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Integrated Oils
CEEMEA

Surgutneftegaz

Prefs should trade at a premium; Best port in a weak-rouble storm

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We make our long-held opinion – that SurgutNG's pref should trade at a premium to the ord – explicit in our recommendations. We now target the pref to trade at a 30% premium to the ord instead of a discount, lowering our ord target price in the process to $0.88/sh and downgrading it to 2-Neutral. We see SurgutNG's preferred share as the best play in Russian oil & gas on a weakening rouble, and remains one of our two favoured stocks among the blue chips.

- **Lower ord TP to $0.88/sh, downgrade to 2-Neutral:** We change our methodology for setting TPs, moving from a target 5% discount of the pref vs. the ord to a 30% *premium*. While our TP for the pref remains relatively unchanged, we drop our ord TP by 29% and downgrade it to 2-Neutral. *We now explicitly favour SurgutNG's pref over its ords, and see no reason for investors to buy the ord if the pref is available.*
- **Rouble weakness helps oil stocks, but especially SurgutNG prefs:** The rouble has devalued c5% vs. the US dollar since January 1st even as oil has held steady. While this boosts EBITDA at all oil companies, it has a unique effect on SurgutNG's net income line via a non-cash revaluation of its $32bn cash pile, with each rouble of devaluation, year-end on year-end, adding c0.2RUB/sh to the pref dividend.
- **One, key catalyst remaining – full trading fungibility:** MICEX continues its drive to improve local volumes and, with the Central Depository established (fall 2012) and T+2 trading achieved (September 2013), the last apparent hurdle appears to be changes to Russia's securities code to allow Euroclear to settle MICEX trades. Likely to happen by July, this should result in SurgutNG's pref shares, which are liquid only on MICEX, becoming much more investable for international funds and help drive the re-rating vs. the ords.
- **A review of why the preferred should trade at a *premium*:** SurgutNG's charter ensures: 1) a minimum 40% pro-rata payout for the prefs and 2) that the pref must receive a dividend at least as large as that paid to the ord. In reality, the prefs' are usually paid 2x-3x more. Add to that the fact that we think the ord deserves no control premium, and the pref should trade at a significant premium, not a discount, to the ord.
- **Kirishi hyrocracker up and running (finally!):** SurgutNG finally fired up its long-awaited deep conversion complex in late December, which will help the company turn c5mtpa of high-sulfur fuel oil into valuable, low-sulfur diesel, jet fuel and the like, contributing c$1.3bn to SurgutNG's EBITDA in 2014E.

		Rating		Target Price		Current Year Earnings Estimates	
Company	Ticker	Old	New	Old	New	Old	New
Surgutneftegaz	SNGS.MM	1	2	US$1.25	US$0.88	US$0.23	US$0.23
Surgutneftegaz(pref)	SNGS_P.MM	1	1	US$1.18	US$1.15	US$0.23	US$0.23

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Weaker rouble = Stronger pref

With a weakening rouble as a catalyst, we are now fully aligning our recommendations with our long-held view that SurgutNG's pref share should trade at a significant premium to the ord as opposed to the traditional discount. We lower our SurgutNG ord TP 29% to $0.88/sh and downgrade it to a 2-Neutral rating. Our TP for SurgutNG prefs remains relatively unchanged (-3% to $1.15/sh). We reiterate our 1-Buy rating of the pref and keep it as one of our two favoured stocks among Russian blue-chip oil & gas companies.

Let the preferred break above the ord

Downgrading ord to Neutral, still love the pref

Figure 1. TP changes, implications

	Comm	Pref	Disc*
Current price	$0.80	$0.73	-9%
TP old	$1.25	$1.18	5%
TP new	$0.88	$1.15	30%
Upside	10%	57%	
2014E dividend	$0.02	$0.07	
Dividend yield	2.5%	9.7%	
Estimated Total Return	12%	66%	
Rating	2-Neutral	1-Buy	
	2014E P/E	**2014E EV/ EBITDA**	
Current price	4.9x	0.2x	
TP old - implied	7.7x	2.0x	
TP new - implied	5.8x	0.8x	
Yield implied by new TP	2.3%	6.2%	

Source: DataCentral, SurgutNG, Citi Research
*Discount = pref/ord-1

We have long held that, due to its demonstrably superior call on company cash flows, SurgutNG's preferred share should trade not at its historical discount to the ord share, but at a *premium*. However, when we began making that argument in March of 2012 (Top Pick: SurgutNG Prefs – Central Depository To Close Discount), the pref/ord discount was around 35%, so we restricted ourselves to calling for the discount to close substantially but stopped short of predicting the relationship between the two stock prices to reverse.

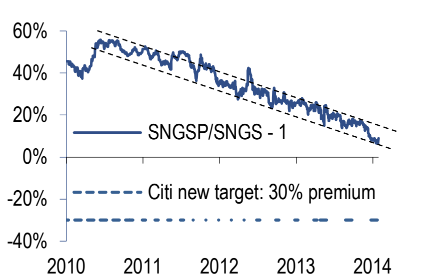
And close it has, slowly but very steadily (Figure 2), to the point that the discount now stands at c9%, in-line with our previous target of 5%. With a swooning rouble providing the near-term catalyst, we now think that achieving parity with the ord is only a matter of time and, once that resistance level is broken, further outperformance of the pref relative to the ord is highly likely. With a concrete catalyst upcoming – Euroclear should begin settling MICEX's new T+2 tickers this summer, significantly largely equalising the availability of the two share classes for foreign investors – we think this trend will not only continue, but could well accelerate.

To underline our preference for the preferred share over the ord, we are now targeting the preferred to achieve a 30% *premium* to the ord (inversely, for the ord to trade at a 23% discount to the common, the average discount the pref traded to the ord since we first made SurgutNG prefs a top idea back in March of 2012). We do this mostly by significantly lowering our TP for the ord — c29% from $1.25/sh to $0.88/sh — rather than raising our TP for the preferred.

Note that our pref TP drops by a modest 3% with this note to $1.15 due to the collective impact of small changes to the model to incorporate updated production and other data.

