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Integrated Oils
CEEMEA

Russian oil & gas

Through the DDM prism – A Deep Dive into fundamental valuation

- **Adopting a conservative DDM methodology:** With geopolitical tensions high, oil prices dropping, the rouble weakening, investors increasingly skeptical about the prospects for corporate governance reform, but dividends yields relatively high, we are taking that cue to transition our valuation methodology from one based on near-term multiples and DCF valuations to a rigorous Dividend Discount Model (DDM).

- **Target prices drop across the board:** Conversion to a DDM methodology is the primary driver behind a significant decrease in all of our target prices, some 30% on average and ranging from -19% for NVTK and -21% for Lukoil at the low end to -35% (ROSN), -40% (SNGS), and -55% (GAZP) at the high end.

- **Crisis resolution would boost TPs significantly, but not equally:** Any resolution of the Ukrainian crisis would lower Russian risk, driving up DDM valuations across the board, but not equally so: ROSN, SIBN, and NVTK would gain the most, SNGSp, SNGS, and GAZP the least, while LKOH would be closer to the average.

- **Stocks we like most – pick your exposure to Russia risk:** Despite the TP falls, several stocks in our universe still have high enough ETRs to justify Buys. **SNGSp** is very defensive and least exposed to swings in Russian risk on its front-loaded dividend stream; **Lukoil** has a higher ETR, may be at or near a support level, and is modestly defensive. **Novatek** offers scope for upside from risk reduction on its growth-focused portfolio. We see **Gazpromneft** having the best combination of ETR and leverage to a potential reduction in Russian risk, but it is still relatively illiquid.

- **Rosneft downgraded to Neutral – but triple leverage to crisis resolution:** We rate Rosneft Neutral at current levels, with the stock's direct exposure to sanctions holding down the DDM and a high leverage to falling oil prices potentially keeping pressure on near term. However, we think the stock could be a very strong performer should the Ukrainian crisis be resolved, or sink further should it deepen.

- **Gazprom downgraded to Sell – serious dividend reform needed:** The switch to the DDM is not kind to Gazprom, as its key weaknesses vs. its peers – payout policy and reinvestment effectiveness – are two key inputs for the methodology. The drop in TP is exacerbated by our new assumption that the government's planned dividend increase will not go through in 2016/17 (this accounts for c21% of the drop in our TP under the DDM). Barring a sudden and visible commitment to effective investment policies – sufficiently large additional Chinese contracts might help – only a large increase in dividend payouts can just a materially higher DDM value.

- **SurgutNG ords downgraded to Sell:** In our view, the DDM is the perfect tool to highlight why SurgutNG ords are unattractive even as it confirms the prefs as one of the better ideas in the space. Our DDM value suggests the common should trade at a large discount to the pref of c40%, and we downgrade it to a high-conviction Sell.

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Data Summary

Company	Ticker	Rating Old	Rating New	Target Price Old	Target Price New	Current Year Earnings Estimates Old	Current Year Earnings Estimates New
Gazprom	GAZP.MM	1	3	US$6.50	US$2.90	US$1.24	US$1.30
Lukoil	LKOH.MM	1	1	US$76.30	US$60.30	US$13.69	US$14.87
Novatek	NVTKq.L	1	1	US$146.00	US$118.00	US$10.01	US$8.52
Rosneft	ROSN.MM	1	2	US$9.30	US$6.00	US$0.93	US$0.79
Gazpromneft	SIBN.MM	1	1	US$6.52	US$4.50	US$1.12	US$1.04
Surgutneftegaz	SNGS.MM	2	3	US$0.78	US$0.47	US$0.23	US$0.24
Surgutneftegaz(pref)	SNGS_P.MM	1	1	US$1.10	US$0.74	US$0.23	US$0.24

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Moving to the DDM

Why we are moving to the DDM

Over the course of the last year, our discussions with investors have shown that a materially large and growing number of them are now using dividend yields as an important – if not the primary – tool in their decision-making process in Russian oil & gas equities. With geopolitical tensions high, investors increasingly skeptical about the prospects for corporate governance reform, but dividends yields relatively high, we are taking that cue to transition our valuation methodology from one based on near-term multiples and DCF valuations to a rigorous Dividend Discount Model (DDM). Much of this note is dedicated to laying down the intellectual groundwork for that switch.

Against a background of international sanctions, falling oil prices and a weakening rouble, we conduct a comprehensive overhaul of our valuation methodology for the Russian oil & gas sector, adopting a rigorous DDM in place of our previous DCF and multiple-based methodology.

We think this appropriate because:

a) Anecdotally, a DDM gives conservative equity valuations (and we think investors are not in a generous state of mind vis-à-vis Russian equities just now);

b) A DDM's key inputs capture well the primary issues facing investors in Russian equities – dividend policy, leverage policy, and the efficacy of reinvested earnings; and

c) Rising dividends, perhaps the only concrete improvement in Russian corporate governance in recent years and still on management team agendas,[1] now make the exercise less theoretical.

TP, recommendation changes

TPs fall across the board, but not equally

As we show in Figure 1, our target prices drop across the board, by an average c33%, with a range from a 19% fall to a 55% fall. Most of this movement is related to our switch to a rigorous DDM-based TP-setting mechanism from our previous system, which used a combination of 50% DCF valuation and 50% near-term multiples. However, not all of the changes in TPs are due to the switch to the DDM alone.

Figure 1. TP changes from move to DDM

	Prev TP	DDM TP*	Change	New Rating	ETR Upside
LKOH	$76.3	$60.3	-21%	Buy	30%
GAZP	$6.5	$2.9	-55%	Sell	-7%
NVTK	$146	$119	-19%	Buy	18%
ROSN	$9.3	$6.0	-35%	Neutral	12%
SIBN	$6.5	$4.5	-30%	Buy	32%
SNGS	$0.78	$0.47	-40%	Sell	-25%
SNGSp	$1.10	$0.74	-33%	Buy	26%

Source: Citi Research
*Note that our DDM-based, 12-month TP is our DDM value *less* the dividend expected to be received in the course of the next year. Therefore, our Estimated Total Return (ETR) by definition equals the return to our DDM valuation, including that upcoming dividend.

- **Lukoil remains an attractive Buy, at a possible support level:** Our Lukoil TP drops 21% to $60.3/sh, better than average, and shows a c30% ETR at these levels. Lukoil's DDM value remains relatively defensive due to its lower growth profile, providing the intellectual underpinning as to why the stock tends to trade defensively. Also, the stock is currently hovering around $50/sh, an historical support level for the stock, although falling oil prices, if continued, may provide the catalyst to break that support.

- **Gazprom is downgraded to a Sell:** Gazprom sees the largest fall in TP (-55% to $2.9/sh ($5.8/ADR) in our universe, with an otherwise typical drop due to the methodology switch exacerbated by a few assumption changes on our part:

  1) <u>We now assume Gazprom maintains indefinitely its current dividend policy of 25% of RAS net income – effectively 17.5% of reported IFRS net income</u> as MinFin dedication to the policy change seems to have weakened somewhat and, in any event, is too far over the horizon

[1] The government wants to increase Gazprom's dividends significantly, and management even has it in the company's official plans, although some skepticism is still warranted. Lukoil's dividend policy is to continue increasing dividends by at least 15% pa in RUB/sh terms at least for the medium term.

(2016/17), we think, for investors to give it credence without a convincing public commitment on the part of government, something we have so far yet to see.

Were we to instead assume the company will follow through on government stated policy and raise payouts to 25% of IFRS net income in 2016/17, our TP drop would be limited to c40%, significantly closer to the 30% typical for the universe, ex-Gazprom (i.e. the DDM would rise c26% from our current calculation).

2) We lower our assumption for European gas pricing from a slope of 10% to 9.5%, dropping the price in our long-term oil price environment of real $90/bbl Brent from c$317/mcm to c$300/mcm in today's prices (both below the $350/mcm to company guides to for 2014 and the c$370/mcm realized in 2013). This change contributes about half of the 16% drop in our 2017 EPS estimate. Lower assumed volumes in Ukraine long term and a hit to normalized Russian prices in USD terms due to a weaker rouble assumption contribute practically all of the remainder.

- **Gazpromneft remains a Buy**, with its TP of $4.5/sh ($22.6/ADR) giving a 32% ETR, more than qualifying the stock for that rating, although investors need to be aware of the relatively low liquidity of the stock. While our TP suffers a 30% fall due to the methodology switch, that's only average for the sector. Note the company is in the middle of a significant investment cycle that will see production and earnings growth jump around 2020E, but then slide back on the expiration of tax breaks and as heavy decline rates kick in.

- **Novatek remains a Buy**, with its new $118/sh TP – down 19% – implying a relatively modest c18% ETR. However, with a strong growth profile, Novatek's DDM is under more pressure than the average from the higher Russian risk premium, and in the event of a resolution to the Ukrainian crisis could be an outperformer (or, conversely, it could underperform should the crisis deepen).

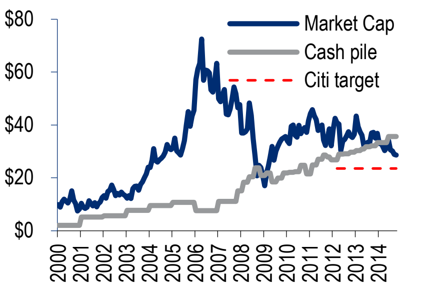
- **Rosneft is downgraded to Neutral**, with its 11% upside being heavily influenced by dint of the company's being directly targeted by sanctions, which contributes significantly to the 35% overall fall in our TP due to the methodology change. <u>However, our Rosneft DDM has most scope for upside should risks subside, and investors should be wary of the risks of an underweight position in the stock.</u>

  a) A standard 100bpt decrease in the Russian Cost of Equity (not an unreasonable expectation in the event of a resolution to the Ukrainian crisis) would boost the stock's DDM value by c31%.

  b) In addition, we would look to potentially remove the additional 50bpts of risk we added to Rosneft's discount rate due to the unique issues the closure of Western financial markets presents to the more heavily levered company (which would push our DDM up by an additional 23%); and

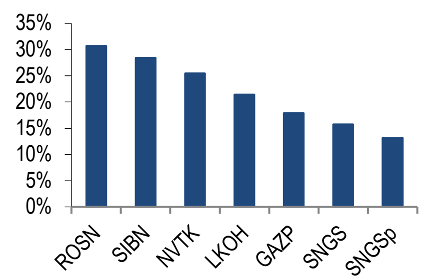
  c) We might also consider increasing somewhat our interim growth assumptions (2021-2029), as the industry sanctions as currently imposed are very specifically targeting the mid-term growth opportunities of the Russian oil sector, especially the offshore, a Rosneft bailiwick.

Figure 2. SurgutNG market cap vs. cash, $bn



Source: Datastream, Citi Research

Figure 3. DDM rise on 100bpt decrease in ERP



Source: Citi Research estimates

- **SurgutNG pref remains a Buy and a favourite of ours**; even though our TP drops 33% on the DDM switch, that's only a bit more than the average. Our new TP of $0.74/share still leaves an ETR of c26%. <u>We argue that SurgutNG prefs remain the premier defensive name in Russian oil & gas, and should be considered an option for investors wanting to limit their downside exposure while maintaining a position in Russian oil & gas.</u>

- **We downgrade SurgutNG ord to a high-conviction Sell,** as our TP suffers sharply under the DDM, dropping a larger-than-typical 40% to $0.47/sh even though we somewhat optimistically assume that by 2025 its dividend is brought up to the generous 40% enjoyed by the preferred. <u>We downgrade the stock to a Sell and expect it to continue to significantly underperform the rest of the Russian bluechip universe. We strongly recommend investors concentrate SurgutNG positions in the pref and, barring that, Lukoil, Gazpromneft, or Novatek.</u>

- **An interesting aside – DDM indicates SurgutNG should trade at a discount to its cash pile:** Our TPs indicate a total market cap for SurgutNG of $24bn, or c$11bn lower than the company's $35bn "cash pile". Already trading at a discount of c$6bn, the additional fall would more than all come from the common share, if realized. Therefore, one of our favourite relative valuation charts (Figure 2) by implication loses some of its validity.

DDM leverage to a 'risk-on' scenario

Our DDM valuations are very sensitive, of course, to the discount rate used, <u>but not equally so</u> (Figure 3). For example, should tensions ease and the ERP assigned to Russian equities by the market drop by 100 basis points across the board, Lukoil's DDM would rise by c21%, average for the group, but Novatek's would increase by 25% and Rosneft's and Gazpromneft's by 31%, due to those higher-growth companies having a larger part of their DDM value concentrated in the constant stage (2030). On the other hand, SurgutNG's preferred stock would likely be a laggard in any relief rally as, due to the front-loaded nature of its dividend stream, its DDM would rise only 13%.

Our 3-stage DDM model

In experience, a DDM is best used as a relative ranking tool rather than absolute valuation tool. Also, and the DDM as applied by investors often implies significant downside potential vs. the current market prices. However, with investor skepticism towards Russia running high, we think a fundamentally sound, rigorous valuation metric such as the DDM may be superior to multiples and DCF valuations on both an absolute and relative basis.

Valuing only that cash that flows directly to shareholders

What is a Dividend Discount Model? In short, a DDM model values only that cash flowing directly to shareholders via dividends, discounted by the cost of equity (CoE). Longer term, earnings and dividends are assumed to grow at a rate determined by the amount of earnings retained in the company multiplied by the average return on equity earned on that reinvested cash.

This is in contrast to widely used discounted cash flow (DCF) models, which value the cash thrown off by the company at its weighted average cost of capital (WACC, a mixture of the CoE and cost of debt), regardless of how it is used by management – to pay down debt, to pay dividends to shareholders, or to be reinvested into the business.

This difference is critical, as in addition to all of the fundamental work necessary to build a competent DCF, the analyst is forced by the DDM to make additional estimates of both what level of dividends management is likely to pay out and, more importantly, how well management is likely to reinvest earnings not paid out as dividends.

For our purposes we are using a 3-stage DDM model, including:

Adding an interim stage allows a DDM to better value higher-growth firms

1) **An explicit stage**, pulled from our full models running through 2020 (2017 for Gazprom, 2024 for Gazpromneft);

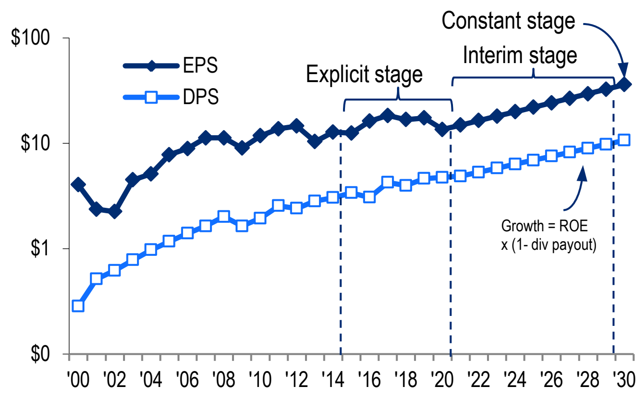
2) **An interim stage (2021-2029)**, in which we grow dividends at a rate determined by: a) the amount of earnings retained in the company (i.e., not paid out as dividends); and b) the attractiveness of the investment opportunities available to each company in the somewhat-visible medium term; and

3) **A constant growth stage** beginning in 2030, which via the Gordon Growth Model captures in a single year the PV of dividends from 2030 onwards (Figure 4). Our growth assumptions in this stage fall into a relatively narrow band for most companies, as over the long term we think they will have trouble differentiating themselves from one another.

The sensitivity of the DDM prompts us to spend a significant portion of this report walking through the derivation of our long-term assumptions

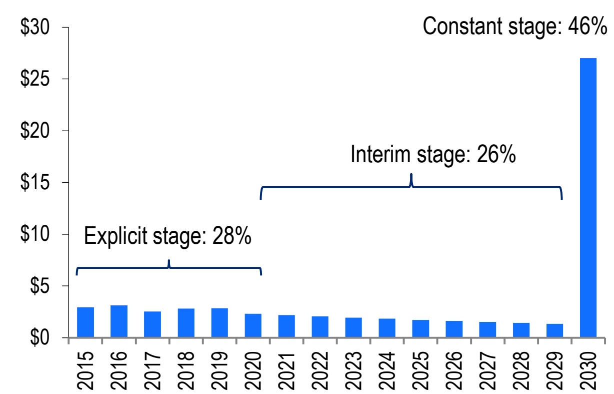
As is typical of both DCF and DDM models, the constant stage accounts for the bulk of the total calculated value for the stocks (Figure 5). It is for that reason we spend a large amount of effort on the normalization process (the methods by which we arrive at our earnings forecast for the final year of our explicit stage) and on determining the best inputs for the relatively few assumptions that drive EPS and DPS growth in the interim and constant stages.

Figure 4. EPS, DPS by stage of DDM model (Lukoil example, log scale)



Source: Company data, Citi Research estimates (from 2014)

Figure 5. Relative weight of PV/sh of dividends, Lukoil example, % of total



Source: Citi Research estimates

DDM by stage, in formulas

1) Explicit stage

Dividends for 2014-2020 fall out of our explicit company models, with the 2020 dividend providing the base for the next two stages. All dividends are discounted back to the present date using the estimated Cost of Equity (CoE) for the given company, where:

$$(1)\ CoE = Risk\ free\ rate + Equity\ risk\ premium, \text{ or}$$
$$CoE = RFR + ERP$$

2) Interim stage

Dividends are grown at a rate consistent with retained earnings (i.e., earnings not paid out as dividends) and the rate of return earned on that reinvested capital, such that:

$$(2)\ D_{2021} = D_{2020}\ x\ growth \text{ , and}$$

$$(3)\ g = ROE\ x\ (1 - dividend\ payout)$$

This is a nice and neat little formula. Unfortunately, we cannot use ROE as a direct input, as it is a function not only of field-level returns but of leverage, such that.

$$(4)\ ROE = \frac{Net\ Income}{Assets} * \frac{Assets}{Equity} = ROA * \frac{A}{E}$$

Breaking ROE down to ROA x leverage as we have is a step in the right direction, but ROA, being a function of Net Income, is also related to leverage and therefore is not a fully independent variable. Rather, we need to go further down to project-level IRRs and then – calculating the impact of our assumptions for leverage, interest rates, income tax rates, and the like – get back up to an ROA and then further back to an ROE we can use.

We do this in the exercise below, calculating ROA from a shorthand income statement and balance sheet. We then simplify the equation somewhat by substituting constants for some of the balance sheet ratios, basing those constants on both the Russian universe as well as the international peer group.

$$(5)\ \boldsymbol{ROA} = \left(\left(\boldsymbol{IRR} * \frac{\boldsymbol{LTAssets}}{\boldsymbol{TotAssets}}\right) - \boldsymbol{Interest\ rate} * \left(100\% - \frac{1}{\boldsymbol{A/E}} - \frac{\boldsymbol{OtherLTLiab}}{\boldsymbol{TotAssets}} - \frac{\boldsymbol{CurrLiabLessSTDebt}}{\boldsymbol{CurrAssets}} * \left(1 - \frac{\boldsymbol{LTAssets}}{\boldsymbol{TotAssets}}\right)\right)\right) * (1 - \boldsymbol{tax\ rate})$$

$$(6)\ \boldsymbol{ROA} = \left((\boldsymbol{IRR} * 75\%) - \boldsymbol{Interest\ rate} * \left(100\% - \frac{1}{\boldsymbol{A/E}} - 9\% - 31\% * (1 - 75\%)\right)\right) * (1 - 20\%)$$

$$(7)\ \boldsymbol{ROA} = \left((\boldsymbol{IRR} * 75\%) - \boldsymbol{Interest\ rate} * \left(83.3\% - \frac{1}{\boldsymbol{A/E}}\right)\right) * (1 - 20\%)$$

3) Constant stage

We calculate our constant stage value using the Gordon Growth model (see below), which we then discount back to today using the company's Cost of Equity.

Inputs for ROE and growth in the Constant Stage are calculated by the same methods – albeit perhaps with different inputs – as in the Interim Stage.

$$(8)\ \boldsymbol{Gordon\ Growth\ Model}: \boldsymbol{Price_0} = \frac{\boldsymbol{D_1}}{\boldsymbol{Cost\ of\ Equity} - \boldsymbol{g}} = \frac{\boldsymbol{D_1}}{\boldsymbol{CoE} - \boldsymbol{g}}$$

$$\text{or}: \boldsymbol{Price_{2030}} = \frac{\boldsymbol{D_{2031}}}{\boldsymbol{CoE} - \boldsymbol{g}} = \frac{\boldsymbol{D_{2030}} * (1 + \boldsymbol{g})}{\boldsymbol{CoE} - \boldsymbol{g}}$$

We devote a good bit of the rest of this report to how we determine our driving independent assumptions: Project-level IRRs, leverage ratios, and the like.

Where do we get our IRR, leverage, and other assumptions?

Determining key variables for growth

The key assumptions for our DDM valuations, beyond the normal year[2] DPS, are ROE and leverage. As explained above, however, ROE isn't sufficient, and we need to drill down further, first to ROAs and then further to IRRs at the field level. Before drilling down, however, we start by looking at what ROAs look like across the industry, allowing us to cross-check the results of our bottom-up work.

Benchmarking ROAs vs. history

Key drivers for a DDM: Normal (2020) dividend, payout ratio and ROE on reinvested capital

Historically, ROAs in the global oil & gas industry have averaged around 20% going back to the late 1980s (Figure 6). Our assumptions – which are based on IRRs we think companies can reasonably expect to reap in the field (see pg 12), leverage, and other inputs – give us long-term ROAs for our Russian oil & gas stocks of 4.9% to 8.2%, with the mean of 7.2% being very close to that historically observed number for the international peer set. (For a deeper look into oil company earnings, we'd suggest seeing the latest version of Alastair Syme's Oil Vision.)

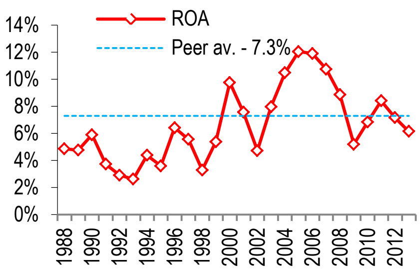
Russian ROAs have historically been noticeably above peer levels in the same oil price environment (Figure 8). However, we somewhat discount the idea that these historical returns will be fully replicable going forward, given the following:

[2] 2017 in the case of Gazprom, 2024 for Gazpromneft, and 2020 for all others

a) Returns were boosted due to core assets having been inherited from the companies' Soviet predecessors with low book values, likely well below replacement cost (particularly Gazprom);

b) Some companies acquired other key assets in the 1990s or early in the 2000s at prices that now look quite advantageous (Novatek's Yurkharovskoye field comes to mind). Such asset finds are very difficult to replicate today, and returns since c2004 have been boosted by the run-up in commodity prices. As costs in the oilfield adjust to the new reality marginal returns will come down (arguably this has already happened in the broader, global oil & gas industry).

