

Gazprom Neft

Doing the "2020" strategy!

Recommendation: ACCUMULATE

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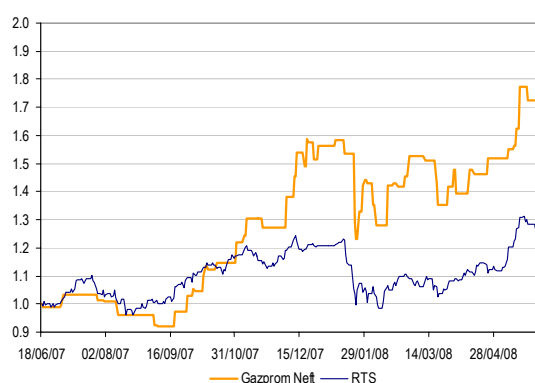
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Bullet moments

- During 2007 Gazprom Neft upped its US GAAP-compliant net income by +13.2% versus 2006, to 4.143 bn USD. The sales of the company expanded by +6.1% to 21.1 bn USD. Operating income rose by +12.2% to 4.899 bn USD, EBITDA +12.8% to 5.828 bn USD. Financial results of the company appeared above our expectations at average of 1.5% and 1.3% above market expectations.
- The growth of net income was supported by several factors, among them was moderate growth of operating costs, forming only +4.3% and secondly the rise of non-operating income. In general – company's cost structure has proved to be satisfactory.
- Judging by all financials, Gazprom Neft has improved its effectiveness throughout 2007. EBITDA margin has formed 27.6%, appearing +1.6 p.p. above prior year, net income margin added 1.2 p.p. up to 19.6%. Invested capital margin of Gazprom Neft is still high, forming 28.4% as of 2007, which is 18 p.p. above average capital costs of company.
- We have corrected our model of Gazprom Neft, making several changes inside. In particular – we have corrected the forecast of oil & oil products prices of the company upwards at average of +27.6%, reflecting all operating elements of development strategy up to year 2020, accepted during spring 2008, and expanded investment plan of forecasted period plus 12.5%. As according to forecasts of company's representatives, company would require 70 bn USD in order to accomplish the set strategy.
- In our model of Gazprom we have reflected the influence from the use of special mining tax at depleted deposits, starting with 2008, as well as tax privileges at new regions, which are set to be applied in 2009. We have also considered the future change of mining tax calculation scale itself. As after January 1st 2009, the cut of oil extraction tax would save over 6 bn RUR during 2009.
- The resulting fair price of Gazprom Neft's stock formed 8.88 USD apiece, versus previously forecasted 6.26 USD, whilst the recommendation is changed to "ACCUMULATE" from "HOLD" due to current growth potential of 12.4%.

Principal estimates

Company's shares vs RTS index



Information about Gazprom Neft

Ticker RTS	SIBN
Market price (cs), USD	7.90
Min / max price during last year (cs), USD	5,00 / 7,90
Fair price at year end (cs), USD	8.88
Upside (downside) (cs), %	12.41
Number of common shares, total	4,741,299,639
MC, mn USD	37,456
EV, mn USD	40,157

Financial values (US GAAP)	2007	2008 (F)	2009 (F)
Sales, mn USD	21,100	32,707	31,654
EBITDA, mn USD	5,828	8,629	8,047
Net income, mn USD	4,143	6,034	5,362
EBITDA margin, %	27.6	26.4	25.4
Net income margin, %	19.6	18.4	16.9

Financial coefficients	2007	2008 (F)	2009 (F)
P/E	9.0	6.2	7.0
P/S	1.78	1.15	1.18
EV/EBITDA	6.9	4.7	5.0

Gazprom Neft's results 2007

Throughout 2007 Gazprom Neft expanded its IAS compliant net income by +13.2%, above the year 2006, from 4.143 bn USD – reports the company. Company's sales rose by +6.1% to 21.1 bn USD, operating income grew +12.2% to 4.899 bn USD, EBITDA added +12.8%, to a total of 5,828 bn USD. Net income of oil company throughout 4Q 2007 has formed 1.323 bn USD, adding 58.6% to corresponding term of past year. Financial values of the company have proved to appear above our expectations, at average of 1.5%, also beating market expectations by 1.3%, providing a significant (over +8%) growth of company's capitalization throughout Thursday. Company's capitalization was not only expanded thanks to that, but also enjoyed support by news on closing of shareholders' registry on May 15th, as company prepares to pay dividends.

While reviewing company's growth dynamics, reader must note that this value grew at low rates, if compared to direct rivals of Gazprom Neft, as those rivals enjoyed an average of +20% sales growth, whilst some companies hiked +49%. We connect this mostly to retargeting of oil and oil products shipments from external to domestic market. As results of 2007 indicate that shipments of crude oil and oil products have been dropped -13.3% over foreign markets. We must note that domestic price on crude oil is two times below the price for foreigners. However – this imbalance has been compensated by expansion of oil products sales to consumers in Russia and CIS +24%, on par with growth of general price on oil and oil products throughout 2007. As "black gold's" prices added +13.3% in past year.

The growth of net income was supported by several factors, among them: moderate growth of operating expenses, which formed 4.3% barely, and growth of non operating values. In general – company's cost structure has proved to be satisfying. Two issues must be still noted – however, first: serious growth of operating costs (+37.5%), caused by industry general rise of operating costs through upped prices of all services for oil industry, secondly – a serious drop of export duties, which formed 27.8% and was caused by retargeting of sales markets by company.

Let us take a broader look at company's effectiveness in 2007. Financials of company indicate that it had improved its positions. EBITDA margin formed 27.6%, appearing above past year +1.6 p.p., net income margin raised +1.2 p.p., up to 19.6%. Gazprom Neft's invested capital effectiveness remains high as well and formed 28.4% in 2007, adding +18 p.p. over company's WACC.

Net cash flow of Gazprom Neft on operating activities of 2007 rose +59.7% to 5.271 bn USD. But it still could not compensate for significant capital investments, made by company back in 2007, which formed 5,636 bn USD. Although – those expenditures had a major part used on pre-new year purchase of 50% in Tomskneft, for 3.6 bn USD. In order to buy the asset, Gazprom Neft – without having required funds – got a syndicate credit worth 2.2 bn USD, provided by consortium of international banks, also agreeing with GazpromBank on getting a credit worth 30 bn RUR. The results of all investment financial operations made company's balance net cash flow drop and form a total of 721.3 mn USD.

