

	2001	2002	2003	2004E	2005F
Revenues	48,875	57,286	77,868	91,072	95,839
Taxes	16,083	23,041	32,293	40,630	46,560
Operating costs*	10,923	12,315	14,983	17,622	18,912
Transportation	5,330	6,154	8,866	9,718	10,639
Capital expenditure	10,247	9,591	11,758	13,415	13,276
Free cashflow	6,291	6,185	9,968	9,687	6,452
Oil production, mln bpd	6.96	7.59	8.43	9.15	9.66
Oil price, \$/bbl	22.92	23.66	27.15	29.00	29.00

* includes working capital outflow

Source: Troika Dialog estimates

Under the new tax regime, the government's marginal take on every dollar over a Urals price of \$25 p/bbl has increased from \$0.69 to \$0.89.

Marginal tax take, \$/bbl

Oil price	Export duty	Production tax	Profit tax	Total
OLD SYSTEM				
<15	–	0.19	0.19	0.38
15-25	0.35	0.19	0.11	0.65
>25	0.40	0.19	0.10	0.69
NEW SYSTEM				
<15	–	0.21	0.19	0.40
15-20	0.35	0.21	0.11	0.66
20-25	0.45	0.21	0.08	0.74
>25	0.65	0.21	0.03	0.89

Source: Troika Dialog

With oil prices set to stay high for the foreseeable future, it is hard to say whether the new system will remain unchanged for long. Indirect signals from the government suggest that the taxation system for the industry is far from developed, implying that companies' future cashflows will be in a volatile environment. The Energy Ministry, for example, has proposed raising the production tax as of 2005. One draft scheme involves hiking the base rate from R400 to R419/ton of crude and from R107 to R135 per '000 cm of natural gas. This would bump up Gazprom's 2005 production tax bill by around \$534 mln to \$2,902 mln, up 22% y-o-y.

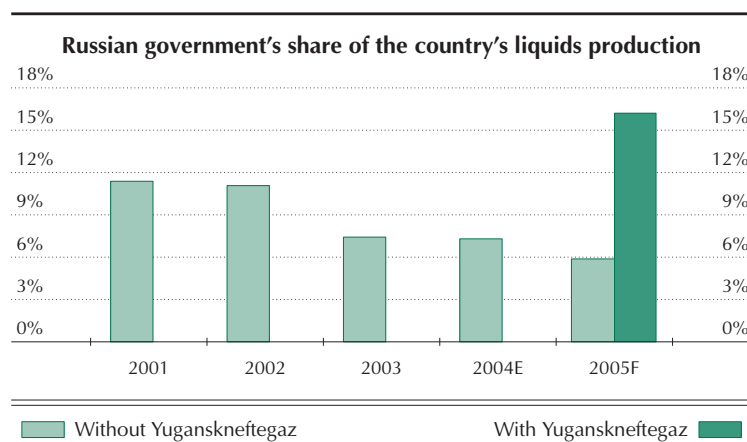
Investment tariff: indirect tax?

In addition to higher taxes, the oil companies are likely to end up at least partly financing Transneft's new pipeline projects. Ironically, in response to lobbying by industry players for private pipelines in Russia, the government is mulling over the idea of charging a so-called "investment tariff" on top of the transportation fees paid to Transneft. The new levy would help finance new trunk line routes and thus relieve the bottlenecks in the pipeline system. Transneft used such a scheme back in 2000, when it launched the first stage of the Baltic Pipeline System. If private firms have to shell out to finance construction of state-owned pipelines, this should be viewed as an indirect tax on producers and is obviously beneficial for Transneft.

Even without new taxation, private oil companies' operating costs are likely to rise as government requests for "socially responsible business behavior" seem to imply more than just simple tax liabilities.

More important, however, is the emerging direct participation of the state in the lucrative production side of the hydrocarbon business, without which the "people's oil" concept would seem incomplete.