Figure 6. International peer group historic ROAs



Source: Bloomberg, Citi Research
Note: Global peers = ExxonMobil, Chevron, ConocoPhillips, Hess, BP, RDShell, Total, ENI, BG, Repsol, and Statoil

That being said, the track record at least suggests that Russian oil & gas companies may be able to sustain a somewhat better-than-average return on total invested assets for an extended period of time.

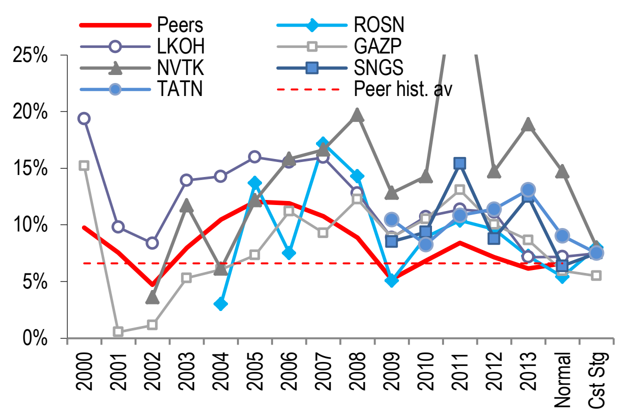
That view is supported by our opinion that domestic geologic resource base enjoyed by Russian oil & gas companies is much better than that available to most international oil majors. Those resources come with a flexible, actively managed tax regime (Figure 7) that should ensure that economically viable reserves remain available for Russian oil & gas companies for decades to come. In particular, we think West Siberia has the geological potential to remain a major global oil production center for decades even before its shale oil potential is taken into consideration.

Figure 7. An aside on the Russian oil tax system

The economics of the Russian oilfield are largely determined not by geological factors, but by taxation. With the government claiming c$70 on the standard barrel of exported Urals in a $100/bbl oil price environment, there is substantial room to adjust the tax burden to match the geological reality of the field in question. This is more than a theoretical hope, as the government in recent years has shown significant flexibility in granting tax breaks to projects (offshore oil, tight oil, large new greenfields such as Vankor, etc) that otherwise wouldn't clear internal hurdle rates.

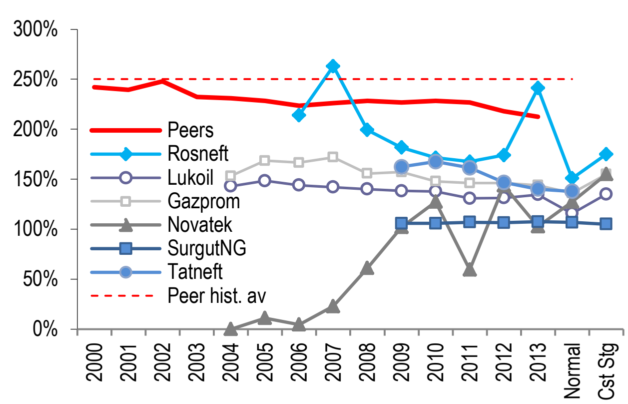
Source: Citi Research

Figure 8. Historical ROAs for Russian oil & gas companies, global peers



Source: Bloomberg, Citi Research
Notes: 1) ROA = net income/total assets; 2) Global peers = ExxonMobil, Chevron, ConocoPhillips, Hess, BP, RDShell, Total, ENI, BG, Repsol, and Statoil; 3) Normal year = 2017 for Gazprom, 2024 for Gazpromneft, 2020 for all others; 4) Cst Stg = Constant stage year of DDM, 2030

Figure 9. Historical leverage (A/E) for Russian oil & gas companies, global peers



Source: Bloomberg, Citi Research
Notes: 1) Leverage = Assets/Equity; 2) Normal year = 2017 for Gazprom, 2024 for Gazpromneft, 2020 for all others; 3) Cst Stg = Constant stage year of DDM, 2030

With all of that said, our assumptions imply that the average Russian oil & gas company can earn an ROA of c7.2%, in-line with the international peer group's historical returns.

However, our ROAs are not equal across the board (Figure 10):

Figure 10. ROA assumptions for Russian oil & gas

	ROA
Lukoil	7.9%
Rosneft	8.2%
Gazprom	4.9%
Novatek	8.1%
SurgutNG	6.9%
Average	**7.2%**

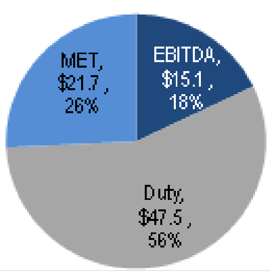
Source: Citi Research

- Rosneft, with its unique access to Russia's offshore oil licences[3] and status as the government's oil champion – presumably allowing it a platform to debate tax and other policies as necessary to improve its returns on the margin – comes out of our process outperforming that average ROA by c90 basis points, or 8.2%.
- Novatek, with its history of excellent returns on invested capital and strong political relationships, should, in our view, also be able to earn an ROA premium similar to that of Rosneft, which we estimate at 8.1%.
- Gazprom, on the other hand, with a long track record of heavy investments with little growth to show for it,[4] will likely underperform the average by c230bpts, for an ROA of 4.9%, on our estimates, in spite of the contribution from Gazpromneft, where we think returns will be closer to Rosneft's.

However, as we pointed out earlier, few investors speak in terms of ROAs, and in reality we need to be able to drill down to project-level IRRs and convert back to ROAs on a company-by-company basis. We tackle that task in the next section.

Projecting IRRs available in the Russian oil field

Figure 11. Rents on Russian exported barrel, $/bbl



Source: Citi Research estimates
Note: In a $100/bbl Urals environment

Russian oil production is extremely profitable. On our estimates, a typical barrel of oil produced, exported, and sold in Europe for $100 generates c$85 of rents (Figure 11). However, most of those rents, some $69/bbl or 85%, are captured by the government. While current earnings are constrained by this high tax burden, there are two positive aspects to this tax system:

- First, the tax burden is directly tied to the price of oil, and therefore oil companies have earnings volatility that is far lower than is suggested by the volatility in oil prices;
- Second, the very large tax take means that there is significant room for the government to lower tax rates as necessary to bring the next barrel of reserves over the economic threshold. Geological reserves are still plentiful in Russia, if in ever more complex formations, and the government in recent years has demonstrated a willingness – if grudging – to adjust the tax regime for new greenfields (Vankor, Talakan, et al) and even for more difficult to produce parts of existing fields (the tight oil tax breaks introduced last year).

The Russian government's tax policies for greenfield projects specifically target an IRR floor of 16.3%, which we understand to have been based upon a consultant study of long-term returns for international oil majors. While we have not been able to confirm the source, the government's target is reasonably close to the 16.0% historic return we calculate among our international peer group for EBIT/long-term assets (Figure 12).

[3] Gazprom also has access, but Rosneft has already locked up the bulk of the licences, and the size of offshore assets is much more material for Rosneft than for Gazprom.

[4] We argue that much of the capital invested by Gazprom in the past 8 years – the large investment into the Bovanenko field on the Yamal Peninsula and related transport infrastructure – should properly be classified as a slug of maintenance CAPEX rather than growth CAPEX. Still, the fact remains Gazprom has little growth to show for that investment.

Tax take of c70% means returns are set by tax policy

Assuming that EBIT/long-term assets is a reasonable proxy of the IRR returns targeted by the Russian government in setting tax policy (and we do not know the methodologies or driving assumptions under the models used by the Ministry of Finance to reach those IRRs), we can translate those returns into the ROA number (net income/total assets) needed by our DDM model.

The Russian government targets returns of 16.3% IRR

However, a targeted return on certain, targeted fields isn't necessarily sufficient, as we need to think a bit about both outsized returns and failed investments, and companies will have both in some number. Below we show the average IRR we think each of our companies is likely to earn, along with the logic behind that number:

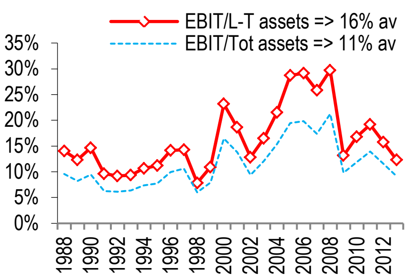
While any changes in tax policy inspired by Rosneft's input *may* help all oil producers, they almost certainly will help Rosneft.

- **Rosneft – 15.0% average IRR:** We think that, all things being equal, Rosneft is likely to somewhat outperform the government target of 16.3% on its average *successful* project due to its superior position as the state-owned oil champion in influencing the tax regime (Rosneft has been visibly involved in the development of the government's recent "tax maneuver" – see link).

  However, the company will at times make mistakes, be the victim of a field that fails to live up to its geological prospects, or otherwise miss investment targets, bringing down the overall average IRR. If we assume that 90% of Rosneft's projects by capital allocated are 'successful', earning a bit over 16.3%, and the remaining 10% are complete failures, earning 0%, then the weighted average return would be around 15.0%.

- We admit this methodology is a bit rough, but we think the chances of Russian oil companies earning above the government target on the average investment is not very high, and this is the best framework we have come up with yet to put those potential returns into context.

Figure 12. Peer group EBIT/long-term assets



Source: Citi Research
Global peers = ExxonMobil, Chevron, ConocoPhillips, Hess, BP, RDShell, Total, ENI, BG, Repsol, and Statoil

- **Lukoil – 14.0% average IRR:** We think Lukoil will start off at a slightly disadvantaged position vs. Rosneft in terms of returns potential, given the state-owned company's influence on policy. Assuming a 15.5% IRR on successful projects and the same 10% miss rate we assume for Rosneft (Lukoil's investments in European refineries and dry holes offshore Africa attest to the fact that no company gets them all right, but we have no reason to think that Lukoil's mistakes will be a larger part of the whole than they will be for Rosneft) gives an average 14.0% IRR on Lukoil's growth capital investments, which we use in both the interim and constant stages of our Lukoil DDM.

- **SurgutNG – 10.5% average IRR:** We think SurgutNG will earn returns comparable to Lukoil's for investments *made in the field*. However, as we assume the company will also continue to build its cash pile, the weighted average return will fall as the lower-risk returns available for long-term bank deposits are averaged in with higher-risk returns the company can earn in the field. Assuming that 33% of reinvestment is into cash earning Russia's 2-year forward risk-free rate plus 150bpts (or c4.5%, very near what Citi's Banking team estimates a corporate client can get currently for large, long-term bank deposits in USD) and the rest at the standard field-level IRR assumption of 14.0% we use for Lukoil, SurgutNG's weighted IRR comes in at 10.5%.

- **Novatek – 15.0% average IRR:** We argue that Novatek's returns should be put on a par with Rosneft's over the medium to long term, which is a balance of the following observations:

  – On the one hand Novatek's relationship with the government, while excellent, will likely fade, as it is based on the personal relationships and political management skills of its two key shareholders, founder and CEO Leonid Mikhelson and long-time Putin confidant Gennady Timchenko. Over time the state's status as the Rosneft majority owner is likely to prove more stable than relationships between key personalities, who in the longer run will depart from the company.

  – On the other hand, Novatek has an excellent track record of investing shrewdly and efficiently (at 30%, Novatek's ROE over the past 5 years has been more than double the average of both its Russian and international peers). In the end, we assume those forces balance out, and give Novatek a 15.0% IRR in the constant stage.

Figure 13. Gazprom IRR assumptions

	$bn	IRR
2020 total reinvestment	**$21.6**	**9.6%**
o/w Gazpromneft	$2.6	15.0%
o/w China expansion	$7.5	12.5%
o/w pipeline expansion	$5.0	5.0%
o/w other	$6.5	7.5%

Source: Citi Research

- **Gazprom – 9.6% average IRR:** Our Gazprom IRR assumption is close to that of SurgutNG but without the excuse of investing heavily in safe, low-yield cash deposits. Rather, we compile this number by making a number of assumptions about the effectiveness of Gazprom's growth CAPEX by likely investment target (Figure 13), the track record of which is less than stellar (albeit probably not as bad as many in the market assume, we think). This assumption is crucial – were we to give Gazprom the same 14% IRR assumption that we assign to Lukoil, our DDM would rise by c60%.

- **Gazpromneft – 15.0% average IRR:** As the other state-owned oil company (albeit held via Gazprom) with offshore oil licences and numerous greenfield opportunities (albeit on a smaller scale), Gazpromneft is most closely comparable with Rosneft, and we therefore equalize our IRR assumption with that company.

Getting from field-level IRRs to ROA

Now that we have IRR assumptions for each of our companies, we need to convert them into the ROAs we need for our DDM model. In Figure 14 below we make a more intuitive presentation of formula 5 shown on page 9, which takes IRR, leverage, and a few other assumptions and, using a standardized $100 of equity for illustration purposes, generates an indicative ROA.

For example, our 14.0% IRR assumption (row 3) for Lukoil, given a 135% A/E leverage ratio, a 6.0% cost of debt (c200 basis points above the sovereign 5-year USD rate), and a handful of typical balance sheet ratios (long-term assets to total assets, long-term liabilities to total assets, etc.), generates an ROA of 7.9%.

Figure 14. Getting from IRR to ROA in detail – Normalized returns given a standard equity commitment

		LKOH	ROSN	SNGS	NVTK	GAZP	SIBN
A/E: input	(1)	135%	155%	105%	155%	155%	155%
LT assets/Tot assets: input	(2)	75%	75%	75%	75%	75%	75%
IRR (EBIT/LT assets): input	(3)	14.0%	15.0%	10.5%	15.0%	9.6%	15.0%
EBIT/Tot assets (output): (7)/(14)	(4)	10.5%	11.3%	7.9%	11.3%	7.2%	11.3%
ROE (output): (11)/(19)	(5)	10.7%	12.7%	7.2%	12.6%	7.6%	12.6%
ROA (output): (11)/(14)	**(6)**	**7.9%**	**8.2%**	**6.9%**	**8.1%**	**4.9%**	**8.1%**
EBIT: (3)*(13)	(7)	$14.1	$17.5	$8.2	$17.5	$11.1	$17.5
Interest rate: input	(8)	6.0%	5.5%	6.0%	6.0%	5.5%	6.0%
Interest: (8)*(16)	(9)	$0.7	$1.6	-$0.8	$1.7	$1.6	$1.7
PBT: (9)-(7)	(10)	$13.4	$15.9	$9.0	$15.7	$9.5	$15.7
NI: (10)*(1-20%)	(11)	$10.7	$12.7	$7.2	$12.6	$7.6	$12.6
Curr assets: (14)-(13)	(12)	$34	$39	$26	$39	$39	$39
LT assets: (14)*(2)	(13)	$101	$116	$79	$116	$116	$116
Total assets: (19)*(1)	(14)	$135	$155	$105	$155	$155	$155
Curr liab less ST debt: (12)*31%	(15)	$10	$12	$8	$12	$12	$12
Curr, L-T debt: (18)-(17)-(15)	(16)	$12	$29	-$13	$29	$29	$29
Other L-T liab: (14)*9%	(17)	$12	$14	$9	$14	$14	$14
Total Liabilities: (19)-(14)	(18)	$35	$55	$5	$55	$55	$55
Equity: Input at $100	(19)	$100	$100	$100	$100	$100	$100
Total assets & liab: (18)+(19)	(20)	$135	$155	$105	$155	$155	$155

Source: Citi Research estimates
Note: SNGS represents SurgutNG as a whole in this table rather than just the common stock; SIBN = Gazpromneft

Why leverage (A/E) can be a differentiator:

Leverage as important as returns for growth rates…

We are now back to formula 4, reproduced below, which allows us to use our hard-won ROAs to get to an ROE and, with one more step, to the all-important growth forecast.

$$(4)\ ROE = ROA * \frac{A}{E}$$

The first thing we want to point out is that, mathematically speaking, leverage can be almost as important in determining a return on equity as the ROA (i.e., the underlying project level returns). The only thing that keeps it from being as important is the circularity leverage exhibits on ROA – that is, higher leverage lowers to some extent ROA due to interest costs.

As balance sheet policies are more transparent than future investment returns, we have a higher degree of confidence in our spread of ROEs across our universe to the extent they depend upon leverage than to the extent they depend upon ROAs. Therefore, a good bit of our DDM value rests on our judgment of a company's willingness to utilize its balance sheet as well as its ability to generate returns in growth projects.

Figure 15. A/E (net income/tot assets)

	Historical	Interim, constant stages
Peers	**240%**	
ROSN	187%	155%
LKOH	134%	135%
GAZP	148%	155%
NVTK	169%	155%
SNGS	106%	105%
SIBN	163%	155%

Source: Company data (historical), Citi Research estimates (interim, constant stages)

It is in that light that the advantage that Rosneft's large offshore opportunity can best be understood: It is not necessarily so much the superior returns those projects may offer – although the new offshore tax regime passed in 2013 leads us to think returns will be at least adequate and potentially quite good – but rather that those licences may afford the company merely the opportunity to employ larger amounts of capital at adequate rates of return, creating a significantly large NPV.

Over the last 25 years, the international peer group we benchmark against has had an average A/E leverage of c240% (Figures 15, 9). Historically, most Russian companies have been well below this leverage number, barring Rosneft

immediately after its acquisition of the Yukos assets in 2007 and the TNK-BP acquisition in 2013 (i.e., currently).

For most of our companies, we assume long-term leverage ratios remain close to the historical standard for the Russian oil & gas industry of c155%. Due to sanctions, this group includes Rosneft in spite of that company's large offshore opportunity, as we have the company's leverage decreasing in the explicit stage. If and when sanctions are lifted, we would be tempted to lift our leverage assumption at least in the interim period, and potentially even in the constant stage, as the development of the Kara Sea alone would require investment measured in the tens of billions of dollars over the next 10-15 years, leaving aside Rosneft's other offshore licences. Were we to increase both stages' A/E assumption from 155% to 165%, say, our Rosneft DDM would rise by c9%, a significant amount.

Note that Lukoil's reticence[5] to more aggressively utilize its balance sheet is, we think, is a contributor to the relatively low multiples it is trading at on the market. For example, our DDM value of $63.3/sh implies a P/E on 2014E EPS of c4.3x. Were we to increase our interim and constant-stage leverage assumptions from 135% to the 155% we use for Rosneft and most other Russian oil & gas companies, Lukoil's DDM value would climb to c$69/sh, pushing its implied multiple to 4.6x. A move to a 200% leverage ratio – still well below Rosneft's recent levels and those of the international peer group – would see Lukoil's DDM-implied P/E jump to c5.9x.[6]

Implied ROE assumptions

Return on Assets (ROA): Not all opportunity sets are equal

Figure 16 summarizes our constant stage growth forecasts for our universe based on the IRR, leverage, and the other driving inputs we explored above. Note that, while we have the average Russian company earning returns on assets similar to those in the international peer group, lower leverage means the returns on equity for the Russians are noticeably lower, enough so that the implied growth rates in earnings and dividends lag the international peers in spite of the Russians retaining and reinvesting noticeably more earnings.

Figure 16. Constant stage ROEs, payout ratios, dividend growth rates

	ROA*	x	A/E	= ROE	* (1-payout)	= growth**	Notes
Peers: Historical***	7.3%		240%	17.5%	* (1-40%)	10.4%	Implied growth rate from historical averages unsustainable, well above econ growth + inflation
Peers: More likely	7.3%		200%	14.6%	* (1-50%)	7.3%	Increasing payout, lowering leverage (amount of capital employed) brings growth in-line.
Rosneft	8.2%		155%	12.7%	* (1-35%)	8.3%	ROA above average given preferred access to large resource base, influence on tax regime.
Lukoil	7.9%		135%	10.7%	* (1-33%)	7.2%	Standard Russian ROA + low leverage per corporate policy = growth a bit below peers'.
Gazprom	4.9%		155%	7.6%	* (1-20%)	6.1%	Low ROA via inefficient CAPEX + but low payout and mid-range leverage = average growth
Novatek	8.1%		155%	12.6%	* (1-40%)	7.6%	Above average ROA drives higher growth
SurgutNG	6.9%		105%	7.2%	* (1-40%)	4.3%	Average ROA, no leverage, assume equalized 40% payout long-term = growth barely > inflation
Gazpromneft	8.1%		155%	12.6%	* (1-35%)	8.2%	As another state-owned oil company with offshore licenses, assume returns similar to Rosneft

Source: Citi Research
* ROA = net income/total assets; if this seems low, remember it's an after-tax number, and encompasses returns on all assets, operating capital included, rather than just returns on field-level CAPEX, as well as financing costs. Later in this note we walk through how to convert from project-level IRRs to ROAs.
** DPS growth = ROE x (1 - payout ratio). This is a theoretical, implied number rather than historical fact
*** Historical data 1985 to 2013 for ExxonMobil, Chevron, ConocoPhillips, Hess, BP, RDShell, Total, ENI, BG, Repsol, and Statoil via Bloomberg

[5] Leonid Fedoun, Lukoil's second-largest shareholder, indicated the company might consider actually building up a cash reserve on the company's balance sheet, making it even stronger than it has been historically.

[6] However, if we were to maintain Lukoil's current payout policy while raising leverage, we would of course have to revisit our return assumptions, as it is not a given that Lukoil would be able to reinvest the extra capital at the same IRR as we are already assuming in our base case. If those opportunities are not available, then Lukoil management could increase both leverage and payout, thereby creating more value for investors out of the same basket of investment opportunities in the field.

The interim stage – our assumptions

An oft-cited criticism of the DDM methodology is its difficulty with valuing fast-growing firms. In spite of this, we think we can use the DDM on Russian oil & gas firms for two reasons:

1) Large oil & gas firms have trouble growing much faster than the nominal rate of growth of the entire economy for any appreciable length of time. The Russian oil & gas names are generally no exception. Although Rosneft, Novatek, and Gazpromneft all have ambitious growth programs, they have finite lives before the business will settle back down to growth rates near overall, nominal GDP levels.

Q: Why use an interim stage?

A: Because some companies have obviously better growth opportunities than others in the medium term (5-15 years)

2) We incorporate an interim stage into our model, allowing us to project faster-than-typical growth for a finite period of time to account for the visible growth opportunities companies may have in their portfolios.

- **Novatek's** management has a strong track record of investing capital at high rates of return, and the company's liquids and LNG opportunities, backed by a large, as-yet undeveloped resource base on the Yamal and Gydan peninsulas, should allow it to maintain a high rate of growth (for a largish oil & gas company) well into the next decade. Indeed, in recent days the company received clearance to export LNG from three trains in addition to the three currently under construction in the Yamal LNG project. As such, our interim stage growth rate of 8.2% outstrips our long-term growth rate of 7.6%.