Implications

Figure 2. SurgutNG's pref/ord discount



Source: Bloomberg, Citi Research

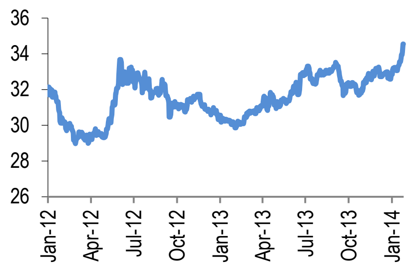
This change in recommendation methodology has several implications worth noting:

- First, it reduces our target total market cap (i.e., that implied by our target prices) from $54bn to $40bn, and vs. the $35bn the total company is valued at by the market.
- This gives us implied target multiples of 2014E 5.8x (P/E) and 0.8x (EV/EBITDA) vs. 4.9x and 0.2x currently, respectively, and the 7.7x and 2.0x implied by our previous TP (Figure 1).
- Were the preferred to achieve our TP this year, our projected dividend yield would fall from c9.7% to c6.2%.
- Note that, as we see substantial upside to most of the stocks in the Russian oil & gas universe, for the prefs to fully achieve our TP would probably require a general rally in the whole sector. Therefore, while that c6.2% implied dividend

yield looks unlikely in light of 5%-6% expected yields from Russian blue chips such as Lukoil and Gazprom, those yields are on *current* prices, and that supposed sector re-rating would push down those yields as well, leaving SurgutNG prefs as one of the premier dividend payers in the country.

The rouble slides, and…

Figure 3. RUB/USD

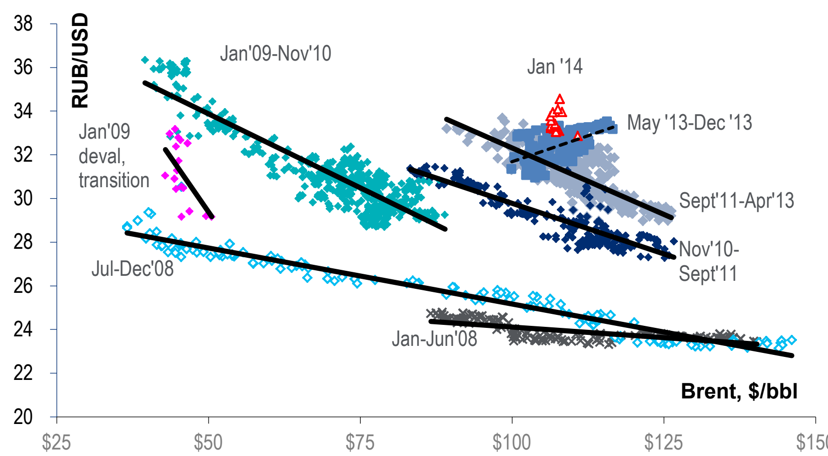


Source: Bloomberg

Since the first of the year the Russian rouble has slid by 1.9RUB/USD, or c6% (Figure 3), from 32.9RUB/USD to c34.8RUB/USD. Historically, the rouble has been highly correlated with oil prices in the short term, with relatively rapid, periodic devaluations followed by a return to an oil price linkage (Figure 4).

The most recent move by the rouble shown in Figure 4 may be merely the next in that series of mini-devaluations, to be followed by a re-linkage to oil prices, although from May to December of 2013 that correlation not only disappeared, but was reversed (see dashed best-fit line). While the oil price is obviously not the only driver to the RUB/USD rate, there are strong logical reasons – most notably balance of payments implications of a large oil & gas exporter – for why the rouble *should* be positively correlated with the dollar, all else being equal, and we would expect that relationship to reassert itself at some point, but at a weaker overall level.

Figure 4. RUB/USD vs. oil prices



Source: Citi Research

…Oil companies benefit

Oil companies benefit from a weaker rouble, especially SurgutNG via the prefs

Here is how a secularly weak rouble (i.e., not accompanied by a corresponding weakness in oil prices) should affect the earnings profile of the blue-chip Russian oil & gas companies.

For oil companies a weaker rouble generally helps at the EBITDA and net income lines. Revenues are effectively dollar-denominated (even in Russia, crude oil and oil products prices, while being nominally denominated in roubles, are actually tied to the global, dollarised price of oil), as are the major operating taxes (being directly linked to the price of oil). However, other operating costs are typically 80%-90% rouble-denominated (salaries and locally-sourced services). Therefore, secular rouble weakness (again, not linked to a drop in oil prices) helps Russian oil companies cut costs relative to revenues.

But gas companies are either neutral (Gazprom) or negatively (Novatek) exposed

For gas companies a weaker rouble is neutral to negative: Although gas companies also see a cut in costs, they also sell their domestic gas at regulated rouble prices, which cuts revenues in USD-terms, with the latter effect partially offset by the gas companies' export business.

Sensitivities: To generate the sensitivity table below, we have lowered year-end rouble rates by 5% while holding everything else, including oil prices, constant. Note we find the following:

- All of the oil companies benefit more or less equally at the EBITDA line, seeing 4%-5% increases based on the effective cost-cuts from the devaluation. At the net income line SurgutNG benefits more than Lukoil on SurgutNG's cash pile exposure, but Rosneft's higher leverage generates a big one-time, non-economic FOREX charge.
  - Note that that SurgutNG's currency gain is only a paper, not economic, gain for the company. However, it is a gain for preferred shareholders, as it boosts reported net income, which the also boosts the dividend the company is required to pay out per its charter to preferred shareholders, an effective 40% payout of pro-rata EPS.
  - On the other hand, Rosneft's EBITDA gain, which should boost FCF in USD-terms, has relatively large, real economic benefits for shareholders due to that company's higher leverage. However, the non-economic FOREX charge will decrease dividends (Rosneft's dividend policy is to pay out 25% of IFRS net income) for the one year, so in the near term we see this as being a wash for Rosneft, but positive in the medium term as as costs are cut.
- The gas companies see a neutral to negative effect, with Novatek's EBITDA and net income both dropping 2%-3%. Gazprom, however, due to its larger (than Novatek) oil-linked gas export business, is largely indifferent to rouble moves.

