Citi Research
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Integrated Oils
CEEMEA

Russian oil & gas

Corporate Governance Is Improving – An Overlooked Theme

We see 3 key, active themes in Russian oil & gas: 1) The investment environment continues to improve, with the government pushing for better management of SOEs, with higher dividends from Gazprom a potential bright-line indicator of progress; 2) Russia is looking to open two major new oil production provinces (the Kara Sea and onshore shale plays) with the drill bit; and 3) The Russian OFS sector may be going through a phase change as the horizontal revolution arrives in Russia. Gazprom and SurgutNG prefs remain our favourite E&P plays, but we think a strong argument can be made for an overweight position in Russian oil & gas in general.

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- **Investment environment improvements likely to continue, watch dividends:** With top-down improvements in the Russian oil & gas investment environment in the books – a new gas tax law, tight oil tax breaks and LNG export liberalization were all passed in 2013 – the focus in 2014 is on improvements in corporate governance. Most prominently, we will be watching for follow-through on proposed shareholder-friendly KPIs for state-owned companies, with higher dividend payouts, particularly at Gazprom, being the key event to look for. Given the skepticism with which investors view the returns on reinvested cash at Russian companies, we think another material dividend increase could have profound implications.

- **A key year for offshore, tight oil development:** Rosneft and ExxonMobil will drill a key exploratory well in the Kara Sea this summer, with that well holding the potential to catalyze investor interest in the upside inherent Rosneft's 46 offshore licences. Elsewhere, tight-oil tax breaks in hand, oil companies are testing the Bazhenov shale and other tight oil plays in earnest, and 2014 should see substantial news flow regarding Russia's prospects for joining the shale oil boom.

- **OFS activity growth to continue, but complexity/tight oil may change flavour:** We think OFS activity in Russia should continue to grow at a steady, strong rate, with OFS companies generally benefitting. However, higher horizontal drilling may cannibalize vertical drilling, and change the calculus of who benefits.

- **Model and target price adjustments:** We revise our forecasts and target prices to include: Novatek's swap of 51% of Sibneftegaz to Rosneft for more SeverEnergia; Rosneft's full-year 2013 results; our lower 2014 and 2015 oil price assumptions (in line with Citi's commodity team's view); and our weaker ruble assumptions to reflect both lower oil price assumptions and recent ruble weakness.

- **Favoured stocks – Gazprom, SurgutNG prefs, plus TMK and CAToil in OFS:** ■ Our favoured blue chip play is Gazprom (Focus List), where we see 3 catalysts (strong European exports, potential Chinese deal, and increasing dividend payouts). ■ SurgutNG prefs (Focus List) also remain a favourite, destined, we think, to trade at a significant premium to the ords and providing the best leverage in the sector to a weaker ruble; ■ TMK and CAToil remain our favoured Russian OFS plays.

Data Summary

		Rating		Target Price		Current Year Earnings Estimates	
Company	**Ticker**	**Old**	**New**	**Old**	**New**	**Old**	**New**
Bashneft	BANE.MM	1	1	US$80.50	US$81.60	US$9.28	US$7.50
Gazprom	GAZP.MM	1	1	US$7.80	US$7.50	US$1.46	US$1.50
Lukoil	LKOH.MM	1	1	US$95.00	US$92.90	US$14.05	US$13.21
Novatek	NVTKq.L	1	1	US$168.00	US$173.00	US$9.52	US$8.90
Rosneft	ROSN.MM	1	1	US$11.00	US$11.30	US$1.08	US$0.53
Gazpromneft	SIBN.MM	1	1	US$6.48	US$6.52	US$1.15	US$1.15
Surgutneftegaz	SNGS.MM	2	2	US$0.88	US$0.87	US$0.23	US$0.23
Surgutneftegaz(pref)	SNGS_P.MM	1	1	US$1.15	US$1.14	US$0.23	US$0.23
Tatneft	TATN.MM	2	2	-	-	US$0.95	US$1.06
Tatneft(pref)	TATN_p.MM	2	2	-	-	US$0.95	US$1.06

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The Key Themes for 2014

The key themes for Russian oil & gas names 2014 will likely include: 1) Will the investment environment improvement continue in 2014? (hint: watch dividends); 2) Will major oil provinces be found in Russia's Kara Sea and Russia's shale plays? (test wells are planned in both); and 3) Will drilling activity continue to rise, or will rising horizontal drilling cannibalize vertical activity?