- **Rosneft's** role as the state-owned oil champion, and the fact that it controls upwards of 90% of the offshore acreage issued by the government – including the bulk of the Kara Sea, the most attractive region available – gives the company the potential for strong growth not only in the 2020s, but arguably even beyond that time period.

  However, with Rosneft currently under sanctions that specifically target those opportunities, we are being very modest in our interim assumptions for Rosneft, assuming only that the company will earn an 8.7% ROA in the interim period, 50bpts above our long-term assumption, the equivalent of an average field-level IRR c80bpts higher than our constant-stage assumption, while we hold leverage constant at our standard Russian A/E level of 155%.

  Should sanctions be lifted, we would likely be inclined to account for that by lifting leverage in the interim period significantly rather than returns, as the full development of the Kara Sea and other offshore regions would likely prompt Rosneft to more fully utilize its balance sheet to finance the growth. This would boost our DDM valuation noticeably. By way of sensitivity, increasing leverage from 155% to 200% for the interim period only would boost growth to 13% pa and add c12% to our DDM.

- For several companies – **Lukoil, Gazprom, and Gazpromneft** – our interim and constant stage assumptions are one and the same, as we see no particular reason to think their medium-term growth prospects are materially different from their long-term prospects.

  – That could change for **Gazprom**, however, should the company land one or two more Chinese export contracts, but we will wait for them to be achieved before addressing that possibility in our interim stage assumptions.

– **Gazpromneft** likewise has a portfolio of well-defined ONSHORE growth projects. However, we are fully capturing those in the explicit model, which unlike our other models ends in 2024, allowing us to begin using our long-term assumptions for returns and growth from that point.

– For **SurgutNG** we use the same leverage and ROA assets in the interim stage that we use in the constant stage. However, our ramp-up of the dividend payout on the common share by 2025E means that growth is somewhat lower in the constant stage than in the interim stage (4.3%pa vs. 5.8%pa, respectively).

All of the above being said, we do think Russian oil companies in general have substantial geological resources at their disposal that, in the right tax environment, could provide reasonably attractive if modest growth opportunities for an extended period of time. Please see "Growth opportunities in Russian oil & gas" on pg 22 for a deeper discussion of the issue.

The constant stage – our assumptions

Determining long-term growth rates

In Figure 16 above we showed the long-term growth rates we end up using in our DDM models by company given our inputs. Below we delve a bit into the thinking behind them:

- The international peer group provides us a base line against which we can judge the rationality of our forward-looking assumptions for the Russian oil & gas companies. However, using average ROA and A/E numbers seen over the last quarter century for the long term even for the international companies would likely result in growth rates that would prove unsustainable, exceeding handily the nominal growth rate of the global economy of, say, 3.5% and US dollar inflation of 3%. We think a more likely outcome for those companies as a group going forward is a similar ROA, but somewhat lower leverage and higher payout ratios, which would put the overall industry's growth rate in-line with the nominal rate of global economic growth.

- Our **Lukoil** long-term growth rate of 7.2% is roughly equal to that of nominal global GDP growth, and thus passes the common sense test. This confirms somewhat our use of Lukoil as our benchmark for Russia – the archetypical Russian oil company.

- **Rosneft's** 8.3% growth – based on an ROA of 8.2%, leverage of 155%, and a payout ratio of 35% – outstrips that international peer number of 7.3% and the 7.2% of Lukoil, its most comparable Russian peer. We think this is defensible given Rosneft's preferential access to an immense resource base, which should allow it to run with a lower payout ratio and higher leverage – i.e. to employ more capital at reasonable rates of return – than most of its Russian peers. Additionally, management has visible influence on the Russian oil tax regime, which is the single largest determinate of profitability in the Russian oilfield, allowing it to somewhat out-earn its Russian peers on a long-term basis.

- **Gazprom's** growth rate of 6.1% is roughly equal to its Russian peers' levels only because we have the company retraining its current low payout ratio of c17.5%[7] of nominal IFRS net income, or c20% of our adjusted 2020 net income. This

[7] Gazprom's actual policy is to pay 25% of parent net income under Russian Accounting Standards (RAS). However, the lack of full consolidation means that RAS operating profit and net income are usually c70% of IFRS levels, implying an effective IFRS payout ratio of c17.5%.

means the company is employing a larger-than-normal amount of capital to achieve that level of growth, which is reflected in its 7.6% implied ROE.

- **Novatek's** long-term growth rate of 7.6% lags Rosneft's but somewhat exceeds that of nominal global GDP growth. As with Rosneft, we see Novatek having superior access to assets, with growth over the medium and even long term being tied to its Yamal LNG project and the resources already secured on the Yamal and nearby Gydan peninsulas. The only differentiator we see with Rosneft in the terms set out in Figure 16 is this: However good Novatek's access to Russia's resource base, Rosneft's is at least a little better, with this being reflected in Rosneft being able to consistently dedicate a bit more capital to investment via a lower payout ratio.

- **SurgutNG's** implied long-term growth rate of 4.3% is below that of both its Russian peers and the global nominal, USD GDP growth rate. Indeed, it only marginally outstrips USD inflation. While we have the company earning the same ROA on capital invested into the field as Lukoil – the company is well run on an operational level, but like Lukoil has predominantly old fields in West Siberia with only a smattering of new licences – management's penchant to allow cash on the balance sheet with effectively no leverage[8] limits the amount of capital available for reinvestment and, simultaneously, reduces the average return.

  This growth number is influenced by our assumption that SurgutNG will eventually raise the payout ratio on the common shares to 40%, matching the ratio set forth in the company's charter for the smaller amount of preferred shares. Were the company to keep the current payout policy on commons, the DDM value for the prefs would climb even as it would fall for the commons. This is because, even with the extra cash likely going into bank deposits rather than higher-return projects in the field, earnings would nonetheless grow faster than they would otherwise, and the prefs are guaranteed a 40% payout of pro-rata EPS by the company's charter.

Determining payout ratios

A DDM valuation is largely indifferent to the payout ratio assumed, provided that the company is earning ROEs on reinvested funds near its cost of equity. However, for those companies that are earning materially above or below that level, dividend payout policy can have a negligible to profound effect on valuation.

On the face of it, determining a plausible payout assumption should be relatively straightforward, reflecting both current dividend policies as well as plausible adjustments to them long term. However, in some cases our normalization process of adjusting DD&A to replacement cost levels affects effective vs. book payout ratios, requiring an adjustment to the payout ratio to get the expected same dividend the company is likely to pay. In other words, applying Gazprom's effective 17.5% IFRS payout to a normalized EPS in 2020 may lead to an undershoot in payout due to our significant increase in DD&A.

Note that constant-stage ROEs of Rosneft and Novatek are near the long-term cost of equity of 12.8% for those companies. This means that their DDM valuations are not very sensitive to this assumption, as the model is near indifferent to what the company does with the marginal dollar, retaining and reinvesting it or paying it out as a dividend. Even Lukoil is only marginally sensitive to payout assumptions at these risk levels, with a higher payout raising the DDM value only modestly.

[8] The 105% leverage is only held up above 100% by long-term tax liabilities.

However, the effect of payout decisions will become more important if Russian market risk moves appreciably from these levels. If risk levels were to fall, for example, Lukoil's DDM would remain indifferent, and Novatek and Rosneft valuations would rise with *lower* dividend payout assumptions.[9]

Note that we assume companies engage in no share buybacks, instead choosing to return cash to investors only via dividends, although buybacks have been done by Lukoil and Novatek in the past.

- We set **Lukoil's** payout ratio at 33% in both the interim and constant stages, which is effectively an extrapolation of the dividend policy we see being in effect now and in the near future. In 2013 Lukoil declared RUB110/sh (c$3.45/sh) of dividends on 2013 earnings, a 25% payout on adjusted earnings of $13.8/sh[10]. However, were we to normalize 2013 earnings to account for a real $9/bbl oil replacement cost, which we do in our 2020 normalized year, adjusted EPS would have dropped to c$11.0/sh, pushing up the payout to c31%.

  Lukoil will convert to IFRS accounting from US GAAP accounting for the 2015 fiscal year, as required by Russian law. Rosneft's experience shows that IFRS DD&A calculations can be higher than US GAAP calculations, so we may see Lukoil's reported net income drop even as its dividend – assuming that management is still using a policy of minimum 15% increase in RUB/sh at that time, which we think quite possible – may continue to climb, boosting reported payout sooner rather than later.

- **Rosneft's** DD&A under IFRS is currently not appreciably far away from where we'd expect it to be on a full-replacement cost basis, being close to where we see its current CAPEX per produced barrel in the upstream at c$7/bbl. Therefore, we see no need to adjust our payout ratios for accounting differentials. We project Rosneft maintaining its current 25% of IFRS net income policy through the end of the next decade at the least, increasing to 35% in the 2030 constant stage to get long-term growth ratios closer to nominal global GDP growth (although still outstripping it, as we think Rosneft's massive resource potential implies that it can take market share from mature players for an extended period of time).

- **Gazprom**, we assume, will keep its current effective 17.5% of IFRS (25% of RAS) official net income policy for both the interim and constant stages. We adjust this number modestly for our DD&A normalization, boosting the payout to our adjusted IFRS net income number to 20%.

  Unlike Rosneft and Novatek, Gazprom's marginal ROE of 7.6% is well below the long-term CoE of 12.8%, so the DDM is quite sensitive to payout policy. Were the company to stick to the official plan and increase payouts to 25% of IFRS net income in 2016 (on 2015 earnings) – which we now somewhat doubt will happen after long having been optimists on that point – then the effective payout would actually be c30% on our accounting, which would add c26% to our DDM valuation. Increasing the nominal payout to 35% of IFRS, which the Ministry of

[9] There is a reality check here, though, as no company can reinvest all earnings at high returns indefinitely, else it will grow to be the entire global economy in time. At some point all companies, no matter how well-run, begin to run short of investment opportunities relative to their earnings, and have to make the decision either to increase dividends or invest in lower-return, value-destructive opportunities.

[10] Lukoil booked $10.4 per net share, but booked $2.5bn of write-downs in 4Q13. Backing out those non-cash one-offs, the EPS were closer to $13.8/sh.

Finance has in its 2017 fiscal budget, would boost the DDM by c50%, although we consider such a strong policy highly unlikely in the foreseeable future.

- We assume **Novatek** will pay out 40% long-term vs. 30% today, as we think the company's ability to reinvest the funds it generates will decrease as its earnings climb, especially once the current resource base on the Yamal and Gydan peninsulas is fully developed in the interim period. As with Rosneft and Lukoil, Novatek's cost of equity is close enough to its marginal ROE that the DDM model does not react strongly to this assumption change.

- **SurgutNG** is something of a special case – we assume the company's preferred share will continue to get the 40% payout of pro-rata EPS[11] dictated by the company's charter, but that the common will continue to get substantially less than that for another decade. We then somewhat generously assume that the payout on the common share will be equalized with that on the preferred share beginning in 2025. Our SurgutNG payout ratios require no substantial adjustments for DD&A normalization.

- **Gazpromneft**, unlike parent Gazprom, currently pays out 25% of IFRS net income as dividends, in-line with stated government policy and state-owned oil peer Rosneft. We therefore equalize our assumptions with those for Rosneft, bumping payout slightly to 35% in 2030.

Determining discount rates

Figure 17. Base cost of equity workup (2028)

	Russia	DM
Risk-free rate (2021)	5.8%	2.6%
ERP	7.0%	4.2%
Base cost of equity	12.8%	6.7%

Source: Bloomberg, Damodaran,[12] Citi Research

Our base, long-term cost of equity (CoE) for Russian oil & gas companies based on the following:

- The Russian risk-free rate, for which we the Russian sovereign 2028 USD-denominated Eurobond yield, currently at c5.8% (Figure 17), some 323 basis points above the equivalent US yield. Note that at 299 basis points, the spread over US treasuries has increased by 82 basis points since the start of the year (Figure 19), although it has come in somewhat from the 342bpts hit in April and the 335bpts seen on September1st.

- An Equity Risk Premium (ERP) of 700 basis points for almost all companies, which is 285 basis points above a standard 4.2% ERP for Developed Markets gleaned from the available academic research.[13] Those two exceptions are: a) Rosneft, where we add another 50bpts in an attempt to account for the additional risk the financial sanctions carry for that company, given its relatively heavy debt load; and b) SurgutNG preferred shares, where we take off 100bpts vs. the standard to help account for the high quality of its guaranteed 40% dividend payout of pro-rata EPS, as well as make an adjustment for the lower risk of earnings associated with its c$35bn cash position.

ERPs in general are open to much debate and disagreement, and our 700bpt base ERP for Russian equities is no exception. However, we think the combined base cost of equity for Russian equities we arrive at of 12.8% (608 basis points above the equivalent cost of equity we calculate for DM stocks in Figure 17) will be acceptable to most observers. Note that this summer we raised our ERPs to account for the elevated risks we see in the Russian market because of the Ukrainian crisis (link to

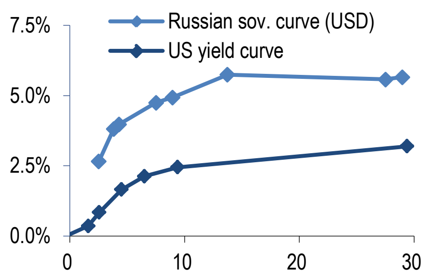
[11] Pro-rata EPS is net income divided by all shares outstanding, ord and pref combined.

[12] http://people.stern.nyu.edu/adamodar/pdfiles/papers/ERP2012.pdf: We take our DM ERP as the average of the arithmetic and geometric means of world ERPs (3.5% and 4.8%, respectively) found on page 31.

[13] Damodaren http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html

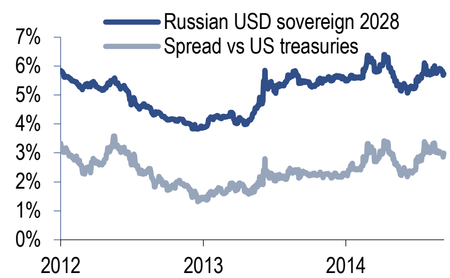
note), and in the event of a crisis resolution we'd be inclined to bring it back down at least somewhat.

Figure 18. Russian vs. US USD yield curve



Source: Bloomberg, Citi Research

Figure 19. Historical Russian sovereign yields, %



Source: Bloomberg, Citi Research

Growth opportunities in Russian oil & gas

While our long-term growth rates are somewhat theoretical, being formulaically based on historic returns on assets, leverage, and payout ratios, we think Russian oil & gas companies generally have the investment opportunities necessary to support that growth in the real world. We are of the general opinion that Russia's major oil & gas provinces, principally West Siberia, hold more than enough hydrocarbons to sustain current production levels all but indefinitely, although adjustments to the tax code or further steady advances in technology will be required to keep the marginal barrel economic.

Indeed, we think Russia's proved reserves estimate of 93bn barrels is likely a conservative estimate. [14] Per our conversations with geologists and auditors familiar with the state of Russian reserve accounting, the average Russian oil company's proved reserve estimates assume a recovery factor of maybe 32%. By contrast, we think that, using currently available technology and a tax regime not significantly different than that currently in effect today, recovery factors of 40% to 45% should be readily achievable in Russia's conventional horizons, especially in West Siberia.

The opportunities inherent in Russia's multiple shale plays (Bazhenov, Domanik, et al) fall into a different category, and should with time (and the eventual lifting of sanctions) provide further upside to economically recoverable reserves. This potential for "behind-the-pipe" reserve additions can be seen in the 2P[15] reserve ratios for Rosneft (35 years) and Lukoil (28 years), with 3P reserves holding out the possibility of further expansions of proved reserves (Figure 20).

Figure 20. Russian bluechip reserve ratios, years

	1P	2P	3P
Lukoil - oil (SEC)	19.9	27.9	32.5
Lukoil - gas (SEC)	26.4	37.0	40.4
Lukoil - total (SEC)	**21.2**	**29.2**	**33.6**
	1P	**2P**	**3P**
Rosneft - oil (PRMS)	20.1	35.2	50.2
Rosneft - gas (PRMS)	39.5	65.2	85.5
Rosneft - total (PRMS)	**23.1**	**39.9**	**55.8**
Rosneft - oil (SEC)	16.4		
Rosneft - gas (SEC)	27.1		
Rosneft - total (SEC)	**18.1**		
	1P	**2P**	**3P**
Gazprom - oil (PRMS)	27.2	47.6	n/a
Gazprom - gas (PRMS)	38.8	41.1	n/a
Gazprom - total (PRMS)	**37.3**	**46.8**	n/a
	1P	**2P**	**3P**
Novatek - oil (PRMS)	44.2	73.5	112.1
Novatek - gas (PRMS)	41.2	60.1	73.0
Novatek - total (PRMS)	**41.5**	**61.4**	**76.8**
Novatek - oil (SEC)	32.6		
Novatek - gas (SEC)	33.5		
Novatek - total (SEC)	**33.4**		

Source: Citi Research

The potential for additions to proved reserves via increased recovery ratios, when combined with the existing reserve ratios of c24 years for the country as a whole (and significantly more for some companies), gives the Russian oil industry a relatively secure future on the E&P side of the business.

Not all visible growth necessarily included in explicit models

Note that we are not necessarily trying to encompass all known, major projects for our companies into our explicit models. For example:

[14] 2014 version of BP's Statistical Review of World Energy

[15] 2P = Proved + Probable, while 3P = Proved + Probable + Possible

- **Gazprom's** recently-signed Chinese export contract won't see volumes fully ramped up until 2025 at the least and – if the contract is expanded from the initial 38bcm to 60bcm or more – the ramp-up period would likely run to 2030 or even beyond.

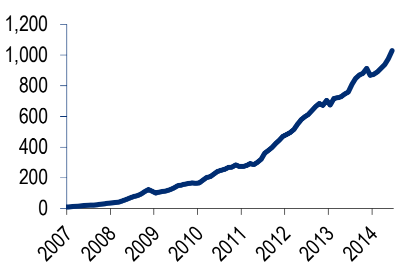
  Instead, we effectively assume the ramp-up of Chinese deliveries underpin the growth assumptions of our interim stage. If Chinese deliveries max out at 38bcm, they could account for c20%, while if they hit 60bcm of exports by 2030 they could account for up to c50% of our forecast earnings growth in the interim stage as well as much of the capital that will be reinvested in the period. If the 30bcm Western Route contract with China gets signed – which seems quite possible to us – Chinese sales could account for 75% of all of the net income growth that occurs in the interim stage of our model.

- **Rosneft's** explicit period, which ends in 2020, does include the ramp-up in output from its visible on-shore projects (the Vankor Cluster, Yurubcheno-Tokhomskoye, the refinery upgrades), but leaves the very substantial upside potential in its offshore licences – where production is unlikely to start before 2020 – to be captured by the interim stage growth rates. However, due to sanctions targeting the offshore, we only partially account for that potential even so (see pg 33).

- However, we DO include **Novatek's** Yamal LNG in our explicit period, extending our model out to 2020 to specifically capture the ramp-up of all three trains. In spite of that, we still expect Novatek to have better-than-average interim growth opportunities on the base of its Gydan and, to some extent, Yamal resources not committed to Yamal LNG.

- We also include all of **Gazpromneft's** large slate medium-term onshore growth projects into our explicit stage, which we extend to 2024 for the purpose, but not its offshore acreage.

Figure 21. Bakken oil production, kbd



Source: Citi Research

The mid-term growth opportunities we see:

- **Tight oil:** The latest version of Russia's "tax maneuver" submitted to the Duma (parliament) is likely to be signed into law by year-end, and will likely expand substantially the tax breaks for shale oil production, making, we think, the chances of a full-on shale revolution in the Russian oilfield much more likely, assuming EU and US sanctions on shale oil technology are lifted in the medium term. Of all of the growth targets for Russia's oil producers, this appears to be the most promising outside of the offshore opportunity (which is largely material only to Rosneft and, possibly, Gazpromneft), both because the returns may well turn out to be more than acceptable (link), and because the amount of capital that could be deployed is potentially very large.

  Running the numbers on shale oil production

  Returns: Assuming a 1,000bpd initial flow rate (optimistic but potentially achievable, we think) and a per-well cost of $8mn (potentially conservative on the high side), under the current tax regime we calculate a shale well in Russia might earn an IRR of c23%. Under the latest "tax maneuver" proposal, however, the returns on that same well could jump to c48%, we estimate.

  Should the initial production rate be a more easily achieved 700bpd rather than 1,000pbd, the well's IRR would still come in comfortably above a 20% hurdle rate, we calculate, under the proposed tax regime.

Over time, we'd expect the government to adjust the tax regime to ensure the major shale plays are profitable enough to warrant significant investment and economic growth, but not so profitable as to pull activity away from more lucrative (from a tax point of view) conventional projects or to leave more returns on the table than necessary. Therefore, we would not pencil in a 40%+ returns on a large shale effort for the Russian oil companies in the long run.

Shale can absorb an immense amount of capital

Capital requirements: Shale developments, given a sufficiently large play such as the Bakken in North Dakota, the Eagle Ford in Texas, or potentially West Siberia's Bazhenov, can absorb an immense amount of capital.

For example, let's assume the Bazhenov shale activity comes to the level seen in the Bakken shale in North Dakota, which appears to be a comparable play on a geological basis. Over the last 7 years Bakken production has gone from c10kbd to 1.1mmbpd as of July (Figure 21) with the addition of a net[16] 7,500 wells. At recent activity levels, with 170-200 rigs consistently deployed in North Dakota, some 2,000 wells are being added annually to that total. At the $8mn/well we assume a West Siberian shale well will cost, that represents $16bn per year of CAPEX in West Siberia just on the Bazhenov. Relative to the $30bn-$35bn we calculate is reinvested annually into Russia's upstream oil production, a $16bn additional annual spend is a very material amount.

Even in the best case, it will likely be years before the Russian industry is ready to devote that number of rigs and capital just to shale development. However, with the tax regime apparently in place and an industry actively looking for investment options, we think that by 2020 Russian shale oil development could be ramping up to a significant undertaking for the country's oil companies.

For more details on Russia's shale plays, please refer to our large OFS note from last September, in which we explored in detail the economics of Russia's shale opportunity (link, see ppg 16-26). Also note that the EU and US sanctions have, as of mid-September, barred the transfer of shale oil technology and services to Russian oil companies (link), and will probably have to be lifted for Russia to participate in the shale oil revolution (Russia has its own OFS industry, but replicating the US experience on its own would be inefficient and take years, if it could be accomplished at all, we think).

- **Russian offshore, shelf development:** This is mostly an opportunity for Rosneft via its 46 offshore licences, although Gazprom has a modest (given the company's scale) level of exposure to the offshore as well via Gazpromneft, for which the scale could be potentially material. Lukoil also has exposure via its Caspian projects (which are mostly captured in the explicit stage of our DDM model). We recently looked in some detail at the opportunity for ExxonMobil and Rosneft in the Russian Arctic (link), and roughly estimated its worth at $12-$36bn net to Rosneft, with IRRs potentially in the low 30% range. The capital required could potentially be immense, as we show in that note, maybe $10bn per year during the plateau of activity of a liquids-rich Kara Sea development, 2/3 of which should come from Rosneft and 1/3 from ExxonMobil.