Figure 5. Effect on earnings of a move in the RUB/USD rate from 32.9 to 34.5

	Gazprom		Rosneft		Lukoil		Novatek		SurgutNG	
	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015
EBITDA	1%	1%	4%	4%	4%	4%	-2%	-2%	5%	7%
Net income	0%	1%	-19%	12%	6%	7%	-2%	-2%	23%	10%

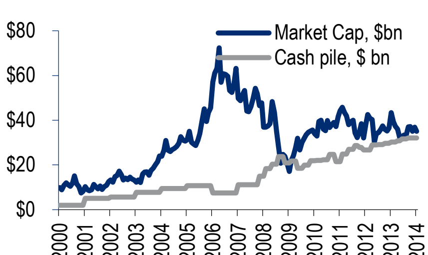
Source: Citi Research

Still defensive – The buoyancy of the cash pile

With a total market capitalisation of c$35bn as of this writing, and with SurgutNG's 'cash pile' standing $32bn as of 3Q13, SurgutNG's operating business is being valued by the market at only $3bn or so, and the company continues to look substantially undervalued with an EV/EBITDA ratio of just above zero (0.2x).

In addition to making the company look cheap on an absolute basis, there is reason to think that the cash pile acts as a trading floor. As can be seen in Figure 6, SurgutNG's total market cap has only once — briefly — fallen below its cash position. While there is no fundamental reason why market participants couldn't collectively decide to value the company's equity below its cash holdings, the track record is pretty strong.

Figure 6. SurgutNG's cash pile vs. market cap, $bn



Source: Citi Research and company reports

Improved MICEX trading still primary catalyst

We think the prefs will surpass the ords, not only because we think they *should* trade at a premium (given their demonstrably superior call on company cash flows via guarantees of a minimum 40% payout and a dividend at least equal to the ord's), but because we expect a major change in trading patterns to occur in 2014.

In our note from March 2012, we posited that the primary catalyst for the preferred shares would be trading reforms on the Russian exchange making the preferred share more investible for foreign investors. While that process has taken much longer than we anticipated at the time, substantial progress has nonetheless been made, in particular the establishment of Russia's Central Depository in the fall of 2012 and the move to T+2 trading on MICEX last September. The final hurdle appears to be changes to Russia's tax laws that will allow Euroclear to settle MICEX trades. At last word, the details have largely been worked out, and Euroclear should start settling Russian equity trades by summer.

Once that happens, the availability of the preferred — which trades with substantial liquidity only on MICEX (Figure 7), while the ord has liquid tickers both in London and Moscow — should improve substantially relative to the ord. Once international investors can trade on MICEX as easily as they can in London — or at least with much less difficulty than in the past — then we expect investors to switch out of the ord into the preferreds to take advantage of the much higher dividend flows.

Figure 7. SurgutNG trading volumes, 6- month average, $mn/day

	MICEX	London/ New York	Total
Ord	$22.7	$11.0	**$33.7**
Pref	$20.0	$0.3	**$20.3**

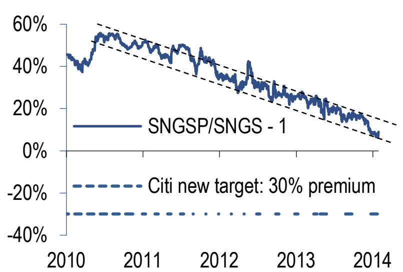
Source: Bloomberg

We now explicitly favour SurgutNG's pref over its ords, and see no reason for investors to buy the ord if the pref is available.

A review of why the pref should trade at a *premium*

Despite the fact that the pref has historically traded at a large discount to the ord (Fig 8), we argue that it should instead trade at a *premium* for the following reasons:

Figure 8. SurgutNG's pref/ord discount



Source: Bloomberg, Citi Research

1) The pref has a substantially superior claim on cash flows to the ord via its guaranteed minimum payout on dividends;
2) The pref has equal voting power to the ord (effectively none on ordinary items); and
3) The pref does have substantial voting rights when it comes to protecting the privileges of preferred shareholders.

Elaborating on each of those points:

1) Superior claim on cash flows

There are two aspects to the guaranteed dividend levels in the company's charter (Figure 11).

First, the charter effectively states that preferred shares have to be paid at least 40% of their pro-rata EPS. The charter actually reads that 10% of net income must be paid to preferred holders, but as the prefs made up 25% of the capital base of the company at that time, this was the equivalent to a 40% payout ratio.[1] However, the actual share of net income paid to prefs is now 7.1%, which allows for the dilution effects of a reverse takeover of SurgutNG's former parent back in 2000, which reduced the pref's share of the company's charter capital to 17.7%. However, the payout ratio (7.1/17.7=0.4) remains the same.

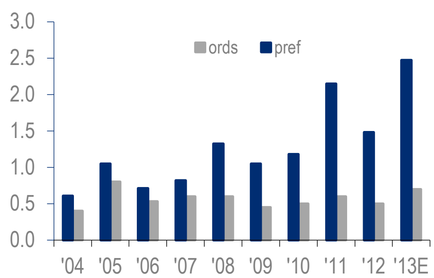
[1] 10/25=0.4

1) The pref has a demonstrably superior claim on company cash flows

Second, the charter states that preferred shares cannot be paid less than ord shares regardless. In practice they have always been paid more, usually much more: Since 2005, when a law went into effect requiring that preferred dividends be paid on clean net income,[2] the dividend on the preferred share has been, on average, 130% higher than that paid to the ord, and 180% over the last five years through 2013E (Figures 9, 10).

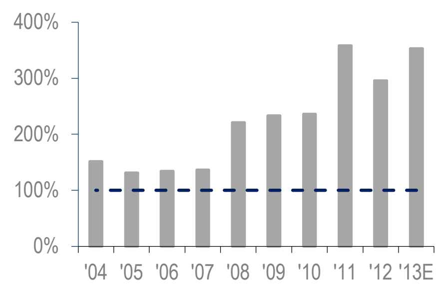
Another way to look at the superior call on cash flows enjoyed by holders of SurgutNG's preferreds is the share of overall dividends they gather. In spite of having only 17.7% of overall share capital, over the last 5 years 36% of overall dividends paid have gone to the prefs, while for 2013E we anticipate c43% will go to preferred shareholders.

