METROPOL®
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MARKETING MATERIAL

RUSSIAN EQUITY RESEARCH: OIL & GAS

Gazprom Neft

Sell
22%
Downside

FAIR VALUE DECREASE

21 April 2010

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▲ Fair value reduced by 5% with a downgrade from Hold to Sell

We have revised our model for Gazprom Neft based on updated production and CAPEX guidance. Our new DCF-based fair value is USD 4.55 per share, implying a Sell recommendation with 22% downside.

▲ A planned 50% y-o-y increase in 2010 CAPEX is likely to be long-term

The company plans to increase CAPEX by 50% y-o-y in 2010 to USD 3.9bn. Most of the increase will be targeted toward modernizing the NIS refinery in Serbia and the Moscow refinery, but upstream capital expenditures are also expected to increase by 24% y-o-y. In 2012, we expect a 30% increase in upstream CAPEX y-o-y to develop two greenfields scheduled to start producing in 2013-2014. As these fields are expected to plateau only in 2017-2019, we see no room for major reductions in capital expenditure until then.

▲ We expect stagnant production in 2010-2013. All major greenfields should plateau in 2017 or later.

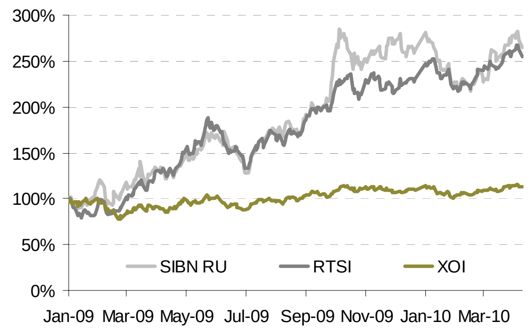
Gazprom Neft's key greenfield projects to offset the natural decline at its core fields include two fields to be transferred from the parent company, and two major fields to be developed by 50%-owned affiliate Slavneft. However, production from these fields should start no earlier than 2013, and plateaus are expected to be reached in 2017-2024. As a result, the fields' contribution to output should range from zero to 10% in the five years between 2010 and 2014. We expect the company's oil output to range from 99% to 102% of the 2009 level from 2010-2013, increasing to 106% by 2014.

▲ Liquidity could greatly improve if Gazprom chooses to sell the 20% stake it bought from ENI in 2009

Gazprom Neft's free float remains low at 4% while Gazprom controls about 96% of the company. We think that Gazprom might sell the 20% stake purchased from ENI for about USD 4.1bn in 2009 through an SPO. Gazprom would still retain complete control over the subsidiary with a 75% stake. Such an action would greatly improve liquidity and make the stock accessible to a wide range of investors. It would allow us to decrease our company-specific risk premium from 3% to 1% or less, increasing the fair value by 33% to USD 6 per share.

Bloomberg	SIBN RU SIBN RM
Rating	Sell
Fair value (Common stock), USD	4.55
Current price (Common stock), USD	5,54
Market cap, USD mn	26,267
EV, USD mn	31,709
Common shares outstanding, mn	4,741
52 week high, USD:	6.00
52 week low, USD:	2.64
Free float %	4%
Average daily traded volume, USD mn	13
Share price performance over the last:	
1 month	2%
3 months	2%
12 months	119%

Gazprom Neft, RTS, XOI relative performance



Source: Bloomberg

Summary valuation and financials, USD bn

	Revenues, USD bn	EBITDA, USD bn	EBITDA margin, %	Net Income, USD bn	EV/Revenues (x)	EV/EBITDA (x)	P/E (x)
2009	24,166	4,904	13%	3,081	1.3	6.5	8.5
2010E	27,231	5,705	11%	2,941	1.2	5.6	8.9
2011E	28,562	6,014	10%	2,985	1.1	5.3	8.8
2012E	30,199	6,381	10%	2,955	1.1	5.0	8.9

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Investment summary and conclusions

DCF-based fair value reduced, rating cut to Sell from Hold

We have revised our DCF-based fair value for Gazprom Neft's common stock by 5% to USD 4.55 per share. At the current price, this fair value suggests a potential downside of 22% and a downgrade to a Sell from our previous Hold recommendation. The new fair value is based primarily on higher CAPEX guidance from management, and a schedule for new field development that sees production plateaus coming later than we previously expected.

Gazprom Neft looks overvalued on multiples

We have also looked at peer group multiples, which show that for 2011, Gazprom Neft's P/E should be 21% above that of Russian peers, while EV/EBITDA should exceed the domestic peer average by 41%. We also note that Gazprom Neft's cash generation capacity is likely to be inferior in per barrel terms to that of LUKOIL and Rosneft until 2014.

Capex focused on modernizing refineries bought in 2009, Sibir Energy and NIS

The company made an important acquisition in 2009, Sibir Energy, which added 9% to crude production and 15% to refining capacity in 2H 09. Early in 2009, it also bought a controlling interest in Serbian oil and gas company NIS, increasing its refining capacity by about 20%.

Following the acquisitions, Gazprom Neft's strategic focus is on bringing a number of new Russian fields into operation and improving the quality of its Moscow and NIS refineries. The problem we find with this plan is that once the company completes its refinery modernization program, optimistically in 2012, it would have to commit significant CAPEX to greenfield projects that are not likely to plateau before than 2017.

In the years 2010-2012, we expect the company to prioritize downstream CAPEX, spending USD 2.5bn to upgrade refineries and USD 1bn to develop its distribution networks. The key beneficiaries of this would be the Moscow Refinery and NIS, although we doubt that NIS would ever be able to exceed the Moscow Refinery's profitability given the latter's location and tax treatment.

But any cash generated by revamped refineries is expected to be channeled to greenfields

As a result, the company's EBITDA margin should grow by 3 ppts over the 2009 level to 23% in 2013. However, much of the additional cash flow would be channeled into new upstream projects. As a result, we do not see CAPEX decreasing in real terms from the 2010 level (when it is planned to rise by 50% y-o-y) in any year going forward.

The greenfields are long-term projects -- no major output growth is likely until 2014

According to our forecasts, oil output should grow by 2% y-o-y in 2010 and decrease by 1%-2% pa in 2011-2013. From 2013-2014, the company expects to see production beginning at four major fields. Two are to be 100%-owned by Gazprom Neft, transferred from Gazprom, and the other two belong to 50%-owned affiliate Slavneft. Their combined plateau should equal 75% of Gazprom Neft's 2009 oil output.

However, all of these fields are scheduled to reach their maximum output only between 2017 and 2024. In addition, the terms of the transfer from Gazprom to Gazprom Neft remain unclear. We also fear that CAPEX for the Novoport field in Yamal could greatly exceed our projections, since the remote area has no infrastructure.

In the future, Gazprom could hold an SPO, boosting liquidity

We identify one scenario which, business fundamentals remaining unchanged, could nevertheless improve the stock's liquidity and appeal to investors. This scenario would involve Gazprom selling all or part of its 20% stake in Gazprom Neft via an SPO. This is the most significant risk to our fair value and Sell recommendations and could result in unanticipated upside potential.

Risks

We have identified three major company-specific risks that could result in upward revisions to our fair value and Sell recommendation, which could force us to revise both the valuation and rating upward. A higher-than-anticipated oil price is the most significant systematic risk to our valauation..

Increased free float

Gazprom controls 96% of Gazprom Neft, having bought a 20% stake from ENI in April 2009. In buying the shares, Gazprom exercised a call option at an above market price. We suspect Gazprom chose to proceed with the acquisition based on an earlier informal agreement with ENI. Therefore, it would make sense, in our view, for Gazprom to dispose of the stake. At the current price, the stake is worth about 20% more than the amount Gazprom paid in 2009. Gazprom could choose to sell the stake via an SPO, which would greatly boost liquidity and increase free float to 24%, greater than that of Rosneft. The higher liquidity would also make Gazprom Neft accessible to a greater range of investors and expand demand for the stock, more than offsetting the temporary overhang created by the potential SPO. Were an SPO to take place, we would probably reduce our company-specific risk premium from 3% to 1% as a result, increasing our fair value by one-third.