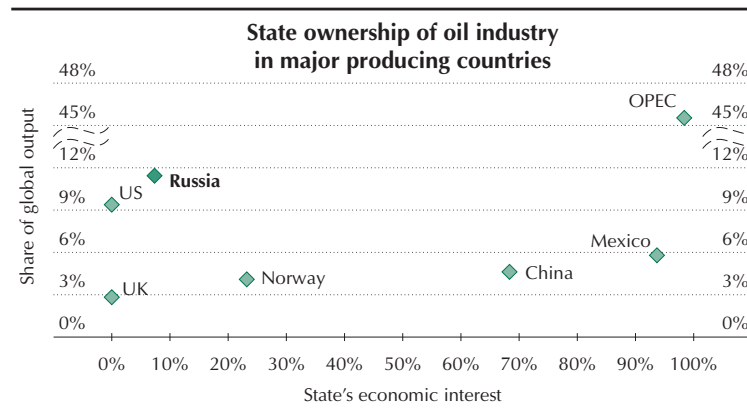
Currently, the government's share of Russia's 2004E oil production (including its share of Gazprom's output of liquids) is limited to some 7.2%. Should Yuganskneftegaz in one way or another end up in the hands of the state, this would grow to almost 18%, making the state the second largest producer after LUKoil.



* Includes Rosneft, share of Gazprom's gas condensate output, share in Slavneft (until 2003) and share in LUKoil's output. Implies privatization of LUKoil's 7.6% stake in 2004.

Source: Troika Dialog

Judging by the experience of all other major producer countries that depend on oil revenues to "survive", the Russian government's intention to partly nationalize the industry does not seem remotely out of the ordinary. In fact, it would even confirm the trend, as the Russian government is clearly underexposed to its oil resources relative to GEM and Middle Eastern producing peers. Among the major producing countries, its ownership of oil production today is behind only that of developed countries: the US, the UK and Canada.

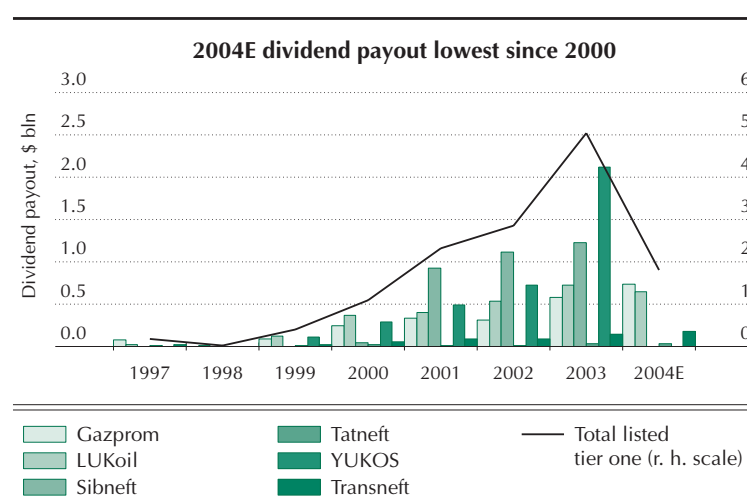


Source: BP Statistical Review, Energy Intelligence Research, Troika Dialog estimates

Over the long term, the government's participation in the energy business, from license distribution to production and transportation, seems set to increase anyway, as evidenced by Gazprom and Rosneft becoming the new coordinators and leaders of the drive to tap Eastern Siberia's oil and gas reserves.

