19 November 2013 | 8 pages

Integrated Oils
CEEMEA | Russian Federation

Rosneft (ROSN.MM)

Alert: Brownfield Briefing – Production Stabilisation, Cost Control

Rosneft held a briefing for analysts on its brownfield production plans. The main takeaways were: a) overall oil production is projected to grow at c1%pa through 2017 before accelerating; b) production at key brownfield assets Samotlor and YuganskNG to be stabilised; c) capex per produced barrel in 2013 looking encouraging to us; d) testing in shale ongoing, results to be summarised next February; and e) unconventional production to grow to 200kbd by 2020.

- **Oil production guidance – slow, steady growth through 2017** – Management indicated that on average it expects c1% annual oil production growth through 2017, when greenfield projects such as the Vankor cluster will start to kick in. This number includes recently acquired assets such as the Taas Yuriakh field in East Siberia. Once those new greenfields begin to come online, growth should accelerate for a time to 3-4% per annum, a number which we think will have to include some level of offshore success if it is to be extended past 2020.

- **Samotlor, YuganskNG production to be largely stabilised…**– Management indicated it expects to stabilise production at YuganskNG (1.33mbpd in 3Q13) and Samotlor (479kbd) for the medium term. YuganskNG has been steady at 1,320-1,330kbd for some time. However, Samotlor has been declining at a c5% CAGR since 2006, so stabilising production at that mature field would be an accomplishment. Management believes the key to stabilising Samotlor will likely be the Ryabchik formation – a thin, shallow layer TNK-BP has been ramping up for some years, and which management estimates has 350m tonnes (2.5bn bbl) of recoverable reserves (ABC1+C2). Additionally, Rosneft will be targeting fringe zones and infill drilling as well as formations with lower porosity and permeability, including the Achimov.

- **…via horizontal wells, multi-stage fracturing, other technologies** – Rosneft will achieve brownfield stabilisation by ramping up usage of horizontal wells with multi-stage fracs, more sidetrack wells, better water floor management, and dual well completions and injections. Per company data, horizontal wells with multi-stage fracs in YuganskNG have average initial production rates of 157tpd (1,150kbd), well above the 60tpd (440kbd) the company reported last year as the rate for the typical vertical well. Samotlor horizontal wells – better than half of such wells currently being drilled by Rosneft due to TNK-BP having earlier started development of the Ryabchik formation – are averaging 37tpd (270bpd).

- **Brownfield cost control highlighted, replacement costs good by our numbers** – In the first nine months of 2013, Rosneft has invested RUB159bn ($5.3bn) into its brownfields. This works out to about $6.1 per produced barrel for the period, which we would consider a very good number if: a) it can be sustained for the full year; and b) production at brownfields was already stabilised. Sustaining this per-barrel number, if it can be done when Samotlor and other brownfield production is stabilised, would be a major accomplishment for Rosneft, in our view.

Buy	**1**
Price (19 Nov 13)	US$7.52
Target price	US$11.00
Expected share price return	46.3%
Expected dividend yield	3.6%
Expected total return	**49.9%**
Market Cap	US$79,674M

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

Ronald Paul Smith
+7-495-643-1581
ronald.p.smith@citi.com

Alexander Bespalov, CFA
+7-495-643-1587
alexander.bespalov@citi.com

- **Why replacement costs are important to our analysis** – To put this number into context, one must understand that the cost of replacing a produced barrel is a key assumption – if not the key assumption – in our Russian oil company models. For example, our long-term assumption for Lukoil is $10/bbl – in line with its historical investments in those years when it has had stable oil production – while for Rosneft and its younger fields we assume cost climb from historical levels of $5-$7/bbl to $9/bbl longer term. As a sensitivity test, were we to lower that for Rosneft by just $1/bbl to $8/bbl, our DCF would rise c18% (if that number seems large, consider that $1/bbl on the 4.4mmbpd we forecast Rosneft producing in 2017 is $1.6bn of CAPEX which, if removed from maintenance capex, would be pure cash flow to investors). Therefore, the indication that Rosneft may be able to stabilise production at brownfields with a substantially smaller-than-forecast amount of capex is a quite positive one, should that number hold up (we are making no changes to our assumptions at this point).

- **Unconventional oil production to climb** – In 2013 Rosneft will produce about 500ktons (10kbd) of hard-to-produce reserves,[1] per management, but those levels are forecast to climb to 1.6m tonnes (32kbd) in 2014, to 4.4mt (88kbd) in 2017, and 7.4mt (150kbd) in 2020. By 2017 management expects a bit over 200kbd of Samotlor production to be coming from horizontal wells of all types vs. 20kbd today. At YuganskNG by 2017 tight oil production (Bazhenov etc, and not necessarily comparable with the Samotlor number above) should reach 32kbd from negligible levels today.