Steeper production profiles for new fields

The company has four major greenfield projects in the planning stages, including two to be transferred from Gazprom and two to be developed by Slavneft. They are scheduled to begin producing in 2013-2014. However, the Slavneft fields are only due to reach their production plateaus ten years later, in 2023-2024. The Gazprom fields should start producing at the maximum level from 2017-2018. Although by 2020 these four fields should contribute 45% of total production, this would still be 25% short of Gazprom Neft's 2mn bpd target. We think that Gazprom Neft, in partnership with TNK BP, could revise the production schedules to accelerate field development once the initial infrastructure is set up. This could have a tangible positive impact on our terminal value.

Lower CAPEX, or even a sale of NIS

The terms of NIS' sale include Gazprom Neft spending about USD 735mn on modernizing the refinery in the years 2009-2011. Gazprom Neft may also have to buy about 19% in NIS stock from its employees, spending an additional USD 200mn-300mn according to our estimates. While NIS could prove a valuable asset in the medium to long term as demand for oil products builds in the Balkans, we doubt that the CAPEX will be efficient in generating a return. Although we do not see more than a 3% impact on fair value as a result, a decision by Gazprom Neft to abandon the CAPEX program could be interpreted by the market as a sign that Gazprom Neft could dispose of NIS altogether. Since NIS has proven less efficient and is burdened with higher personnel and SG&A costs than expected, selling the non-core, low-margin asset could be considered positive by the market.

Recent results

We look at Gazprom Neft's 2009 results relative to three other Russian oil majors in order to compare profitability and their capacity to generate cash.

First, we examine EBITDA per barrel of output. This includes oil and gas production not only by subsidiaries, but also by affiliates, which accounted for 35% of Gazprom Neft's total crude output in 2009. EBITDA is calculated as operating profit plus DD&A plus income from affiliates.

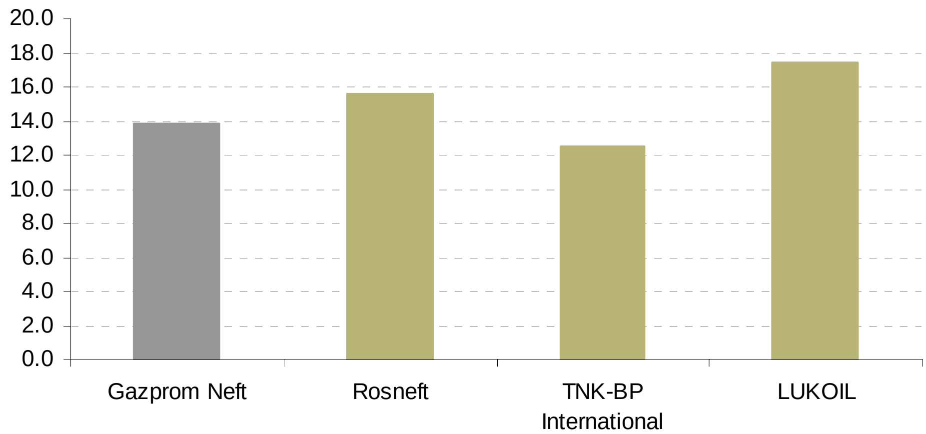
Despite a refining/production ratio of 70%, ahead of the other three companies on the graph, Gazprom Neft lagged behind LUKOIL and Rosneft in EBITDA per bbl in 2009. The figure would be 65% if NIS were excluded, because as a non-Russian refinery, it does not enjoy the higher margins attributable to Russia's more favorable tax regime. However, 65% is also above the 55% for LUKOIL and 50% for Rosneft.

In our view, Gazprom Neft is less profitable due to its relatively high OPEX and SG&A as well as the inefficiencies at NIS. Export shipments via the ESPO as well as a failure to increase crude exports in 2Q 09 also had a negative effect on EBITDA, although we expect the impact to be a one off event Gazprom Neft upstream OPEX was USD 5.32 per bbl of output (excluding subsidiaries). Rosneft's USD 2.57 per bbl was less than half that figure in 2009. LUKOIL's OPEX per bbl was also below Gazprom Neft's 2009 figure at USD 4.

In terms of refining OPEX per bbl of throughput, Gazprom Neft with its USD 2.69 stood between Rosneft with USD 1.88 and LUKOIL's USD 3.45. However, refining expenses at the newly acquired NIS were significantly above the average for the company, at USD 5.45 per bbl.

Gazprom Neft also incurred the highest SG&A per bbl, at USD 5.78. Rosneft reported USD 1.95 and LUKOIL, USD 4.75 per bbl of subsidiaries' oil output.

Figure 1:
EBITDA per boe produced, USD

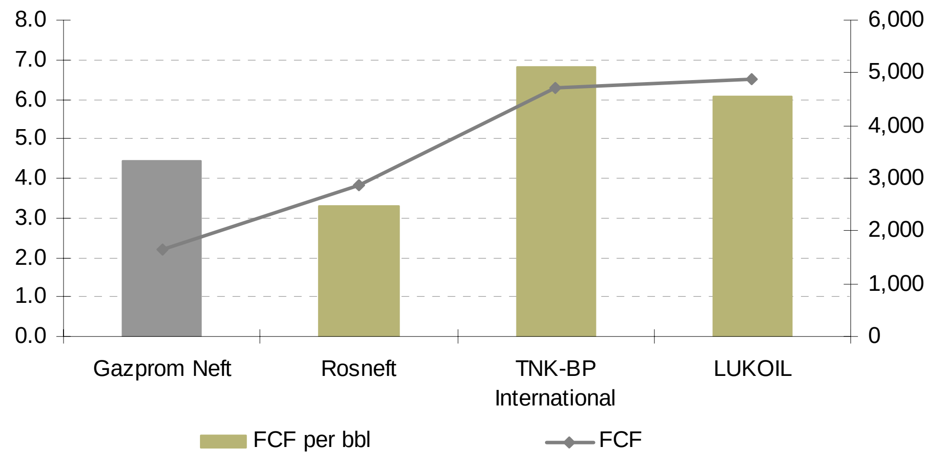


Source: Company data, IFC Metropol estimates

We also examine free cash flow (FCF), which we define for our purposes as cash flow from operating activity, excluding the impact of changes in working capital, less CAPEX (which is different from the FCF used in our DCF model, which also includes working capital movements and acquisitions). This definition should serve as a measure of the company's ability to generate cash in a stable price environment.

We find that in per boe terms, Gazprom Neft came ahead of Rosneft, but lagged both LUKOIL and TNK BP International (the non-traded parent company of TNK BP).

Figure 2:
Free cash flow (FCF), USD mn, and FCF per boe produced, USD



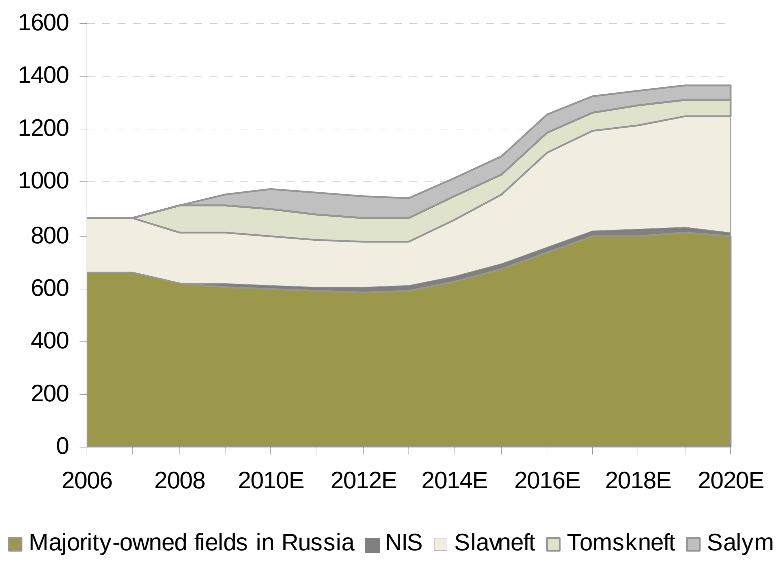
Source: Company data, IFC Metropol estimates

Revised production, refining and CAPEX plans

Production profile forecast

We expect the company's total oil output to grow by 2% y-o-y in 2010, but decline slowly at less than 2% pa in the years 2011-2013. We see growth returning only in 2014, when new fields, both at Slavneft - and those directly owned, are brought on-stream. Our production forecasts are summarized in Figure 3 below.

