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GAZPROM NEFT LEADS THE PACK

2008 COMPARATIVE ANALYSIS OF OIL TRIO

Gazprom Neft leads the way in 2008. In this note we compare the 2008 US GAAP results of Gazprom Neft (SIBN – Buy), LUKOIL (LKOH – Buy) and Rosneft (ROSN – Hold) in terms of financial and operational results. Our analysis indicates that Gazprom Neft remains the leader in profitability, but the company is also more undervalued on multiples than its peers. Taking account of one-offs, investors should consider the 4Q08 results as out of the ordinary and focus on quarterly 2009 results to assess the effectiveness of the company's performance. Gazprom Neft remains our top-pick and we reiterate our Buy recommendation on the stock with a target price of $3.4/share. We also reiterate our Buy recommendation on LUKOIL and the Hold on Rosneft.

Downstream diversification provides for profitability. We favor companies with a strong downstream presence, good refining cover and solid retail networks.

- ***Strongest on "per boe of production" comparison.*** Gazprom Neft's refining cover is about 95%, while LUKOIL's is 49% and Rosneft's 44%. Thus, Gazprom Neft is the strongest in terms of per boe production.
- ***Strongest in terms of profitability.*** Gazprom Neft and Rosneft remained the leaders in terms of profitability. Both of their EBITDA and net margin remained the highest, primarily due to high operational efficiency on EBITDA level. Rosneft posted high currency gains, which improved 2008 net margin.

Gazprom Neft is the cheapest on multiplies. We compared companies by EV/sales, EV/EBITDA, P/E, EV/production and EV/reserves multiples, using current market prices and 2008 financial and operational results in the denominator. Gazprom Neft remains the most attractive investment – solid and efficient and the most undervalued. Rosneft is valued with a premium to Gazprom Neft and LUKOIL. Although historically the market paid a premium for the long-term growth opportunities that Rosneft provided, we believe that in the crisis environment such premiums are unjustified.

4Q08 financials were out of the trend. In 4Q08, EBITDA and net income were influenced by various one-off items and non-operating activities that resulted in out of the ordinary results. One-off currency losses sent net income into negative territory, while the high tax burden undermined EBITDA. Although the revenues of oil companies are highly related to the oil price, the sales specifics, i.e. trading operations, international sales, the share of revenues generated through oil products sales, provided the differences to such an inter-relation. Gazprom Neft has well diversified sales of oil products and its quarterly revenues are less dependent upon oil price volatility, which can be seen in the chart below.

Gazprom Neft – the most efficient

2008 GAAP: Gazprom Neft vs LUKOIL vs Rosneft

	SIBN	LKOH	ROSN
Sales/boe	151	139	89
EBITDA/boe	34	21	22
Net income/boe	21	12	14
EBITDA margin	23	15	25
Net margin	14	8	16
ROA, %	23	13	14
ROCE, %	39	23	22
ROE, %	33	18	28

Source: Companies, URALSIB estimates

To compare the three companies on a per barrel basis, we recommend to look at a net income/boe multiple. Revenue/boe and EBITDA/boe are too distorted: LUKOIL has lots of trading operations with very narrow margin, while Gazprom Neft accounts for crude purchased from Slavneft and Tomskneft in form of oil products incorporated into Revenues, while it is not accounted for consolidated production of these affiliates.

Russian oils undervalued; Gazprom Neft - more than others

Comparison Analysis Based on Current Market Prices & 2008 results

	EV/ Sales	EV/ EBITDA	P/E	EV/prod $/boe	EV/Res $/boe
Gazprom Neft	0.4	1.7	2.8	59	1.9
LUKOIL	0.4	2.7	4.1	58	2.4
Rosneft	1.1	4.5	4.8	95	3.3
Av. DVIC*	0.6	2.8	5.9	150	12.8
Av. EMVIC**	1.4	5.0	8.7	217	13.2

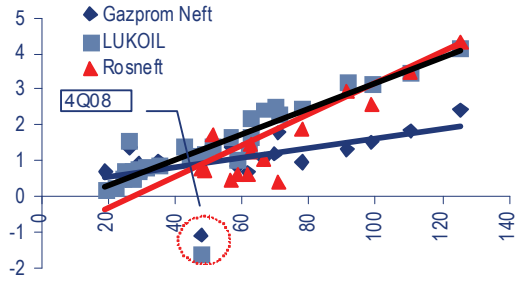
Source: Companies, Bloomberg, URALSIB estimates

* - Vertically integrated oil companies from developed countries

** - Vertically integrated oil companies from emerging countries

4Q08: One-offs impacted the bottom line

Quarterly Net income (loss) ($ bln) vs Brent ($/bbl)



Source: Companies, URALSIB estimates

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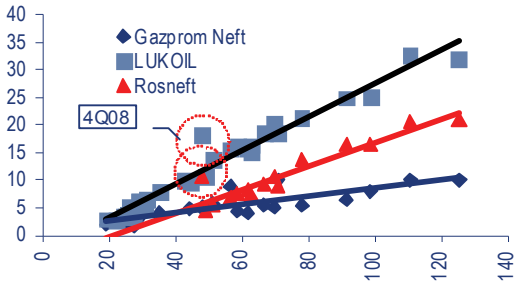
4Q08: Out of trend