Oligarch incentives to maximize net worth is no longer the driving force

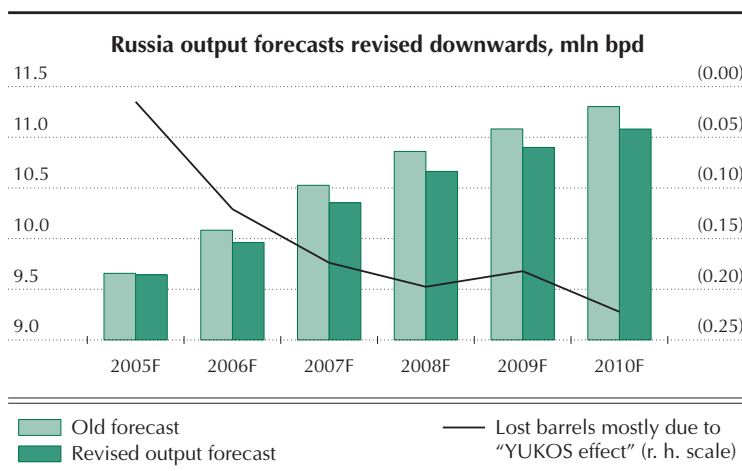
The second most profound change in the rules of the post-oligarch era is that the incentives of company owners to maximize net worth from efficiency gains and better transparency (put simply, by pushing up the stock price) is no longer the driving force due to the change in the balance of political power. Going forward, dividend distribution is likely to be more balanced and huge payouts are set to become a thing of the past.



While some unlisted integrated companies, such as TNK-BP, are likely to pay out more than \$1 bln to owners this year, minority shareholders of operating subsidiaries are being forced out of the profit center entirely. TNK-BP made more than \$2.8 bln in 2003 and distributed a generous \$1,049 mln to core shareholders. This seems an appalling dividend practice by a company controlled by an international major.

Slower production growth

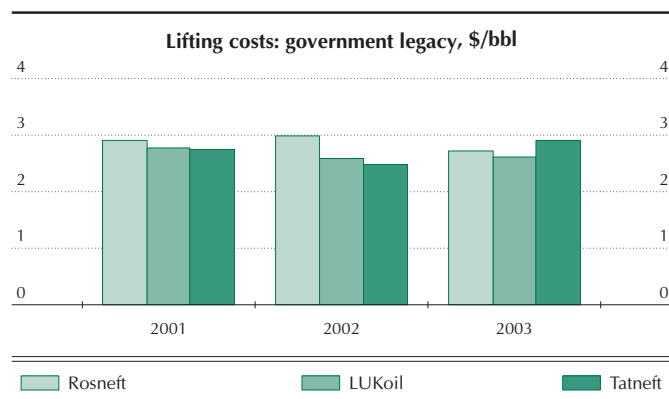
While some integrations such as TNK-BP and Slavneft are likely to continue exceeding production growth expectations, output growth is decelerating even more rapidly than we thought. With Sibneft, YUKOS and Rosneft already below their output targets this year, we doubt that the "people's oil" companies are capable of producing additional barrels at low cost. Consequently, we no longer expect Russia to pump out 10 mln bpd on average in 2006. We have also lowered our long-term production forecasts by some 3% for 2009 and 2010, to 10.9 mln bpd and 11.1 mln bpd, respectively. This is due mostly to the "YUKOS effect", i.e. the company's main production subsidiaries being transferred to the government, as our assumptions already allow for the bottlenecks in the export infrastructure.



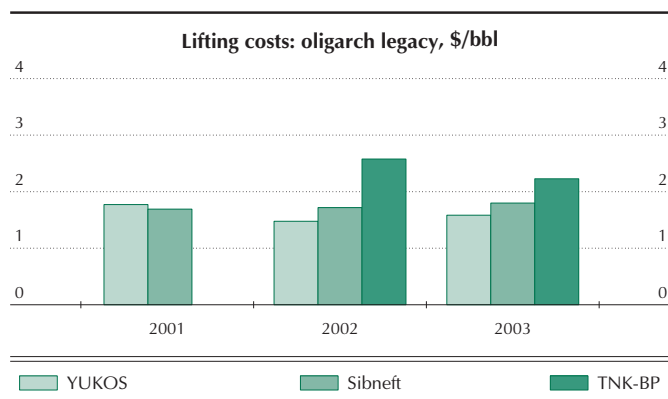
Source: Troika Dialog estimates

Lower efficiencies, higher cost base

One of the most important qualities of the “people’s oil” companies is a high cost base. On average, we estimate that the government legacy companies have 47% higher lifting costs than the more efficient oligarch legacy firms. While we praise LUKoil’s efforts to rein in costs, they still really look good only relative to the company’s own historical base and still pale in comparison with YUKOS and Sibneft, which have managed to keep production costs below \$2/bbl.