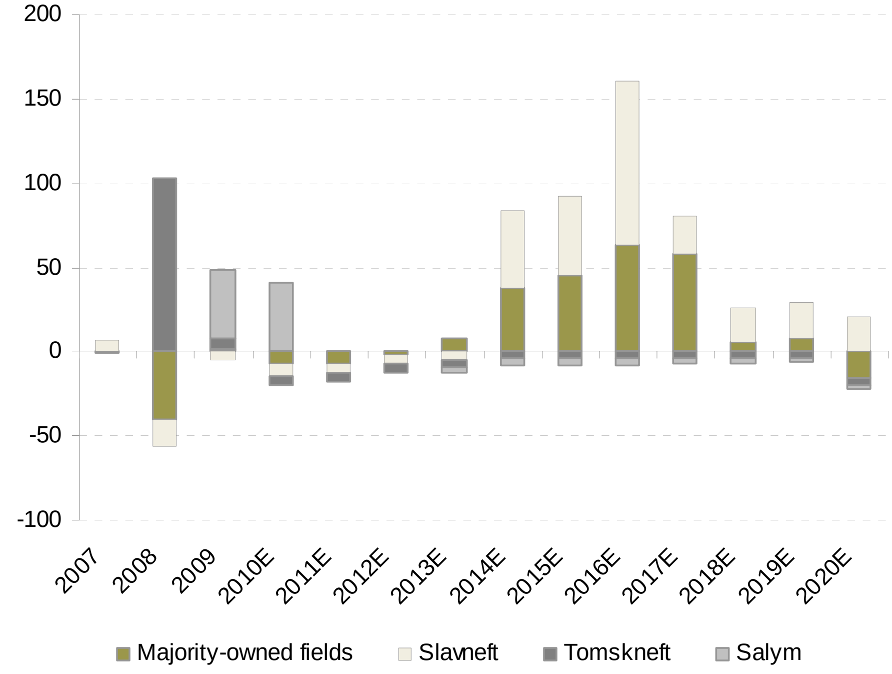
Figure 3:
Production projections, thousand bpd



Source: Company data, IFC Metropol estimates

To clarify the contribution of Gazprom Neft's various projects to output growth, we attach a graph showing incremental oil output: actual output in 2007-2009 and projected output in 2010-2020, broken down by source.

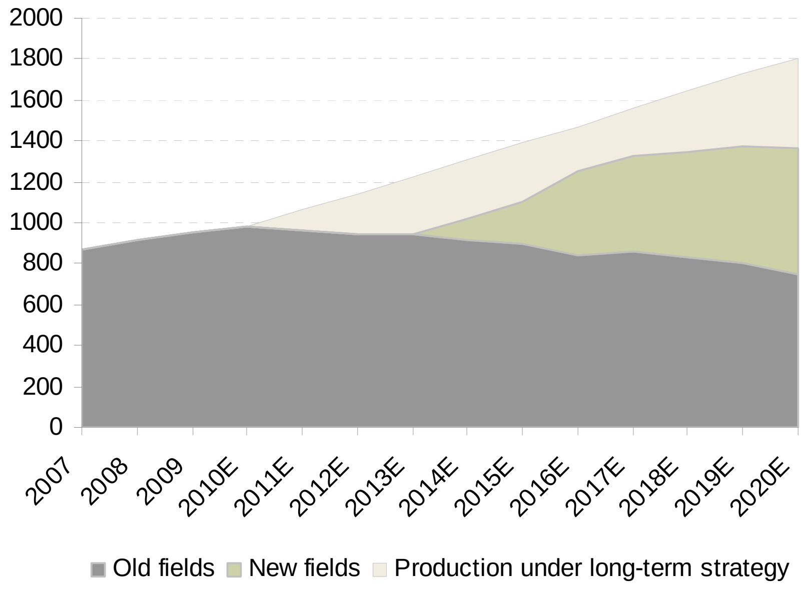
Figure 4:
Incremental oil production, thousand bpd



Source: Company data, IFC Metropol estimates

Our projected production profile is largely based on comments by the company's management regarding separate fields and projects. We have compared our estimates with the company's 2020 production target. We note that about 30% of the company's 2020 target remains unaccounted for. Even if we add back the projects that we argue are unlikely to materialize, they would probably only compensate for one-third of the shortfall.

Figure 5:
Metropol production projections vs. Gazprom Neft 2020 target, thousand bpd



Source: Company data, IFC Metropol estimates

Sibir Energy acquisition impact

Before acquiring Sibir Energy (SBE) in 2009, Gazprom Neft was producing about 0.6mn bpd from 100%-owned fields and 0.3mn bpd from equity affiliates Slavneft and Tomskneft. The SBE acquisition should add 0.08mn bpd to affiliate oil output from 2010, thanks to SBE's 50% share in Salym Petroleum Development (SPD).

As a result, we are looking for a 2% increase y-o-y in total oil output in 2010. Shell is the operator for SPD and has thus far met its production targets, so we see few risks associated with this project.

Decline slowing at Gazprom Neft core fields

Gazprom Neft experienced a 6% y-o-y decline in production at its majority-owned fields in 2008, followed by a 2% y-o-y decline in 2009. Judging by the company's plans and 2010 production estimates, we expect a smaller, 1% decline in 2010. We anticipate a similar rate of decline in 2011-2012. This would be the result of depletion at a number of large fields, partially offset by production growth at the company's segment of Priobskoye. The acquisition of NIS added 2% to subsidiary output in 2009, but is unlikely to make a large difference for decline/growth rates in the future.

We also that the Priobskoye field is now projected by the company to plateau at some 180,000bpd, less than the 200,000bpd we expected.

New project summary

Figure 6:
Gazprom Neft new production projects, mn bpd

	Gazprom Neft's share	Plateau output, 000bpd	Start of production	First plateau year	In the model?
Messoyakha	50%	252	2013	2024	Yes
Novoport	100%	191	2013	2017	Yes
Kuyumba	50%	167	2013	2023	Yes
Orenburg	100%	133	2014	2019	Yes
Badrah	30%	51	2013	2016	No
Junin 6	8%	42	2013	2018	No
Elephant	4%	5	n/a	2008	No

Source: Company data, IFC Metropol estimates

Fields transferred by Gazprom should start producing only in 2013

Gazprom Neft's management expects that Gazprom will transfer licenses for two fields to its oil subsidiary in 2010. The fields are Novoportovskoye (Novoport) and Orenburgskoye (Orenburg), located in the Yamalo-Nenets District (YND) and the southern Urals. The company expects Novoport to reach its plateau of 190,000bpd in 2017. Considering the remoteness of the field, currently lacking virtually any transportation infrastructure, even this could be an optimistic deadline. Orenburg is due to produce 132,000bpd when it hits the plateau 2019. Neither field is expected to start production before 2013.

The company has not specified how exactly it will compensate Gazprom for these new fields. In our model, we assume that there will be no compensation at all, which is probably generous to Gazprom Neft. On the other hand, we completely disregard Gazprom Neft's plans to produce gas from the Cenomanian reservoirs of its oil fields. We believe Gazprom would probably object to its oil subsidiary profiting from a gas project, as it goes against Gazprom Neft's intended role as an oil arm of the gas giant. It is possible, in our view, that Gazprom would transfer the oil fields to Gazprom Neft in exchange for a waiver of profits from the gas project.