  These numbers imply potential growth rates well in excess of what we have penciled into our interim stage. However, and in spite of the announced success of the first test well (link), we would recommend waiting for a lifting of sanctions before making assumptions materially more aggressive than what we have in the model currently.

[16] Net of shut-in wells

- **Refining, petrochemical upgrades and expansion:** Driven by government policy, backed up by upcoming changes in the tax regime, Lukoil, Rosneft, and the other Russian refiners have been heavily investing into plant upgrades in recent years. We have calculated the returns on those upgrades have ranged from good (Rosneft with c20% IRRs) to very good (Lukoil with 30%+ IRRs).

  The refining investment opportunity will be reduced going forward, as many of the potential investment projects are being executed now, due to be completed in the next few years and incentivized by export duties on fuel oil that begin to climb next year towards parity with crude duties in 2017 (per the "tax maneuver").

  That said, even after Rosneft's current, $25bn upgrade program is completed by 2016, the company's product slate will still likely be c20% fuel oil, leaving substantial opportunities for further upgrade projects – hydrocrackers and the like – to turn that low-value, high-duty product into higher-value, lower-duty gasoline, diesel, and the like. By comparison, both Lukoil and SurgutNG have plans to drive fuel oil production down to the low-single-digit range by the end of the decade, meaning our explicit stage largely captures them.

  Beyond refining, Russian companies are exploring opportunities to add value to their products by integrating further downstream, particularly in the petrochemical region. All of Rosneft (Far East), Lukoil (Caspian), and Gazprom (Eastern Gas Program) have plans on the drawing board to either expand upon existing facilities or to build significant new greenfield plants. Returns, we think, would be in the 15%-20% range, although the scope for investing large amounts of capital beyond 2020 is unclear, and may not be material.

- **Expanding independents' domestic gas production and sales:** Rosneft, Novatek, and Lukoil all have the geological capacity to expand domestic gas production, with Rosneft in particular having relative aggressive plans on this front. This is partially financed by the tax regime, which taxes gas produced by independents at a lower rate than that assessed on Gazprom's own production. However, the halt in tariff increases last year, and the potential that Gazprom may be allowed to compete on price with independents for the most attractive domestic customers, may limit the returns available in this business.

- **LNG:** Gazprom, Rosneft, and Novatek all have the right to develop LNG projects for export. Novatek's Yamal LNG is the only project currently under construction, while Rosneft's planned LNG train with ExxonMobil on Sakhalin and Gazprom's 3rd train at Sakhalin-2 and its proposed plants at Vladivostok and on the Baltic Sea near St Petersburg exist only on paper for now. At $3-$5bn per 5mtpa train, LNG facilities can absorb a large amount of capital, but the returns are not immediately obvious, especially for projects that haven't already locked in sales contracts in what currently appears to be a global market currently tilted somewhat towards buyers. Therefore, while we see Novatek's Yamal LNG as yielding 15% or more, including on expansion (follow-on LNG trains often have economics superior to the initial trains), we think the returns on trains built by Rosneft and Gazprom could be lower, maybe around 10%[17].

- **China gas exports (Gazprom):** Our calculations show that Gazprom's Eastern Route contract, signed this past May, will likely have returns of c13% (link to

[17] We arrived at this estimate by modeling Gazprom's proposed Baltic LNG as a stand-alone project, buying gas from Gazprom at the regulated city-gate price in St. Petersburg, liquefying it and shipping it to the UK at prices approximating Gazprom's average export price to Europe. This would allow Gazprom to tap a market it has little direct access to currently and to more fully utilize the excess production and transport capacity it has developed domestically.

note). The potential returns on the proposed Western Route, given that it will only require the construction of a c$15bn pipeline from existing producing fields to the Russian-Chinese border between Kazakhstan and Mongolia, should be at least that high (link to note), although the Chinese side may demand that some of that profitability be returned to them via lower gas prices. As mentioned above, Chinese exports could come to account for the bulk of the interim stage growth in our model.

- **Politically required investments:** Russia's state-owned companies, especially Gazprom, are occasionally directed by the government to make investments of dubious value to shareholders. Into that category we lump Gazprom's acquisition of Rosneftegaz's gas distribution assets in 2013 (low single digits, we think), its power asset acquisitions from years past (same), and the several billion dollars it invested into infrastructure for the 2014 Sochi Winter Olympics. Indeed, over the past decade, Gazprom has spent on average some $3-$6bn annually on acquisitions, few of which at first glance appear to be in the company's core business of producing and transporting natural gas. Gazprom is not the only company affected, as Rosneft's proposed Chechnya refinery appears to us to be motivated more by political than economic goals.

- **Mistakes, or 'oops':** No company has a 100% success rate with its investments, and some portion of a company's invested capital will miss its targets, potentially badly. In this category we can file Lukoil's European refinery acquisitions (low single-digits at best) and the company's ill-starred Yuzhnaya Khulchuya field in Timano Pechora. Rosneft's own investments into European refining may well yield low returns, in our view. Gazprom's heavy investments into the Yamal-Torzhok pipelines, built to carry gas from the Bovanenko super-giant field to the central Russian hub at Torzhok, however well built, may not have been necessary, as a much shorter set of lines linking the field to the existing transport system at declining core fields in West Siberia (which Bovanenko is meant to supplant with time) may have been sufficient and much more financially efficient, even if it would have involved a somewhat longer overall shipping distance.

Therefore, the relatively healthy rates of return we are showing for some of these projects should not be directly translated to a company's overall IRR. Rather, the existence of the projects that make sense on paper should be used by the investor to gain comfort that overall ROA targets are generally reasonable.

Figure 22. Russian comp table

Company	Total	Target		Price	Return	Market	P/E			EV /EBITDA			Div yield		
Name	Return	Price	Rating	10/18/14	to TP	Cap	2013A	2014E	2015E	2013A	2014E	2015E	2013A	2014E	2015E
International															
BG	33%	14.0	Buy	10.7	31%	$59	13.4x	14.7x	14.1x	6.7x	7.4x	6.7x	1.7%	1.8%	2.0%
BP	25%	5.1	Buy	4.3	19%	$126	9.8x	9.8x	10.0x	3.7x	3.4x	3.4x	5.4%	5.7%	5.8%
Eni	20%	18.5	Neutral	16.4	13%	$76	12.8x	13.9x	12.6x	3.4x	3.8x	3.9x	7.0%	7.2%	7.0%
Repsol	42%	23.0	Buy	16.9	36%	$29	16.6x	12.5x	13.3x	5.1x	4.9x	4.8x	6.0%	6.0%	5.9%
RD Shell Class A	24%	25.5	Neutral	21.5	19%	$224	11.2x	8.7x	9.8x	3.6x	3.4x	3.8x	5.2%	5.4%	5.4%
Statoil	23%	180.0	Neutral	153.0	18%	$75	9.6x	10.0x	10.5x	2.2x	2.7x	2.9x	5.1%	5.0%	4.9%
Total	35%	57.0	Buy	44.2	29%	$134	9.0x	9.9x	9.7x	3.1x	4.0x	4.1x	5.6%	5.8%	5.6%
ExxonMobil	15%	102.0	Neutral	91.2	12%	$389	12.7x	13.1x	12.8x	4.8x	5.2x	5.1x	2.7%	3.0%	3.1%
ConocoPhillips	51%	100.0	Buy	68.1	47%	$84	11.9x	11.2x	11.9x	3.4x	3.2x	3.5x	4.0%	4.1%	4.2%
Chevron	30%	141.0	Buy	111.8	26%	$212	10.1x	11.0x	11.8x	3.6x	3.7x	4.0x	3.5%	3.8%	3.9%
Weighted average							**11.4x**	**11.3x**	**11.5x**	**4.0x**	**4.2x**	**4.3x**	**4.2%**	**4.4%**	**4.5%**
EMEA															
Petrobras	17%	17.0	Neutral	14.9	14%	$99	8.8x	8.3x	6.7x	5.5x	5.7x	5.2x	3.4%	3.6%	4.4%
Sinopec	21%	7.6	Neutral	6.6	16%	$99	9.6x	10.0x	10.5x	5.2x	4.9x	4.4x	4.6%	4.2%	4.0%
PetroChina	4%	9.3	Sell	9.4	-1%	$221	10.5x	10.0x	11.8x	5.0x	4.7x	4.9x	4.3%	4.5%	3.8%
CNOOC	49%	18.0	Buy	12.5	44%	$72	7.8x	7.9x	8.5x	2.9x	3.1x	2.8x	4.4%	4.2%	3.9%
Weighted average							**9.6x**	**9.3x**	**10.0x**	**4.8x**	**4.7x**	**4.6x**	**4.2%**	**4.2%**	**4.0%**
Russian oil & gas															
Gazprom	-8%	2.9	Sell	3.29	-12%	$76	2.1x	2.5x	2.8x	1.8x	2.1x	2.3x	6.9%	4.7%	6.1%
Gazpromneft	30%	4.50	Buy	3.66	23%	$17	3.1x	3.5x	4.5x	2.1x	2.3x	2.8x	8.0%	7.1%	5.6%
Lukoil	30%	60.3	Buy	48.6	24%	$38	4.7x	3.3x	4.4x	2.4x	2.1x	2.4x	7.1%	7.4%	8.1%
Novatek	18%	118.00	Buy	103.0	15%	$32	13.3x	12.1x	8.1x	5.9x	5.9x	4.7x	2.3%	2.5%	3.7%
Rosneft	11%	6.0	Neutral	5.6	7%	$59	3.6x	7.1x	4.8x	3.5x	4.2x	3.8x	7.2%	3.5%	5.2%
Surgutneftegaz ord	-25%	0.47	Sell	0.65	-28%	$24	3.0x	2.8x	5.0x	nm	nm	nm	2.4%	2.6%	2.8%
Tatneft ord			Neutral	5.5	n/a	$12	4.4x	4.7x	5.0x	3.7x	3.4x	3.4x	4.7%	5.1%	4.8%
Transneft	-21%	68,800	Sell	88,130	-22%	$3	3.2x	2.9x	3.1x	1.8x	1.6x	1.3x	1.1%	1.2%	1.1%
Surgutneftegaz (pref)	24%	0.74	Buy	0.66	12%	$5	3.1x	2.8x	5.1x	nm	nm	nm	7.0%	9.9%	11.8%
Tatneft (pref)			Neutral	3.35	n/a	$0.5	2.7x	2.9x	3.0x	3.7x	3.4x	3.4x	7.7%	8.3%	7.9%
Weighted average							**4.4x**	**5.0x**	**4.5x**	**2.7x**	**2.9x**	**2.8x**	**6.0%**	**4.5%**	**5.6%**
Central Asia															
KMG EP	34%	18.50	Neutral	15.19	22%	$6	6.7x	3.5x	6.5x	0.2x	0.7x	1.2x	14.2%	12.0%	7.8%
Nostrum Oil&Gas	34%	8.77	Buy	6.72	31%	$2.0	9.2x	9.4x	12.9x	4.5x	4.9x	6.2x	3.1%	3.3%	3.2%
Weighted average							**7.3x**	**4.9x**	**8.0x**	**1.3x**	**1.7x**	**2.5x**	**11.5%**	**9.8%**	**6.6%**

Source: Powered by dataCentral

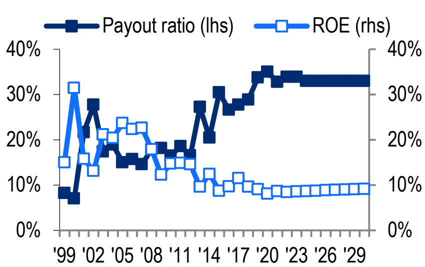
Applying the DDM to Individual Stocks

Below we walk through the application of the DDM to each of our companies. Lukoil offers perhaps one of the more straightforward applications of the DDM to a Russian oil & gas company, and in our mind comes very close to representing the overall Russian oil sector, so we will therefore start with it.

Lukoil

Our DDM value of Lukoil's stock is $63.3/share, giving an ETR of 30% vs. the current market price. Under Citi methodology, this DDM value is broken down into the next 12 months dividends of c$3.0/sh and our 12-month TP of $60.3/sh. In spite of a 21% TP drop on the methodology change, Lukoil remains a Buy (1), albeit with much more constrained implied upside potential.

Figure 23. Lukoil payout ratio and ROE



Source: Company data, Citi Research estimates (from 2014)

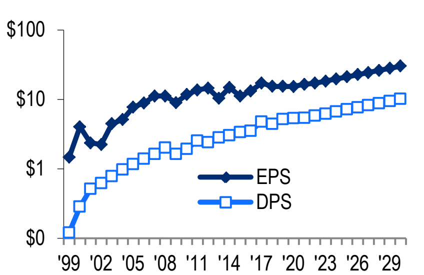
Figure 24. Lukoil DDM summary

	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2020**	**Interim**	**2030**
EPS	$11.1	$13.3	$14.6	$10.4	$14.9	$11.1	$15.3	- - -	$30.7
DPS	$1.6	$1.9	$2.6	$2.9	$3.5	$3.0	$5.4	- - -	$10.1
Payout	15%	15%	18%	23%	19%	27%	35%	33%	33%
ROE (total)	14.2%	14.8%	14.4%	9.6%	12.4%	8.8%	8.5%	- - -	9.2%
ROA (marginal								7.9%	7.9%
Leverage								135%	135%
ROE (marginal)							10.7%	10.7%	10.7%
DPS growth	-18%	19%	31%	-5%	17%	8%	7.2%	7.2%	7.2%
Cost of equity					10.0%	10.0%	11.3%	- - -	12.8%

DDM value by period		
2014-2020	$17.3	27%
2020-2029	$18.1	29%
2030 (terminal)	$27.9	44%
Total	**$63.3**	**100%**

Source: Company data, Citi Research estimates (from 2014)
*Note that DPS may not match up with the dataCentral numbers on pg **Error! Bookmark not defined.** due to RUB/USD exchange rate differences in year paid vs year declared.

Figure 25. Lukoil EPS, DPS on log scale



Source: Company data, Citi Research estimates (from 2014)

- **Normalized EPS:** We forecast Lukoil will earn $15.3/share in 2020, 48% above the $10.4/sh booked in 2013, which included a large write-down on various assets, including some of Lukoil's European refining. Backing out those accounting charges, our 2020 number is 27% above Lukoil's adjusted 2013 net income of $12.1/sh.

  Our 2020 EPS has the following main drivers and assumptions:

  – Oil prices of $111/bbl Brent ($90/bbl real), a rouble exchange rate of 42.7 per USD and PPI rouble inflation of 7% pa.

  – We assume the oil tax regime remains stable, with the "tax maneuver" passed as submitted to the Duma and in place indefinitely.

  – 2.1mmbpd of oil production and 44bcmpa of gas production, up c10% and c120%, respectively, on 2013 levels. Of the sharp increase in gas production, 38% or 9bcm of it comes from higher production at the company's Bolshekhetskaya deposit in Russia, while 56% or c13bcm comes from expansion at the company's international gas assets in Central Asia. Note these growth assumptions are not new for our Lukoil model, but rather have been incorporated for some time.

  – We assume fuel oil and vacuum gasoil output declines from the current ratio of c30%+ of the total product slate to c14% of the total. This is a significant value

addition for the company, although again this is an assumption that has been in our model for some time.

– DD&A of $13.5/share in 2020 is the equivalent of $10.2bn, almost double the $5.8bn booked in 2013, and is set equal to our estimate of the CAPEX necessary to maintain earnings at the level we forecast in that year. Our normalized CAPEX number is mostly accounted for by $8.7bn of E&P spending, primarily driven by an assumed, nominal replacement cost of $10.9/bbl for oil in 2020, while maintenance CAPEX for Lukoil's refineries and 'other' activities combined account for the remaining $1.6bn per annum.

Note the large increase in booked DD&A mentioned above is a significant constraint to our forecast EPS in 2020, but is necessary to ensure the DDM model is only accounting for growth CAPEX in calculating growth prospects from that point forward.

Q: How do we get from a 30% payout indication from management to 33%?

A: Our DD&A write-up requires an adjustment to apparent payout

- **Dividend policy:** Lukoil's current dividend policy, in place for several years, is to grow dividends by at least 15% per annum in roubles per share terms. However, this policy can't stay in place forever, as dividends would eventually grow beyond the ability of the income statement to support them. Management admitted as much on its 2Q14 conference call, and indicated the long-term payout ratio might settle in around 30% of net income, which forms the basis for our 33% in 2020 and beyond.

  Note 1: Lukoil still reports under US GAAP, and we think the company's DD&A may increase when it first reports under IFRS in 2016 (on 2015 results). Therefore, our DD&A adjustment to match maintenance CAPEX may end up being close to the accounting number in 2020. However, we still see a need to make a modest adjustment to our payout ratio to account for the difference.

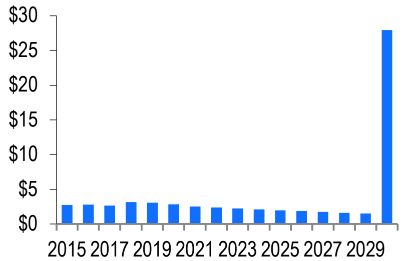
  Note 2: As Lukoil's Cost of Equity is somewhat greater than its marginal ROE, our assumed increase in payout in the constant stage to 33% from 30% adds to our DDM valuation, but not dramatically, boosting it by c1%. Were Lukoil to raise its dividend payout to 100% of net income from 2020 onwards, our DDM would rise, but only to c$68/sh.

- **Returns on growth CAPEX, EPSG:** We assume Lukoil will earn a 10.7% ROE on earnings it reinvests into its business in the both the 2021-2029 interim stage and the constant stage, giving a sustainable growth rate[18] of 7.2% per annum. By way of comparison, Lukoil's EPS in the 2000-2013 time period grew at a compounded rate of c7.5% (Figure 25), helped on the one hand by the large increase in global oil prices but constrained, on the other, by the large increases in Russian oil taxation in 2001 and again in 2004.

- **Cost of equity:** We estimate Lukoil's cost of equity at 12.8% in 2030, made up of an ERP of 7.0% on top of the current Russian risk-free rate (RFR) of 5.8% for that year. Note that prior to the crisis, we had been using a base ERP of 600 basis points for our Russian oil & gas stocks, and would be inclined to reduce it back to that level should the geopolitical situation normalize. Also note that we are using the Russian yield curve to determine discount rates across the forecast period, giving us discount rates in the intermediate years that are lower than our long-term assumption, and also opening up our valuations to potential fluctuations as Russian sovereign interest rates expand or contract.

[18] g = ROE x (1 – payout ratio)

Figure 26. Lukoil dividend PV by year



Source: Citi Research estimates

Figure 27. Lukoil interim, constant stage assumptions

ROA x	7.9%
Leverage (A/E)	135%
= ROE	10.7%
x (1-Payout ratio)	1-33%
= DPS, EPS growth	7.2%

Source: Citi Research estimates

- **Terminal year valuation:** On a present-value basis, $27.9/share or 44% of our DDM valuation occurs in the 2030 terminal value year (Figures 24, 26). This value, arrived at using the Gordon Growth Model, discounts the 2030 projected $10.1/sh dividend assuming the previously-mentioned 12.8% cost of equity and 7.2% sustainable annual growth rate.

- **Interim stage – No leverage adjustment:** Lukoil already has a relatively strong balance sheet, and per second-largest shareholder Leonid Fedoun, it might get stronger in the medium term. Mr. Fedoun stated that, in the face of frozen debt markets for Russian companies, Lukoil may look to build its cash position to $30bn over the next five years. However, management has also stated in meetings with investors that, should it become comfortable that it will have steady access to debt markets going forward, the company would actually like to materially increase leverage.

  However, for our purposes we assume a major cash build over the 2014-2020 period won't actually become company policy, but neither do we assume that leverage will be ramped up, which would serve to materially lift our DDM valuation. Rather, we assume the company will maintain its current balance sheet policies for the duration. We will not be inclined to change this relatively important assumption unless and until we see concrete steps being taken by management to lever up the balance sheet.

  Therefore, for the interim period we have Lukoil's leverage ratio at 135% A/E, below the 155% we use for most of its peers, and the same ratio we use for the company long-term. Similarly, we have an interim ROA of 7.9% and a payout ratio of 33%, giving an interim growth rate of 7.2%, all the same as our long-term, constant stage assumptions.

  For sensitivities: The effective elimination of debt to a SurgutNG-like 105% A/E for the interim period would be negative for our DDM valuation, limiting the amount of capital to be reinvested, lowering growth for the period and depressing our DDM by c10%. On the other hand, expanding leverage to our industry-standard assumption of 155% A/E would push Lukoil's DDM value up by c9%.

How Lukoil could increase its DDM valuation

- **Increase leverage (primary):** Lukoil has a strong balance sheet – excessively strong, we think, given the opportunity Russian oil companies had in recent years to borrow at very low rates, and at least partially accounting for why the stock trades at lower multiples than Rosneft. Lukoil could increase its DDM value by levering up and using the proceeds either to buy back stock/increase dividends (preferred), or even by buying assets earning at least the 7.9% ROA we assume the company earns on its average reinvested growth dollar.

  The $2bn acquisition of Samara-Nafta in early 2013 was actually an excellent example of this, as the company financed the acquisition with $2bn in low-interest debt. While the market was generally unimpressed with the returns evident in the deal (note), as a use of cash we think it was actually a positive for stockholders.

- **Increase dividends (secondary):** With an ROE on reinvested capital (10.7%) that is somewhat lower than its cost of equity (12.8%), Lukoil could add value by foregoing growth investment and instead paying out a higher dividend instead. An increase in dividend payout of 5ppt to 38% would lift the DDM by a modest $1/sh in isolation, *ceteris paribus*. However, an argument could be made that one should raise expected IRRs in that event, as presumably higher dividends would

come at the expense of the company's more marginal projects, raising the average return and moderating the impact on growth via a lower retention ratio. Note that in the event that Russian risk should come down, putting Lukoil's CoE and marginal ROE more in-line with one another, the DDM would become indifferent to payout.

Rosneft

Our DDM value for Rosneft is $6.2/share, broken down into a target price of $6.0/sh and a 3.5% projected dividend yield. That TP is 35% down on our previous TP on the change in valuation methodology, exacerbated by our increase of the company's cost of equity by 50bpts above our base CoE. We downgrade Rosneft to a Neutral (2) on the 12% ETR to the current market price, but note that our DDM valuation for Rosneft is very sensitive to any potential resolution of the current crisis.