In general – we see given report of Gazprom Neft as quite positive, considering company's development prospects, set within development strategy up to 2020, on par with positive conditions at primary commodities market and upcoming cut of tax load upon oil sector, therefore we find investments into stocks of Gazprom quite adequate and investment appealing. The results of published report would be now used to reevaluate company's model, but even now we could tell that price is set to grow by at least +25-30%.

Gazprom Nefit's US GAAP 2007 report, mn USD

	4Q 2006	Chg., %	4Q 2007	2006	Chg., %	2007
Sales	4 363	47,2	6 423	19 894	6,1	21 100
<i>including sales of products</i>	4 294	45,8	6 259	19 670	4,6	20 581
<i>other sales</i>	69	137,5	164	224	132,0	520
Operating costs	(3 235)	50,4	(4 864)	(15 528)	4,3	(16 201)
<i>inc. amortization</i>	(64)	70,9	(109)	(803)	15,7	(929)
Operating income	1 129	38,2	1 560	4 366	12,2	4 899
<i>Operating income margin, %</i>	25,9		24,3	21,9		23,2
EBITDA	1 192	39,9	1 669	5 168	12,8	5 828
<i>EBITDA margin, %</i>	27,3		26,0	26,0		27,6
Income of affiliates	25	231,9	83	507	-19,6	408
Liabilities wrote off losses	13	n/m	0	0	n/m	0
Interest receivable	19	-56,1	8	39	139,7	94
Interest payable	(41)	22,7	(51)	(126)	18,1	(149)
Other costs	(11)	n/m	73	(6)	n/m	45
Loss (gain) on currency exchange rates	8	568,6	56	74	117,3	162
Income before tax	1 142	51,4	1 730	4 854	12,4	5 458
<i>Income before tax margin, %</i>	26,2		26,9	24,4		25,9
Current income tax	(201)	86,7	(376)	(1 113)	20,6	(1 342)
Deferred income tax	(107)	-71,9	(30)	(80)	n/m	27
Net income	834	58,7	1 324	3 661	13,2	4 143
<i>Net income margin, %</i>	19,1		20,6	18,4		19,6

Source: company's data; Estimation: Veles Capital Source: company's data; Estimation: Veles Capital

New forecasts and estimates

We have corrected our model of Gazprom Neft, adding several changes to it. We have corrected our forecast of oil & oil products prices upwards at average of 27.6%, using current trends of global markets of energy carriers and forecasts of further development of world economy and political situation in the world. We think that growth of oil prices would be supported by several factors, among which – global growth of costs by oil industry, reduction of easily extracted reserves backed by growing demand of developing countries (China specifically), plus the inflated speculative part, which forms about 20 USD of oil price. There are also withholding factors, such as crisis events in US, which decrease the consumption of hydrocarbons and second important fact – overbought oil contracts during latter months. We think that oil market is soon to see a correction down to 110 USD per bbl of WTI oil, however, in long-term we are sure to see upwards dynamics. Regarding long-term growth of oil price we consider the gradual exhaustion of existing large deposits, knowing the in order to sustain extraction companies would have to intensify extraction at smaller deposits, thus increasing the real costs of extraction. We think that under current terms, oil prices are unlikely to dive below 70 USD per barrel, due to general growth of oil industry costs per one barrel of extracted oil, which closely reached 60 USD. When examining short-term prospects we have learned that futures oil market is currently run by several large investment banks, which warm up the interest of market players towards the given tool, by making optimistic forecasts of the future.

This on its part leads to a high volatility of oil market, which is not likely to bring anything good, in our opinion. About less than a month weeks ago – oil prices have demonstrated an unprecedented hike of prices of over 11 USD. And the latest day show the galloping volatility, when prices either add 2.5-3 USD or lose about the same value. Oil price risk is also confirmed by the value of financials poured into commodity sector. According to reports of funds operating at commodity markets, the investments into commodities as of 1Q 2008 have formed 930 bn USD, and that is excluding marginal trade. And if we consider derivative market, which mostly hold speculative trade over oil futures, then total number of positions could reach almost 10 trn UD, from which about one and half trillion is spread at futures and forward market of oil. Do remember that in the beginning of 2007 the commodities funds have announced just 300 bn USD of investments put into commodities. But oil prices are still at their highest, whereas oil companies and Gazprom Neft in particular continue to get over income, allowing the company to implement last year's accepted strategic and rather ambitious development strategy up to year 2020.

In our model of LUKOIL we have tried to reflect the influence of macroeconomic values of Russia (GDP, inflation, energy tariffs and pipeline transport) and their respective forecasts for the upcoming years. The forecasted values remain unchanged, besides of values of 2008, which we have boosted upon the general expectations of Russian government and other various financial institutes on inflation and GDP.

The company's model also experienced a number of corrections regarding operating activities. In particular – we have based our conclusions of the fact that starting with April 22 2008 – the company approved long term development strategy up to 2020. According to the development strategy, to year 2020 Gazprom Neft would expand its extraction to 90-100 mn tons per year, including all subsidiaries, and shares within controlled companies (Slavneft, Tomskneft), development of oil deposits of Gazprom and new purchases in Russia and abroad. Throughout the whole 2007 company extracted 42.9 mn tons of oil. Oil processing of 2020 would form 70-80 mn tons, whilst retail network would be expanded to 5000-5500 gas stations. Today's refining forms 26.23 mn tons of oil. The sales of oil products through company's own retail chain would form 12 mn tons per year to year 2020.

Over long-term prospect – company plans on expanding its activities abroad. In particular – the regions of company's strategic interest are European countries, especially its eastern parts, Asian-Pacific region and USA.

In order to implement such ambitious target, in both extraction and refining Gazprom Neft would require significant capital expenses. According to estimates by the company's representatives, the whole program is estimated in 70 bn USD. Whereas we have used given estimates and re-estimated previous forecast of CapEx, increasing it at average of +12.5% over the post-forecast term,.