Slavneft's Krasnoyarsk fields

Slavneft owns licenses for two fields in the Krasnoyarsk region with total estimated C1 reserves of 570mn bbl. The Kuyumbinskoye (Kuyumba) field has C1 reserves of 476mn bbl and C2 reserves of 1.11bn bbl, which puts the C1+C2 total at 1.68bn bbl. The Tersko-Kamovsky block of the Yurubcheno-Tokhomskoye field has C1 reserves of 94mn bbl; however its C2 reserves are estimated at 1.10bn bbl, almost as large as the other Krasnoyarsk field.

Measured against the largest Russian field put into operation since 2000, the two Krasnoyarsk blocks appear a major prospect. For comparison, Rosneft's Vankor field was estimated to hold C1+C2 reserves of 2.40bn bbl in 2006, before Rosneft began actively drilling the field. The combined C1+C2 reserves of Slavneft's two Krasnoyarsk fields are therefore 70% of Vankor's, as estimated in 2006.

However, both Kuyumbinskoye and Tersko-Kamovsky are located in a remote and sparsely populated part of the Krasnoyarsk region, the former Evenk Autonomous District. A 370km long pipeline connecting the field to Transneft's ESPO I pipeline would be required to transport the oil to export markets.

Of these fields, Slavneft has only slated Kuyumba for development. This field is due to start production in 2014 and reach its plateau of 333,000bpd in 2023 (Gazprom Neft's share would be 50% of this).

Slavneft's Messoyakha

Messoyakha is another major field licensed to Slavneft, located in the north-east of the YND, and currently not connected to Transneft's pipeline system, even by rail. However, it could benefit from the Zapolyarnoye-Purpe pipeline that Transneft proposes to build by 2014. With C1 reserves estimated at 470mn bbl net to Gazprom Neft, Messoyakha is scheduled to begin production in 2014 and reach a plateau of 500,000bpd (50% to Gazprom Neft) by 2024.

Projects omitted from our model

Apart from the Cennomanian gas project, we do not include the Badra field in Iraq or the Venezuelan Junin-6 in our model. After both reach their hypothetical plateaus in 2016, they could add up to 7% to the company's output. Badra appears to be a service contract, at least in part. Thus, despite Gazprom Neft's 30% ownership share in the operating consortium, the company may be unable to book the oil as its own production.

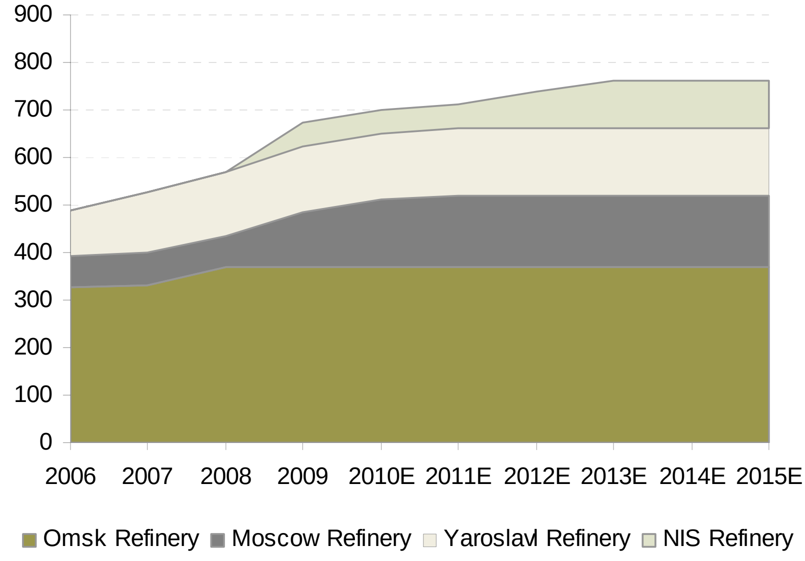
At Junin-6, we see both political and geological risks. The former could include unfavorable pricing for crude extracted as well as unexpected reductions in the Russian consortium's oil take. The geological risks have to do with the heavy oil found at Junin-6, which most Russian consortium members have no experience with, excepting LUKOIL with its heavy oil fields in Komi.

Refining

The acquisition of Sibir Energy increased Gazprom Neft's share of Moscow Refinery's capacity from 50% to 75%. We expect that the Moscow city government will retain the right to use 25% of Moscow Refinery's capacity, as well as a 25% share in Sibir Energy. Since Moscow Refinery's capacity appears to be about 200,000bpd (rather than the nominal 240,000bpd), net capacity added was 50,000bpd. The acquisition of NIS early in 2009 added about 145,000bpd of capacity, according to our estimates. Overall, Gazprom Neft should have access to an additional 30% of refining capacity. However, NIS' margins are likely much lower than Moscow Refinery's, and at present NIS is probably breaking even at best.

We expect Gazprom Neft to gradually increase utilization at Moscow Refinery to about 100% and 70% at NIS (since we think NIS' nominal capacity is overstated). As a result, we project refining throughput in 2013 to be 14% above 2009, and remain at that level going forward.

Figure 7:
Projected refinery throughput, thousand bpd



Source: Company data, IFC Metropol estimates

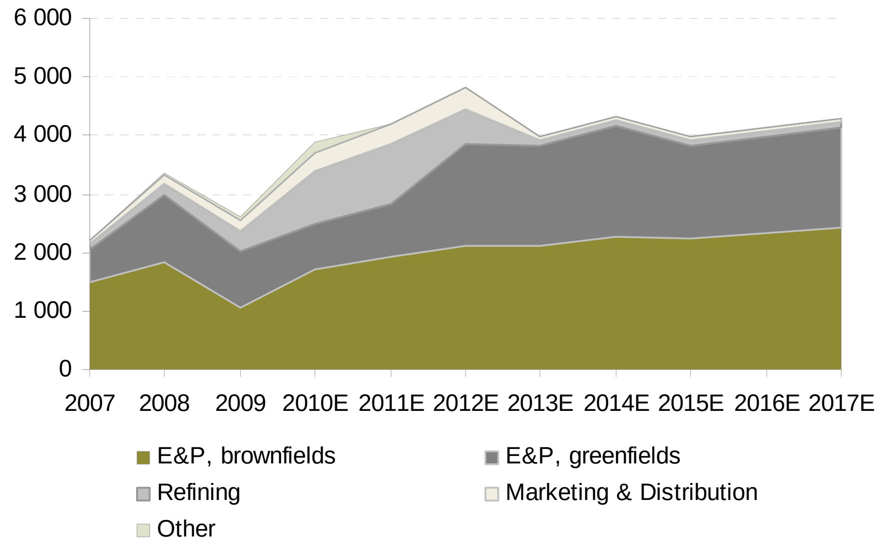
CAPEX

The company plans to increase CAPEX by 50% y-o-y in 2010, to USD 3.9bn. The company said the reason for the sharp increase is partly due to higher refining CAPEX, which should increase by 170% y-o-y and include modernization of NIS, Moscow Refinery, and Omsk Refinery. The company suggested that upstream CAPEX would also rise by about a quarter on 2009.

In 2011, we anticipate that the company will have to maintain refining CAPEX to complete the modernization. The following year, we model refining CAPEX to be nearly cut by half. However, as the company plans to launch the Novoport field in 2013, and probably the Orenburg field in 2013-2014, we have made adjustments to greenfield CAPEX. We model a 90% y-o-y jump in greenfield CAPEX in 2012, and a 37% y-o-y increase in upstream CAPEX. Overall CAPEX would still increase by 15% y-o-y in 2012 as a result, instead of declining upon completion of refinery revamps.

As a result, we see the CAPEX hike of 2010 as permanent, leading to relatively thin free cash flows in 2010-2012, until new production yields larger operating cash flows.

Figure 8:
Projected CAPEX, USD mn



Source: Company data, IFC Metropol estimates

Financial outlook

Income statement

Our income statement forecast for the years 2010-2015 can be found in the Appendix. We discuss certain important aspects below.