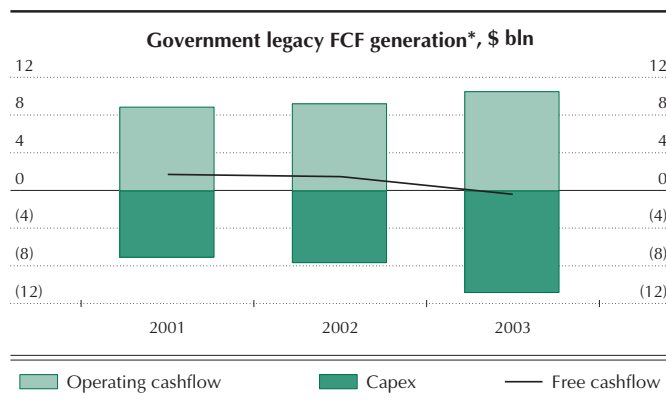
Source: Companies



Source: Companies

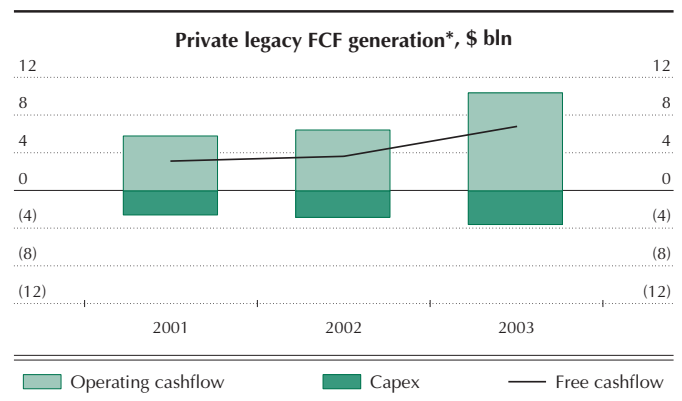
Higher capex, lower or no free cashflow generation

Perhaps the most visible and disappointing qualities of the “people’s oil” companies in the post-oligarch era are higher capex and the failure to build cash. As amazing as it may seem, despite the Urals price averaging more than \$27/bbl in 2003, Gazprom, Rosneft and Transneft all posted negative free cashflows for the year, while LUKoil and probably Tatneft barely broke even. In fact, LUKoil has already set the trend for this year, reporting a negative free cashflow of \$328 mln for 1Q04, when the Urals price averaged over \$29/bbl. Russia’s oil and gas companies are clearly divided into two camps: one with low/average production growth and high capex (a government legacy), the other with robust output growth and superior free cashflow generation (an oligarch legacy). While each group generated around \$10.5 bln in operating cashflow last year, the second invested just under one third of the amount “capexed” by the first.