In Gazprom Neft's model we have also reflected the influence of concessional taxation concerning extraction on old deposits, which will be applied in new regions starting with 2009. We also took into account the changes in Mineral Extraction Tax (MET) scale, approved by Kudrin and supported by Putin in March of the current year. The tax rate decrease will allow Rosneft to save 6 mn USD, including the forecast of oil market situation which was presented in the model. Only due to the tax decrease, the fundamental price of the company increased by 9.5%. It should be mentioned that among the possible tax remission, which we chose not to use in our model, we should point out the possibility of export tax reviewing policy and further steps of its decrease to 2010, which is one of the main subjects, discussed by the government, but there were no concrete proposals yet. One of the last statements was made by Arkadiy Dvorkovich, the president aide at 12th International Economic Forum in St. Petersburg. He said about further decrease of oil taxation. He said that according to experts' calculations the confirmed measures: are only enough for oil sector stabilization, but the further steps are needed for increase of oil extraction rate, including the implementation of a more rational MET system and export taxation.

The resulting analysis of Gazprom Neft's activities and corrections of the model, including results of 2007 financials, indicates the new fair price, which formed 8.88 USD per stock, which is 41.9% above the previously forecasted 6.27%. Current potential of Gazprom Neft's stocks forms 12.47%. Due to limited growth potential and a relative over purchased status of stocks over the last month, we recommend "ACCUMULATE" on stocks of the company, and we do not exclude some short-term corrections to hit the security.

Financial model

Gazprom Neft's oil extraction and sales of oil and petrochemicals, 2006-2016

	2006	2007	2008(F)	2009(F)	2010(F)	2011(F)	2012(F)	2013(F)	2014(F)	2015(F)	2016(F)
Oil extraction mn tons											
Oil extraction by Gazprom Neft	32.7	32.7	32.8	33.7	35.1	36.8	39.4	42.4	45.5	49.0	52.6
Oil extraction by Slavneft for Gazprom Neft	11.7	10.3	10.5	10.8	11.1	11.4	11.8	12.1	12.5	12.9	13.2
Oil extraction by Tomskneft for Gazprom Neft	0.0	0.0	5.9	5.9	6.0	6.1	6.2	6.3	6.4	6.5	6.6
Gas extraction (bn cb m)	2.1	1.8	1.8	1.8	1.9	2.0	2.1	2.3	2.5	2.7	2.9
Oil (mn tons)											
Export and sales at international markets	17.2	14.7	19.0	17.1	18.0	19.0	20.2	21.5	22.7	23.7	24.5
Domestic and CIS markets sales	2.8	2.0	3.3	2.5	2.6	2.7	2.9	3.1	3.3	3.4	3.5
Oil products (mn tons)											
Export and sales at international markets	10.9	9.7	10.2	11.7	12.0	12.4	13.2	13.9	14.7	15.8	17.2
Domestic market sales	12.2	15.3	15.3	17.5	17.9	18.6	19.7	20.8	22.1	23.7	25.8

Source: company's data; Estimation: Veles Capital

Sales price of oil and oil products forecast for Gazprom Neft, 2005-2015

	2006	2007	2008(F)	2009(F)	2010(F)	2011(F)	2012(F)	2013(F)	2014(F)	2015(F)	2016(F)
External market											
Brent oil price, USD/Barr	65.1	73.1	108.9	99.8	90.2	95.5	99.3	102.3	105.8	109.2	113.0
Urals oil price (CIF Mediterranean region), USD/Barr	61.4	69.5	104.0	95.3	86.1	91.2	94.8	97.7	101.1	104.3	107.9
Oil sales price (IM), USD/t	449.8	493.7	738.4	699.5	632.0	669.4	695.8	717.1	741.7	765.2	792.0
Oil sales price (CIS), USD/t	260.0	285.4	426.8	404.3	365.3	386.9	402.2	414.5	428.7	442.3	457.8
Oil products sales price, USD/t	573.9	602.5	832.9	763.2	689.5	730.4	759.2	782.4	809.2	834.9	864.1
Internal market											
Oil sales price, USD/t	206.4	233.9	349.8	320.5	289.6	306.7	318.8	328.6	339.9	350.6	362.9
Oil sales price, USD/t	407.7	453.6	543.5	528.4	511.4	541.6	563.0	580.2	600.1	619.1	640.8

Source: company's data; Estimation: Veles Capital

Sales of products by Gazprom Neft, 2005-2015, mn USD

	2006	2007	2008(F)	2009(F)	2010(F)	2011(F)	2012(F)	2013(F)	2014(F)	2015(F)	2016(F)
Oil											
Export and sales at international markets	7,753	7,243	14,013	11,973	11,373	12,741	14,055	15,420	16,868	18,143	19,442
Domestic market sales	603	494	1,223	830	788	883	974	1,069	1,169	1,258	1,348
Oil products											
Export and sales at international markets	6,274	5,826	8,471	8,909	8,246	9,056	9,991	10,867	11,925	13,186	14,886
Domestic market sales	4,977	6,933	8,293	9,251	9,173	10,074	11,114	12,089	13,265	14,669	16,560
Value	19,606	20,497	32,000	30,963	29,580	32,754	36,134	39,445	43,227	47,257	52,236
Gas sales in Russia	64	84	114	147	189	211	251	288	320	350	395
Other types of products	224	520	593	543	491	520	541	557	576	594	615
Sales, Total	19,894	21,100	32,707	31,654	30,260	33,485	36,926	40,289	44,123	48,201	53,246