- **Results of shale test projects to be summarized in February of 2014** – Production from the Tyumen suite (shale) at the Em-Egovskaya pilot project (Halliburton) should ramp up from 14kbd in 2014 to 36kbd in 2017 and peak at 65kbd in 2022 or so. The Severo-Kokhryakovskoye pilot project (Schlumberger) is a bit more modest, but production from low-permeability reservoirs there should ramp up from 4kbd in 2014 to 32kbd in 2025 or so. Both projects are using test wells to experiment with drilling and completion techniques, so the current focus isn't production so much as optimisation. Management indicated that it will sum up pilot project results to-date in February of next year.

- **Ramp-up of horizontal + multi-stage fracturing may cause temporary OFS shortages in 2014, but unlikely to persist** – Management opined that the rapid increase in horizontal drilling with multi-stage fracturing in Russia may give rise to tightness in the oilfield services market for certain categories of equipment, in particular for coil-tube and sidetrack drilling rigs. However, management felt that these issues would likely be addressed by the OFS industry by 2015, and are manageable in any event. Frac fleet availability might also be a bit tight, but additional equipment and crews are already being mustered and therefore shortages are less likely to be encountered in that area.

- **YuganskNG reserves replacement above 100%** – ABC1 reserves increases at YuganskNG (including the key Priobskoye field) this year have totalled 75mt (550m bbl) will cover production by 113% in the unit.

[1] The definition "hard-to-produce" in Russia does not necessarily have a perfect overlap with the term "unconventional" used elsewhere, as it may include conventional reserves that are either in these layers or just have poorer than usual porosity and permeability, but which require the same technology as unconventional reserves in order to be economically developed

Rosneft

Valuation

Our target price for Rosneft is $11.0, which is the sum of our base case valuation of $10.0 plus $0.99 to account for the value of the offshore opportunity, which we do not include explicitly in our DCF. Our base case valuation is a mix of long-term DCF and near-term multiples. Our DCF value of $11.3/share (50% weighting) reflects the company's access to relatively good investment opportunities in legacy regions as well as substantial growth opportunities on Russia's continental shelf (offshore) and in the gas business. We use a WACC of 8.8%, a long-term growth rate of 3.0% and beta of 1.0. Our near-term (2013E) multiple valuations (25% weighting each) include implied fair values of $8.7/share on a P/E basis and $8.7/share on an EV/EBITDA basis.

Risks

Although state-owned, Rosneft faces the typical oil price risks of any other Russian oil company. Our target price could be exceeded were Rosneft to be the material beneficiary of any further consolidation of Russian hydrocarbon assets sponsored by the state. The government could change its approach to the company in terms of favorable taxation regime and favorable transportation tariffs for eastbound routes.

Appendix A-1

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Ratings and Target Price History
Fundamental Research

Analyst: Ronald Paul Smith
Covered since June 8 2011

	Date	Rating	Target Price	Closing Price
1	14-Jan-11	1L	*9.90	7.75
2	11-Mar-11	*2L	*9.30	8.85
3	7-Jun-11	*1M	*11.30	8.78
4	6-Sep-11	1M	*9.30	7.49
5	7-Oct-11	Stock rating system changed		
6	7-Oct-11	*1	9.30	5.99
7	16-Nov-11	1	*9.90	7.30
8	9-Feb-12	*2	*8.20	7.14
9	19-Apr-12	*1	8.20	7.28
10	22-May-12	1	*7.30	6.35
11	29-Oct-12	1	*9.10	7.32
12	17-Apr-13	1	*9.45	6.74
13	24-Apr-13	1	*9.53	6.98
14	30-May-13	1	*9.20	6.79
15	16-Sep-13	1	*10.00	8.15
16	22-Oct-13	1	*11.00	8.21

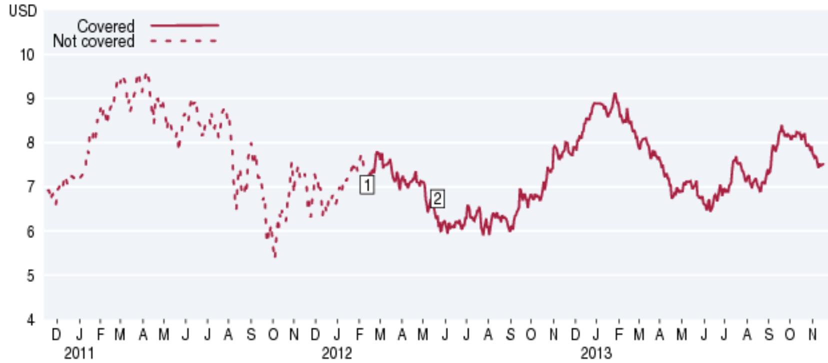
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Rosneft (ROSN.MM)

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

Analyst: Ronald Paul Smith
Covered since June 8 2011



	Date	Rating	Target Price	Closing Price
1	13-Feb-12	*ADD LP	-	7.23
2	22-May-12	*REM LP	-	6.35

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Data current as of 30 Sep 2013	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
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