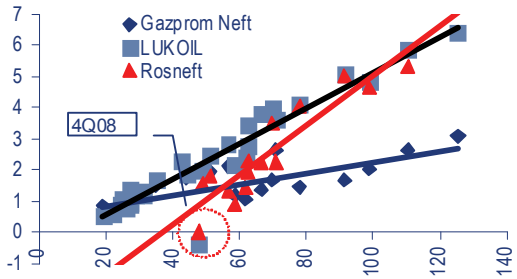
Quarterly Revenues ($ bln) vs Brent ($/bbl)



Source: Companies, URALSIB estimates

4Q08: Effect of lagged taxation resulted in negative EBITDA

Quarterly EBITDA ($ bln) vs Brent ($/bbl)



Source: Companies, URALSIB estimates

2008 financials: specific and common factors. Macroeconomic changes affected the business of companies differently in 2008. The impact of such factors as low commodity prices were well recognized and duly reflected in analyst's models: thus actual revenue was in line with the consensus forecast. But, a variety of specific factors, related mostly to 4Q08 financials, distorted the forecasts, and led to wide gaps in forecasts and miscalculations of EBITDA and net income. Currency losses, impairments and changes in deferred taxes were the most common "uncommon" factors of 2008 financials:

- **Currency gains/losses.** In 4Q08, ruble weakening of 14% resulted currency gains/losses. All three companies use dollars as reporting and functional currencies. For all three, current assets, related to core operating activities on the domestic market (i.e. everything excluding exports) are denominated in rubles and exceed the corresponding current liabilities. All three were supposed to reflect currency losses. Gazprom Neft and LUKOIL did so, reporting currency losses of $384 mln and $1.2 bln, respectively. While Rosneft posted a currency gain of $946 mln due to the fact that ruble denominated liabilities (tax payables related to former YUKOS assets) exceeded ruble denominated current assets.

Currency gains (losses) occurred on the back of different balance sheet structures

Accounting peculiarities - effects of RUB weakening

	Report	Reporting currency	Functional currency		Currency gain/ Currency loss
Rosneft	US GAAP	USD	USD	RUB denominated (Accounts payable + Debt) >> (Accounts receivable + cash)	Large Currency Gain
LUKOIL	US GAAP	USD	USD	RUB denominated (Accounts payable + Debt) << (Accounts receivable + cash)	Large Currency Loss
Gazprom Neft	US GAAP	USD	USD	RUB denominated (Accounts payable + Debt) < (Accounts receivable + cash)	Medium Currency Loss

Source: Companies data, URALSIB estimates

- **Uncommon factors:** Certain one-off factors influenced each of the companies differently, and thus resulted in various specific issues that made their financials substantially different from each other, adding distortions and discrepancies to peer group financials analysis. These are (look at the table below): oil and product purchases, trading operations and income from equity affiliates, hedging, and deferred taxes.

1Q09 – signs of improvement, but April and May might see stagnation. 2009 brought signs of stability to the oil sector and assuming the following changes, we expect 1Q09 to be very strong for all of the oil companies.

- Oil prices grew 17% QoQ to $48/bbl;
- The ruble weakened from RUB29.4/$ as of 31 December 2008 to RUB35.2/$ average for 1Q09.
- Mineral Extraction Tax rate increased from $9/bbl in 2008 to $15/bbl from 2009;
- Profit tax cut from 24% in 2008 to 20% in 2009.

Beware though that April-May results might erode the first signs of positive mood euphoria – as the positive impact of the Brent oil price growth to approximately $50/bbl was very much counter-balanced by ruble appreciation to RUB33.5/$ (operating costs in dollar terms remained flat), while export duties for crude oil and oil products were raised from $111/ton in 1Q09 to $137/ton in May.

Specific factors distorted comparisons

Specific factors of 2008 finacials

	Rosneft	LUKOIL	Gazprom Neft
Crude and products purchases	YES (Medium negative effect) Related to purchases of crude from Tomskneft, Udmurtneft and Polar Lights	YES (Strong negative effect) Related to crude purchases to load up international refineries	YES (Strong negative effect) Related to crude purchases from Slavneft and Tomskneft
Trading operations	NO	YES (Strong negative effect) Trading of products and crude oil	NO
Hedging	NO	YES (Strong negative effect) Hedging on crude oil and products	YES (Strong negative effect) Hedging of RUB/USD rate
Equity pick-up	YES (Low positive effect) Effect from Tomskneft, Udmurtneft and Polar lights	NO	YES (Strong positive effect) Substantial effect from Tomskneft, Slavneft and Moscow refinery
Deffered taxes	YES (strong positive effect)	NO	YES (Strong positive effect)