Theme 1: Investment environment

KPIs, dividends, cost controls, and CAPEX oversight

Last year we tracked closely numerous improvements in the investment environment for Russian oil & gas, including the passage of the new gas tax law, tax breaks for tight oil, LNG export liberalization, further pressure for improving dividends from state-owned companies, and indications the state may push to have shareholder-friendly KPIs established at state-owned companies. Note that the improvements actually booked last year were generally positive for the industry itself, either de-risking investment in the field (the gas tax law) or improving opening up new opportunities for investment (offshore tax law, tight oil tax breaks, LNG liberalization).

Further changes in the operating environment, we think, are likely to wait at least until 2015, as we think the multiple changes to tax laws in 2013 will have to be tested in the field before any further tweaks are proposed. In particular:

- A number of test wells will be drilled into the Bazhenov and other tight oil plays to gauge the economics of production under the tax breaks approved last summer. However, we are not yet sure the waiver of the mineral extraction tax (MET) will prove sufficient for Bazhenov production (see Russian Oil Tax Reform - MET breaks on Bazhenov shale: Sufficient for a West Siberian renaissance?, October 2012), and think the government may have to extend a modest decrease in export duties for shale production to kick off full-scale development of that resource.
- The gas tax law will likely be stable for at least a year or two before meaningful tweaks might be considered based on the experience in the field with its practical implementation.
- Oil taxation should also be relatively quiet until 2015, when we think the scheduled increase in fuel oil duties could potentially be delayed.

In 2014 improvements will likely be more focused on improving corporate governance – KPIs and/or dividend reform – rather than changes to the investment environment directly in the oil field. Improving the economic performance of Russia's SOEs, particularly Gazprom, appears to enjoy government-wide support, with major initiatives having been recently offered by Rosimuschestvo, Ministry of Finance (MinFin) and the Ministry of Economic Development. The key driver behind the push, we think, is a desire to increase Russia's sustainable economic growth rate, increase government revenues, and increase equity market valuations to support the medium- and long-term privatization plans of the Russian government.

Below we detail the initiatives we have noted on this front:

Enter Rosimuschestvo – KPIs

In late November, Rosimuschestvo, or Russia's State Property Agency, issued a proposed set of guidelines for state-owned companies that would establish Key

Performance Indicators (KPIs) for management teams.[1] This proposal came as a direct result of a directive issued by President Vladimir Putin in early July following the St. Petersburg Economic Forum. While yet to be turned into official law, the guidelines as proposed imply a significant improvement in corporate governance may be forthcoming:

- The introductory paragraph of the document (1.1) indicates that total shareholder return (TSR) will be one of the mandatory KPIs for the management teams of publically traded SOEs (Gazprom, Rosneft, et al), underlining its importance to the overall project. Non-traded SOEs will be judged on the dividends they pay to the government.
- Additionally, all companies, public or otherwise, will be required to adopt a minimum target for either return on equity (ROE) or return on invested capital (ROIC).
- Other KPIs, not to exceed 7 in total, are to be chosen depending upon the industry in which the organization works.
- The document lays out official definitions of measurements likely to show up in KPI calculation, including EBITDA, ROE, TSR[2], ROIC, and Net Debt, among others.

The devil in the details – how well will this be enforced, and how incentivized will management teams be?

The KPIs, per the document, are to be tied directly to management compensation and hiring and firing decisions. Unfortunately, there is little to no detail as to how that is to be accomplished. This is the devil lurking in the details: If rigorously implemented, Rosimuschestvo's proposal could revolutionize the management and performance of Russia's state-owned companies. If ignored or lackadaisically implemented, then little to nothing will change other than the generation of some extra paperwork for bureaucrats.

Our own expectations are for partial success, in particular in the realm of the headline KPI, total shareholder returns, and in particular the dividend portion of that measurement. The test case for this, we think, will be Gazprom: 1) it is the largest single pool of dividends for the government; and 2) if discipline cannot be enforced there, then the government might struggle to enforce it elsewhere, raising the stakes from the government's point of view in terms of Gazprom's payout policy.

Enter the Ministry for Economic Development – Cost cuts, CAPEX efficiency

In early December *Vedomosti* reported that Russia's Ministry for Economic Development has ordered 4 major state-owned companies – Gazprom, Transneft, Russian Railroads, and MRSK – to prepare a plan by December 10th for cutting expenses and CAPEX by 10% annually for the next five years, a total 41% cut over the period, without impairing operations. While the chance of achieving that level of cost cuts doesn't appear large to us, the stress between flat tariffs on the one hand (all four of those companies are regulated in the Russian market) and the need to maintain or even increase dividends to the government on the other dictate that something needs to give, hence we think cost savings may – finally – be on the way

[1] The proposed guidelines can be found in Russian at http://www.rosim.ru/documents/143749 or via a machine translation at http://translate.google.com/translate?depth=1&hl=en&ie=UTF8&prev=_t&rurl=translate.google.com&sl=auto&tl=en&u=http://www.rosim.ru/documents/143749.