Source: company's data; Estimation: Veles Capital

Financial model of Gazprom Neft, 2006-2016, mn USD

	2006	2007	2008 (F)	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)	2014 (F)	2015 (F)	2016 (F)
Operating profit	19,894	21,100	32,707	31,654	30,260	33,485	36,926	40,289	44,123	48,201	53,246
Operating costs	5,447	6,324	8,106	8,291	8,486	9,395	10,358	11,357	12,439	13,621	14,901
Marketing, managerial and general expenses	1,918	1,902	2,251	2,179	2,131	2,244	2,359	2,467	2,584	2,704	2,845
Taxes, excluding income tax (+ export duties)	7,328	6,702	13,187	12,620	11,572	13,090	14,628	16,202	17,981	19,790	21,859
Others	33	344	534	517	494	546	603	658	720	787	869
EBITDA	5,168	5,828	8,629	8,047	7,578	8,209	8,978	9,606	10,399	11,300	12,773
<i>EBITDA margin, %</i>	<i>26.0</i>	<i>27.6</i>	<i>26.4</i>	<i>25.4</i>	<i>25.0</i>	<i>24.5</i>	<i>24.3</i>	<i>23.8</i>	<i>23.6</i>	<i>23.4</i>	<i>24.0</i>
PPE amortization	803	929	1,128	1,472	1,779	2,046	2,293	2,527	2,753	2,974	3,190
EBIT	4,366	4,899	7,501	6,575	5,798	6,163	6,686	7,079	7,646	8,326	9,583
<i>EBIT margin, %</i>	<i>21.9</i>	<i>23.2</i>	<i>22.9</i>	<i>20.8</i>	<i>19.2</i>	<i>18.4</i>	<i>18.1</i>	<i>17.6</i>	<i>17.3</i>	<i>17.3</i>	<i>18.0</i>
Non-operating income/expense	488	559	449	489	533	561	564	649	755	905	1,077
Income before taxes and minority interest	4,854	5,458	7,950	7,064	6,332	6,724	7,249	7,728	8,400	9,231	10,660
<i>Income before margin tax, %</i>	<i>24.4</i>	<i>25.9</i>	<i>24.3</i>	<i>22.3</i>	<i>20.9</i>	<i>20.1</i>	<i>19.6</i>	<i>19.2</i>	<i>19.0</i>	<i>19.2</i>	<i>20.0</i>
Income tax	1,193	1,315	1,916	1,702	1,526	1,621	1,747	1,862	2,025	2,225	2,569
Net income	3,661	4,143	6,034	5,362	4,806	5,104	5,502	5,866	6,376	7,007	8,091
<i>Net income margin, %</i>	<i>18.4</i>	<i>19.6</i>	<i>18.4</i>	<i>16.9</i>	<i>15.9</i>	<i>15.2</i>	<i>14.9</i>	<i>14.6</i>	<i>14.5</i>	<i>14.5</i>	<i>15.2</i>

Source: company's data; Estimation: Veles Capital

Gazprom Neft's balance sheets, 2006-2016, mn USD

	2006	2007	2008 (F)	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)	2014 (F)	2015 (F)	2016 (F)
Assets											
Short-term assets	5,443	4,760	6,586	7,174	9,651	12,652	14,293	16,404	18,530	20,775	23,864
Cash and equivalents	1,335	721	1,623	2,324	4,981	7,470	8,575	10,153	11,680	13,293	15,628
Loans receivable	126	12	12	12	12	12	12	12	12	12	12
Accounts receivable	3,073	2,925	3,247	3,142	3,004	3,324	3,665	3,999	4,380	4,784	5,285
Reserves	782	1,083	1,686	1,677	1,636	1,827	2,022	2,221	2,439	2,667	2,920
Prepaid expenses	100	0	0	0	0	0	0	0	0	0	0
Deferred income tax	28	19	19	19	19	19	19	19	19	19	19
Long-term assets	8,659	11,846	14,458	16,741	18,717	20,555	22,334	24,090	25,840	27,604	29,396
Long-term financial investments	2,760	4,685	4,685	4,685	4,685	4,685	4,685	4,685	4,685	4,685	4,685
PPE related to geo-surveying and oil and gas extraction	4,569	5,802	6,685	7,440	8,082	8,699	9,326	9,975	10,651	11,358	12,100
PPE	852	832	2,076	3,279	4,396	5,453	6,468	7,451	8,411	9,355	10,294
Construction-in-progress	161	230	714	1,039	1,256	1,420	1,558	1,681	1,796	1,908	2,019
Other long-term assets	316	298	298	298	298	298	298	298	298	298	298
Total assets	14,102	16,606	21,044	23,915	28,368	33,207	36,627	40,493	44,371	48,379	53,260
Liabilities											
Current liabilities	1,840	3,244	3,899	3,852	3,793	3,917	4,079	4,258	4,482	4,736	5,067
Short-term loans	56	241	307	298	284	315	347	379	415	453	501
Accounts payable and accrued liabilities	649	1,171	1,235	1,196	1,143	1,265	1,395	1,522	1,667	1,821	2,011
Income tax and other taxes	497	734	1,137	1,101	1,052	1,164	1,284	1,401	1,534	1,676	1,852
Current share of long-term debt	638	1,098	1,219	1,258	1,313	1,173	1,053	957	866	786	704
Long-term liabilities	2,331	2,929	2,527	1,795	3,107	4,420	3,981	3,760	3,205	2,391	1,690
Dividends payable	893	381	381	381	381	381	381	381	381	381	381
Assets mandatory for departure	288	324	324	324	324	324	324	324	324	324	324
Long-term debt	977	2,083	1,681	949	2,261	3,574	3,134	2,914	2,359	1,545	844
Deferred income tax liabilities	173	141	141	141	141	141	141	141	141	141	141
Total liabilities	4,172	6,173	6,426	5,647	6,900	8,338	8,059	8,018	7,687	7,127	6,757
Equity	9,930	10,433	14,618	18,268	21,467	24,869	28,568	32,475	36,684	41,252	46,503
Common shares	2	2	2	2	2	2	2	2	2	2	2
Added capital	859	0	0	0	0	0	0	0	0	0	0
Reserves	1,867	573	573	573	573	573	573	573	573	573	573
Retained earnings	7,202	9,859	14,044	17,694	20,893	24,295	27,994	31,900	36,110	40,678	45,928
Total liabilities	14,102	16,606	21,044	23,915	28,368	33,207	36,627	40,493	44,371	48,379	53,260

Source: company's data; Estimation: Veles Capital

Price estimation

	Discount rate (WACC), %										
	2006	2007	2008 (F)	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)	2014 (F)	2015 (F)	2016 (F)
Cost of equity (ks)	11.48	11.59	11.31	11.31	11.31	11.31	11.31	11.31	11.31	11.31	11.31
Risk-free rate, %	5.40	5.41	5.63	5.63	5.63	5.63	5.63	5.63	5.63	5.63	5.63
10 year US Treasuries yield, %	4.35	4.38	4.15	4.15	4.15	4.15	4.15	4.15	4.15	4.15	4.15
Russia risk, %	1.05	1.03	1.48	1.48	1.48	1.48	1.48	1.48	1.48	1.48	1.48
Stock market risk, %	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
Coefficient b	0.92	0.94	0.94	0.94	0.94	0.94	0.94	0.94	0.94	0.94	0.94
Corporate risk	1.50	1.50	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Share of equity, %	85.6	75.3	82.0	87.9	84.8	83.1	86.3	88.4	91.0	93.7	95.8
Cost of debt (kd)	6.00	7.00	7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50
Risk free rate, %	5.40	5.41	5.63	5.63	5.63	5.63	5.63	5.63	5.63	5.63	5.63
Debt cost, %	0.60	1.59	1.87	1.87	1.87	1.87	1.87	1.87	1.87	1.87	1.87
Tax rate, %	24.60	24.10	24.10	24.10	24.10	24.10	24.10	24.10	24.10	24.10	24.10
Share of debt, %	14.41	24.70	17.99	12.06	15.24	16.91	13.70	11.57	9.03	6.32	4.22
WACC	10.48	10.04	10.30	10.63	10.45	10.36	10.54	10.66	10.80	10.95	11.07