Company data, URALSIB estimates

Different one-off effects on financials

Quarterly results for 2008, $ Mln

Gazprom Neft	1Q08	2Q08	3Q08	4Q08	4Q08E, Cons	Diff. %
Revenues	8,045	9,957	10,085	4,988	4,969	0
EBITDA	2,026	3,093	2,642	(203)	338	n/a
Net income	1,517	2,409	1,838	(1,106)	(77)	n/a
Capex	782	777	883	885		
OCF	1,007	1,443	2,147	847		
FCF	226	665	1,264	(38)		
Currency gains (losses)	57	(3)	(187)	(384)		
LUKOIL						
Revenues	25,084	32,088	32,555	18,328	17,343	6
EBITDA	4,824	6,403	5,833	(393)	259	n/a
Net income	3,163	4,130	3,472	(1,621)	(1,118)	n/a
Capex	2,362	2,672	2,667	2,824		
OCF	3,658	3,333	3,952	3,369		
FCF	1,296	661	1,285	545		
Currency gains (losses)	110	76	(216)	(1,163)		
Rosneft						
Revenues	16,368	21,134	20,690	10,799	10,504	3
EBITDA	4,658	7,021	5,297	12	349	(97)
Net income	2,555	4,305	3,455	765	(270)	n/a
Capex	1,748	2,499	2,179	2,250		
OCF	4,505	4,873	4,413	562		
FCF	2,757	2,374	2,234	(1,688)		
Currency gains (losses)	(152)	(152)	(152)	(152)		

Source: Company data

Oil price stabilizes at $50/bbl; RUB weakens in January, but strenthens in March, export duties grow in May

Fragile stability of 2009

Average Integrated Oil Company*	Aug08	Sept08	Oct08	Nov08	Dec08	Jan09	Feb09	Mar09	Apr09E	May09E
Brent, $/bbl	**113,89*** **	**93.9**	**60.4**	**48.1**	**35.6**	**44.2**	**44.6**	**50.0**	**50.0**	**50.0**
Weighted average oil and products mix**	**118,3******	**97,5******	**62,2*******	**49.8**	**33.7**	**45.6**	**46.7**	**51.9**	**51.9**	**51.9**
RUB/USD	**24.7**	**25.6**	**27.1**	**27.9**	**29.4**	**35.7**	**35.9**	**33.0**	**33.0**	**33.0**
Weighted average price ex VAT	**111.9**	**92.3**	**58.9**	**47.1**	**32.2**	**43.2**	**44.2**	**49.1**	**49.1**	**49.1**
Lifting Costs (average for the sector)	6.9	6.7	6.3	6.1	5.8	4.8	4.8	5.2	5.2	5.1
Direct Refining & Marketing Costs	1.2	1.2	1.1	1.1	1.0	0.9	0.9	0.9	0.9	0.8
Transportation	9.1	8.8	8.3	8.1	7.7	7.6	7.6	8.2	8.2	8.2
SG&A	3.8	3.7	3.5	3.4	3.2	2.7	2.7	2.9	2.9	2.8
non-cash DD&A & exploratory	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Taxes other then Income Tax	68.9	59.3	41.8	26.5	18.5	15.1	18.5	20.0	23.1	25.2
including:										
*Export Duties on Crude Oil****	*32.1*	*28.6*	*21.7*	*11.9*	*8.4*	*4.9*	*7.5*	*7.5*	*9.0*	*11.0*
Export Duties on Oil Products	*7.6*	*6.8*	*5.1*	*2.8*	*2.0*	*1.2*	*1.8*	*1.8*	*2.1*	*2.2*
Mineral Extraction Tax	*22.7*	*18.4*	*11.0*	*8.4*	*5.4*	*6.3*	*6.5*	*7.6*	*9.0*	*9.0*
Excise Tax	*1.8*	*1.7*	*1.6*	*1.6*	*1.5*	*1.2*	*1.2*	*1.3*	*1.3*	*1.3*
Other taxes	*4.7*	*3.8*	*2.3*	*1.8*	*1.2*	*1.5*	*1.5*	*1.8*	*1.7*	*1.7*
Total Costs (before profit tax)	**94.0**	**83.8**	**65.1**	**49.3**	**40.3**	**35.2**	**38.6**	**41.3**	**44.4**	**46.2**
profit tax, %	*24%*	*24%*	*24%*	*24%*	*24%*	*20%*	*20%*	*20%*	*20%*	*20%*
Net Income (after profit tax)	**13.6**	**6.4**	**(4.7)**	**(1.7)**	**(6.2)**	**6.4**	**4.5**	**6.2**	**3.7**	**2.3**

** oil company which sells crude according to the average proportion in Russian oil sector: 45% export, 7.5% - sales in CIS, 2.5% - sales on domestic market, 45% - domestic refining.*

*** average integrated company exports crude and sells different products - price for fuel oil is much lower, price for gasoline - much higher. At different oil prices, oil products could be priced differently.*

**** oil prices and export duties are actual. They reflect "Kudrin's scissors" effect that existed in 2008 due to two months lag in calculation of the export duties , which resulted in exports unprofitability.*

***** two month lagged export duty calculation period is used till October 2008.*

****** one month lagged export duty calculation period is used starting from October 2008.*

Source: URALSIB estimates

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