Figure 9. SurgutNG dividends, RUB/sh



Source: SurgutNG, Citi Research

Figure 10. Pref dividend vs. ord dividends, %



Source: SurgutNG, Citi Research

Figure 11. SurgutNG's charter as it pertains to preferred dividend levels

5.6. Shareholders who own preferred shares have the right to receive an annual fixed dividend. The total amount payable as dividend on each preferred share is set forth at 10 percent of the net profit of the Company based on the results of the most recent financial year divided by the number of shares, which constitute 25 percent of the charter capital of the Company. Thereat, if the amount of the dividends payable by the Company on each ordinary share during a certain year exceeds the amount payable as dividends on each preferred share of the original issue, the size of the dividend payable on the latter shall be increased to the size of the dividend payable on ordinary shares. The Company has no right to pay dividends on preferred shares of the original issue in any other manner than that which is set forth herein."

"5.9 … Shareholders of the Company who own preferred shares of the Company have no right to vote when issues at the General Shareholders' Meeting are resolved except for instances when adoption of amendments or supplements hereto affects the rights and interests of owners of preferred shares of the Company."

"4.1.2 … The preferred shares issued at the time of foundation of the Company are not subject to conversion into ordinary shares of the Company."

Source: SurgutNG, http://www.surgutneftegas.ru/en/investors/open/ustav/

2) Same effective voting power (none)

2) Same effective voting power (none)

One might argue that the preferred share should trade at a discount to the ord due to the latter's voting rights, justifying a control premium. However, we believe management has locked up an effective, supermajority of c75% of the ord shares via, as reported in the local press,[3] the former treasury shares, the stock held by company pension fund, and other structures. Therefore, while minority holders of ord shares have a vote, it has no effective value.

[2] For a while, management held down preferred dividends by deducting the upcoming year's capex from the previous year's net income before calculating the payout. Since 2005, following a legal change, the pref dividend has been calculated in a very straightforward manner.

[3] Vedomosti, Kommersant, et al

3) Very defensible rights

3) The pref's superior call on company cash flows is readily defensible by minority shareholders

The prefs' superior call on company cash flows, we think, is highly defensible, as Russian law says that any changes in a company's charter limiting rights of preferred shareholders must be approved by supermajorities (75%) of both ordinary and preferred shareholders (see Figure 12). While we think that management has a near super-majority stake of ord shares under its control and likely could, if it wanted to, meet the first requirement, the free float of the preferred shares is likely far, far too high for that second requirement to be met.

After looking at trading data, we are satisfied that a super-majority of preferred shares has not been accumulated by any one entity

All the official share count data we have is roughly a decade out of date, but at one time showed that some 69% of the ord shares were controlled by entities either directly or indirectly under the control of SurgutNG management. However, that same data showed that management control of preferred shares was limited to only 15% of issued shares in that category. While we have no official data as to what has happened in the ensuing years, trading volumes suggests that the amount preferred shares in free float has remained essentially unchanged, implying that should the need arise, a 25% blocking minority would likely appear to defend preferred rights.

Figure 12. Federal law pertaining to the rights of preferred shareholders

English translation:

"4. Shareholders - the owners of the preferred shares participate in the general meeting of shareholders with the right to vote on issues of reorganization and liquidation of the company, as well as the issue under Article 92.1 hereof. [Federal Law of 04.10.2010 N 264-FZ]

Shareholders - holders of preferred shares gain the right to vote on at the General Meeting of Shareholders on changes and amendments to the charter of the company, limiting the rights of shareholders - owners of preferred shares of this type, including the determination or increase the size of the dividend and (or) the determination or liquidation value paid on preferred shares of the previous stage, and providing shareholders - holders of preferred shares of a type of advantage in priority of payment of the dividend and (or) the liquidation value of the shares. Decision to make such amendments shall be adopted if supported by at least three-quarters of votes of shareholders - owners of voting shares participating in the meeting, excluding the votes of shareholders - owners of preferred shares whose rights are restricted, and three-quarters votes of shareholders - owners of preferred shares of each type whose rights are restricted, if such a decision is not the company's charter established more votes. [Clause 4 as amended. Federal Law of 07.08.2001 N 120-FZ]

Source: Russian government

Hydrocracker – Finally up and running

At the very end of 2013 (Dec 26th) SurgutNG pleased the market with a long-awaited announcement: The company had finally commissioned the hydrocracker unit and the 4.9mmtpa (100kbpd) deep conversion complex at the Kirishi refinery, having spent some RUB88.5 ($2.7bn) on the project over the previous several years.

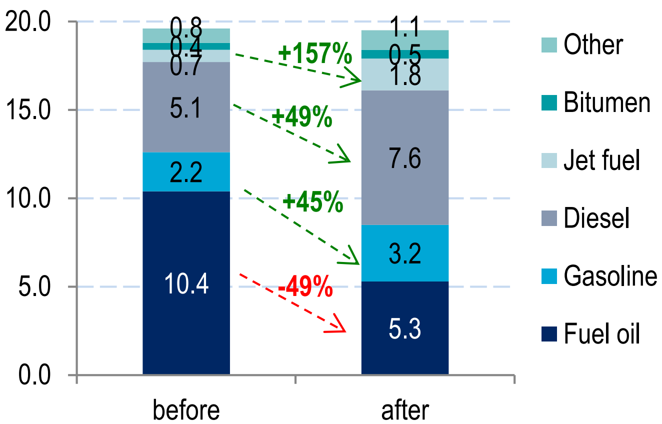
The hydrocracker allows the company to turn high-sulfur fuel oil into the more valuable components such as ultra-low sulfur diesel and jet fuel. SurgutNG's production of fuel oil should fall by 49% in 2014E, while output of gasoline, diesel and jet fuel should rise by 45%, 49% and 157%, respectively (Figure 13).

The new deep conversion plant increases Krishi's refining depth from 55% to 75% and opens the way for further upgrades aimed at minimizing the output of heavy refined products. Refining complexity growth is the strategic priority for all Russian refiners at the moment, given the scheduled tax hike for heavy products in 2015.