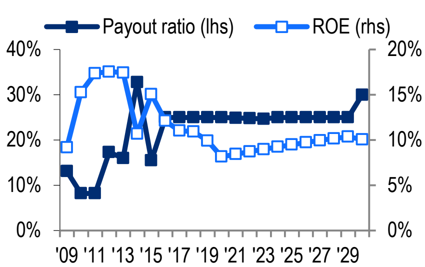
Figure 28. Rosneft DDM breakdown

	2010	2011	2012	2013	2014	2015	2020	Interim	2030
EPS	$0.9	$1.2	$1.2	$1.6	$0.8	$1.2	$1.4	---	$3.5
DPS	$0.1	$0.1	$0.2	$0.3	$0.3	$0.2	$0.3	---	$1.2
Payout	16%	10%	19%	20%	22%	25%	25%	25%	35%
ROE (total)	15.3%	17.4%	17.6%	17.5%	7.7%	10.4%	8.2%	---	10.6%
ROA (marginal								8.7%	8.2%
Leverage								155%	155%
ROE (marginal)								13.5%	12.7%
DPS growth	21%	27%	125%	17%	36%	-43%		10.1%	8.3%
Cost of equity					10.5%	10.5%	11.8%	---	13.3%

DDM value by period		
2014-2020 - Explicit stage	$1.3	22%
2020-2029 - Interim stage	$1.3	21%
2030 - Constant growth	$3.5	57%
Total	**$6.2**	**100%**

Source: Company data, Citi Research estimates (from 2014)
*Note that DPS may not match up with the dataCentral numbers on pg **Error! Bookmark not defined.** due to RUB/USD exchange rate differences in year paid vs year declared

Figure 29. Rosneft payout ratio and ROE

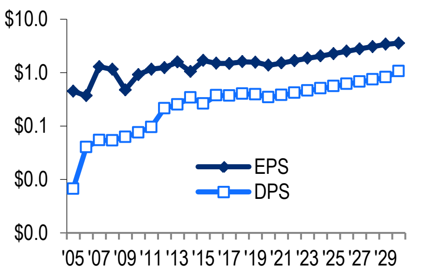


Source: Company data, Citi Research estimates (from 2014)
Note that Rosneft went through two major changes in this period – the acquisition of Yukos assets via bankruptcy auction in 2007 and the acquisition of TNK-BP in 2013.

- **Double-leverage to crisis resolution:** As the state-owned champion oil company with unique access to Russia's offshore, Rosneft both: a) has long-term growth opportunities that are superior to those available to its Russian oil peers, and b) is specifically targeted by sanctions by Europe and the US in relation to the Ukraine crisis. This makes our DDM valuation trebly dependent up a potential resolution to that crisis.
  - First, we have restrained the mid-term growth rate for Rosneft below that we think what may be possible due to the sanctions on technology transfers, as much of the company's opportunities for output growth rely on imported, cutting edge technology, especially the offshore. With a crisis resolution we'd be tempted to boost interim growth rates, most likely by increasing leverage rather than returns.
  - Second, Rosneft's DDM is naturally more sensitive to discount rate changes, given the back-end weighting of dividends because of the company's substantial long-term growth opportunities, even with our restrained assumptions. Therefore, a market-wide lowering of risk would boost Rosneft's DDM more than the average.
  - Third, and finally, we have added an extra 50bpts of ERP on top of our base rate in an attempt to account for the higher risk the financial sanctions present

for the relatively heavily-levered Rosneft (although the Chinese prepayments left to be drawn down may be more than enough to cover all contingencies). So, rather than a full resolution of the crisis lowering our CoE by 100bpts as we would see with Lukoil, Novatek, and Gazprom, with Rosneft we'd see a 150bpt drop. All else being equal, a 150bpt reduction in the CoE would boost Rosneft's DDM by 52%.

Figure 30. Rosneft EPS, DPS on log scale



Source: Company data, Citi Research estimates (from 2014)
Note that Rosneft went through two major changes in this period – the acquisition of Yukos assets via bankruptcy auction in 2007 and the acquisition of TNK-BP in 2013.

- **Normalized EPS:** We forecast Rosneft will earn $1.36/share in 2020, down 14% on the $1.6/sh booked in 2013. However, that 2013 number was supported by a $5.2bn revaluation of TNK-BP assets. Stripped of that effect, our 2020 forecast is up c16% on the adjusted 2013 number.

  Our normalized, 2020 EPS forecast has the following main drivers and assumptions:

  – Oil prices of $111/bbl Brent ($90/bbl real), a rouble exchange rate of 42.7 per USD and PPI rouble inflation of 7% pa.

  – We assume the oil tax regime remains stable, with the "tax maneuver" passed as submitted to the Duma in place unchanged indefinitely.

  – 4.1mmbpd of oil production and 85bcmpa of gas production, up c8% and c120%, respectively, on 2013 levels. Most of the oil production increase is coming from the ramp-up of the assets of the Vankor cluster as well as the Yurubcheno-Tokhomskoye field in East Siberia. The sharp increase in gas production is underpinned, per management, by long-term sales contracts already totaling at least 75bcmpa in 2017.[19]

  – DD&A of $1.7/share in 2020 is the equivalent of $18.4bn, c50% above $12.3bn booked in 2013. This is set equal to our estimate of the CAPEX necessary to maintain earnings at the level we forecast in that year, which in turn is mostly accounted for by $16.2bn of E&P spending via an assumed replacement cost of $9.8/bbl for oil and $2.7/mcf for gas. Additionally, we have $2.2bn of annual maintenance CAPEX of Rosneft's refineries and 'other' activities.

- **Dividend policy:** With the arrival of Igor Sechin in mid-2012 as CEO, Rosneft almost immediately moved to a new dividend policy of 25% of IFRS net income. Since that time Mr. Sechin has reaffirmed that policy on numerous occasions, stating at one point to investors that the policy will be in effect for at least the next decade and that, while Rosneft may choose to pay more at some point, it will not pay less.

  For our DDM model, we assume that Rosneft pays 25% of net income until our 2030 constant stage year, at which point the company bumps it up slightly towards the level seen for the company's international peers. As Rosneft's constant stage ROE (12.7%) is very near its long-term cost of equity (13.3%), this assumed increase actually has little impact on our DDM valuation (a small increase), but is necessary to rationalize long-term growth rates.

- **Returns on growth CAPEX, EPS growth, and the offshore opportunity:** Our valuation partially captures the offshore opportunity – potentially a game-changer even for an oil producer as large as Rosneft – in the interim stage via a

[19] In Russia gas sales are more often constrained by market limitations rather than production limits, as gas resources are relatively plentiful in the country, so the existence of contracts is a key point.

somewhat higher returns on invested capital (8.7% ROA vs. the 8.2% we our assumptions generate for the constant growth stage). However, as we pointed out further above, we keep leverage a relatively low (for Rosneft) 155% in the interim stage due to international sanctions, a number we'd be inclined to revise upwards should sanctions be lifted.

Combined, these ROA and A/E assumptions give us an ROE of 13.5% on reinvested capital for Rosneft in the interim period, roughly comparable to the ROEs earned by the company's international peer group, albeit via higher returns on assets and lower leverage. With a 25% payout ratio, this implies an interim growth rate of 10.1%.

In our constant growth stage our IRR and leverage assumptions imply Rosneft earns an ROA of 8.2%, 90bpts above our standard assumption for Russian oil & gas companies, on the strength of both its role as Russia's state-owned oil champion in general and for its substantial onshore and offshore opportunities which should have an impact on growth well beyond the 2020s. Note that, unlike with the interim stage, we would be unlikely to change our constant stage assumptions upon the lifting of sanctions, as Rosneft's growth advantage over its Russian peers should shrink with time, although it is unlikely to disappear.

- **Balance sheet normalization:** Rosneft's balance sheet is relatively heavily levered at this time when compared to its Russian peers, with nearly $100bn of debt and interest-bearing long-term obligations, including $25bn of prepayments on future oil deliveries to China's CNPC. This gave Rosneft a D/E ratio of 94% and rolling net debt to EBITDA ratio of 2.0x as of the of 2Q14, with both numbers well in excess of Lukoil's 14% D/E and 0.5x net debt/EBITDA for the same period. In A/E terms, at the end of 2Q14 Rosneft had a DuPont leverage ratio of 244% vs. 142% for Lukoil and 153% for Novatek.

  By 2020, the end of our explicit stage, our model has Rosneft's leverage ratio (A/E) declining to c155%, under the assumption the company will strengthen its balance sheet ahead of the full-bore development of the Kara Sea and/or other offshore opportunities beginning in earnest around the end of this decade.

How we account for sanctions – lower leverage in interim period

- **Lower payout, but industry-average leverage pending sanctions resolution:** Due to current EU and US sanctions, which specifically target Rosneft's key mid-term growth opportunities (deepwater offshore, arctic offshore, and shale oil), some of Rosneft's natural advantage over its Russian peer group is impaired, at least for a time. While we think sanctions will be lifted at some point in the near to medium term, we would not expect equity markets to price in Rosneft's unique growth opportunities unless and until it becomes apparent those opportunities will indeed be realized. This will require a lifting of sanctions as well as confirmation of the recently announced large oil find in the Kara Sea with flow tests, we think.

  However, we would be inclined to account for any lifting of sanctions by lifting leverage in the interim period significantly, as the full development of the Kara Sea and other offshore regions would likely prompt Rosneft to more fully utilize its balance sheet to finance the growth. This would likely boost our DDM valuation noticeably. By way of sensitivity, increasing leverage from 155% to 200% for the interim period – while holding our constant stage assumptions – would boost growth to c13% pa and add c20% to our DDMDM.

  In the mean time, we keep Rosneft's interim leverage at 155% A/E, our standard, normalized assumption for both it and the industry in general (Figure 31). Note we do give the company some allowance for superior assets by: a) having an

Figure 31. Rosneft interim stage assumptions

ROA x	8.7%
Leverage (A/E)	155%
= ROE	13.5%
x (1-Payout ratio)	1-25%
= DPS, EPS growth	10.1%

Source: Citi Research estimates

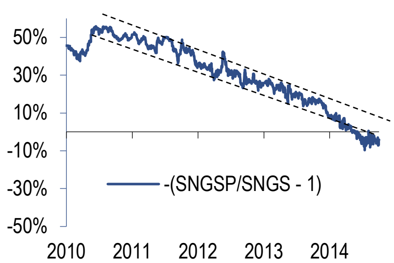
ROA of 8.7%, 50bpts above our constant stage assumption; and b) keeping Rosneft's payout ratio at 25% vs. 30%-35% long-term for its peers. The combination of those two assumptions gives a higher EPS and DPS growth rate in the interim of 10.1% vs. 8.3% for the constant stage.

SurgutNG – Buy the pref, Sell the ord

Our DDM value for SurgutNG prefs is $0.82/share, giving a c26% ETR vs. the current market price. Our TP declines 33% on the methodology change, from $1.10/sh to $0.74/sh, with next year's expected dividend filling the gap between our DDM value and our 12-month TP. We keep the pref on Citi's CEEMA Focus List, and argue that it remains one of the most defensive plays in the Russian oil & gas universe.

Our DDM value for SurgutNG ords is $0.48, giving a -25% ETR vs. the current stock price. With our TP falling 40% on the change in methodology, from $0.78/sh to $0.47/sh, we downgrade the ord from Neutral (2) to Sell (3), and we recommend investors concentrate their SurgutNG exposure in the prefs alone, as we see strong valuation support for a continuation of the long relative revaluation between the two stocks (Figure 32).[20]

Figure 32. SurgutNG pref/ord discount is gone



Source: Citi Research

Figure 33. SurgutNG DDM model

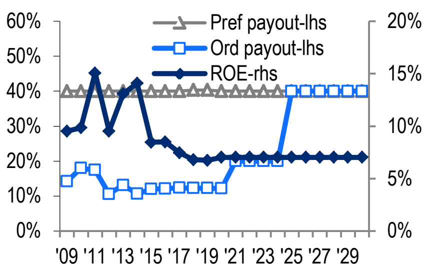
	2010	2011	2012	2013	2014	2015	2020	2030
EPS	$0.10	$0.18	$0.12	$0.19	$0.21	$0.12	$0.15	$0.24
DPS - ord	$0.01	$0.02	$0.02	$0.02	$0.02	$0.02	$0.02	$0.10
DPS - pref	$0.03	$0.04	$0.07	$0.05	$0.07	$0.08	$0.06	$0.10
DPS - weighted av*	$0.02	$0.02	$0.03	$0.02	$0.03	$0.03	$0.03	$0.10
Payout	22%	12%	24%	39%	14%	14%	18%	40%
ROE (total)	9.8%	15.1%	9.5%	13.1%	14.4%	8.4%	8.3%	7.7%
ROE (marginal)							7.2%	7.2%
DPS growth (total)	-35%	15%	33%	-25%	19%	15%		4.4%
Cost of equity (ord)					8.6%	8.6%	9.9%	11.4%
Cost of equity (pref)					7.8%	7.8%	9.1%	10.6%
SNGSp DDM by period								
2014-2020	$0.27	33%						
2020-2029	$0.24	30%						
2030 (terminal)	$0.30	37%						
Total	**$0.82**	**100%**						
SNGSp DDM by period								
2014-2020	$0.08	16%						
2020-2029	$0.17	34%						
2030 (terminal)	$0.24	50%						
Total	**$0.48**	**100%**						

Source: Company data, Citi Research estimates (from 2014)
*Note EPS here is total net income divided by total shares, pref+ord. The official EPS on ppg **Error! Bookmark not defined.** and **Error! Bookmark not defined.**, are calculated as net income less pref dividends divided by ord shares.
Note that DPS may not match up with the dataCentral numbers on ppg **Error! Bookmark not defined. and **Error! Bookmark not defined.** due to RUB/USD exchange rate differences in year paid vs year declared as well as rounding differences.

- **Normalized EPS:** We forecast SurgutNG will earn $0.15/sh (both share classes combined to calculate a pro-rata EPS) in 2020, down 18% on the $0.19/sh booked in 2013. Note the 2013 number was partially supported by tax breaks on

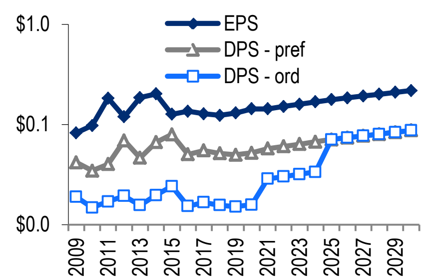
[20] Note: We previously targeted a pref 'discount' of -40%, on the scale of the chart in Figure 32. Our DDM valuations are substantially more rigorously determined, and actually point to a larger, -58% number. Flipped, our valuations indicate the pref should trade at a c60% *premium* to the ord, similar to the 56% premium at which the ord traded at relative to the pref in mid-2010.

Figure 34. SurgutNG payout ratios and ROE



Source: Citi Research

Figure 35. SurgutNG EPS, DPS on log scale



Source: Citi Research

Figure 36. SurgutNG constant stage assumptions

ROA x	6.9%
Leverage (A/E)	105%
= ROE	7.2%
x (1-Payout ratio)	1-40%
= DPS, EPS growth	4.3%

Source: Citi Research estimates

the company's East Siberia fields that are expiring in 2014, so the adjusted comparison would be a bit better than this.

- Our normalized, 2020 EPS forecast has the following main drivers and assumptions:
  - Oil prices of $111/bbl Brent ($90/bbl real), a rouble exchange rate of 42.7 per USD and PPI rouble inflation of 7% pa.
  - We assume the oil tax regime remains stable, with the "tax maneuver" passed as submitted to the Duma by year-end and in place unchanged indefinitely.
  - Oil production will be largely flat at c1.2mmbpd, similar to today's levels. We think SurgutNG has enough geological reserves to maintain production indefinitely, given that we think the government will over time ease the upstream tax burden as necessary to keep overall production stable. However, we do not see it having sufficient access to greenfields to allow the company to grow production outright from current levels, barring a possible shale oil boom in Russia, which would require a lifting of western equipment sanctions at the least.
  - We assume that SurgutNG continues its current balance sheet and cash flow policies, generating FCF and allowing it to pile up on the balance sheet with no leverage and a limited overall payout.

- **Interim stage – dividend equalization from 2025:** In the interim stage our primary – and rather generous – adjustment is to raise the dividend paid on the ordinary share, first bumping it up to half that of the preferred in 2020, then equalizing it from 2025 at 40% of pro-rata EPS (Figures 34, 35).

  Otherwise, our interim assumptions are the same as our long-term assumptions, with an ROA of 6.9%, which takes our industry-standard IRR assumption of 14.0% on field-level projects and adjusts it for a continued buildup of cash on the balance sheet, which dilutes earnings due to the lower (but less volatile) returns available on long-term, dollarized bank deposits in Russia. With dividends equalized at 40% for both stocks in 2025, this gives us an interim growth rate of 4.3% from that year, the same as in our constant stage (Figure 36).

  Relative to keeping SurgutNG's current dividend policy, which tends to pay the pref 2-4x more than the common, equalizing payouts between the two share classes adds significantly to our DDM for the ord and materially lowers it for the pref by eliminating the pref's superior call on company cash flows, slowing the growth in earnings associated with a continued cash buildup on the balance sheet, as modest as that growth is.

  Were we to assume the common payout were to be half that for the preferred (again vs. being 2x to 4x lower in recent years), then our DDM for the pref would rise c10% while our DDM for the ord would fall by c20%.

- **Discount rate adjusted for lower risk of pref, cash position:** SurgutNG's shares are the only stocks for which we adjust our discount rate policy. For the prefs we lower our ERP by 100bpts to account for the high pref payout guaranteed by the company's charter. For a full discussion of how preferred shareholders are both guaranteed a 40% payout and protected by the charter, please refer to this note (link). For both the prefs and the ords we make an additional adjustment for SurgutNG's large, c$35bn cash position, which lowers the volatility on the earnings stream attributable to the interest earned, which we

estimate will account for c24% of the total by 2020. As a result, our long-term CoEs come out at 11.4% for the ords and 10.6% for the prefs.

Novatek

Our DDM value for Novatek is $121/share, giving an 18% ETR vs the current market price. Our TP of $118 is down 19% on our previous TP on the change in valuation methodology. We maintain our Buy (1) rating on Novatek.

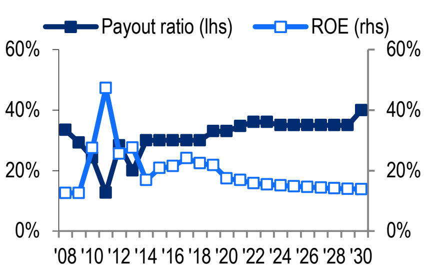
Figure 37. Novatek DDM breakdown

	2010	2011	2012	2013	2014	2015	2020	2030
EPS	$4.4	$12.3	$7.5	$7.8	$8.5	$12.7	$25.5	$55.7
DPS	$1.1	$1.6	$2.1	$2.2	$2.1	$2.4	$8.4	$22.3
Payout	24%	13%	28%	28%	25%	19%	33%	40%
ROE (total)	27.4%	47.3%	25.6%	27.6%	17.3%	20.7%	16.9%	13.7%
ROE (marginal)							12.6%	12.6%
DPS growth	28%	45%	38%	4%	-4%	14%	8.2%	7.6%
Cost of equity					10.0%	10.0%	11.3%	12.8%

DDM value by period		
2014-2020	$22	18%
2020-2029	$33	28%
2030 (terminal)	$66	55%
Total	**$121**	**100%**

Source: Company data, Citi Research estimates (from 2014)
*Note that DPS may not match up with the dataCentral numbers on pg **Error! Bookmark not defined.** due to RUB/USD exchange rate differences in year paid vs year declared.

Figure 38. Novatek payout ratio and ROE



Source: Company data, Citi Research estimates (from 2014)

- **Like Rosneft, sensitive to crisis resolution:** With a strong track record of efficient growth, a substantial resource base accumulated, and the ambitious Yamal LNG project well started, Novatek has an unusually strong medium-term growth outlook. As with Rosneft, this stronger growth profile makes our DDM valuation more back-loaded, making Novatek's valuation more sensitive to any resolution of the Ukraine crisis and a lifting of sanctions, such that a 100bpt decrease in ERP and/or the risk-free rate would boost the DDM by c25%. Note that, like Lukoil, Novatek has been somewhat affected by sanctions via more difficult access to credit markets for its Yamal LNG project, but we expect it to nonetheless land the necessary debt financing, if a bit later and a bit more expensively than we would have thought a few months ago.

- **Normalized EPS:** We forecast Novatek will earn $25.5/ADR in 2020[21], up 130% on the $11.1/sh booked in 2013. Much of that growth will come from the ramp-up of the 3-train Yamal LNG project – in 2020 Yamal LNG will account for c18% of operating profit, per our model. The remainder will come mostly from strong liquids growth expected in the next 2-3 years from visible projects, most of which are in the SeverEnergia JV.

  Our normalized, 2020 EPS forecast has the following main drivers and assumptions:

  – Oil prices of $111/bbl Brent ($90/bbl real), a rouble exchange rate of 42.7 per USD and PPI rouble inflation of 7% pa.

  – We assume the oil tax regime remains stable, with the "tax maneuver" passed as submitted to the Duma by year-end and in place unchanged indefinitely.

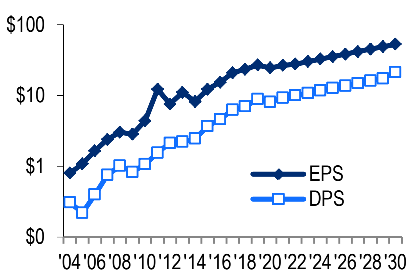
[21] The explicit periods end in 2017 for Gazprom, 2024 for Gazpromneft and 2020 for all others.

– 77bcm of gas production and 316kbd of liquids production, up c29% and c155%, respectively, on 2013 levels. Most of the liquids production increase is coming from the ramp-up of the assets at the company's SeverEnergia JV, which will happen in 2015E following launch delays this year associated with an unfortunate fire. The more modest increase in gas production – c6%pa – reflects the company's increased focus on liquids production after last year's sharp slowdown in increases in domestic regulated gas prices.

– DD&A of $6.8/share in 2017 is the equivalent of $2.1bn, or c380% above the $400mn booked in 2013. This is set equal to our estimate of the CAPEX necessary to maintain earnings at the level we forecast in that year, which is mostly E&P spending via an assumed replacement cost of $2.4/boe, well below the levels we see for Novatek's peers (the company has largely already acquired the properties at which we'd expect these reserves to be found, including via reserve expansion at existing fields) but also well above the $1.5/boe the company has historically spent to add reserves to the proved category.