* sample of Gazprom, LUKoil, Tatneft, Rosneft, Transneft

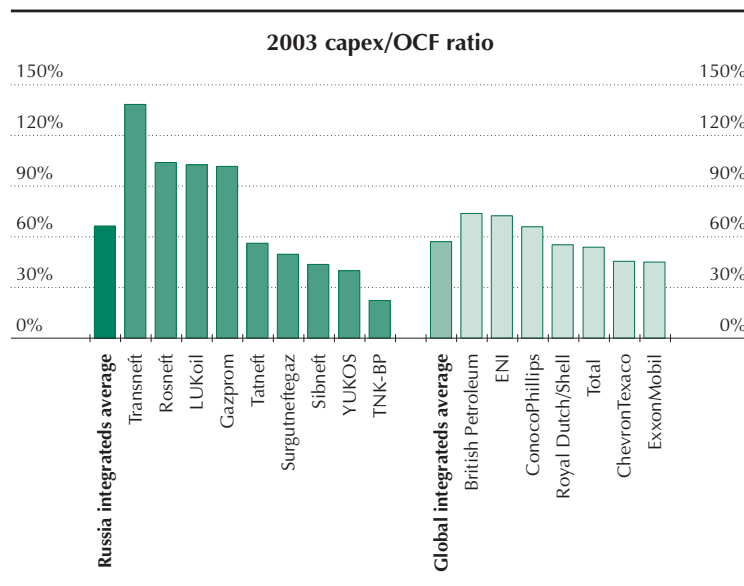
Source: Companies



* sample of YUKOS, Sibneft, TNK-BP

Source: Companies

Last year, the capex to operating cashflow ratio of Russia's nine largest oil and gas companies was 66%, versus 57% for the developed market majors. Interestingly enough, the figure rose from 65% in 2002 for the Russian firms, yet fell from 68% for the global peers. Excluding TNK-BP, which we believe invested an unsustainably low amount last year, this reinvestment ratio for Russia would have been 75%. While the counter-argument says that growing companies should invest more, Russia's oil majors such as TNK-BP, Sibneft, YUKOS and Surgutneftegaz posted the highest output growth figures over 2001-03 while managing to sustain a ratio of 40-50%.



Source: Companies, Troika Dialog estimates

Poorer transparency and corporate governance

Just as with dividends, owners of oil companies in the emerging post-oligarch era no longer have any incentive to improve transparency and corporate governance, as their responsibilities have shifted from minority shareholders toward the government. In fact, only LUKoil has no major visible corporate governance issues.

Largest integrators	Main corporate governance/transparency issues
LUKoil	No visible deterioration
YUKOS	Poor transparency, suspiciously low cashflow generation in 2004
Surgutneftegaz	Suspended release of US GAAP accounts
Sibneft	Behind-the-scenes transactions with Sibir Energy, opaque demerger with YUKOS
Tatneft	Delayed 2003 US GAAP accounts due to auditors' refusal to sign them
Transneft	Stopped releasing full IAS accounts
Gazprom	Vast inefficiencies, murky EuralTransGaz transactions
TNK-BP	Appalling treatment of minorities in E&P subsidiaries
Rosneft	Continued transfer pricing in E&P subsidiaries

Source: Troika Dialog estimates

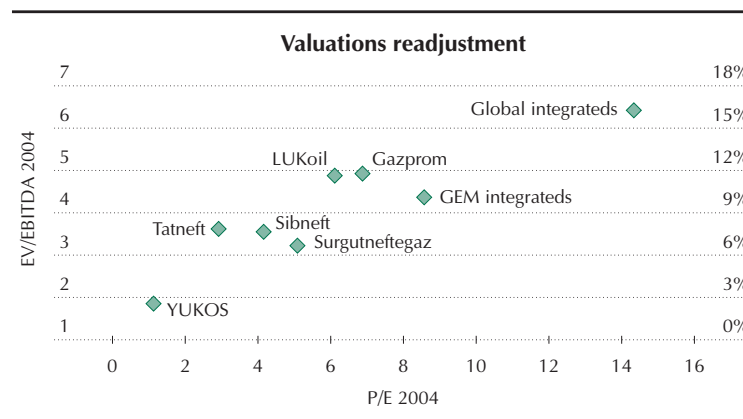
Quite different foreign participation in the industry

Despite the possibility of the state's 7.5% stake in LUKoil being sold to a foreign major, the government is visibly becoming less willing to let global majors buy controlling or blocking minority stakes in Russian oil majors (see our desknote "LUKoil: Privatization Process Evolves, Does ConocoPhillips Want to Be Part of It?" of August 4). Nevertheless, the presence of foreigners in the oil and gas sector could actually increase, but in a quite different way. We believe that the government will offer foreign majors access to the large, capital-intensive greenfield projects in frontier areas, such as East Siberia or the Far East. Should stakes in firms become "non-sellable" to foreign strategic investors, the market should apply lower valuation multiples to the companies.