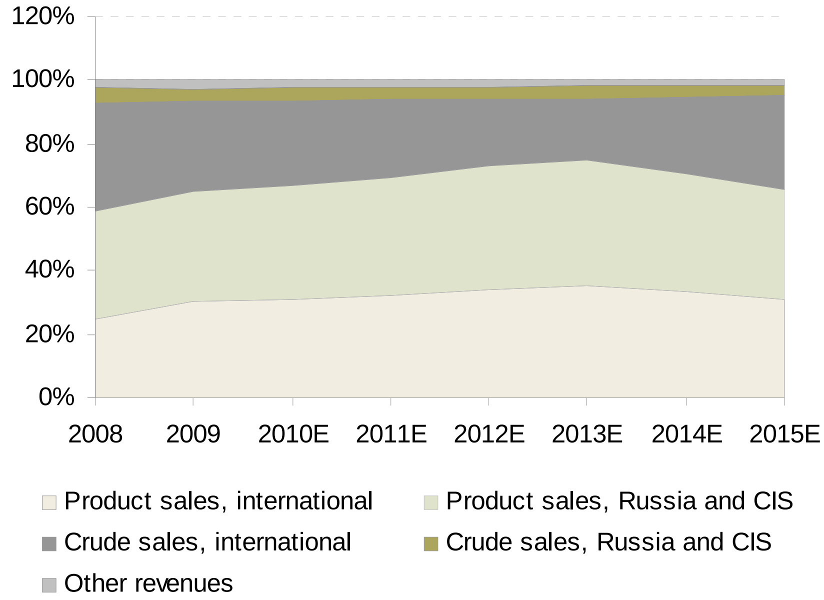
Revenues

Product sales, international, domestic and CIS, accounted for 65% of 2009 revenues. As the company plans to refine more of its own crude at Moscow Refinery and NIS, and as oil production should only resume growth in 2013, we expect the share of product sales in revenues to increase to 75% by 2013. It should gradually decline after that, as we anticipate new production will not find any matching refining capacity and would have to be sold as crude.

Accordingly, we predict the share of crude sales will decline from 32% in 2009 to 23% in 2013, picking up thereafter.

Gas sales were a meager 0.4% of total revenues in 2009 (included in “other revenues” in the figure below). Gazprom Neft plans to start producing natural gas from Cenomanian layers in two of its deposits in 2011, but as we do not include these volumes in our model for reasons explained above, and we project gas sales to remain negligible.

Figure 9:
Projected revenue breakdown, %



Source: Company data, IFC Metropol estimates

Overall, we expect revenues to recover in 2010 with a 12% y-o-y increase following a 29% y-o-y drop in 2009. In the years 2011-2013, revenues should grow largely in line with the oil price. From 2014, we expect the growth rate to be higher due to new production from fields transferred from Gazprom, and it should keep growing until 2017-2018.

Figure 10:
Projected revenue breakdown, USD mn

	2009	2010E	2011E	2012E	2013E	2014E	2015E
Crude sales, international	6,749	7,325	7,022	6,365	6,358	8,867	11,789
Growth y-o-y, %	-41%	9%	-4%	-9%	0%	39%	33%
Product sales, international	7,373	8,393	9,130	10,204	11,772	12,066	12,368
Growth y-o-y, %	-12%	14%	9%	12%	15%	3%	2%
Crude sales, Russia and CIS	1,042	1,097	1,139	1,193	1,299	1,323	1,348
Growth y-o-y, %	-39%	5%	4%	5%	9%	2%	2%
Product sales, Russia and CIS	8,377	9,729	10,547	11,668	13,234	13,520	13,812
Growth y-o-y, %	-28%	16%	8%	11%	13%	2%	2%
Gas sales	107	110	112	115	118	121	124
Growth y-o-y, %	-28%	2%	2%	2%	2%	2%	2%
Other revenues	518	518	518	518	518	518	518
Growth y-o-y, %	-22%	0%	0%	0%	0%	0%	0%
Total revenues	24,166	27,172	28,468	30,063	33,299	36,415	39,959
Growth y-o-y, %	-29%	12%	5%	6%	11%	9%	10%

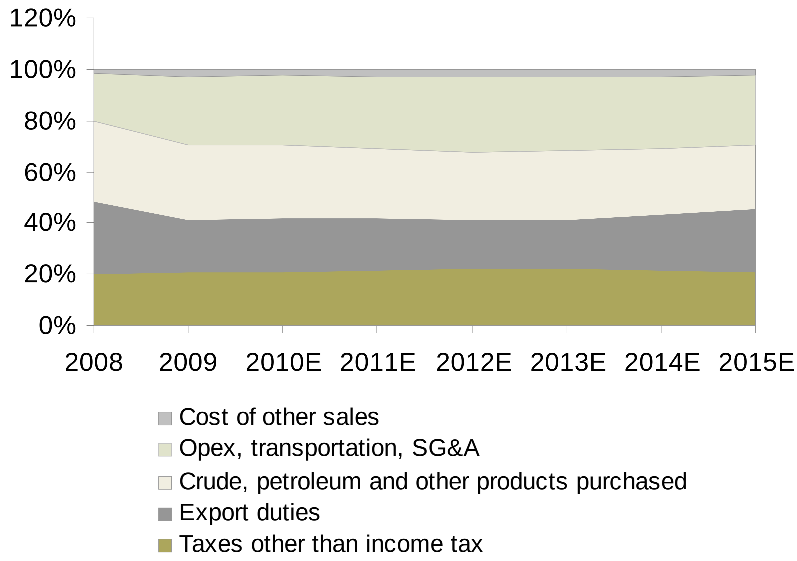
Source: Company data, IFC Metropol estimates

Expenses

Expenses were dominated by taxes and export duties and costs of purchased crude and products in 2009. Taxes and duties constituted 41% of expenses, purchased crude and products 29%, and opex, SG&A and transportation, 27% of cash operating costs.

We expect the weight of taxes and duties to increase to 47% by 2015 due to higher oil exports and higher production in general. The share of purchased oil and products should fall to 25%, also due to higher oil and gas output by Gazprom Neft and its affiliates.

Figure 11:
Projected expense breakdown, %



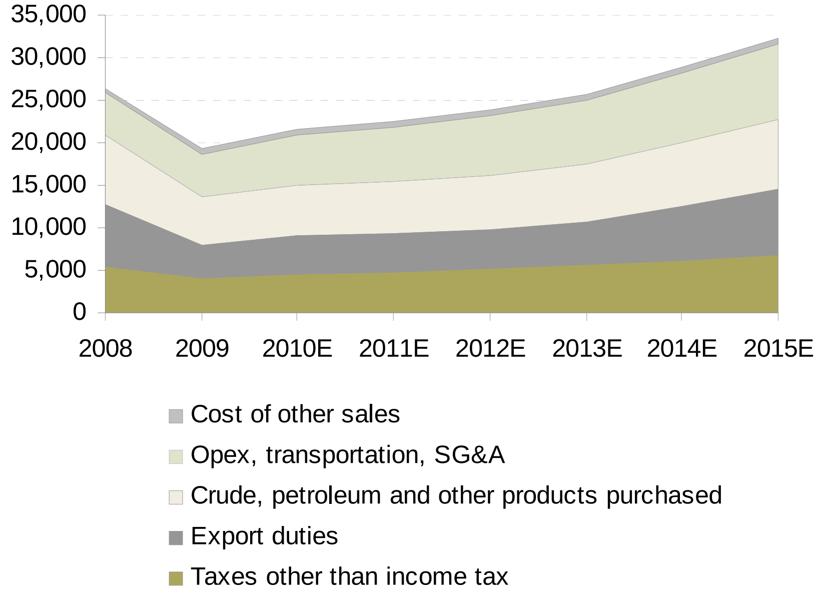
Source: Company data, IFC Metropol estimates

We project operating expenses per barrel of crude output and refining throughput, as well as transportation, to grow with PPI. Generally, we assume that SG&A will grow with CPI. However, we think the company should be able to cut down on SG&A, especially at NIS, and reduce this expense by 10% from the value implied by the PPI in 2010 and 2011.