The new refining complex is now up and running, which is already being reflected in the production numbers. According to Argus FSU Energy, on Dec 19th, 2013 SurgutNG started shipping 10ppm sulfur diesel to Primorsk through the Transnefteproduct pipeline following the hydrocracker launch and we are looking forward to seeing the January operating statistics to gauge the impact on the product slate.

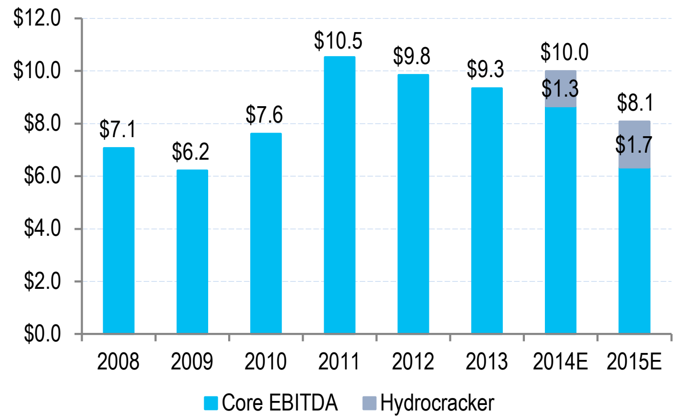
Running at full capacity, the hydrocracker should contribute c$1.3bn (13%) and $1.7bn (21%) to SurgutNG's EBITDA in 2014E and 2015E, respectively (Figure 14).

Figure 13. Hydrocracker impact on SurgutNG's product slate, mmtpa



Source: Company data, Citi Research

Figure 14. Hydrocracker impact on SurgutNG's EBITDA, $mn



Source: Company data, Citi Research

Figure 15. Comps table

Company Name	Total Return	Target Price	Rating	Price 01/28/14	Return to TP	Market Cap	Perfomrance 1d	1w	1m	YTD	P/E 2012A	2013E	2014E	EV /EBITDA 2012A	2013E	2014E	Div yield 2012A	2013E	2014E
BG	32%	14.0	Buy	10.7	31%	$60.6	-1.0%	-19.7%	-16.9%	-17.3%	13.9x	14.0x	17.0x	6.9x	7.0x	8.2x	1.5%	1.6%	1.7%
Eni	11%	17.8	Neutral	16.9	5%	$84.1	-0.3%	-1.9%	-4.1%	-4.1%	9.9x	14.7x	13.7x	2.9x	4.0x	3.7x	6.0%	6.3%	6.6%
Repsol	36%	23.0	Buy	17.7	30%	$32.0	0.8%	-4.8%	-4.5%	-4.1%	11.8x	12.4x	14.7x	6.4x	4.4x	5.6x	5.2%	5.4%	5.5%
RD Shell Class A	11%	22.5	Neutral	21.2	6%	$228.5	-0.6%	-1.5%	-1.3%	-1.7%	8.8x	11.5x	11.1x	4.5x	4.8x	5.1x	4.9%	5.1%	5.2%
Statoil	5%	150.0	Neutral	149.9	0%	$77.7	0.5%	-2.8%	1.5%	0.6%	8.5x	9.4x	10.3x	2.0x	2.3x	2.8x	4.8%	4.9%	4.9%
Total	23%	50.0	Buy	42.4	18%	$137.7	0.0%	-3.3%	-5.3%	-5.4%	8.3x	9.1x	9.4x	3.5x	3.9x	4.1x	5.2%	5.4%	5.7%
Weighted average											**9.4x**	**11.4x**	**11.7x**	**4.1x**	**4.4x**	**4.7x**	**4.8%**	**5.0%**	**5.1%**
Petrobras	18%	13.4	Neutral	11.7	14%	$79.0	-0.5%	-4.1%	-14.1%	-14.8%	7.0x	7.1x	5.9x	4.7x	4.8x	5.0x	4.1%	4.1%	5.0%
Sinopec	22%	7.3	Buy	6.2	17%	$92.8	-0.6%	-3.1%	-2.5%	-2.5%	9.4x	8.5x	7.6x	5.0x	4.8x	4.5x	4.6%	5.0%	5.5%
Weighted average											**8.3x**	**7.9x**	**6.8x**	**4.9x**	**4.8x**	**4.7x**	**4.4%**	**4.6%**	**5.3%**
Gazprom	90%	7.8	Buy	4.2	84%	$97.3	-0.4%	-1.2%	-0.6%	0.2%	2.6x	2.9x	3.0x	2.2x	2.1x	2.2x	4.5%	6.3%	5.7%
Gazpromneft	65%	6.48	Buy	4.09	58%	$19.4	-1.1%	-6.2%	-9.5%	-9.1%	3.4x	3.6x	3.6x	2.4x	2.2x	2.3x	7.2%	6.9%	6.0%
Lukoil	72%	95.0	Buy	56.9	67%	$44.1	0.6%	-3.4%	-7.6%	-8.5%	3.9x	3.7x	4.0x	2.2x	2.1x	2.1x	4.3%	5.0%	5.7%
Novatek	37%	168.00	Buy	124.70	35%	$37.8	-2.0%	-4.8%	-7.8%	-8.9%	16.9x	13.1x	12.1x	11.8x	8.7x	7.9x	1.7%	2.2%	2.4%
Rosneft	61%	11.0	Buy	7.0	56%	$74.7	-0.9%	-4.4%	-7.3%	-8.1%	5.7x	5.0x	6.5x	4.6x	4.0x	5.1x	3.8%	4.6%	3.5%
Surgutneftegaz ord	12%	0.88	Neutral	0.80	9%	$28.7	-1.1%	-2.3%	-6.6%	-6.9%	6.2x	3.6x	4.1x	0.5x	0.1x	nm	2.0%	2.7%	2.6%
Tatneft ord			Neutral	5.6	n/a	$12.2	-1.8%	-5.3%	-11.6%	-11.9%	5.1x	5.3x	5.7x	4.2x	4.3x	4.3x	4.9%	4.6%	4.0%
Bashneft ord	44%	80.50	Buy	58.75	37%	$9.2	-1.1%	-6.5%	-3.5%	-3.6%	6.4x	6.3x	6.3x	4.5x	4.4x	4.3x	1.3%	6.5%	6.6%
Surgutneftegaz (pref)	67%	1.15	Buy	0.73	57%	$5.7	-2.5%	-3.9%	-7.7%	-7.0%	5.6x	3.3x	3.7x	0.4x	0.1x	n/m	6.3%	10.3%	9.3%
Tatneft (pref)			Neutral	3.55	n/a	$0.5	-1.2%	-2.0%	-4.3%	-4.4%	3.2x	3.4x	3.6x	2.7x	2.8x	2.7x	7.7%	7.3%	6.3%
Weighted average											**5.7x**	**4.9x**	**5.3x**	**3.8x**	**3.2x**	**3.4x**	**3.9%**	**5.0%**	**4.6%**
Total weighted average											**8.2x**	**9.0x**	**9.1x**	**4.1x**	**4.1x**	**4.3x**	**4.4%**	**4.9%**	**5.0%**
KMG EP	22%	18.00	Neutral	15.52	16%	$6.3	-2.0%	-0.8%	-0.5%	-1.1%	6.0x	6.2x	4.6x	0.9x	1.5x	1.7x	11.4%	6.3%	8.5%
Dragon Oil PLC	40%	8.2	Buy	6.0	36%	$4.9	-0.2%	0.4%	7.3%	5.9%	8.3x	9.9x	7.4x	2.9x	3.0x	2.1x	2.6%	3.2%	2.5%
Nostrum Oil&Gas	36%	14.90	Buy	11.05	35%	$2.1	-1.3%	-9.4%	-11.6%	-15.0%	12.7x	8.8x	10.2x	5.5x	4.5x	4.9x	2.8%	1.5%	2.2%
Weighted average											**7.9x**	**8.0x**	**6.5x**	**2.4x**	**2.5x**	**2.3x**	**6.8%**	**4.4%**	**5.3%**