At the same time, PSAs may be making a comeback as the oil industry's propensity to lobby against the PSA structures seems to be waning. Some areas in Eastern Siberia and the Far East offshore, especially gas fields, may receive PSA status or exclusive tax breaks to attract foreign financing, particularly if government-owned companies are actively involved in the projects. Another way that foreign majors may be allowed in is via international consortia, mostly to implement the hard-to-recover upstream and expensive gas export infrastructure projects, such as the Northern European Gas Pipeline or the link from Eastern Siberia to China and South Korea.

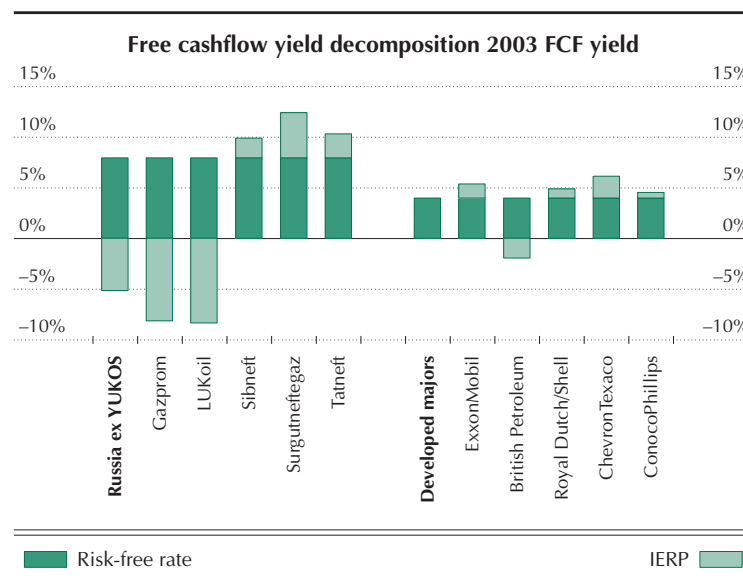
Valuation and Stock Picking Strategy

Russia's oil companies have not only failed to close the gap with their global peers but have also fallen behind their EM peers, trading at respective discounts of 43% and 15% on a 2004 EV/EBITDA basis.



Source: I/B/E/S, Troika Dialog estimates

At the same time, Russia's oil and gas industry ex-YUKOS yields just 3% on 2003 free cashflow, which translates into an implied equity risk premium of -5% for the sector. By way of comparison, the global integrated majors have a much better 2003 IERP of 0%. Admittedly, on a 2004 free cashflow basis, ex-YUKOS Russia has a much healthier IERP of 1%, with selective names such as Sibneft and Surgutneftegaz boasting a strong 9% and 6%, respectively. That said, the positive average for 2004 is based on our rather aggressive capex assumptions and still fails to cover the 4% equity risk premium.



Source: Companies, Troika Dialog

Lower FCF generation demands lower valuations

To summarize, the oil and gas industry that re-emerges from the oligarchs' ashes is likely to end up less efficient, more highly taxed, more government-controlled and less transparent. In our opinion, this warrants lower valuations as investors should demand higher returns on the riskier cashflows. Consequently, we are raising the risk profile of the sector, which has brought down our fair values across the board. We reiterate our neutral stance on the sector as a whole.

	Old fair value	New fair value	Upside	Recommendation
Gazprom	2.62	2.39	17%	BUY
LUKoil	31.73	30.10	11%	BUY
Sibneft	3.10	2.49	-4%	HOLD
Surgutneftegaz	0.61	0.60	-10%	HOLD
Tatneft	1.23	1.16	-2%	HOLD
YUKOS	6.40	4.00	-12%	HOLD
Transneft	1,050	948	18%	BUY

Stock picking strategy

CRISIS MANAGEMENT

As discussed above, we believe that the Russian oil and gas sector is gradually entering a post-oligarch era, or what we have named the "people's oil" period, with its own set of rules and far-reaching implications. Just as the "oligarch era", which emerged from the 1998 crisis, produced new sector leaders bent on boosting output, generating cashflow and pushing up share prices (which has its own risks, as discovered recently), so too will this crisis give birth to a new generation of industry leaders. At the same time, we feel that the "people's oil" era will be less investor-friendly and more accountable to the government than to minority shareholders. On this basis, it deserves lower multiples and higher risk premiums than its ancestor.