In projecting the mineral extraction tax, which accounted for 56% of non-income taxes in 2009, we used a 3% discount to the base rate due to depletion in the years 2010-2012, and 5% from 2014. We note that in 2009, the effective discount to the base rate was close to zero.

We project the amount of crude oil purchased internationally to remain constant at the 2009 level going forward at about 440,000bpd. Purchases of crude in Russia should be mostly from affiliates, including Slavneft, Tomskneft, and Salym Petroleum Development. We do not expect major changes in these amounts until 2014, when Slavneft should begin producing at the Kuyumba and Messoyakha fields.

Figure 12:
Projected expense breakdown, USD mn



Source: Company data, IFC Metropol estimates

EBITDA and net income

We expect EBITDA to be up 16% y-o-y in 2010 at USD 5.7bn, for a margin of 21%, an increase of 1 ppt y-o-y. We also use a “net” EBITDA margin, based on revenues net of the cost for purchased oil and production. This second margin would be 27% in 2010, also growing by 1ppts. On higher oil prices and refinery throughput, we forecast 2011 EBITDA to grow by 5% y-o-y in 2011 and 6% y-o-y in 2012, with the two margins unchanged.

We predict EBITDA will jump by 22% y-o-y in 2013, on the back of a 13% y-o-y increase in the oil price as well as weakening of the rouble, which our macroeconomics team forecasts for 2013. In 2013, EBITDA margin should widen by 2ppts y-o-y to 23%. However, from 2014 the balance between crude output and refining should start shifting towards the former, margins should narrow and remain at 18%-21% going forward.

Below the EBITDA line, income from equity affiliates is an important item since it reflects, in part, contributions from Slavneft, Tomskneft and Salym to Gazprom Neft’s results. In our model, this income depends on the crude export netback and crude output by affiliates. We expect it to increase 14% q-o-q to USD 241mn in 2010, partly on higher Salym output. After slow growth in 2011-2013, we forecast larger increases from 2014 on as Slavneft’s Kuyumba and Messoyakha start producing.

Interest expense more than doubled y-o-y in 2009 and will probably grow further in 2010 due to Gazprom Neft’s new borrowings to finance 2009 acquisitions. However, we expect interest obligations to decline as the company pays off its debt by 2016.

Net income should also be down 5% y-o-y in 2010, but for non-cash items mostly. Depreciation should increase by 27% y-o-y in 2010 due to new assets, and we do not include forex gains or losses from 2010. Net income would only recover to above-2009 levels in 2013 with a 37% increase on a higher EBITDA.

Figure 13:
Projected expense breakdown, USD mn

	2009	2010E	2011E	2012E	2013E	2014E	2015E
EBITDA	4,904	5,705	6,014	6,381	7,763	7,762	7,870
Growth y-o-y, %	-35%	16%	5%	6%	22%	0%	1%
EBITDA margin	20%	21%	21%	21%	23%	21%	20%
Net EBITDA margin	26%	27%	27%	27%	29%	27%	24%
Income from equity affiliates	212	241	249	252	262	297	333
Growth y-o-y,%	-48%	14%	3%	1%	4%	13%	12%
Interest expense	-369	-494	-483	-452	-380	-205	-102
Growth y-o-y, %	121%	34%	-2%	-6%	-16%	-46%	-50%
Net income attributable to Gazprom Neft	3,013	2,876	2,920	2,890	3,955	3,908	4,006
Growth y-o-y, %	-35%	-5%	1%	-1%	37%	-1%	2%

Source: Company data, IFC Metropol estimates

Balance sheet analysis

Gazprom Neft's net debt increased over 2009, from USD 1.6bn at the beginning of the year to USD 5.4bn at the end. The company had to borrow to finance the Sibir Energy and NIS acquisitions. Net debt to equity went up from 0.12x at end-2008 to 0.34x at end-2009, when it was also equal to 1.11x 2009 EBITDA.

We think the company could afford to increase net debt even further, by 50%-75%, but our model shows no need for that. We project net debt/equity to stay below 0.3x from 2010-2014. At the same time, net debt/EBITDA should not exceed 1x, which is also acceptable in our view. A full balance sheet forecast can be found in the Appendix.

Cash flow analysis

We have discussed projected CAPEX in the Production and CAPEX section above. An important revenue stream is dividends received from affiliates, which we assume to be equal to 100% of income from affiliates in the years 2010-2012. In fact, in 2009 the company's affiliates paid dividends exceeding their combined net income. However, we reduce the payout to 25% from 2013-2016 and allow it to gradually return to 100% in 2019.

As for dividends to Gazprom Neft's shareholders, we assume that the company will adhere to the 20% payout ratio it plans for the 2009 dividend. We note that for the 2009 dividend, the 20% ratio will apply to net income adjusted for certain one-time and/or non-cash items and the actual payout might be only 18% of US GAAP net income. However, we straightforwardly apply the 20% ratio for dividend payments from 2010.

We doubt the company will be able to repeat the large distributions of past years, such as 2007 when 41% of the previous year's net income was paid out. We believe Gazprom Neft's CAPEX needs are unlikely to allow that before 2016.

Valuation

DCF valuation

We estimate Gazprom Neft's fair value using a DCF model. We prefer a DCF valuation to a multiples-based comparative valuation as we believe that a DCF valuation incorporates value drivers that cannot be accounted for in a multiples-based valuation.

WACC

Figure 14:
WACC calculation

Risk-free rate: 10-year US Treasury yield, 1M average	3.7%
Yield difference: 10-year US Treasury/Russia-30, 1M average	1.4%
Standard equity risk premium	4.0%
Cost of equity	10.0%
Company-specific premium	3.0%
Company cost of equity	13.0%
After tax cost of debt	7.20%
Weight of equity	80%
Weight of debt	20%
WACC	11.8%

Source: IFC Metropol estimates

We use a company specific premium of 3%, higher than the premiums we use for Rosneft (1%) and LUKOIL (2%). This is because Gazprom Neft is a relatively illiquid stock, traded mostly on MICEX in roubles, with only a 4% free float. As a Gazprom subsidiary, the company's strategic choices appear limited and influenced by the parent company (as in the NIS acquisition), which is an additional risk to minority shareholders in our view.

DCF model summary

We summarize our DCF model in the table below. We have increased the terminal growth rate from 0% to 2.5%. The reason for the increase is that Gazprom Neft should still benefit from growing production at Slavneft's Kuyumba and Messoyakha fields after the end of the forecast period in 2019.

Our new fair value estimate is USD 4.55 per share, implying a 22% downside and a Sell recommendation.

Figure 15:
DCF model, USD mn

	2009	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E
Revenues	24,166	27,231	28,562	30,199	33,520	36,655	40,218	46,301	49,785	51,030	52,305
Operating costs (excl. DD&A)	-19,262	-21,526	-22,547	-23,818	-25,757	-28,893	-32,348	-37,530	-40,637	-41,653	-42,695
EBITDA	4,904	5,705	6,014	6,381	7,763	7,762	7,870	8,771	9,148	9,376	9,611
EBIT	3,429	3,838	3,857	3,878	5,124	4,902	4,889	5,637	5,859	5,931	6,071
- Profit tax	-804	-765	-776	-768	-1,051	-1,039	-1,065	-1,274	-1,319	-1,352	-1,386
- CAPEX, incl. acquisitions	-4,889	-3,900	-4,190	-4,810	-3,976	-4,316	-3,975	-4,134	-4,300	-4,472	-4,584
- Changes in working capital	-798	17	-180	-195	-327	-608	-645	-733	-419	-234	-236
+ DD&A	1,475	1,867	2,158	2,503	2,639	2,860	2,982	3,134	3,289	3,371	3,539
- Interest expense	-261	-373	-344	-406	-290	-163	-60	126	25	25	25
+ Disposals	10	0	0	0	0	0	0	0	0	0	0
+ Other adjustments	433	241	249	252	65	74	83	103	216	407	464
Free cash flows	-1,405	926	773	453	2,184	1,710	2,209	2,859	3,350	3,676	3,893