Source: DataCentral

Company Focus

Surgutneftegaz(pref) (SNGS_P.MM)

Still a preferred play – Now explicitly favoured over ords

- Target Price Change

Buy	1
Price (28 Jan 14)	US$0.73
Target price	US$1.15
from US$1.18	
Expected share price return	56.7%
Expected dividend yield	9.7%
Expected total return	**66.4%**
Market Cap	US$34,396M

Price Performance
(RIC: SNGS_p.MM, BB: SNGSP RM)

- **TP tweaked down 3% to $1.15/sh, Still a 1-Buy and favoured play in Russian oil & gas:** We change our methodology for setting TPs, moving from a target 5% discount of the pref vs. the ord to a 30% *premium*. While our TP for the pref remains relatively unchanged (a minor 3% drop), note that we drop our ord TP by 29% and downgrade it to 2-Neutral. *We now explicitly favour SurgutNG's pref over its ords, and see no reason for investors to hold the ord if the pref is available.* SurgutNG's preferred share remains one of our two favoured plays among Russian blue chip oil & gas names, with the other being Gazprom. We make small changes to the model to incorporate updated production and other data.

- **Rouble weakness helps oil stocks, but especially SurgutNG prefs:** The rouble has devalued c6% vs. the US dollar since January 1st even as oil has held steady. While this boosts EBITDA at all oil companies, it has a unique effect on SurgutNG's net income line via a non-cash revaluation of its $32bn cash pile, with each rouble of devaluation, year-end on year-end, adding c0.2RUB/sh to the pref dividend.

- **One key catalyst remaining – full trading fungibility:** MICEX continues its drive to improve local volumes and, with the Central Depository established (fall 2012) and T+2 trading achieved (September 2013), the last apparent hurdle appears to be changes to Russia's securities code to allow Euroclear to settle MICEX trades. Likely to happen by July, this should result in SurgutNG's pref shares, which are liquid only on MICEX, becoming much more investable for international funds and help drive the re-rating vs. the ords.

Surgutneftegaz(pref) (USD)

Year to 31 Dec	2011A	2012A	2013E	2014E	2015E
Sales ($M)	25,635.2	26,246.1	25,646.9	27,745.6	26,601.9
Net Income ($M)	7,613.8	4,646.3	8,067.7	7,034.5	5,171.4
Diluted EPS ($)	0.21	0.13	0.23	0.20	0.14
Diluted EPS (Old) ($)	0.21	0.13	0.23	0.20	0.17
PE (x)	3.4	5.6	3.2	3.7	5.0
EV/EBITDA (x)	0.7	0.4	0.1	-0.2	-0.4
DPS ($)	0.07	0.05	0.08	0.07	0.05
Net Div Yield (%)	10.0	6.5	10.6	9.6	7.2

Company Focus

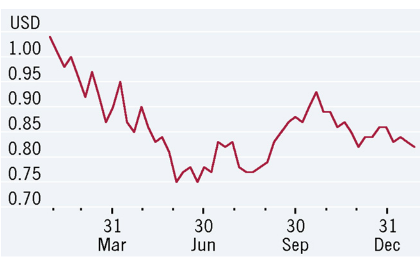
Surgutneftegaz (SNGS.MM)

Downgrade to 2-Neutral – Better to Buy the pref

- Estimate Change
- Target Price Change
- Rating Change

Neutral	**2**
from Buy	
Price (28 Jan 14)	US$0.80
Target price	US$0.88
from US$1.25	
Expected share price return	9.4%
Expected dividend yield	2.5%
Expected total return	**11.9%**
Market Cap	US$34,396M

Price Performance
(RIC: SNGS.MM, BB: SNGS RM)



- **Downgrading Surgut's ordinary share, lowering TP** — We change our methodology for setting TPs, moving from a target 5% discount of the pref vs. the ord to a 30% *premium*. Inversely, this targets the ord to trade at a 23% discount to the common, the average discount the pref traded to the ord since we first made SurgutNG prefs a top idea back in March of 2012. While our TP for the pref remains relatively unchanged, we drop our ord TP by 24% and downgrade it to 2-Neutral. We make small changes to the model to incorporate updated production and other data. *We now explicitly favour SurgutNG's pref over its ords, and see no reason for investors to buy the ord if the pref is available.*