Source: company's data; Estimation: Veles Capital

Free Cash Flow of LUKOIL, forecast, 2006-2016, mn USD

	2006	2007	2008 (F)	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)	2014 (F)	2015 (F)	2016 (F)
EBITDA	5,168	5,828	8,629	8,047	7,578	8,209	8,978	9,606	10,399	11,300	12,773
Amortization and depreciation	803	929	1,128	1,472	1,779	2,046	2,293	2,527	2,753	2,974	3,190
EBIT	4,366	4,899	7,501	6,575	5,798	6,163	6,686	7,079	7,646	8,326	9,583
Income tax	1,074	1,181	1,808	1,585	1,397	1,485	1,611	1,706	1,843	2,007	2,310
after-tax EBITDA	3,292	3,718	5,694	4,990	4,401	4,678	5,075	5,373	5,803	6,320	7,274
CapEx	1,525	5,636	3,740	3,755	3,755	3,884	4,072	4,283	4,504	4,737	4,982
Change of operating capital	(1,064)	1,004	(390)	27	65	(247)	(255)	(257)	(285)	(298)	(341)
FCF	3,633	16	2,692	2,734	2,491	2,593	3,040	3,361	3,767	4,258	5,141

Source: company's data; Estimation: Veles Capital

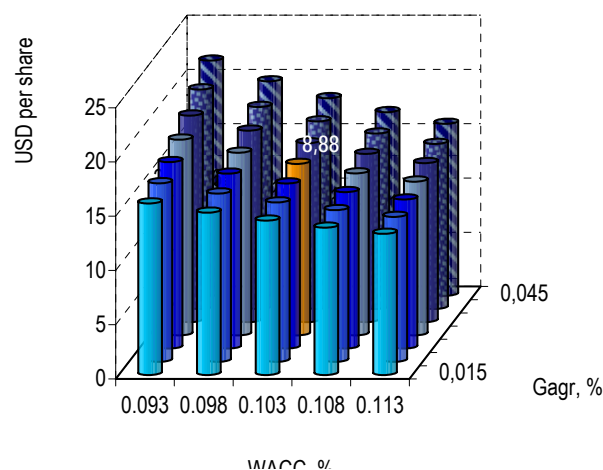
Gazprom Neft's stocks valuation

TGR, %	3.00
Discount rate, %	11.07
Terminal value, mn USD	65,586
Discounted terminal value, mn USD	25,488
Enterprise value, mn USD	44,804
Net debt, mn USD	2,701
Shareholder's equity (incl. minority interest), mn USD	42,103
Number of shares, mn units	4,741,299,639
Fair value of common stock at the year end, USD	8.88
Upside (downside) of common stock, %	12.41

Source: company's data; Estimation: Veles Capital

Analysis of the share's weighted average fair value sensitivity

Growth rate over post-forecast term, %	WACC, %				
	10.1%	10.6%	11.1%	11.6%	12.1%
1.5%	8.92	8.41	7.97	7.58	7.24
2.0%	9.28	8.73	8.24	7.82	7.44
2.5%	9.69	9.08	8.54	8.08	7.67
3.0%	10.16	9.47	8.88	8.37	7.92
3.5%	10.70	9.93	9.26	8.69	8.20
4.0%	11.33	10.45	9.70	9.06	8.51
4.5%	12.07	11.05	10.20	9.48	8.87



Financial analysis

Value forming estimates

	2006	2007	2008 (F)	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)	2014 (F)	2015 (F)	2016 (F)
Invested capital at years start, mn USD	15.3	27.9	23.4	13.9	10.3	10.4	9.2	8.3	7.8	7.3	7.1
Growth of invested capital (IC), %	10,267	13,134	16,202	18,449	20,346	22,461	24,528	26,572	28,643	30,743	32,923
Share capital at years start, mn USD	9,930	10,433	14,618	18,268	21,467	24,869	28,568	32,475	36,684	41,252	46,503

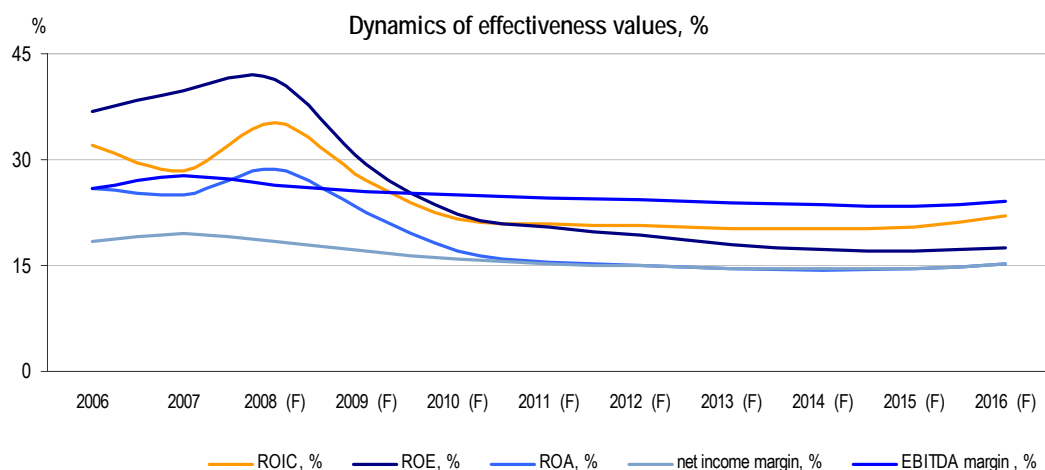
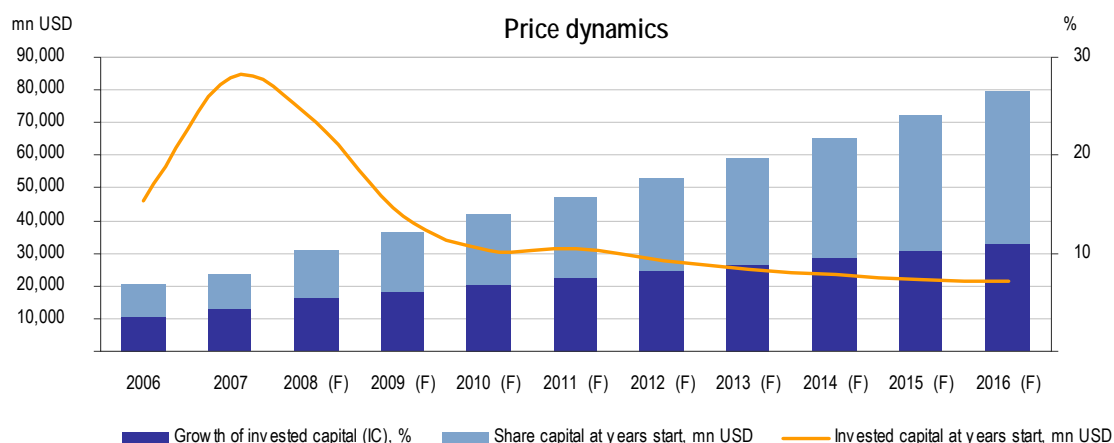
Business effectiveness analysis