Source: Company data, IFC Metropol estimates

Figure 16:
DCF summary, USD mn

NPV	11,805
Perpetual growth rate	2.5%
Terminal value	15,198
Net debt	5,442
Total fair value	21,561
Common shares outstanding, mn	4,741
Fair value per share, USD	4.55

Source: Company data, IFC Metropol estimates

Figure 17:
Fair value sensitivity analysis, USD per share

Terminal growth rate	WACC							
	10.0%	10.5%	11.0%	11.8%	12.0%	12.5%	13.0%	13.5%
0.0%	5.05	4.69	4.36	3.87	3.79	3.54	3.32	3.11
0.5%	5.23	4.85	4.50	3.98	3.90	3.64	3.40	3.18
1.0%	5.44	5.02	4.65	4.10	4.02	3.74	3.49	3.26
1.5%	5.67	5.22	4.82	4.24	4.14	3.85	3.59	3.35
2.0%	5.92	5.44	5.01	4.38	4.29	3.98	3.70	3.45
2.5%	6.21	5.68	5.22	4.55	4.44	4.11	3.82	3.55
3.0%	6.54	5.96	5.46	4.73	4.61	4.26	3.95	3.66
3.5%	6.93	6.28	5.72	4.93	4.81	4.43	4.09	3.79
4.0%	7.37	6.65	6.03	5.16	5.03	4.62	4.25	3.93

Source: IFC Metropol estimates

Multiples-based comparison

For the sake of completeness, we have carried out a peer group analysis based on EV/EBITDA and P/E. We use our own estimates for Gazprom Neft, its Russian peers and Kazakh company KMG EP, and Bloomberg consensus estimates for international peers.

On 2010E and 2011E EV/EBITDA, Gazprom Neft appears to be more expensive than both international and Russian peers, trading in line with emerging market oil companies. Of the Russian peer group, Gazprom Neft is close to Rosneft. A crucial difference in our view is that Rosneft expects its Vankor field to plateau in 2013, while Gazprom Neft plans to only start production at its major greenfields in that year.

On 2010-2011E P/E, Gazprom Neft is also close to Rosneft but higher than the figures for the Russian and international peer groups. Only in 2010 do we expect Gazprom Neft's P/E to be below the emerging market mean and median.

We admit that, on P/E, Gazprom Neft is trading at a discount to its emerging market peers. However, most other Russian companies have also done so for at least the last 3 years, so the discount appears to be persistent and systemic.

Figure 18:
Multiples comparison

	Market cap, USD mn	EV/EBITDA (x)			P/E (x)		
		2009	2010E	2011E	2009	2010E	2011E
International majors							
BP	165,460	3.7	3.9	3.6	6.9	7.3	6.6
Chevron	164,817	3.2	3.2	3.1	15.3	8.4	7.9
ConocoPhillips	87,644	3.4	3.6	3.4	4.1	8.0	7.4
Exxon Mobil	325,626	5.2	4.2	4.2	19.3	9.5	8.6
Royal Dutch Shell	165,928	5.6	3.7	3.2	16.0	7.3	6.4
Total SA	138,056	5.3	3.9	3.5	4.6	9.0	8.3
Int'l majors mean		4.4	3.8	3.5	11.0	8.2	7.5
Int'l majors median		4.4	3.8	3.5	11.1	8.2	7.6
Emerging market companies							
KazMunaiGaz E&P	10,533	3.7	4.7	5.1	4.7	7.3	7.3
ONGC	48,467	4.6	4.4	4.2	10.6	9.8	9.2
Petrobras	184,198	5.9	5.4	4.9	10.9	9.7	8.6
Petrochina	366,050	8.7	7.9	7.1	18.4	16.3	14.4
Repsol YPF	30,208	4.8	4.1	3.8	9.4	8.6	7.3
Sinopec	140,627	7.8	7.1	6.7	14.4	13.5	12.8
Emerging market mean		5.9	5.6	5.3	11.4	10.9	9.9
Emerging market median		5.4	5.1	5.0	10.7	9.7	8.9
Russian peers							
LUKOIL	50,209	4.3	3.9	3.5	7.1	6.7	5.9
Rosneft	90,083	6.3	5.6	5.6	9.8	8.7	10.1
Surgutneftegas	35,726	2.1	2.3	2.0	7.1	7.1	5.9
TNK-BP	35,655	2.7	4.6	3.9	4.8	8.5	7.1
Russian integrated mean		3.9	4.1	3.7	7.2	7.8	7.2
Russian integrated median		3.5	4.3	3.7	7.1	7.8	6.5
Gazprom Neft		6.5	5.6	5.3	8.5	8.9	8.8

Source: Bloomberg, IFC Metropol estimates

Appendix

Figure 19:
Income statement forecast, USD mn

	2009	2010E	2011E	2012E	2013E	2014E	2015E
Oil, gas and refined product sales	23,648	26,654	27,950	29,545	32,781	35,897	39,441
Growth y-o-y, %	-29%	13%	5%	6%	11%	10%	10%
Other	518	577	611	654	739	758	777
Growth y-o-y, %	-22%	11%	6%	7%	13%	3%	3%
Total revenues	24,166	27,231	28,562	30,199	33,520	36,655	40,218
Growth y-o-y, %	-29%	13%	5%	6%	11%	9%	10%
Revenues net of purchased oil, gas and products	18,530	21,169	22,395	23,857	26,597	29,208	32,163
Growth y-o-y, %	-28%	14%	6%	7%	11%	10%	10%
Crude, petroleum and other products purchased	-5,636	-6,062	-6,167	-6,341	-6,923	-7,447	-8,055
Growth y-o-y, %	-32%	8%	2%	3%	9%	8%	8%
Operating expenses	-1,862	-2,209	-2,450	-2,709	-2,949	-3,265	-3,504
Growth y-o-y, %	-8%	19%	11%	11%	9%	11%	7%
SG&A (excluding transportation)	-1,280	-1,322	-1,334	-1,433	-1,491	-1,582	-1,646
Growth y-o-y, %	22%	3%	1%	7%	4%	6%	4%
Transportation expense	-1,982	-2,352	-2,608	-2,847	-3,014	-3,310	-3,724
Growth y-o-y, %	10%	19%	11%	9%	6%	10%	12%
Export duties	-3,948	-4,570	-4,586	-4,514	-4,887	-6,266	-7,920
Growth y-o-y, %	-46%	16%	0%	-2%	8%	28%	26%
Taxes other than income tax	-3,982	-4,462	-4,784	-5,236	-5,726	-6,231	-6,716
Growth y-o-y, %	-26%	12%	7%	9%	9%	9%	8%
Cost of other sales, loss on sale of assets	-425	-362	-406	-447	-465	-479	-498
Growth y-o-y, %	57%	-15%	12%	10%	4%	3%	4%
Exploration expenses	-147	-188	-212	-290	-302	-312	-286
Total cash expenses	-19,262	-21,526	-22,547	-23,818	-25,757	-28,893	-32,348
Growth y-o-y, %	-27%	12%	5%	6%	8%	12%	12%
EBITDA	4,904	5,705	6,014	6,381	7,763	7,762	7,870
Growth y-o-y, %	-35%	16%	5%	6%	22%	0%	1%
EBITDA margin	20%	21%	21%	21%	23%	21%	20%
Net EBITDA margin	26%	27%	27%	27%	29%	27%	24%
DD&A	-1,475	-1,867	-2,158	-2,503	-2,639	-2,860	-2,982
Growth y-o-y, %	13%	27%	16%	16%	5%	8%	4%
Operating income	3,429	3,838	3,857	3,878	5,124	4,902	4,889
Growth y-o-y, %	-45%	12%	0%	1%	32%	-4%	0%
Income from equity affiliates	212	241	249	252	262	297	333
Growth y-o-y, %	-48%	14%	3%	1%	4%	13%	12%
Gain on investment	470	0	0	0	0	0	0
Interest income	108	122	139	45	90	42	42
Interest expense	-369	-494	-483	-452	-380	-205	-102
Growth y-o-y, %	121%	34%	-2%	-6%	-16%	-46%	-50%
Other (expense) income net	-3	0	0	0	0	0	0
Foreign exchange gain, net	50	0	0	0	0	0	0
Total other income (expense)	468	-132	-95	-155	-28	133	273
Growth y-o-y, %	-632%	-128%	-28%	62%	-82%	-570%	105%
Pre-tax income	3,897	3,706	3,761	3,724	5,096	5,036	5,161
Growth y-o-y, %	-37%	-5%	1%	-1%	37%	-1%	2%
Provision for income taxes	-804	-765	-776	-768	-1,051	-1,039	-1,065
Growth y-o-y, %	-44%	-5%	1%	-1%	37%	-1%	2%
Deferred income tax expense	-12	0	0	0	0	0	0
Net income	3,081	2,941	2,985	2,955	4,044	3,997	4,097
Growth y-o-y, %	-34%	-5%	1%	-1%	37%	-1%	2%
Minority interest	-68	-65	-66	-65	-89	-88	-90
Net income attributable to Gazprom Neft	3,013	2,876	2,920	2,890	3,955	3,908	4,006
Growth y-o-y, %	-35%	-5%	1%	-1%	37%	-1%	2%