  In other words, while more than half of the increase in DD&A is due to projected production increases, a large part comes from our assumption that, no matter how efficient Novatek may be going forward, the cost of replacing produced reserves in the future will be noticeably higher than historical cost (Novatek's core Yurkharovsky field will be difficult if not impossible to repeat).

Figure 39. Novatek EPS, DPS on log scale



Source: Company data, Citi Research estimates (from 2014)

- **Slight adjustment to payout ratio on DD&A normalization:** Our normalized DD&A number in 2020 will likely be $500mn above the level reported in the company's accounts, we estimate. This means that we need to restate its payout ratio, as per the company's current dividend policy of a minimum of 30% of IFRS net income, the company will actually be paying out a somewhat larger 34% of sustainable net income, which we round to 35%.

- **Interim stage – Higher growth on strong resource base:** We include Novatek's ambitious Yamal LNG project in our explicit model, but the company has initial plans to expand LNG production beyond the initial 3 trains, potentially outside of the current JV. Any such expansion would likely use gas from undeveloped fields the company has already secured on the Gydan peninsula. Given that, we have reason to believe that Novatek will have better than average growth prospects in the interim stage, and we reflect that in our growth forecasts.

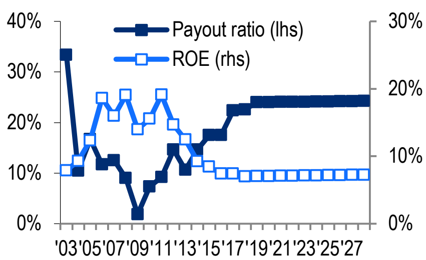
- **Earnings changes in out years:** We make a number of changes to our model with this publication, most of them technical. First, we extend our explicit model from 2017 to 2020. This results in a jump in 2017E EBITDA, due almost exclusively to a move of our normalized crude extraction tax assumption to 2020. Novatek's strong crude growth in the next few years will be mostly MET-free through 2022E. We had previously assumed 75% of those returns starting 2017 as a normalization procedure. Now, with our terminal year close to that final year of tax breaks, we normalize by assuming only 5% of the tax break remains in 2020.[22]

[22] One could argue that Novatek may have sustainable level of tax breaks, as it will likely continue to develop new fields on a rolling basis. However, this is very difficult to estimate, and we would hesitate to attempt to do more than we've done here.

Gazprom

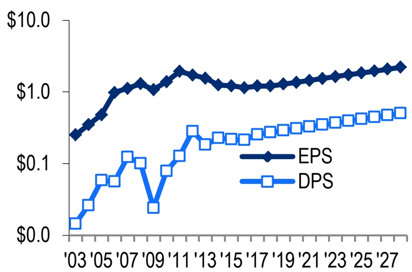
Our DDM value for Gazprom is $3.1/share, giving a -7% ETR vs. the current market price. Excluding the upcoming dividend, that gives us a 12-month target price of $2.9, off 55% from our previous TP on both the change in valuation methodology as well as more conservative assumptions on: a) payout ratio (we keep the current policy, awaiting hard confirmation from the government that Gazprom will indeed be moved to a 25% of IFRS requirement as is currently in the budget); and b) long-term European pricing and volumes (decreases in both). Our assumptions for long-term returns on reinvested capital for Gazprom are markedly lower than for our other companies[23], giving us low growth rates in spite of a high retention ratio.

Figure 40. Gazprom payout ratio and ROE



Source: Company data, Citi Research estimates (from 2014)

Figure 42. Gazprom EPS, DPS on log scale



Source: Company data, Citi Research estimates (from 2014)

Figure 41. Gazprom DDM breakdown

	2010	2011	2012	2013	2014	2015	2017	2030
EPS	$1.39	$1.94	$1.72	$1.55	$1.30	$1.19	$1.18	$2.55
DPS (as paid)	$0.08	$0.13	$0.28	$0.18	$0.23	$0.16	$0.24	$0.51
Payout	7%	9%	15%	11%	15%	12%	20%	20%
ROE (total)	15.5%	19.2%	14.6%	12.5%	9.6%	8.2%	7.1%	7.0%
ROE (marginal)							7.6%	7.6%
DPS growth	227%	61%	122%	-35%	24%	-32%	6.1%	6.1%
Cost of equity					10.0%	10.0%	10.0%	12.8%

DDM value by period		
2014-2020	$1.0	31%
2020-2029	$1.0	31%
2030 (terminal)	$1.2	38%
Total	**$3.1**	**100%**

Source: Company data, Citi Research estimates (from 2014)
*Note that DPS may not match up with the dataCentral numbers on pg **Error! Bookmark not defined.** due to RUB/USD exchange rate differences in year paid vs year declared.

- **Normalized EPS:** We forecast Gazprom will earn $1.18/share in 2017 (our normalized year for Gazprom), down 24% on the $1.55/sh booked in 2013 and with the following main drivers and assumptions:
  - Oil prices of $102/bbl Brent ($90/bbl real), a rouble exchange rate of 41.4 per USD and PPI rouble inflation of 7% pa.
  - We assume that both the oil and gas tax regimes remain stable, with the oil "tax maneuver" passed as submitted to the Duma by year-end and both it and the gas tax law passed in 2013 unchanged for the duration.
  - We lower our long-term European gas export assumption slightly, from 158bcm to 155bcm on the reported relaxing of some take-or-pay clauses during renegotiations of European gas contracts. We lower our 2015 assumption from 155bcm to 150bcm on the same basis. However, our 146bcm assumption for 2014, in place since April, remains unchanged.
  - More importantly, we lower our European pricing assumption from a 10% slope[24] to Brent to 9.5%. On our nominal oil forecast of $102/bbl in 2017 ($90/bbl real), a 9.5% slope implies a normalized European gas price of

[23] Barring SurgutNG, as that company's average return is depressed by its retention of cash on the balance sheet earning low interest at low risk.

[24] A "slope" in gas contract parlance ties the price of gas in USD/mcf to the price of oil in USD/bbl. In this case, if oil is at $100/bbl, the price of gas will be 10% x $100/bbl = $10/mcf, or $360/mcm.

Figure 43. US LNG landed in Europe, $/mcf

Henry Hub	$4.0
Losses in process (15% of Henry Hub)	$0.6
Liquefaction	$3.5
Shipping	$1.0
Regas	$0.5
Total	**$9.6**

Source: Citi Research estimates

$9.7/mcf or $342/mcm vs. c$370/mcm in 2013 and company guidance for an average of $350/mcm this year.

One way to put that price assumption into context is vs. the netback for US LNG exports to Europe. On a full-cost basis, we calculate that US gas could be landed in Europe at c$9.6/mcf assuming Henry Hub is at $4/mcf (Figure 43).

In a pinch, of course, US gas could be landed in Europe at a price substantially lower than that, as that $3.5/mcf liquefaction charge is a sunk cost for the contract holder. However, we do not think that is a stable market situation, and is unlikely to become the year-round norm on the market. Rather, with Asian arbitrage opportunities for LNG, and Henry Hub that will likely be higher than $4/mcf (Citi's house long-term US Henry Hub gas price is in excess of $5/mcf), we think Gazprom's gas should be quite competitive with US LNG in Europe.

– Our FSU pricing continues to assume full netback parity pricing for Ukraine, equal to Ukraine's own demand for $268.5/mcm on a gross basis – i.e. assuming the re-imposition of export duties.

  For 2014 we lower our Ukrainian volume assumption to 19bcm – the c14bcm delivered YTD plus the 5bcm of additional supplies preliminarily agreed to in late September. We assume a price that is the average of the Ukrainian and Russian positions, or $268.5/mcm and $385/mcm, respectively, with the final say likely to rest with the Stockholm Arbitration Court. We will adjust these numbers depending upon the final outcome of negotiations, and it is entirely possible that those will fail to result in any agreement, pushing out both further gas deliveries and collections on 2014 sales into 2015, which would require a downgrade of 2014 numbers on our part.

  Our long-term Ukrainian volume assumption is at 33bcm, well above 2014 levels on the logic that the large decrease in average pricing vs. the current contract price we assume will result in a rebound of Ukrainian gas demand: This is consistent with our past research, which has indicated that Ukrainian volumes are highly sensitive to price (link to note).

– We continue to project Russian domestic gas tariffs as growing at rouble inflation rates. Rosneft recently suggested marginally higher growth of inflation plus 1.5 percentage points, but we would enter such a change into our assumptions only when confirmed by the government. Recent rouble weakness has resulted in a lower USD Russian price, from $118/mcm to $105/mcm.

- **Dividend policy:** Officially MinFin still plans to raise Gazprom's dividend in the medium term by moving it to an IFRS-based payout rather than the current requirement of 25% of RAS[25] net income. Per recent press reports,[26] MinFin is now targeting that policy change to happen in 2017 (on 2016 earnings), while Gazprom is still officially planning on doing it a year earlier. However, we'd expect Gazprom soon to move its plans to match those of MinFin, as management has never seemed to be eager to pay large dividends.

[25] Russian Accounting Standard

[26] Vedomosti, September 17, 2014

The planned increase in Gazprom's payout ratio may continue to recede over the horizon

Indeed, we think that the planned increase in Gazprom's payout ratio may continue to recede over the horizon, much as it has done the last few years since Gazprom's initial sea change increase in dividend payouts in 2011-12. While the Ministry of Finance continues to budget a jump to 25% of IFRS in 2016/17, and while meetings with Ministry representatives have indicated that MinFin stands behind that policy initiative, in recent months MinFin has nonetheless lowered its official dividend expectations (link to note) for 2016 even as other government officials backtracked somewhat on the wisdom of demanding higher dividends from SOEs.

For the record, we have removed from our forecasts any change in Gazprom's dividend policy, in part because we think any concrete, indisputable signal that Gazprom will be required to pay 25% of IFRS net income is unlikely to be received and believed by the market in the course of the next 12 months, and in part because we ourselves now harbour doubts – after long being optimists – on that score, given the absence of meaningful developments to date.

Dividend policy the difference between a Sell and a Buy

Our long-term payout assumption is the current 25% of RAS net income policy, or the rough equivalent of 17.5% of IFRS net income, which we have adjusted to account for our DD&A adjustments, lowering net income, which raises the effective payout ratio to c20%.

All else being equal, this change removes c21% from our DDM value, and is the difference at these levels between the stock being a Sell and a Buy.

- **Returns on growth CAPEX, EPS growth – big, visible projects needed and the case for the China contract:** Dividend policy aside, the other way Gazprom's DDM could be increased would be for us to boost our last-in-the-pack IRR assumption for growth CAPEX of 9.6% (Figure 44). We arrive at that number via a weighted average of returns by type of project we think Gazprom likely will engage in going forward. Growth CAPEX from Gazpromneft should be quite good, equal to that available to Rosneft, but on a smaller scale, in our view. China expansion, which we think will likely be a long-running story – should also garner IRRs at least close to Gazprom's cost of capital, based on our estimates of the economics of the first contract signed. Pipeline expansions, however, have a history of absorbing significant capital for low returns – in particular, we estimate Gazprom's $50bn South Stream project may earn c5%, once the alternative costs and the insurance value of removing Ukrainian risk from European exports is included. Our "other" CAPEX assumption here is set at roughly the weighted average of the other three components.

Figure 44. Gazprom normalized IRR assumptions

	$bn	IRR
2020 total reinvestment	**$21.6**	**9.6%**
o/w Gazpromneft	$2.6	15.0%
o/w China expansion	$7.5	12.5%
o/w pipeline expansion	$5.0	5.0%
o/w other	$6.5	7.5%

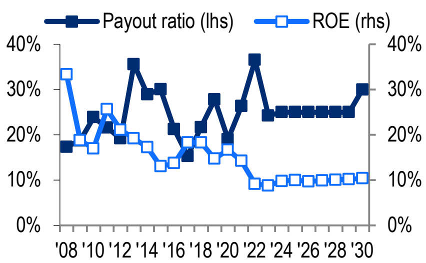
Source: Citi Research

Some might argue that even our existing return assumption of a 9.6% IRR is too high. However, keep in mind that our DD&A adjustment, which is equal to our normalized maintenance CAPEX level of $19.2bn, includes a healthy dollop of zero-return, politically required CAPEX a-la the Sochi Olympic Games. We are therefore focusing only on the CAPEX which actually goes to attempted growth projects.

Gazpromneft

Our DDM value of Gazpromneft's stock is $4.8/share, giving a 32% ETR vs. the current market price. This DDM value is broken down into the next 12 months' dividends of c$0.24/sh and our 12-month TP of $4.5/sh. Note our TP is down 30% from our previous TP on the change in TP-setting methodology, including DD&A normalization. We maintain our Gazpromneft rating of Buy (1).

Figure 45. Gazpromneft payout ratio and ROE



Source: Company data, Citi Research estimates (from 2014)

Figure 46. Gazpromneft DDM summary

	2010	2011	2012	2013	2014	2015	2024	Interim	2030
EPS	$0.7	$1.2	$1.2	$1.2	$1.0	$0.8	$1.5	---	$2.1
DPS	$0.16	$0.25	$0.23	$0.42	$0.30	$0.24	$0.37	---	$0.74
Payout	25%	37%	20%	34%	25%	24%	25%	25%	35%
ROE (total)	17.0%	25.7%	21.1%	19.2%	17.3%	13.0%	9.8%	---	10.4%
ROA (marginal								8.7%	
Leverage								155%	
ROE (marginal)								12.6%	12.6%
DPS growth	33%	56%	-6%	80%	-29%	-19%		9.4%	8.2%
Cost of equity					10.0%	10.0%	12.1%	---	12.8%

DDM value by period		
2014-2024 - Explicit stage	$1.9	39%
2025-2029 - Interim stage	$0.4	9%
2030 - Constant growth	$2.5	52%
Total	**$4.8**	**100%**

Source: Company data, Citi Research estimates (from 2014)
*Note that DPS may no match up with the dataCentral numbers on pg **Error! Bookmark not defined.** due to RUB/USD exchange rate differences in year paid vs year declared, and an interim dividend declared in 2012 that got paid out in 2013.

- **Normalized EPS:** We forecast Gazpromneft will earn $1.48/share in 2024, 25% above the $1.18/sh booked in 2013. Our 2020 EPS has the following main drivers and assumptions:

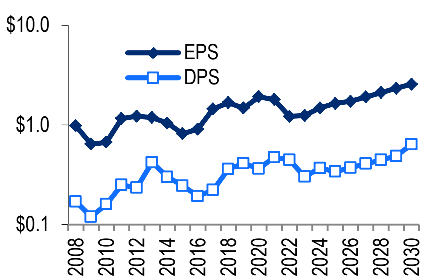
  – Oil prices of $125.4/bbl Brent ($90/bbl real), a rouble exchange rate of 44.3 per USD and PPI rouble inflation of 7% pa.

  – We assume the oil tax regime remains stable, with the "tax maneuver" passed as submitted to the Duma and in place indefinitely.

  – Including a contribution from JVs, in 2024 we project Gazpromneft to be producing 938kbd of oil production and 46bcmpa of gas production, up c11% and c219%, respectively, on 2013 levels. Most of the sharp increase in gas production comes from the company's SeverEnergia JV with Novatek.

  – The sharp drop in profitability seen around 2022 in Figure 47 comes from the expiration of tax breaks on the company's several greenfield projects.

Figure 47. Gazpromneft EPS, DPS on log scale



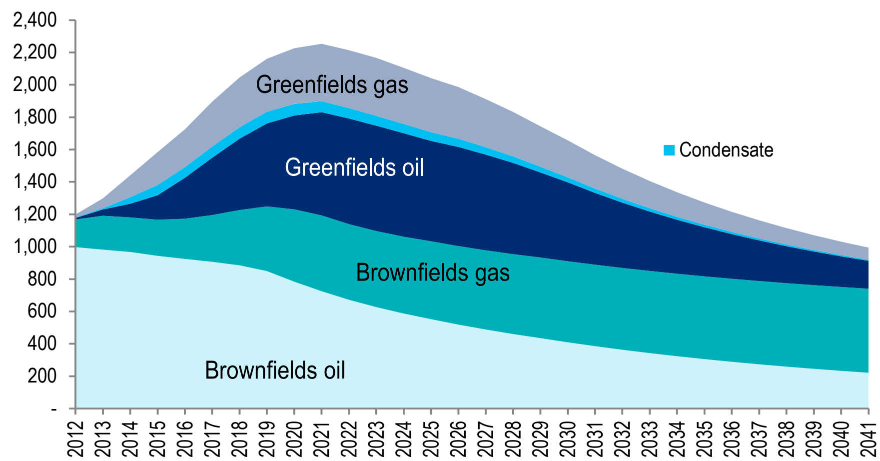
Source: Company data, Citi Research estimates (from 2014)

Growth prospects: Gazpromneft offers one of the best growth opportunities in the Russian oil and gas universe, in our view, aiming at growing hydrocarbon production by 74% up to 100mmtoe per annum by 2020 vs. 2013 and sustaining that plateau level throughout 2025 (Figure 48).

The growth case is underpinned by the ample portfolio of greenfield projects in Russia, which Gazpromneft is putting on stream from this year onwards. More importantly, many of those greenfields enjoy various tax breaks (predominantly on the MET front), which implies the impact on Gazpromneft's earnings will be even more pronounced than on production numbers (Figure 49).

The strong growth momentum, however, is preceded by a period of heavy capital expenditures needed to kick-start those greenfields, which in turn will depress Gazpromneft's free cash flows in 2015-2016E, possibly somewhat weighing over the share price performance in the near term (Figure 50).

Figure 48. Gazrpomneft's hydrocarbon production profile, kbpd



Source: Company data, Citi Research estimates (from 2014)

Figure 49. Gazpromneft's upstream greenfield projects in Russia and relevant tax breaks

Project	Gneft's share	Startup	Peak output, kboepd	Tax breaks
Orenburg	100%	2011	173	n/a
Severenergia	50%	2013	764	Zero MET rate unitl 2021 or total cumulative production of 25mmt
Novoport	90%	2014	172	Zero MET rate until 2021 or cumulative production of 15mmt; preferential export duty until 16.3% IRR reached
Prirazlomnoye	100%	2014	110	Zero MET rate until 2021 or cumulative production of 35mmt; preferential export duty until 16.3% IRR reached
Messoyakha	50%	2016	229	Two fields (Vostochno- and Zapadno Messoykhskoye) - Zero MET rate unitl 2021 or total cumulative production of 25mmt, preferential export duty rate until IRR of 16.3% is reached
Chonsky - North	100%	2017	50	(Tympuchikanskoye, Vakunaiskoye fields) - Zero MET rate until 2021 or total cumulative production of 25mmt, preferential export duty rate until IRR of 16.3% is reached
Chonsky - South	51%	2018	19	Ignyalinsky field - Zero MET until 2021 or total production of 25mmt, preferential export duty until IRR of 16.3% reached
Kuyumba	50%	2018	276	Zero MET rate until 2021 or cumulative production of 25mmt; preferential export duty until 16.3% IRR reached
Dolginskoye	100%	2021	96	Offshore tax regime: MET of 15% of hydrocarbon price, zero export duty until 31 Mar, 2032

Source: Company data, Citi Research

Figure 50. Gazpromneft's FCF decomposition, $bn

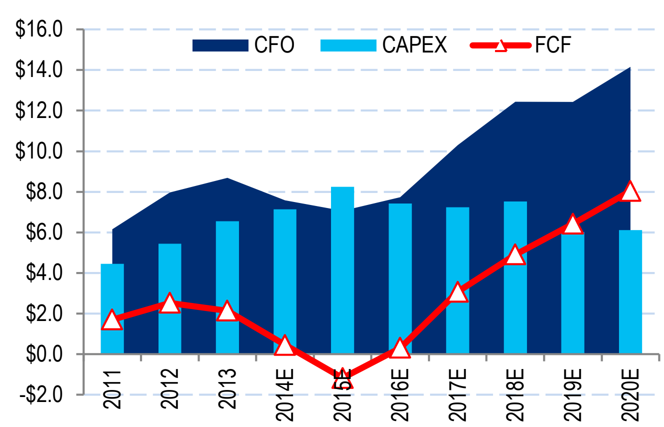
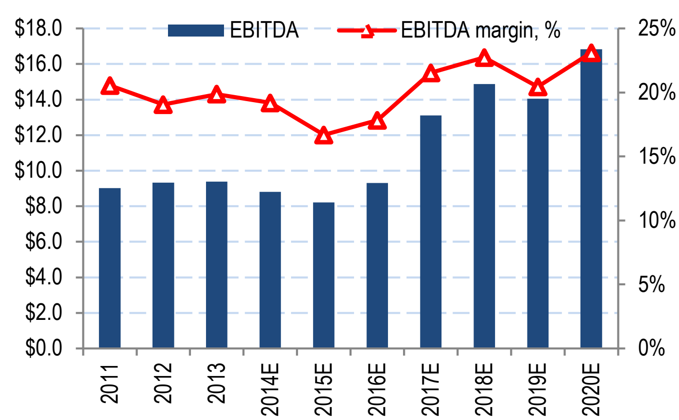


Figure 51. Gazpromneft's EBITDA outlook, $bn



Source for both charts: Company data, Citi Research estimates

Tax Maneuvers, Sanctions and Roubles

The Russian oil & gas sector, like the rest of the Russian equities market, has been roiled by the Ukrainian crisis, with some companies having been directly targeted by sanctions, a falling rouble, and a large "tax maneuver" being planned for the oil industry by the government.

Sanctions – Long-term opportunity costs

Modest near-term effect, but long-term opportunity costs will mount if sanctions sustained

In short, we see only a modest near-term effect on Russian production from the sanctions imposed by Europe and the US, possibly indiscernible against the normal background of decline rates, new greenfields being brought on-line, and the transition from vertical to horizontal drilling. Also, most of the activity on the margin of production in Russia is not actually in shale or the Russian arctic, activities on which sanctions apply, but in tighter, conventional horizons in West Siberia and other existing production regions.

However, longer term, the effects of sustained sanctions may begin to accumulate as Russian oil companies see their access to replacement resources limited. Over the course of 5 to 7 years, we'd expect the effect on Russian oil production to be increasingly noticeable, including the potential for outright decreases in production. In contrast, in the absence of sanctions we'd expect Russian oil production to continue to grow slowly overall, with offshore and unconventional production becoming a larger and growing part of the whole in the 2020s.

The "maneuver" and its effects on profitability

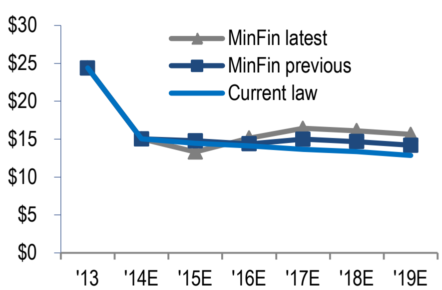
The so-called "tax maneuver", which has been in the works by the government for most of 2014, was submitted to the Russian Duma (parliament) in September, and we'd expect it to be passed largely as-is by the end of the year. We wrote about the proposal over the summer (link).