Surgutneftegaz (USD)

Year to 31 Dec	2011A	2012A	2013E	2014E	2015E
Sales ($M)	25,635.2	26,246.1	25,646.9	27,745.6	26,601.9
Net Income ($M)	7,613.8	4,646.3	8,067.7	7,034.5	5,171.4
Diluted EPS ($)	0.21	0.13	0.23	0.20	0.14
Diluted EPS (Old) ($)	0.21	0.13	0.23	0.20	0.17
PE (x)	3.8	6.2	3.5	4.1	5.5
EV/EBITDA (x)	0.7	0.4	0.1	-0.2	-0.4
DPS ($)	0.02	0.02	0.02	0.02	0.02
Net Div Yield (%)	2.5	2.0	2.7	2.7	2.0

Surgutneftegaz(pref)

Company description

Surgutneftegaz is the third-largest vertically-integrated producer in Russia, with its upstream asset base in Western Siberia. Kirishi (near St Petersburg) is its only refinery. As such, it has less downstream exposure relative to its production level than do most of its domestic peers (bar Tatneft). Shareholder structure opaque and is distorted by a significant treasury position.

Investment strategy

Operationally, Surgutneftegaz provides limited volume growth now, but a long-running downstream upgrade project now completing should improve profitability there. Poor corporate governance and transparency are offset by the benefits of the largely dollar-denominated cash pile, which decreases the company's leverage to oil prices and changes in ruble strength relative to its Russian peers. Corporate governance did improve noticeably on April 30, 2013 when the company finally began publishing IFRS results. We rate the Surgutneftegaz preferred share a Buy, and strongly prefer it to Neutral-rated ordinary share due to the pref's demonstrably superior call on company cash flows via its high, guaranteed payout ratio. The pref has an effective dividend kicker if the ruble should weaken due to the effect on net income from currency gains, and should also benefit from the opening of the Russian market to a wider group of investors.

Valuation

Our $1.15 target price for Surgutneftegaz preferred share is based on: 1) DCF valuation of $1.21 with a 14.2% WACC and 3.0% terminal growth rate; and 2) Near-term multiple valuations (25% weighting each) include an implied target price of $0.98/share on a P/E basis (2013E) and $1.19/share on an EV/EBITDA basis.

Risks

SurgutNG is exposed to all of the same industry-specific risks as its peers. Corporate governance and transparency issues are an issue, but by and large are not as important as the broader industry risks of oil prices and moves in the RUB/USD exchange rate, and to some extent are offset by the positive effects of the large, dollar-denominated cash pile (c$32bn). These risks could impede the share price from reaching our target price.

Surgutneftegaz

Company description

Surgutneftegaz is the third-largest vertically-integrated producer in Russia, with its upstream asset base in Western Siberia. Kirishi (near St Petersburg) is its only refinery. As such, it has less downstream exposure relative to its production level than do most of its domestic peers (bar Tatneft). Shareholder structure opaque and is distorted by a significant treasury position.

Investment strategy

Operationally, Surgutneftegaz provides limited volume growth now, but a long-running downstream upgrade project now completing should improve profitability

there. Poor corporate governance and transparency are offset by the benefits of the largely dollar-denominated cash pile, which decreases the company's leverage to oil prices and changes in ruble strength relative to its Russian peers. Corporate governance did improve noticeably on April 30, 2013, when the company finally began publishing IFRS results. We rate SurgutNG's ordinary shares as Neutral due to their limited upside to our target price combined with a sub-standard dividend yield vs. its Russian peers. We rate the Surgutneftegaz preferred share a Buy, and strongly prefer it to Neutral-rated ordinary share due to the pref's demonstrably superior call on company cash flows via its high, guaranteed payout ratio. The pref has an effective dividend kicker if the ruble should weaken due to the effect on net income from currency gains, and should also benefit from the opening of the Russian market to a wider group of investors.

Valuation

Our $0.88 target price for SurgutNG's common share is achieved by applying a 23% discount to our $1.15/share preferred TP (inversely, we assume the preferred should trade at a 30% premium to the common). We need to add to that, however, the c$0.020 dividend we expect the common stock to pay out in 2014.

Risks

SurgutNG is exposed to all of the same industry-specific risks as its peers. Corporate governance and transparency issues are an issue, but by and large are not as important as the broader industry risks of oil prices and moves in the RUB/USD exchange rate, and to some extent are offset by the positive effects of the large, dollar-denominated cash pile (c$32bn). These risks could impede the share price from reaching our target price.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Surgutneftegaz(pref) (SNGS_p.MM)

Ratings and Target Price History
Fundamental Research

Analyst: Ronald Paul Smith
Covered since June 30 2011

	Date	Rating	Target Price	Closing Price
1	11-Mar-11	1H	*0.67	0.57
2	4-Oct-11	*1M	0.67	0.41
3	7-Oct-11	Stock rating system changed		
4	7-Oct-11	*1	0.67	0.42
5	9-Feb-12	1	*0.71	0.63
6	5-Mar-12	1	*0.96	0.68
7	22-May-12	1	*0.88	0.48
8	30-Jan-13	1	*0.99	0.77
9	2-Sep-13	1	*1.11	0.67
10	16-Sep-13	1	*1.18	0.71

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Surgutneftegaz(pref) (SNGS_p.MM)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Ronald Paul Smith
Covered since June 30 2011

	Date	Rating	Target Price	Closing Price
1	18-Oct-11	*ADD MP	-	0.45

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Surgutneftegaz (SNGS.MM)

Ratings and Target Price History
Fundamental Research

Analyst: Ronald Paul Smith
Covered since June 30 2011

	Date	Rating	Target Price	Closing Price
1	11-Mar-11	2H	*1.21	1.13
2	4-Oct-11	*1M	1.21	0.79
3	7-Oct-11	Stock rating system changed		
4	7-Oct-11	*1	1.21	0.78
5	9-Feb-12	1	*1.28	0.98
6	22-May-12	1	*1.17	0.81
7	16-Sep-13	1	*1.24	0.85
8	22-Oct-13	1	*1.25	0.93