	2006	2007	2008 (F)	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)	2014 (F)	2015 (F)	2016 (F)
ROIC, %	32.1	28.3	35.1	27.1	21.6	20.8	20.7	20.2	20.3	20.6	22.1
ROE, %	36.9	39.7	41.3	29.4	22.4	20.5	19.3	18.1	17.4	17.0	17.4
ROA, %	26.0	24.9	28.7	22.4	16.9	15.4	15.0	14.5	14.4	14.5	15.2
EBITDA margin, %	26.0	27.6	26.4	25.4	25.0	24.5	24.3	23.8	23.6	23.4	24.0
EBIT margin, %	21.9	23.2	22.9	20.8	19.2	18.4	18.1	17.6	17.3	17.3	18.0
net income margin, %	18.4	19.6	18.4	16.9	15.9	15.2	14.9	14.6	14.5	14.5	15.2

Financial state analysis

	2006	2007	2008 (F)	2009 (F)	2010 (F)	2011 (F)	2012 (F)	2013 (F)	2014 (F)	2015 (F)	2016 (F)
Financial leverage	0.17	0.33	0.22	0.14	0.18	0.20	0.16	0.13	0.10	0.07	0.04
liquidity estimates											
coverage ratio	2.53	1.13	1.26	1.43	2.11	2.76	3.01	3.33	3.59	3.82	4.13
current ratio	2.96	1.47	1.69	1.86	2.54	3.23	3.50	3.85	4.13	4.39	4.71
quick ratio	0.79	0.23	0.42	0.61	1.32	1.91	2.11	2.39	2.61	2.81	3.09
business activity estimates											
accounts receivable coverage period, days	56	50	36	36	36	36	36	36	36	36	36
turnover of supplies, days	14	18	19	19	19	20	20	20	20	20	20
use of own turnover capital	5.52	13.91	12.17	9.53	5.17	3.83	3.62	3.32	3.14	3.01	2.83

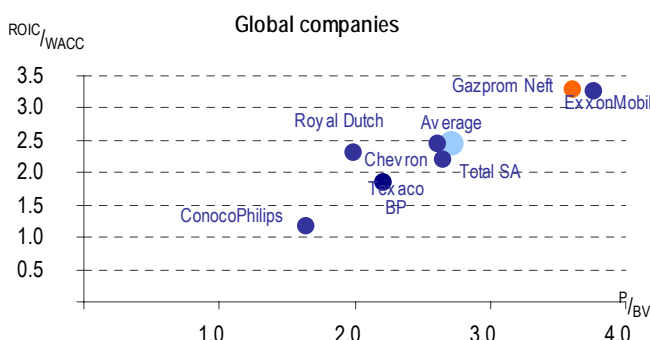
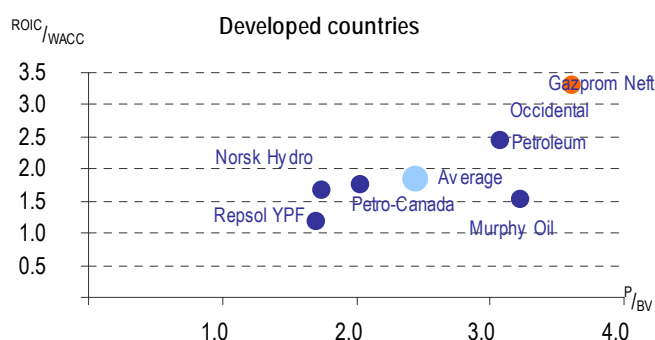
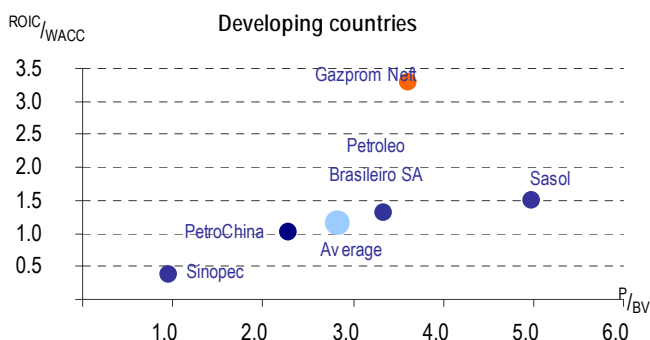
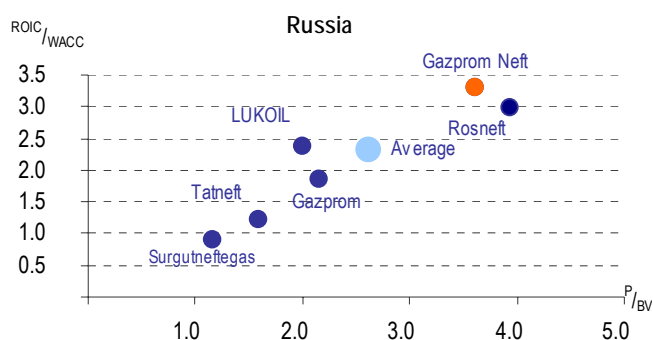
Source: company's data, Estimation: Veles Capital