Source: Company data, Bloomberg, IFC Metropol estimates

Figure 20:
Balance sheet forecast, USD mn

	2009	2010E	2011E	2012E	2013E	2014E	2015E
CURRENT ASSETS							
Cash and cash equivalents	868	1,239	1,424	435	903	396	399
Short-term investments	45	45	45	45	45	45	45
Loans receivable	108	108	108	108	108	108	108
Accounts receivable	2,818	3,038	3,187	3,223	3,251	3,562	3,917
Inventories	1,737	1732	1,817	1,920	2,131	2,333	2,564
Other current assets	1,226	1292	1240	1250	1352	1517	1698
Total current assets	6,802	7,454	7,821	6,982	7,789	7,962	8,731
NON-CURRENT ASSETS							
Long-term investments and loans receivable	6,972	6,972	6,972	6,972	7,168	7,391	7,641
Property, plant and equipment, net	14,265	16,433	18,599	21,041	22,513	24,104	25,232
Goodwill	1,347	1,212	1,078	943	808	674	539
Other non-current assets	402	156	156	156	156	156	156
Non-current deferred income tax assets	124	124	124	124	124	124	124
Total non-current assets	23,110	24,897	26,929	29,236	30,770	32,448	33,691
Total assets	29,912	32,351	34,750	36,218	38,559	40,410	42,422
CURRENT LIABILITIES							
Short-term debt	682	682	682	682	682	682	682
Accounts payable and accrued liabilities	2,434	2,474	2,487	2,416	2,404	2,493	2,563
Income and other taxes payable	694	706	695	721	746	727	778
Dividends payable	416	416	416	416	416	416	416
Current portion of long-term debt	1,466	1,688	1,688	1,435	1,097	2,251	253
Total current liabilities	5,692	5,966	5,968	5,669	5,345	6,569	4,693
NON-CURRENT LIABILITIES							
Asset retirement obligation	367	367	367	367	367	367	367
Long-term debt	4,162	3,940	3,940	3,349	2,561	0	591
Deferred income tax liabilities	755	755	755	755	755	755	755
Other long-term liabilities	279	279	279	279	279	279	279
Total non-current liabilities	5,563	5,341	5,341	4,750	3,962	1,401	1,992
Total liabilities	11,255	11,307	11,309	10,419	9,306	7,970	6,685
Minority interest	2,506	2,506	2,506	2,506	2,506	2,506	2,506
SHAREHOLDERS' EQUITY							
Common stock	2	2	2	2	2	2	2
Additional paid-in capital	573	573	573	573	573	573	573
Retained earnings	15,621	18,008	20,405	22,763	26,217	29,404	32,702
Treasury stock	-45	-45	-45	-45	-45	-45	-45
Total shareholders' equity	16,151	18,538	20,935	23,293	26,747	29,934	33,232
Total liabilities and shareholders' equity	29,912	32,351	34,750	36,218	38,559	40,411	42,422
Net debt/Equity (x)	0.34	0.27	0.23	0.22	0.13	0.08	0.03
Net debt/EBITDA (x)	1.11	0.89	0.81	0.79	0.44	0.33	0.14

Source: Company data, Bloomberg, IFC Metropol estimates

Figure 21:
Cash flow statement forecast, USD mn

	2009	2010E	2011E	2012E	2013E	2014E	2015E
OPERATING ACTIVITIES							
Net Income	3,013	2,876	2,920	2,890	3,955	3,908	4,006
Reconciliation of net income to net cash provided by operating activities:							
Income from equity affiliates, net of dividends received	11	0	0	0	-196	-222	-250
Gain on investment	-470						
Non-controlling interest	68	65	66	65	89	88	90
Deferred income tax expense (benefit)	12	0	0	0	0	0	0
Depreciation, depletion and amortization	1,475	1,867	2,158	2,503	2,639	2,860	2,982
Asset retirement obligation/accretion expense	27	0	0	0	0	0	0
Provision for doubtful accounts	-26	0	0	0	0	0	0
Disposal of property, plant and equipment - (gain)/loss	-6	0	0	0	0	0	0
Loss/(gain) on investment	142	0	0	0	0	0	0
Changes in assets and liabilities, excluding cash and debt:							
Accounts receivable	-393	-220	-149	-36	-28	-312	-354
Inventories	-248	5	-84	-104	-210	-203	-230
Other current assets	-290	-66	51	-10	-102	-165	-181
Other non-current assets	-185	246	0	0	0	0	0
Accounts payable and accrued liabilities	156	40	13	-71	-12	89	70
Income and other taxes payable	188	12	-11	26	25	-19	51
Net cash provided by operating activities	3,474	4,826	4,963	5,263	6,159	6,026	6,184
Purchase of short-term investments	-360	0	0	0	0	0	0
Proceeds from sales of short-term investments	459						
Purchase of investments in associated entities	-2,282	0	0	0	0	0	0
Loan proceeds received	247	0	0	0	0	0	0
Loans issued	-346	0	0	0	0	0	0
Proceeds from disposals of property, plant and equipment	10	0	0	0	0	0	0
Capital expenditures	-2,607	-3,900	-4,190	-4,810	-3,976	-4,316	-3,975
Net cash used in investing activities	-4,879	-3,900	-4,190	-4,810	-3,976	-4,316	-3,975
Short and long-term loans proceeds received	5,702	0	0	0	0	0	0
Short and long-term loans repaid	-4,580		0	-844	-1,126	-1,407	-1,407
Dividends paid	-937	-555	-588	-597	-591	-809	-799
Purchase of treasury shares	0	0	0	0	0	0	0
Net cash used in financing activities	185	-555	-588	-1,441	-1,717	-2,216	-2,206
Forex effect	13	0	0	0	0	0	0
Increase (decrease) in cash and equivalents	-1,207	371	185	-989	467	-506	2
Cash and equivalents at beginning of year	2,075	868	1,239	1,424	435	903	396
Cash and equivalents at end of year	868	1,239	1,424	435	903	396	399

Source: Company data, Bloomberg, IFC Metropol estimates

Figure 22:
Key macroeconomic assumptions

	2009	2010E	2011E	2012E	2013E	2014E	2015E
Brent price, USD per bbl	63	70	75	80	90	92	95
Urals price, USD per bbl	61	68	72	77	87	89	92
Average RUB/USD rate	31	29	28	27	28	27	27
Rouble CPI	10.5%	8.0%	6.0%	5.0%	4.5%	4.5%	4.0%
Rouble PPI	-8.2%	16.0%	12.8%	10.4%	-0.7%	8.5%	4.2%

Source: Company data, Bloomberg, IFC Metropol estimates

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