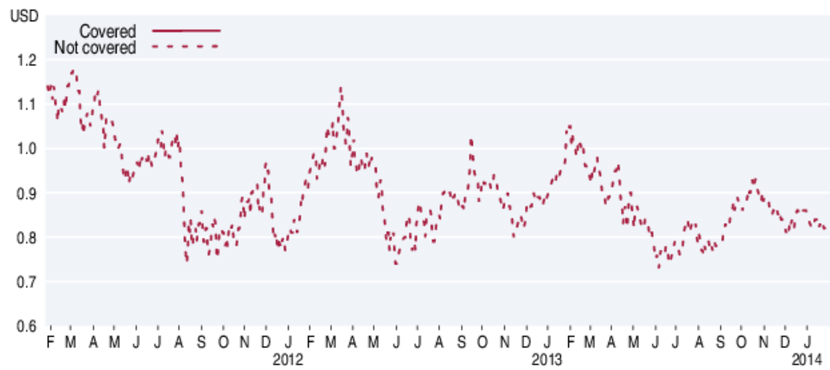
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Surgutneftegaz (SNGS.MM)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Ronald Paul Smith
Covered since June 30 2011



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Citi is acting as financial advisor to China Petroleum & Chemical Corp and ENN Energy Holdings in the proposed takeover of China Gas Holdings.

Citigroup Global Markets Limited is currently acting as advisor to Gazprom Neft in the proposed acquisition of a stake in the Dung Quat oil refinery from Vietnam Oil and Gas Group (Petrovietnam).

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of Statoil ASA

Citigroup Global Markets Ltd acted as advisor and joint bookrunner on Caixabank SA's recently announced mandatory exchangeable bond, converting into equity in Repsol SA.

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Citi Research Equity Ratings Distribution

	12 Month Rating			***Relative Rating***		
Data current as of 31 Dec 2013	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Research Global Fundamental Coverage	49%	40%	12%	6%	88%	6%
% of companies in each rating category that are investment banking clients	55%	52%	44%	62%	52%	49%

Guide to Citi Research Fundamental Research Investment Ratings:

Citi Research stock recommendations include an investment rating and an optional risk rating to highlight high risk stocks.

Risk rating takes into account both price volatility and fundamental criteria. Stocks will either have no risk rating or a High risk rating assigned.

Investment Ratings: Citi Research investment ratings are Buy, Neutral and Sell. Our ratings are a function of analyst expectations of expected total return ("ETR") and risk. ETR is the sum of the forecast price appreciation (or depreciation) plus the dividend yield for a stock within the next 12 months. The Investment rating definitions are: Buy (1) ETR of 15% or more or 25% or more for High risk stocks; and Sell (3) for negative ETR. Any covered stock not assigned a Buy or a Sell is a Neutral (2). For stocks rated Neutral (2), if an analyst believes that there are insufficient valuation drivers and/or investment catalysts to derive a positive or negative investment view, they may elect with the approval of Citi Research management not to assign a target price and, thus, not derive an ETR. Analysts may place covered stocks "Under Review" in response to exceptional circumstances (e.g. lack of information critical to the analyst's thesis) affecting the company and / or trading in the company's securities (e.g. trading suspension). As soon as practically possible, the analyst will publish a note re-establishing a rating and investment thesis. To satisfy regulatory requirements, we correspond Under Review and Neutral to Hold in our ratings distribution table for our 12-month fundamental rating system. However, we reiterate that we do not consider Under Review to be a recommendation.

Relative three-month ratings: Citi Research may also assign a three-month relative call (or rating) to a stock to highlight expected out-performance (most preferred) or under-performance (least preferred) versus the geographic and industry sector over a 3 month period. The relative call may highlight a specific near-term catalyst or event impacting the company or the market that is anticipated to have a short-term price impact on the equity securities of the company. Absent any specific catalyst the analyst(s) will indicate the most and least preferred stocks in the universe of stocks under consideration, explaining the basis for this short-term view. This three-month view may be different from and does not affect a stock's fundamental equity rating, which reflects a longer-term total absolute return expectation. For purposes of NASD/NYSE ratings-distribution-disclosure rules, most preferred calls correspond to a buy recommendation and least preferred calls correspond to a sell recommendation. Any stock not assigned to a most preferred or least preferred call is considered non-relative-rated (NRR). For purposes of NASD/NYSE ratings-distribution-disclosure rules we correspond NRR to Hold in our ratings distribution table for our 3-month relative rating system. However, we reiterate that we do not consider NRR to be a recommendation.

Prior to October 8, 2011, the firm's stock recommendation system included a risk rating and an investment rating. **Risk ratings,** which took into account both price volatility and fundamental criteria, were: Low (L), Medium (M), High (H), and Speculative (S). **Investment Ratings** of Buy, Hold and Sell were a function of the Citi Research expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating. Additionally, analysts could have placed covered stocks "Under Review" in response to exceptional circumstances (e.g. lack of information critical to the analyst's thesis) affecting the company and/or trading in the company's securities (e.g. trading suspension). Stocks placed "Under Review" were monitored daily by management and as practically possible, the analyst published a note re-establishing a rating and investment thesis. For securities in developed markets (US, UK, Europe, Japan, and Australia/New Zealand), investment ratings were:Buy (1) (expected total return of 10% or more for Low-Risk stocks, 15% or more for Medium-Risk stocks, 20% or more for High-Risk stocks, and 35% or more for Speculative stocks); Hold (2) (0%-10% for Low-Risk stocks, 0%-15% for Medium-Risk stocks, 0%-20% for High-Risk stocks, and 0%-35% for Speculative stocks); and Sell (3) (negative total return). For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings were:Buy (1) (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold (2) (5%-15% for Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell (3) (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks, and 20% or less for Speculative stocks).

Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

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OTHER DISCLOSURES

The subject company's share price set out on the front page of this Product is quoted as at 28 January 2014 06:45 PM on the issuer's primary market.

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