Comparable analysis

Company	Country	Ticker	Current capitalization, mn USD	Market multipliers				Financial multipliers				
				P/S	P/E	EV/EBITDA	P/BV	ROE, %	ROA, %	ROIC, %	WACC, %	ROIC/WACC
Gazprom	Russia	GAZP RU	336,637	3.51	13.08	9.82	2.16	21.28	12.70	16.51	8.89	1.86
LUKOIL	Russia	LKOH RU	88,884	1.15	7.60	5.34	2.00	25.67	17.63	22.46	9.50	2.36
Gazprom Neft	Russia	SIBN RU	37,219	1.93	9.98	-	3.61	40.69	26.98	33.44	10.15	3.29
Surgutneftegas	Russia	SNGS RU	45,901	1.86	12.29	-	1.17	9.83	9.15	9.71	10.84	0.90
Tatneft	Russia	TATN RU	17,503	1.20	13.37	7.14	1.60	13.84	9.90	13.59	11.30	1.20
TNK-BP	Russia	TNBP RU	32,803	1.40	4.84	-	2.71	73.96	31.86	60.87	10.50	5.80
Transneft	Russia	TRNFP RU	9,018	0.74	3.42	3.47	0.39	15.09	10.38	13.94	9.86	1.41
Rosneft	Russia	ROSN RU	123,575	1.96	15.42	10.69	3.94	51.13	21.16	29.45	9.86	2.99
NOVATEK	Russia	NVTK RU	25,657	-	24.54	-	6.84	25.04	19.90	23.62	9.86	2.40
Russia average				2.54	12.51	9.13	2.62	29.53	16.32	22.10	9.50	2.31
PetroChina	China	857 HK	399,920	1.97	11.31	10.53	2.29	22.06	15.07	20.44	19.88	1.03
Petroleo Brasileiro SA	Brazil	PETRA BZ	271,150	2.26	16.61	9.54	3.34	20.35	9.74	16.07	12.34	1.30
Sasol	SAR	SOL SJ	40,138	2.53	17.32	-	4.99	29.82	15.33	23.82	15.92	1.50
Sinopec	China	338 HK	6,657	0.36	12.06	20.87	0.95	8.25	5.71	7.45	19.42	0.38
Emerging markets average				2.10	13.65	10.24	2.83	21.72	12.98	18.86	16.81	1.15
Murphy Oil	USA	MUR US	17,566	0.81	16.31	8.02	3.23	16.69	8.51	13.46	8.81	1.53
Norsk Hydro	Norway	NHY NO	18,540	0.72	7.06	-	1.75	24.17	11.16	21.40	12.91	1.66
Occidental Petroleum	USA	OXY US	73,759	3.59	13.74	6.24	3.08	25.67	15.66	24.14	9.87	2.45
Petro-Canada	Canada	PCA CN	27,269	1.20	10.04	3.64	2.04	24.50	11.76	19.69	11.33	1.74
Repsol YPF	Spain	REP SM	49,792	0.58	9.24	-	1.71	17.74	6.90	11.95	10.19	1.17
Developed markets average				1.89	11.58	5.91	2.45	22.39	11.64	18.97	10.37	1.84
BP	UK	BP/ LN	217,495	0.72	9.24	5.75	2.21	23.39	9.19	18.64	10.04	1.86
Chevron Texaco	USA	CVX	204,315	0.93	10.70	5.44	2.61	25.60	13.28	23.11	9.47	2.44
ConocoPhillips	USA	COP	143,247	0.81	8.84	5.13	1.64	13.86	6.94	11.33	9.64	1.18
ExxonMobil	USA	XOM US	464,384	1.23	11.43	5.81	3.77	34.47	17.61	32.47	9.94	3.27
Royal Dutch	Holland	RDSA LN	256,961	0.65	7.78	4.56	1.99	27.28	12.41	23.75	10.25	2.32
Total SA	France	FP FP	201,528	0.84	8.88	4.36	2.65	30.95	12.05	22.81	10.39	2.20
Global average				0.92	9.78	5.27	2.72	27.93	13.11	24.31	9.98	2.44

Effectiveness and assessment ratio of Gazprom Neft's assets versus other companies



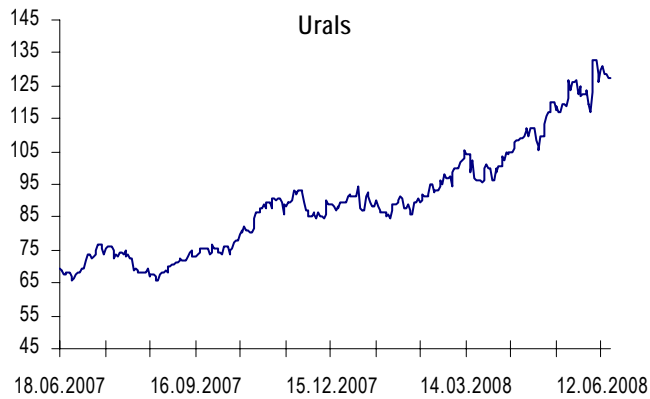
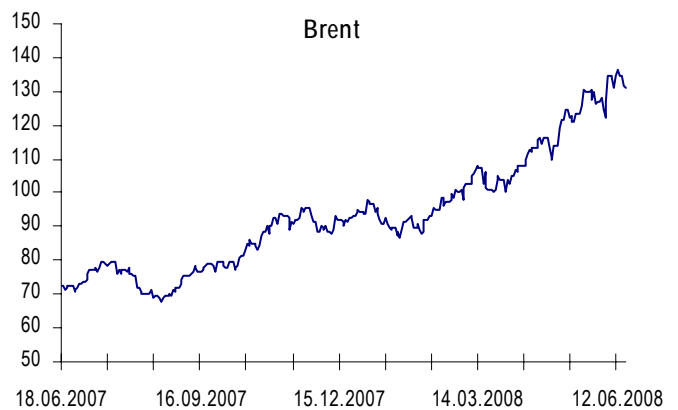
Source: Bloomberg; Estimation: Veles Capital