While some observers have made much of the drop in refining margins implied in the "tax maneuver", the drop is actually smaller than planned under existing law

Other than an effective expansion of tax breaks for shale plays introduced in September (link), the numbers in the final version submitted to the Duma are not all that different from what we wrote about in June. Our models show that, relative to the existing tax regime, the overall profitability of the industry will be boosted by c$3.0 per produced barrel, assuming a 50% refining coverage ratio. This will consist of a $2.8/bbl boost in upstream EBITDA and a $0.5/bbl boost in downstream refining margins, *again relative to the existing law*, which already implied a large overall drop in downstream margins. The downstream margin decline, as such, has been reduced from a fall of $6.7/bbl to $6.2/bbl.

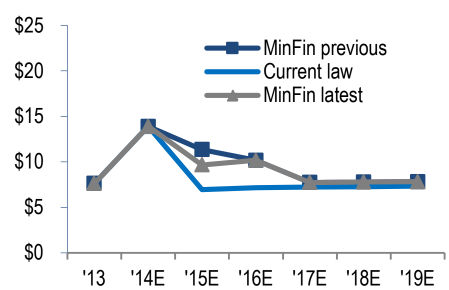
It is the transfer of that fall in downstream margins – achieved by the increase in export duties on fuel oil – that allows upstream margins to be increased without materially affecting government revenues, with the overall uptick in oil industry economics likely being paid for by higher domestic pump prices.

Figure 52. Upstream EBITDA



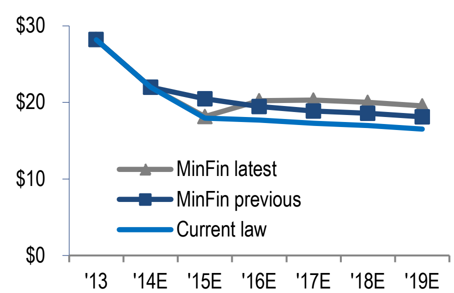
Source: Citi Research

Figure 53. Downstream EBITDA



Source: Citi Research

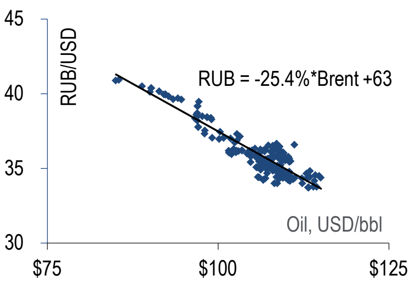
Figure 54. Blended EBITDA (50% coverage)



Source: Citi Research

Rouble levels, oil prices

Figure 55. Recent rouble/oil relationship



Source: Bloomberg, Citi Research

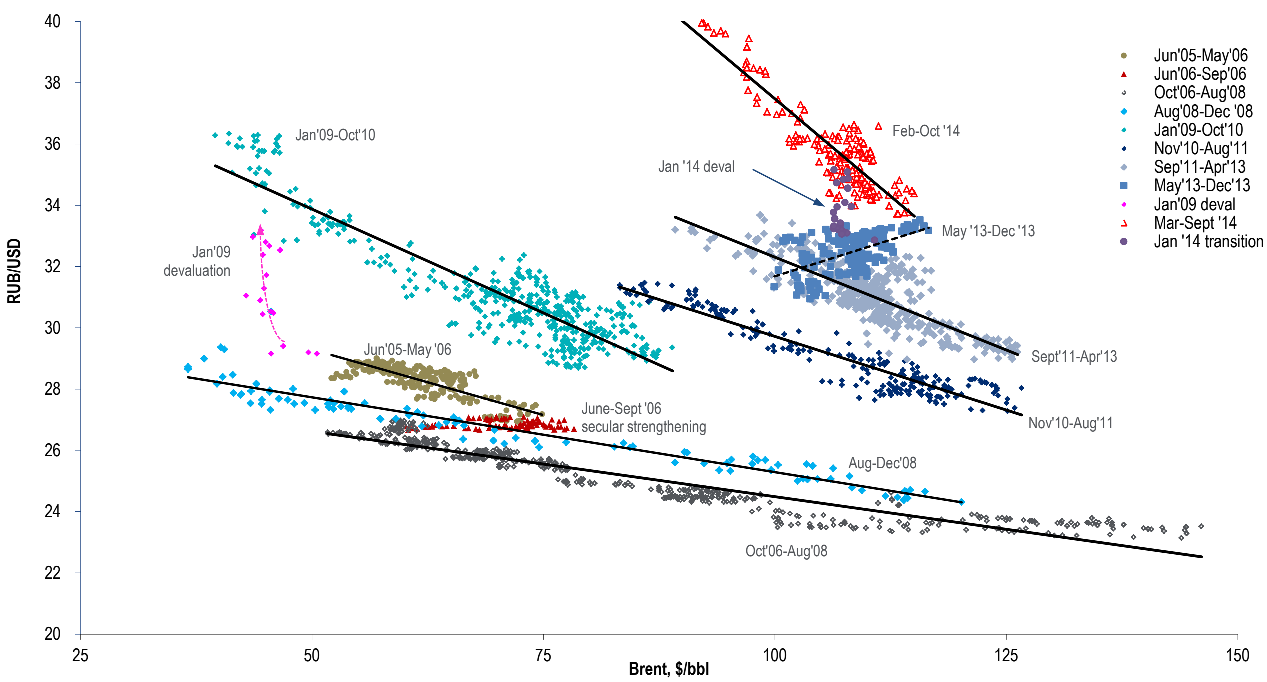
We adjust our rouble assumptions given recent weakness, weakening the rouble relative to the price of oil such that in a $100/bbl oil environment in the current year our rouble assumption moves from 36.0 RUB/USD to 37.3 RUB/USD. Our models now use the rouble/oil slope evident in the most recent trading period – in this case from February to October of 2014 – inflating that relationship going forward by 5%, the difference between an assumed 8% rouble inflation rate and a 3% USD inflation rate.

For more insights into the development of the rouble vs. oil prices this year, see our recent note on the subject available here, where we explain the significance of Figure 56. The addition of an inflation differential to our rouble assumptions is a relatively significant change to our policy and adds value to our oil companies' DDMs, helping the company stay abreast of cost inflation more than we had previously assumed. For example, all else being equal, it adds c2.2% to our 2020 EBITDA estimate for Lukoil and a larger 5.7% to our 2020 net income estimate.

We mark-to-market 2015 oil prices, raising our Russian oil team's $95/bbl Brent assumption to $97.5/bbl, in-line with Citi's broader oil team's assumptions for next year, and bring down our 2016 oil price assumption from $100/bbl Brent to $95/bbl, which accounts for the >10% in earnings in that year in our Lukoil and other models. All other near- and medium-term oil assumptions remain unchanged. In particular, we maintain a $90/bbl real oil price assumption in the 2016-2020 period.

Note that the changes in taxation policies and our rouble assumptions have caused some volatility in our medium-term forecasts for our explicit oil company models (2015-2019), and have generally boosted EBITDA by c$1 per produced barrel.

Figure 56. RUB/USD vs. Brent oil prices



Source: Citi Research

Company Focus

- Estimate Change
- Target Price Change
- Rating Change

Sell	**3**
from Buy	
Price (20 Oct 14)	US$3.28
Target price	US$2.90
from US$6.50	
Expected share price return	-11.5%
Expected dividend yield	4.3%
Expected total return	**-7.3%**
Market Cap	US$75,236M

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

Gazprom (GAZP.MM)

Downgrading to Sell; government dividend policy critical to DDM

- **Target price set at $2.9/sh ($5.9/ADR), downgrade to Sell:** Our DDM valuation for Gazprom is $3.1 per local share, giving an ETR of -7%. Excluding the next dividend, which we forecast at $0.16/sh and which should be paid in August of 2015, our 12-month target price is set at $2.9/sh ($5.9/ADR). We downgrade Gazprom from a Buy to Sell.

- **Dividend assumption change key to target price drop:** With this note we have lowered our mid- and long-term dividend assumption from 25% of IFRS net income – the official government target for state-owned companies, and number already in MinFin's 2016/17 budget – to the current effective 17.5% policy used by the company. We think the market fully discounts this possibility due to multiple delays of the deadline, and it is entirely plausible that the company will be able to put that increase off indefinitely.

  However, were we to receive indisputable confirmation that the company will be moved to that higher payout, our DDM value would rise by c26%, putting the stock back into Buy territory. Gazprom is by far the most sensitive stock to dividend policy in our universe of Russian oil & gas producers, given our low assumption for returns on retained earnings.

  Had we maintained our dividend assumption at 25% of IFRS net income, our TP would still have dropped a larger-than-average c40%, well above the 30% drop seen ex-Gazprom on the change to the DDM methodology. The difference is largely accounted for by our lowered assumptions on European pricing.

- **Upside possibilities in crisis resolution scenario:** Gazprom is the only company in the Russian oil & gas sphere with direct operational exposure to the Ukrainian crisis. While its DDM sensitivity to a reduction in Russian risk is a bit lower than average (refer back to Figure 3), the stock could conceivably outperform that in the event of a resolution to the Ukrainian crisis, as it would likely involve a resolution to the Russian-Ukrainian dispute over gas prices and volumes, a company-specific risk factor for Gazprom.

- **Changes to our forecasts:** We update our forecasts to reflect the so-called "tax maneuver", changes in the commodity team's 2015 oil prices, and a change in our rouble methodology to account for a devaluing currency. We lower our European pricing assumption from a 10% slope to oil to 9.5% (see pg 39), and reduce our European export volumes assumption slightly, from 158bcm in 2017 to 155bcm.

Gazprom (USD)

Year to 31 Dec	2012A	2013A	2014E	2015E	2016E
Sales ($M)	153,403.5	165,017.7	148,861.0	142,754.2	142,638.9
Profit Before Tax ($M)	50,104.1	46,658.7	38,446.6	35,211.2	33,003.7
Diluted EPS ($)	1.72	1.55	1.30	1.19	1.11
Diluted EPS (Old) ($)	1.72	1.55	1.24	1.20	1.22
PE (x)	1.9	2.1	2.5	2.8	3.0
EV/EBITDA (x)	1.8	1.8	2.1	2.2	2.3
DPS ($)	0.19	0.23	0.16	0.20	0.19
Net Div Yield (%)	5.9	6.9	4.7	6.1	5.7

Company Focus

- **Estimate Change**
- **Target Price Change**

Buy	**1**
Price (20 Oct 14)	US$3.59
Target price	US$4.50
from US$6.52	
Expected share price return	25.4%
Expected dividend yield	6.7%
Expected total return	**32.1%**
Market Cap	US$17,011M

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

Gazpromneft (SIBN.MM)

Still a Buy, but much less implied upside to TP

- **Target price lowered to $4.5/sh:** Our DDM valuation for Gazpromneft is $4.8 per local share ($23.8 per ADR). Excluding the next dividend, which we forecast at $0.24/sh and which should be paid in August of 2015, our 12-month target price is set at $4.5/sh.
- **Buy maintained, ETR similar to Lukoil:** With an ETR of 32%, a similar level to Lukoil, we rate Gazpromneft Buy. However, investors need to be aware that Gazpromneft's liquidity is relatively low, at c$2.5mn/d over the last month.
- **Changes to our forecasts:** We update our forecasts to reflect the so-called "tax maneuver", changes in the commodity team's 2015 oil prices, and a change in our rouble methodology to account for a devaluing currency.

Gazpromneft (USD)

Year to 31 Dec	2012A	2013A	2014E	2015E	2016E
Sales ($M)	48,969.1	47,222.5	45,941.0	49,239.1	52,213.6
Net Income ($M)	5,767.0	5,586.1	4,907.9	3,847.0	4,282.2
Diluted EPS ($)	1.22	1.18	1.04	0.82	0.91
Diluted EPS (Old) ($)	1.20	1.18	1.12	0.83	0.86
PE (x)	2.9	3.0	3.5	4.4	4.0
EV/EBITDA (x)	2.0	2.0	2.3	2.7	2.6
DPS ($)	0.30	0.29	0.26	0.20	0.23
Net Div Yield (%)	8.3	8.2	7.2	5.7	6.3

Company Focus

- Estimate Change
- Target Price Change

Buy	**1**
Price (20 Oct 14)	US$48.57
Target price	US$60.30
from US$76.30	
Expected share price return	24.2%
Expected dividend yield	6.2%
Expected total return	**30.3%**
Market Cap	US$37,614M

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

Lukoil (LKOH.MM)

Most attractive on implied upside potential, limited downside risk, and average exposure to crisis resolution

- **Target price set at $60.3/sh:** Our DDM valuation for Lukoil is $63.3 per share. Excluding the dividends to be paid over the next 12 months, our 12-month target price is set at $60.3/sh.
- **Maintain Buy, one of the more attractive stocks in our universe:** Lukoil's ETR of 30% is one of the most attractive in our universe after our switch to the DDM.
- **Middle-of-the-pack exposure to crisis resolution, limited downside risk:** In the event of a resolution to the Ukrainian crisis, Lukoil's DDM increase on a uniform reduction in Russia risk would be around average for our Russian oil & gas universe. With the stock currently trading around $50/sh – historically something of a support level for the stock – we think Lukoil offers an attractive combination of very solid fundamental upside potential, relatively limited downside risk and average exposure to any possible resolution of the crisis.
- **Changes to our forecasts:** We update our forecasts to reflect the so-called "tax maneuver", changes in the commodity team's 2015 oil prices, and a change in our rouble methodology to account for a devaluing currency.

Lukoil (USD)

Year to 31 Dec	2012A	2013A	2014E	2015E	2016E
Sales ($M)	139,171.0	141,452.0	140,723.4	134,683.8	135,727.7
Net Income ($M)	11,004.0	7,832.0	11,223.4	8,400.9	9,989.8
Diluted EPS ($)	14.58	10.38	14.87	11.13	13.23
Diluted EPS (Old) ($)	14.58	10.38	13.69	10.05	14.13
PE (x)	3.3	4.7	3.3	4.4	3.7
EV/EBITDA (x)	1.9	2.4	2.1	2.4	2.0
DPS ($)	2.89	3.45	3.60	3.91	3.52
Net Div Yield (%)	6.0	7.1	7.4	8.1	7.3

Company Focus

- Estimate Change
- Target Price Change

Buy	1
Price (20 Oct 14)	US$102.25
Target price	US$118.00
from US$146.00	
Expected share price return	15.4%
Expected dividend yield	2.5%
Expected total return	**17.9%**
Market Cap	US$30,884M

Price Performance
(RIC: NVTKq.L, BB: NVTK LI)

Novatek OAO (NVTKq.L)

Solid upside potential, high exposure to crisis resolution

- **Lower target price, but still a Buy:** Our DDM value for Novatek is $121/share, implying an 18% ETR from current levels. Excluding the dividends to be paid over the next 12 months, our 12-month target price is set at $118, 19% down vs. our previous target price on the change in valuation methodology. We maintain our Buy (1) rating on Novatek.

- **Solid upside potential, high exposure to crisis resolution:** Novatek's c18% ETR gives a reason to own the stock now, but it is the stock's exposure to a potential crisis resolution – its DDM value is among the most sensitive to a lowering of Russian risk – that makes it an interesting option for investors that might be seeking exposure to any potential Russian rally.

- **Changes to our forecasts:** We update our forecasts to reflect the so-called "tax maneuver", changes in the commodity team's 2015 oil prices, and a change in our rouble methodology to account for a devaluing currency. Note that the swooning rouble has led us to project a large paper FOREX loss in the 3rd and 4th quarters, contributing strongly to the reduction seen in our EPS projection for this year.

Novatek OAO (USD)

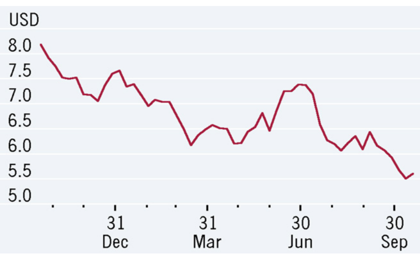
Year to 31 Dec	2012A	2013A	2014E	2015E	2016E
Sales ($M)	6,946.8	9,109.8	10,789.0	13,343.7	15,637.3
Net Income ($M)	2,287.1	2,353.6	2,583.0	3,851.8	4,845.6
Diluted EPS ($)	7.54	7.76	8.52	12.70	15.98
Diluted EPS (Old) ($)	7.37	7.96	10.01	11.82	15.28
PE (x)	13.6	13.2	12.0	8.0	6.4
EV/EBITDA (x)	9.1	5.8	5.8	4.7	3.8
DPS ($)	2.26	2.41	2.56	3.81	4.79
Net Div Yield (%)	2.2	2.4	2.5	3.7	4.7

Company Focus

- Estimate Change
- Target Price Change
- Rating Change

Neutral	**2**
from Buy	
Price (20 Oct 14)	US$5.55
Target price	US$6.00
from US$9.30	
Expected share price return	8.2%
Expected dividend yield	3.6%
Expected total return	**11.8%**
Market Cap	US$58,778M

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



Rosneft (ROSN.MM)

Downgrade to Neutral, but triple leverage to crisis resolution

Downgrade to Neutral:

- **Downgrade to Neutral:** Our DDM value for Rosneft is $6.2/share. Excluding the dividends to be paid over the next 12 months, our 12-month target price is set at $6.0/sh. That target price is 35% lower than our previous target price on the change in valuation methodology, exacerbated by the increase our CoE assumption by 50bpts above our base CoE used for most other companies in our universe. We downgrade Rosneft to Neutral (2), given the 12% ETR vs. the current market price.

- **But Rosneft most sensitive to crisis resolution:** Note that our DDM valuation for Rosneft is very sensitive to any potential resolution of the current crisis for 3 reasons:

  – First, its growth opportunities make the DDM relatively back-weighted, meaning a standard 100bpt decrease in Russia risk would result in a larger-than-typical increase in its DDM.

  – Second, we have added an extra 50bpts to Rosneft's risk in order to account for the effect the financial sanctions have on the relatively heavily levered company. The removal of this in the event of a lifting of sanctions would exaggerate Rosneft's DDM increase relative to the rest of our universe.

  – Third, we have held down our growth rate estimate in the interim period on the assumption that technological sanctions will limit the company's ability to exploit its arctic shelf and deepwater licences. We do this by limiting leverage in the interim period to the standard 155% A/E we use for most Russian oil & gas companies. Upon a full lifting of sanctions, however, we would be inclined to increase leverage, allowing the company to grow earnings faster by applying more capital to develop Rosneft's extensive offshore acreage.

- **Changes to our forecasts:** We update our forecasts to reflect the so-called "tax maneuver", changes in the commodity team's 2015 oil prices, and a change in our rouble methodology to account for a devaluing currency.

Rosneft (USD)

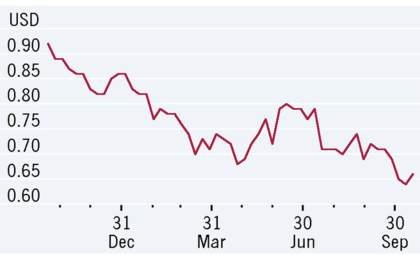
Year to 31 Dec	2012A	2013A	2014E	2015E	2016E
Sales ($M)	98,616.9	147,001.6	148,063.8	139,633.2	142,825.1
Net Income ($M)	12,576.4	16,671.9	8,331.6	12,395.3	12,894.4
Diluted EPS ($)	1.25	1.57	0.79	1.17	1.22
Diluted EPS (Old) ($)	1.25	1.57	0.93	0.98	1.42
PE (x)	4.5	3.5	7.1	4.7	4.6
EV/EBITDA (x)	4.0	3.5	4.2	3.8	3.5
DPS ($)	0.26	0.40	0.20	0.29	0.30
Net Div Yield (%)	4.7	7.3	3.5	5.3	5.5

Company Focus

- Estimate Change
- Target Price Change
- Rating Change

Sell	**3**
from Neutral	
Price (20 Oct 14)	US$0.65
Target price	US$0.47
from US$0.78	
Expected share price return	-28.2%
Expected dividend yield	3.1%
Expected total return	**-25.1%**
Market Cap	US$28,384M

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



Surgutneftegaz (SNGS.MM)

Downgrade to a high-conviction Sell

- **TP falls 40%:** Our DDM value for SurgutNG ords is $0.48. Excluding the dividends to be paid over the next 12 months, our 12-month target price is set at $0.47, giving a -25% ETR vs. the current stock price. The switch to the DDM methodology has an unusually large impact on the SurgutNG ord, as it provides a concrete methodology for putting a value on the vastly different dividend policies in effect for the ord and the pref. As we discuss in the main body of this report, this DDM value would be even lower but for our rather generous assumption that the common's payout will be equalized with that of the pref in 10 years' time.

- **Downgrade to a high-conviction Sell:** With our target price falling 40% on the change in methodology, from $0.78/sh to $0.47/sh, we downgrade the ord from Neutral (2) to Sell (3), and we recommend investors concentrate their SurgutNG exposure in the prefs alone, as we see strong valuation support for a continuation of the long relative revaluation between the two stocks. Indeed, SurgutNG's ordinary share is our least favourite Russian oil & gas stock under our coverage.

- **Changes to our forecasts:** We update our forecasts to reflect the so-called "tax maneuver", changes in the commodity team's 2015 oil prices, and a change in our rouble methodology to account for a devaluing currency.

Surgutneftegaz (USD)

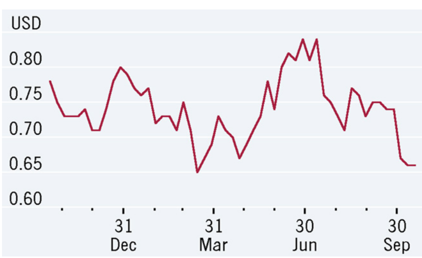
Year to 31 Dec	2012A	2013A	2014E	2015E	2016E
Sales ($M)	26,232.7	25,563.2	25,338.0	28,647.1	30,501.4
Net Income ($M)	4,644.0	7,696.0	8,442.9	4,615.5	5,177.2
Diluted EPS ($)	0.13	0.22	0.24	0.13	0.14
Diluted EPS (Old) ($)	0.13	0.22	0.23	0.14	0.15
PE (x)	5.0	3.0	2.8	5.0	4.5
EV/EBITDA (x)	-0.2	-0.6	-1.0	-1.0	-0.6
DPS ($)	0.02	0.02	0.02	0.02	0.01
Net Div Yield (%)	3.0	2.4	2.6	2.8	2.1

Company Focus

■ Target Price Change

Buy	**1**
Price (20 Oct 14)	US$0.65
Target price	US$0.74
from US$1.10	
Expected share price return	14.0%
Expected dividend yield	12.0%
Expected total return	**26.1%**
Market Cap	US$28,384M

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



Surgutneftegaz(pref) (SNGS_P.MM)

Still on Focus List; best defensive option available

- **Still a Buy and a favourite:** Our DDM value for SurgutNG prefs is $0.82/share, giving a c26% ETR vs. the current market price. Our target price declines 33% on the methodology change, from $1.10/sh to $0.74/sh, with next year's expected dividend filling the gap between our DDM value and our 12-month target price. The pref, long one of our favourite names in the Russian oil & gas sphere and our only stock on Citi's CEEMA Focus List, remains Buy-rated.
- **Very defensive, but limited upside risk from crisis resolution:** We argue that the pref remains one of the most defensive plays in the Russian oil & gas universe due to the heavy front-end weighting of its dividend stream. However, that same aspect of its dividend stream means SurgutNG's DDM would see a relatively weak response to lower Russian risk in the event of a resolution of the Ukrainian crisis.
- **Changes to our forecasts:** We update our forecasts to reflect the so-called "tax maneuver", changes in the commodity team's 2015 oil prices, and a change in our rouble methodology to account for a devaluing currency.