We therefore advise investors to stay on the sidelines for now and maintain a generally underweight position in the sector, despite the stubbornly high oil prices. We would remain like this until the YUKOS case has been resolved one way or another, as the sector will be underperforming its oil peers elsewhere. Only when the YUKOS saga is finally behind us, we suspect, will sector valuations become more appealing and offer attractive returns, while reflecting the higher-risk environment.

OPPORTUNITIES AND PICKING NEW WINNERS: THREE RULES OF THUMB

■ Rule one: stick to the companies that need capital markets

We believe that the new darlings of the stock market in the oil and gas sector, at least in the early stages of the "people's oil" era, will be those companies that maintain more or less acceptable corporate behavior and transparency. Therefore, our first rule of the thumb at the dawn of the new era is stick to the companies that need capital markets. LUKoil, followed by Gazprom as a distant second, should outperform strongly although we doubt very much that further re-rating will be possible in the short term. Tatneft, on the other hand, is likely to underperform as its transparency is deteriorating visibly.

■ **Rule two: do not chase short-term free cashflow generation**

The second rule of thumb, which may seem counter-intuitive, is do not aggressively chase short-term free cashflow generation for now, as this is found mostly in the oligarch-legacy companies whose era and values are in the twilight. Thus, Sibneft is likely to underperform its “people’s oil” peers for now.

■ **Rule three: government acts as best for the sector**

The final rule of thumb is the government acts on the basis of what it perceives as being best for the sector, so bet on the government darlings that will not be bullied, such as Transneft. We also feel that Surgutneftegaz could fall into this category and thus recommend gaining exposure to its preferred shares.

	EV/sales		EV/EBITDA		P/CF		P/E		EV/production	EV/reserves
	2003	2004E	2003	2004E	2003	2004E	2003	2004E	\$/boe, 2003	\$/boe, 2003
Russia										
Gazprom	2.1	1.8	5.2	4.9	8.8	5.4	7.8	7.4	15	0.5
LUKoil	1.2	1.0	4.8	4.9	8.0	5.1	6.3	6.8	46	1.6
Sibneft	2.1	1.6	5.5	3.6	5.4	3.8	5.4	4.8	49	3.0
Surgutneftegaz	1.6	1.4	3.6	3.2	4.9	4.3	6.6	5.6	32	1.9
Tatneft	0.7	0.6	4.2	3.8	3.0	2.5	4.2	3.7	20	0.6
YUKOS	0.8	0.7	2.4	1.8	2.2	1.6	2.1	1.8	23	0.9
Transneft	1.4	1.1	2.5	2.1	3.5	2.6	5.0	3.8	–	–
GEM integrateds										
PetroChina	2.6	2.3	5.6	4.9	5.2	5.7	10.4	9.8	107	5.3
Petrobras	1.1	1.0	3.4	2.9	3.4	3.2	5.1	5.3	47	3.3
Global integrateds										
ExxonMobil	1.4	1.4	9.4	7.8	10.6	11.0	14.1	18.1	196	13.8
British Petroleum	1.0	1.0	9.0	7.8	12.4	9.0	20.2	19.2	173	12.5
Royal Dutch/Shell	1.0	0.9	6.5	6.1	8.1	12.7	14.0	12.5	135	13.3
ChevronTexaco	1.0	1.0	6.5	6.2	8.4	8.0	14.3	15.5	120	9.2
Total	1.2	1.3	6.7	7.5	9.0	8.7	16.0	16.8	147	12.4
ConocoPhillips	0.8	0.8	6.1	5.1	5.8	6.1	11.4	11.6	122	8.8
ENI	1.7	1.4	6.1	4.6	6.7	5.1	13.0	10.8	174	13.7