Commodity markets

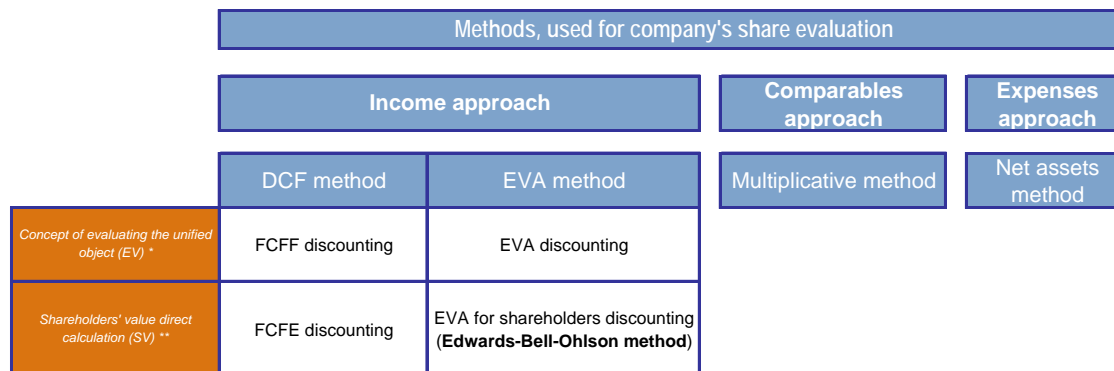
Current oil prices

	Close, USD	Change, USD	Change, %					Current year, USD	
			day	week	month	from Jan 1	year	min	max
Light, USD / bbl	▼ 131,19	-0,16	-0,12	0,63	6,30	36,80	81,78	86,75	136,83
Brent, USD / bbl	▼ 131,09	-0,82	-0,62	-0,05	6,09	39,62	80,81	85,05	138,34
Urals, USD / bbl	▼ 127,36	-0,25	-0,20	0,94	6,81	39,53	83,60	82,80	132,88
WTI, USD / bbl	▼ 134,01	-0,60	-0,45	2,06	6,11	39,59	93,96	86,47	138,88
Brent-Urals	▼ 3,73	-0,57	-13,26	-25,10	-13,86	42,91	19,17	1,66	9,94

Oil price charts



Brief investor's guide



* Debt cost is calculated separately and then subtracted from the sum total cost of business (target EV), formed considering the cash flows/ economic profits of firm.

** Debt is accounted integrated -via annual coverage. So the fair cost of shareholders' value (target SV) is formed directly - considering the cash flow / economic profits for holders.

Note:

DCF methods differ from the methods of economic profit by the way of investments calculation. The methods of unified object evaluation concept differ from these methods of direct calculation of shareholders' value costs - by the way of accounting cost and maintenance of debt liabilities.

Cost calculation within the frames of income approach:

	Business cost calculation (EV) within the frames of unified object cost evaluation	Shareholders' capital value calculation (SV)
DCF method (FCFF)	$EV = \sum_{i=1}^n \frac{FCFF_i}{(1+WACC_i)^i} + \frac{TV}{(1+WACC_1)^n} + NA$	$SV = EV - D$
DCF method (FCFE)		$SV = \sum_{i=1}^n \frac{FCFE_i}{(1+k_{si})^i} + \frac{TV}{(1+k_{si})^n} + \text{Cash} + NA$
EVA method	$EV = IC_1 + \sum_{i=1}^n \frac{EVA_i}{(1+WACC_i)^i} + \frac{TV}{(1+WACC_1)^n} + NA$	$SV = EV - D$
EBO method		$SV = BV_1 + \sum_{i=1}^n \frac{SVA_i}{(1+k_{si})^i} + \frac{TV}{(1+k_{si})^n} + \text{Cash} + NA$

Signs:

- EV - Enterprise Value
- SV - Shareholders Value
- TV - Terminal Value
- Cagr - development rates within the target period
- BV, E - Balance Value, Equity
- EBIT - operational profit from selling, profit before payments of credit interest and income tax
- EBITDA - operational profit before payment of credit interest, income tax and amortization
- EBT - Earnings Before Tax
- EAT - Earnings After Tax
- EPS - Earnings Per Share
- NOPAT - net operational profit, free from effects of debt financing

$$NOPAT = EBIT * (1 - \text{income tax effective rate})$$
- FCFF - Free Cash Flow to Firm

$$FCFF = \text{gross cash flow} - \text{gross investments}$$

$$\text{Gross cash flow} = NOPAT + \text{amortization}$$
- FCFE - Free Cash Flow to Equity

$$FCFE = \text{gross shareholders' cash flow} - \text{gross investments}$$

$$\text{Gross shareholders' cash flow} = EAT \text{ of operational profit (including interest payoffs) - annual debt coverage} + \text{attracted borrowed assets} + \text{amortization}$$
- EVA - Economic Value Added

$$EVA = \text{economic profit spread} * IC = (ROIC - WACC) * IC$$
- SVA - Shareholders Value Added

$$SVA = \text{spread} * E = (ROE - k_s) * E$$
- WACC - Weighted Average Cost of Capital
- k_s - required shareholders' yield
- D - fair (market) cost of net debt
- Cash - cash assets, along with market securities on thee balance
- NA - non-operational assets
- IC - Invested Capital
- ROIC - Return on Invested Capital

$$ROIC = \frac{NOPAT}{IC}$$
- ROE - Return on Equity
- ROA - Return on Assets

Information disclosure

The statement of an analyst and confirmation of the responsibility withdrawal

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The principle of recommendation assignment

The investment recommendations are given based on the evaluation of the company's share yield. The basis for the calculation of the expected company's cost is the evaluation by the discounted cash flows method (DCF). In some estimations the method of comparable coefficients, and also the mixed estimation (by DCF method and by comparable coefficients method) are applied. All recommendations are assigned based on the determined by us the fair cost of the shares within the nearest 12 months.

At the present moment the investment scale of the Investment Company Veles Capital is the following:

BUY – corresponds to the growth potential of the shares within the nearest 12 months by 15% or more.

ACCUMULATE – corresponds to the growth potential of the shares within the nearest 12 months for 5-15%.

HOLD – corresponds to the growth (reduction) potential of the shares within the nearest 12 months from -5% to 5%.

REDUCE – corresponds to the reduction potential of the shares within the nearest 12 months from 15% to 5%.

SELL – corresponds to the reduction potential of the shares within the nearest 12 months by 15% or more.

In some cases the deviations from the evaluation scale given above, based on which the recommendations are assigned, are possible. That fact relates to the high volatility of some securities in particular, and market in the whole, and also to the individual characteristics of one or another issuer.

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