Surgutneftegaz(pref) (USD)

Year to 31 Dec	2012A	2013A	2014E	2015E	2016E
Sales ($M)	26,232.7	25,563.2	25,338.0	28,647.1	30,501.4
Net Income ($M)	4,644.0	7,696.0	8,442.9	4,615.5	5,177.2
Diluted EPS ($)	0.13	0.22	0.24	0.13	0.14
Diluted EPS (Old) ($)	0.13	0.22	0.23	0.14	0.15
PE (x)	5.0	3.0	2.8	5.0	4.5
EV/EBITDA (x)	-0.2	-0.5	-1.0	-0.9	-0.6
DPS ($)	0.07	0.05	0.07	0.08	0.05
Net Div Yield (%)	10.6	7.1	10.1	12.0	7.0

Gazprom

Company description

Gazprom is the world's largest gas company, with a core business producing, transporting and selling natural gas. Gazprom is the world leader by gas reserves, gas production and the size of its high-pressure gas transport system. The company is majority owned by the Russian government.

Investment strategy

We rate Gazprom's stock Sell (3). With Gazprom having largely resolved gas taxation issues, the key issues facing the company today are: a) dividend policy by the Russian government for state-owned enterprises (will they/won't they raise Gazprom's dividend?); b) contract pricing negotiations with Ukraine; and c) the European supply/demand balance and pressure on its pricing structure by clients there. We still nominally expect Ukrainian prices to be sharply cut in 2014 to bring them into line with European netback parity, although the negotiations have dragged on for far longer than we thought possible and are now inextricably intertwined with the entire Ukrainian crisis.

Valuation

Our target price of $2.9 is set as our DDM value of $3.1 less the projected upcoming dividend. Our driving assumptions for the DDM are a long-term growth rate of 6.1%, itself based off a marginal ROE of 7.6% and a dividend payout ratio of 20%. Our DDM value implies a 2014E EV/EBITDA multiple of 2.0x and a 2014E P/E multiple of 2.4x.

Risks

Among the upside/downside risks which could impede the shares from achieving our target price, we highlight potentially higher/lower European gas export prices; slower/faster-than-expected market share losses domestically as independent producers gain traction; and cost efficiencies/overruns on major CAPEX projects.

Gazpromneft

Company description

Gazpromneft (formerly Sibneft) is the fourth-largest integrated producer in Russia, operating from Western Siberia. The company also operates a refinery in Omsk. In 2005, Gazprom acquired 75% of Sibneft, later raised to c95%, and intends to use the unit as its platform for the oil business. Gazpromneft also owns a 50% stake in Slavneft jointly with Rosneft.

Investment strategy

We rate Gazpromneft stock Buy (1). Gazpromneft offers one of the best growth opportunities in the Russian oil and gas space, in our view, aiming to increase hydrocarbon production by c74% in 2020 as compared with 2013. We argue that Gazpromneft’s outstanding growth prospects, coupled with solid dividends yielding more than 5%, make it one of the more attractive oil and gas stocks in Russia in spite of relatively low stock liquidity.

Valuation

Our target price of $4.5 is set as our DDM value of $4.8 less the projected upcoming dividend. Our driving assumptions for the DDM are a long-term growth rate of 8.2%, itself based off a marginal ROE of 12.6% and a dividend payout ratio of 35%. Our DDM value implies a 2014E EV/EBITDA multiple of 3.4x and a 2014E P/E multiple of 4.6x.

Risks

Gazpromneft's primary risks are the same ones facing other Russian oil companies: oil price and ruble volatility, oilfield inflation, and a heavy tax burden. Additionally, there is a risk that Gazpromneft investors could face unfavourable treatment of minorities by the controlling shareholder Gazprom, and Gazprom's less efficient management culture could negatively impact earnings in the medium to long term if it begins to displace the disciplined legacy Sibneft culture. These risks could impede the share price from reaching our target price.

Lukoil

Company description

Lukoil is one of the largest vertically-integrated energy producers in the, world with a well-diversified asset base. Producing over 2mmboepd on a consolidated basis, Lukoil is Russia's second-largest oil producer and is the country's second-largest refiner, as well.

Investment strategy

We rate Lukoil stock Buy (1). Fundamentally, we see the Russian upstream oil segment and Lukoil in particular as being constrained by a high tax burden and by rapidly ageing West Siberian fields. Downstream is rather profitable and the company should see substantial earnings gains from its refinery upgrade programme, in our view. We also see Lukoil as providing solid exposure to the developing Russian independent gas industry among Russian oil majors. The Iraq project, having absorbed cash in 2013, finally began returning it in 2014, boosting FCF generation.

Valuation

Our target price of $60.3 is set as our DDM value of $63.3 less the projected upcoming dividend of $3.0/share. Our driving assumptions for the DDM are a long-term growth rate of 7.2%, itself based off a marginal ROE of 10.7% and a dividend payout ratio of 33%. Our DDM value implies a 2014E EV/EBITDA multiple of 2.8x and a 2014E P/E multiple of 4.3x.

Risks

The following risks may impede the achievement of our target price for Lukoil: Volatility in international crude prices; cost inflation; capex overruns; and changes in legislation, tax or otherwise, either in Russia or other countries where Lukoil has interests. Although the US sanctions levied in September of 2014 only touched Lukoil's operations on the very margin, and in spite of the company not being government-owned, it is conceivable that Lukoil could become more directly targeted by international sanctions.

Novatek OAO

Company description

Novatek is the largest independent gas producer in Russia, producing c62bcm in 2013. The company sells all of its gas in the domestic market, both delivering gas directly to end customers via Gazprom's gas transportation pipeline and, increasingly rarely, by sales to traders at the wellhead. Novatek also produces and sells substantial amounts of stable gas condensate and other liquids, processing and exporting the bulk of them via the company's own plants and port facilities, and is increasing its processing and refining capacity for natural gas liquids. Finally, Novatek is the lead partner in the Yamal LNG consortium, which beginning in 2017 will begin exporting LNG from Russia's Yamal peninsula.

Investment strategy

We rate Novatek stock Buy (1). Novatek is a growth play, in our view, with gas output expected to rise to c75bcm in 2017E from 62bcm in 2013, including increased production from an equity stake in SeverEnergia, but excluding the effect on operating numbers from Yamal LNG. The latter project will allow Novatek to export Russian gas to overseas markets, with first production to come in 2017E. Near term, we think the strongest growth contributor will be in liquids, with strong, double-digit growth expected in both 2014E and 2015E, mostly from the SeverEnergia JV.

Valuation

Our target price of $118 is set as our DDM value of $121 less the projected upcoming dividend. Our driving assumptions for the DDM are a long-term growth rate of 7.6%, itself based off a marginal ROE of 12.6% and a dividend payout ratio of 40%. Our DDM value implies a 2014E EV/EBITDA multiple of 7.8x and a 2014E P/E multiple of 14.2x.

Risks

Among the key risks that could cause the stock to deviate from our target price, we highlight the following: 1) slower pace of domestic gas tariff hikes as approved by the government; 2) Delays in its key Yamal LNG project; 3) Additional sanctions from Europe and/or the US (a key Novatek shareholders was named in the initial rounds of sanctions); and 4) Standard oil & gas company risks relating to oil price and exchange rate volatility. On the positive side, Novatek's DDM valuation is quite sensitive to discount rates, and the stock could rise substantially in the event of a decrease in risk around the Ukrainian crisis.

Rosneft

Company description

Rosneft is Russia's largest vertically integrated oil company and, after the completion of the TNK-BP acquisition, the world’s largest traded oil producer. Rosneft is one of the most active developers of the Russian continental shelf and Eastern Siberia.

Investment strategy

We rate Rosneft's stock Neutral (2). Rosneft provides exposure to vast natural resources, strong operational growth and considerable exploration upside, which comes from an extensive undeveloped portfolio, particularly in Russia's offshore and, to a lesser extent, in East Siberia. Rosneft's upstream prospects appear materially better than those of other major Russian oil companies, with production growth still to come at its key Vankor cluster of fields, numerous promising East Siberian exploration blocks, and long-term from its large offshore portfolio of licensed acreage. The company's $25bn refinery modernisation programme, while ambitious, looks to us set to earn returns well in excess of its cost of capital.

Valuation

Our target price of $6.0 is set as our DDM value of $6.2 less the projected upcoming dividend of $0.20/share. Our driving assumptions for the DDM are a long-term growth rate of 8.3%, itself based off a marginal ROE of 12.7% and a dividend payout ratio of 35%. Our DDM value implies a 2014E EV/EBITDA multiple of 4.3x and a 2014E P/E multiple of 7.9x.

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 favourable taxation regime and favourable transportation tariffs for eastbound routes. In 2H14 Rosneft was hit by sanctions imposed on Russia by Europe and the US, impairing its ability to raise long-term financing and its access to the technology to develop its offshore and shale reserves – there is a possibility that these sanctions could be deepened or, on the positive side, removed in the course of our 12-month target price horizon.

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) as its only refinery. As such, it has less downstream exposure relative to its production level than most of its domestic peers. The shareholder structure is opaque and distorted by a significant treasury position.

Investment strategy

We rate Surgutneftegaz ords Sell (3). Operationally, Surgutneftegaz provides limited volume growth, but a long-running downstream upgrade project now completing should sustain high profitability there even as changes to the tax regime move profitability upstream. Poor corporate governance (via low transparency - we actually consider operational management to be solid) is offset by the benefits of the largely dollar-denominated cash pile, which decreases the company's leverage to oil prices and changes its ruble strength relative to its Russian peers. Corporate governance improved noticeably in 2013 when the company finally began publishing IFRS results. We note the ords have a demonstrably inferior call on company cash flows than the prefs.

Valuation

We set our ordinary share target price at $0.47, calculated as our DDM value of $0.48 less the projected upcoming dividend. Our driving assumptions for the DDM are a long-term growth rate of 4.3%, itself based off a marginal ROE of 7.2% and a dividend payout ratio of 40% across both share classes. We use a lower Cost of Equity of 11.4% for the ord vs. 12.8% for most of the rest of our Russian oil & gas universe to account for the lower-risk earnings on the company's cash position.

Risks

SurgutNG is exposed to all of the same industry-specific risks as its peers. Corporate governance and transparency risks 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$35bn). These risks could cause the share price to overshoot or undershoot our target price.

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) as its only refinery. As such, it has less downstream exposure relative to its production level than most of its domestic peers. The shareholder structure is opaque and distorted by a significant treasury position.

Investment strategy

We rate the Surgutneftegaz preferred share Buy (1). Operationally, Surgutneftegaz provides limited volume growth, but a long-running downstream upgrade project now completing should sustain high profitability there even as changes to the tax regime move profitability upstream. Poor corporate governance (via low transparency - we actually consider operational management to be solid) is offset by the benefits of the largely dollar-denominated cash pile, which decreases the company's leverage to oil prices and changes its ruble strength relative to its Russian peers. Corporate governance improved noticeably in 2013 when the company finally began publishing IFRS results. We note the pref has a demonstrably superior call on company cash flows vs. the ords 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 preferred share target price of $0.74 is set as our DDM value of $0.82 less the projected upcoming dividend. Our driving assumptions for the DDM are a long-term growth rate of 4.3%, itself based off a marginal ROE of 7.2% and a dividend payout ratio of 40% across both share classes. However, we use a lower Cost of Equity of 10.6% for the pref vs. 11.4% for the ord and 12.8% for most of the rest of our Russian oil & gas universe to account for the very high quality of its dividend policy (a guaranteed 40% payout of pro-rata EPS).

Risks

SurgutNG is exposed to all of the same industry-specific risks as its peers. Corporate governance and transparency risks 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$35bn). 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

Lukoil (LKOH.MM)

Ratings and Target Price History
Fundamental Research

Analyst: Ronald Paul Smith

	Date	Rating	Target Price	Closing Price
1	7-Oct-11	Stock rating system changed		
2	16-Nov-11	1	*70.60	56.67
3	22-May-12	1	*66.30	52.16
4	29-Oct-12	1	*76.60	60.44
5	1-Apr-13	1	*81.00	63.53
6	16-Sep-13	1	*88.00	62.77
7	22-Oct-13	1	*95.00	66.52
8	20-Feb-14	1	*92.90	57.11
9	14-Apr-14	1	*90.20	52.24
10	13-May-14	1	*76.30	55.38

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Lukoil (LKOH.MM)

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

Analyst: Ronald Paul Smith

	Date	Rating	Target Price	Closing Price
1	22-May-12	*REM MP	-	52.16
2	29-May-12	*ADD MP	-	53.40
3	21-Sep-12	*REM MP	-	62.61

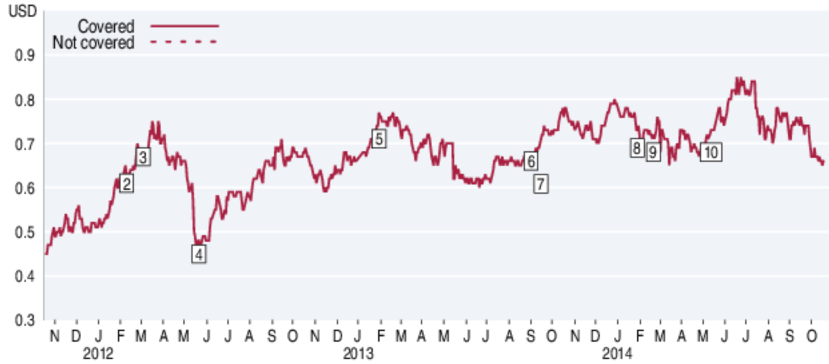
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Surgutneftegaz(pref) (SNGS_p.MM)

Ratings and Target Price History
Fundamental Research

Analyst: Ronald Paul Smith



	Date	Rating	Target Price	Closing Price
1	7-Oct-11	Stock rating system changed		
2	9-Feb-12	1	*0.71	0.63
3	5-Mar-12	1	*0.96	0.68
4	22-May-12	1	*0.88	0.48
5	30-Jan-13	1	*0.99	0.77
6	2-Sep-13	1	*1.11	0.67
7	16-Sep-13	1	*1.18	0.71
8	29-Jan-14	1	*1.15	0.73
9	20-Feb-14	1	*1.14	0.72
10	13-May-14	1	*1.10	0.73

* 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

	Date	Rating	Target Price	Closing Price
1	10-Feb-14	*REM MP	-	0.73

* 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

	Date	Rating	Target Price	Closing Price
1	7-Oct-11	Stock rating system changed		
2	9-Feb-12	1	*1.28	0.98
3	22-May-12	1	*1.17	0.81
4	16-Sep-13	1	*1.24	0.85
5	22-Oct-13	1	*1.25	0.93
6	29-Jan-14	*2	*0.88	0.79
7	20-Feb-14	2	*0.87	0.77
8	13-May-14	2	*0.78	0.73

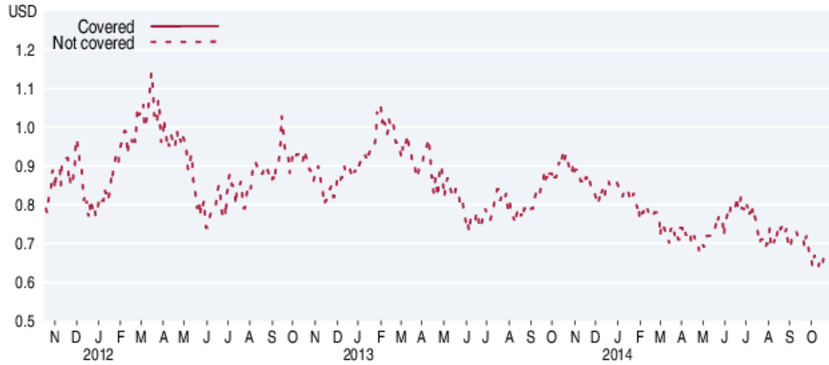
* Indicates change

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



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Novatek OAO (NVTKq.L)

Ratings and Target Price History
Fundamental Research

Analyst: Ronald Paul Smith

	Date	Rating	Target Price	Closing Price
1	7-Oct-11	Stock rating system changed		
2	9-Feb-12	*2	*153.00	135.50
3	30-Apr-12	2	*149.00	127.10
4	16-May-12	*1	149.00	109.30
5	22-May-12	1	*139.00	105.00
6	21-Sep-12	1	*153.00	125.00
7	19-Mar-13	1	*151.00	104.30
8	30-May-13	1	*163.00	112.00
9	22-Oct-13	1	*168.00	141.50
10	20-Feb-14	1	*173.00	124.50
11	13-May-14	1	*143.00	115.45
12	2-Jun-14	1	*146.00	118.85

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Novatek OAO (NVTKq.L)

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

Analyst: Ronald Paul Smith

	Date	Rating	Target Price	Closing Price
1	13-Feb-12	*ADD LP	-	136.50
2	22-May-12	*REM LP	-	105.00
3	30-May-13	*ADD MP	-	112.00
4	17-Jul-13	*REM MP	-	127.70

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Gazpromneft (SIBN.MM)

Ratings and Target Price History
Fundamental Research

Analyst: Ronald Paul Smith

	Date	Rating	Target Price	Closing Price
1	7-Oct-11	Stock rating system changed		
2	22-May-12	1	*5.77	4.22
3	16-Sep-13	1	*6.31	4.43
4	22-Oct-13	1	*6.48	4.66
5	20-Feb-14	1	*6.52	4.07

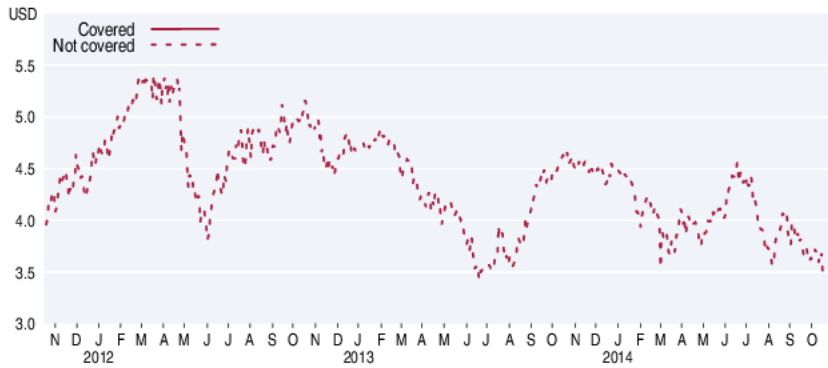
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Gazpromneft (SIBN.MM)

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

Analyst: Ronald Paul Smith



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Gazprom (GAZP.MM)

Ratings and Target Price History
Fundamental Research

Analyst: Ronald Paul Smith

	Date	Rating	Target Price	Closing Price
1	7-Oct-11	Stock rating system changed		
2	9-Feb-12	1	*8.00	6.36
3	20-Mar-12	*2	*6.50	6.36
4	30-Apr-12	*1	*7.50	5.76
5	22-May-12	1	*7.20	4.59
6	30-May-13	1	*6.80	3.78
7	18-Jul-13	1	*7.00	4.01
8	16-Sep-13	1	*7.50	4.50
9	22-Oct-13	1	*7.80	4.86
10	20-Feb-14	1	*7.50	4.15
11	13-May-14	1	*6.50	3.97

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Gazprom (GAZP.MM)

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

Analyst: Ronald Paul Smith

	Date	Rating	Target Price	Closing Price
1	17-Jul-13	*ADD MP	-	4.06
2	20-Jan-14	*REM MP	-	4.14

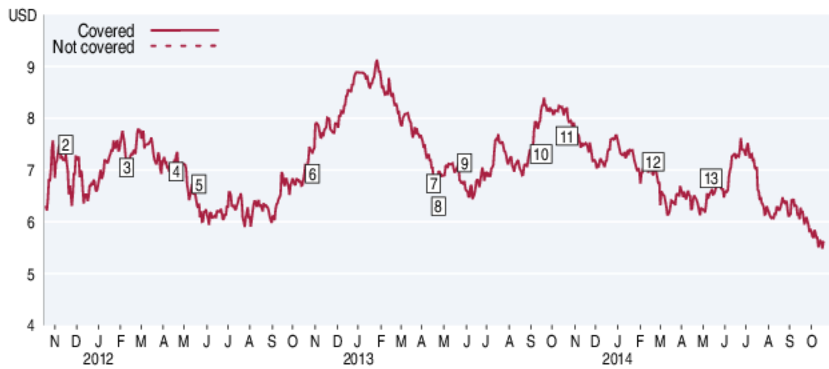
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Rosneft (ROSN.MM)

Ratings and Target Price History
Fundamental Research

Analyst: Ronald Paul Smith



	Date	Rating	Target Price	Closing Price
1	7-Oct-11	Stock rating system changed		
2	16-Nov-11	1	*9.90	7.30
3	9-Feb-12	*2	*8.20	7.14
4	19-Apr-12	*1	8.20	7.28
5	22-May-12	1	*7.30	6.35
6	29-Oct-12	1	*9.10	7.32
7	17-Apr-13	1	*9.45	6.74
8	24-Apr-13	1	*9.53	6.98
9	30-May-13	1	*9.20	6.79
10	16-Sep-13	1	*10.00	8.15
11	22-Oct-13	1	*11.00	8.21
12	20-Feb-14	1	*11.30	6.90
13	13-May-14	1	*9.30	6.58

* 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

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

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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	12 Month Rating			*Relative Rating*		
Data current as of 30 Sep 2014	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Research Global Fundamental Coverage	48%	40%	12%	0%	100%	0%
% of companies in each rating category that are investment banking clients	66%	63%	56%	0%	64%	0%

Guide to Citi Research Fundamental Research Investment Ratings:

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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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Citigroup Global Markets Ltd	Alastair R Syme; Michael J Alsford
Citigroup Global Markets Brazil	Pedro Medeiros
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