Source: I/B/E/S, Troika Dialog

**President,
Chief Executive Officer**

Ruben Vardanian

Executive Managing Director

Sergei Skvortsov

Managing Director, Capital Markets

Jacques Der Megreditchian

Chief Economist

Evgeny Gavrilencov

CONTACT DETAILS

Phone 7 (501) 258 0500
Fax 7 (501) 258 0547
Internet <http://www.troika.ru>

Research

Phone 7 (501) 258 0511
E-mail research@troika.ru

Equity Sales

Phone 7 (501) 258 0550
E-mail salesdesk@troika.ru

Fixed Income Sales

Phone 7 (501) 258 0510
E-mail fid@troika.ru

Trading

Phone 7 (501) 258 0525
E-mail tradingdesk@troika.ru

Structured Products

Phone 7 (501) 258 0572
E-mail structures@troika.ru

New York Office

Phone 1 (646) 613 8585
E-mail ny_office@troika.ru

London Office

Phone 44 (207) 583 3257
E-mail td_uk@troika.ru

RESEARCH

**Chief Equity Strategist,
Head of Research**

James Fenkner, CFA

Oil and Gas

Senior Analyst, Deputy Head of Research
Analyst
Analyst

Kaha Kiknavelidze
Oleg Maximov
Valery Nesterov

Electricity, Pulp and Paper

Senior Analyst, Deputy Head of Research

Lauri Sillantaka, CFA

Telecoms

Senior Analyst

Evgeny Golosnoy

Metals and Mining

Analyst

Vasily Nikolaev

Manufacturing, Automotive, Tire

Analyst

Gairat Salimov

Banking, Insurance, Transport

Analyst

Sergey Donskoy

Consumer, Retail, Pharmaceuticals

Analyst

Victoria Grankina

Chemicals

Assistant Analyst

Alexander Kotikov

Corporate Governance

Analyst

Elena Krasnitskaya

Economy

Economist

Anton Stroutchenevski

Fixed Income

Analyst
Credit Risk Analyst

Alexander Kudrin
Artiom Diatchkov

Technical Analysis

Assistant Analyst

Denis Agaponov

Production

Production Manager
Editor
Editor
Editor/Translator
Translator
Translator
Administrator
Layout
Layout
Assistant
Assistant

Olga Sereda
Jonathan Pyne
Austin Peat
Vladimir Romanov
Pavel Mishachev
Anna Skvortsova
Sergey Tkachev
Yaroslav Pavlov
Dmitry Sukhenko
Yulia Baimler
Marina Zhukova

Design: Karen Kessoyan, Andrey Demchuk

This report was prepared by Kaha Kiknavelidze, Oleg Maximov and Valery Nesterov, who each certify that: all of the views expressed in this report accurately reflect their personal views about the securities and issuers covered in this report; and no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

This research report is prepared by TROIKA DIALOG or its affiliate named herein. It is being distributed in the United States by TROIKA DIALOG USA, which accepts responsibility for its contents. Any U.S. person receiving this report who wishes to effect transactions in any securities referred to herein should contact TROIKA DIALOG USA, not its affiliate. This information herein has been obtained from, and any opinions herein are based upon, sources believed to be reliable, but no representation is made that it is accurate or complete and it should not be relied upon as such. All such information and opinions are subject to change without notice. From time to time, TROIKA DIALOG USA or its affiliates or the principals or employees of its affiliates may have positions or derivative positions in the securities referred to herein or make a market or otherwise act as principal in transactions in any of these securities or may provide investment banking or consulting services to or serve as a director of a company being reported on herein. This information does not constitute an offer to buy or sell securities. Further information on the securities referred to herein may be obtained from TROIKA DIALOG USA upon request. This report may not be reproduced, copied nor extracts taken from it, without the express written consent of TROIKA DIALOG.