[2] For example, Total Shareholder Return = ((Share price at end of period - share price at the beginning of the period + dividends paid during the period) / share price at the beginning of the period) * 100%

(see Government demands for cost reductions may be too ambitious, but even partial success would be a major gain).

Enter MinFin: Dividend demands rising

Russia's Ministry of Finance (MinFin) – arguably the most powerful among Russia's various branches of government – has prominently included in its 3-year budget rising payouts from SOEs in 2015 and 2016, first to 25% of IFRS net income (vs. 25% of RAS currently), and then to 35% of IFRS in 2016 (see Beware misinterpretation – Budget implies higher dividend payouts still coming). In the case of Gazprom – which we argue below will serve in the role of both test case and prominent example for the government's dividend discipline – those changes in policy are the equivalent of two consecutive 40% increases in payout for the company.[3]

While we have our doubts about the move to a 35% payout – we think it may have been put on the table by MinFin as a bargaining chip in intra-governmental budget negotiations – we are increasingly confident that the 25% of IFRS requirement will indeed be achieved for the 2015 budget cycle, implying that Gazprom's dividends on 2014 earnings will likely be rising significantly, and investors should get confirmation of this by October, if not earlier.

Why dividends are key, and likely rising

Raising the dividend requirements for SOEs has several advantages from the government's point of view – they are easily measurable, are easily implemented from the top down, are less subject to accounting manipulation, immediately raise much-needed funds for government coffers, and, in our view, should have a noticeable impact on share prices.

Higher dividends are also supported by a broader swathe of the government than just MinFin, we think, as Rosimuschestvo sees in them the chance to improve market valuations ahead of its ambitious privatization schedule and the Ministry of Economic Development likely sees improved capital efficiency as an important factor in increasing Russia's medium- and long-term economic growth rate.

We have written before on this subject, and suggest referring to the notes below for more background.

- Autumn policy blitz moving faster, more positive than thought;
- Policy blitz update: Investment environment improving; Oil tax changes boost unconventional economics

[3] As Gazprom RAS accounts only consolidate the gas business, net income under RAS is typically c70% of the size of reported IFRS net income. Therefore, a move from a RAS-based payout to an IFRS-based payout increases dividends by 1/0.7-1=40% increase. Likewise, a move from a 25% payout to 35% payout is also a 40% increase.

What's different this time – Slow economic growth

The corporate governance improvements, like last year's tax reform and LNG export liberalization, are largely top-down initiatives and are driven, we think, by two general goals: 1) to broaden the government's revenue base; and 2) to improve Russia's investment environment, in turn accelerating economic growth and improving the government's chances of successfully privatizing at least some of the several hundred SOEs on its privatization list. In our view, the sharp slow-down in economic growth in the 2nd half of 2012 is providing the impetus behind the thrust towards an improved investment environment.

Broadening the revenue base…

By requiring state-owned companies – Gazprom in particular – to increase their payout ratios to 25% of IFRS net income, the government can potentially raise billions of additional dollars annually for its budget. Because of the absolute size of the company, Gazprom is the primary source of potential additional dividend revenues.

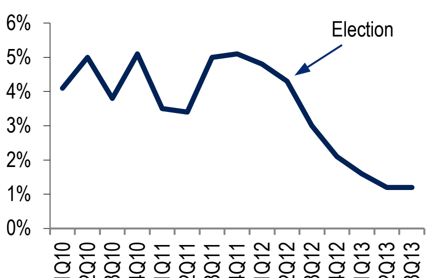
For example, in 2014 we expect the company to generate c$32bn of net income per IFRS accounting, and to book probably $23bn under RAS accounting. RAS net income is typically – but not always – around 70% of net income under IFRS. A move from 25% of RAS net income to 25% of IFRS net income would therefore raise the typical dividend by c.40%. In this case, the current RAS-based dividend policy would generate a total payout of c$5.6bn, while a policy of 25% of IFRS net income would result in a $8.1bn dividend, pushing the government's 50% share of that up by $1.2bn, and increasing the prospective dividend yield from 5.5% to 7.8% on the current share price.

We see the Ministry of Finance (MinFin) as being the primary champion of this line of argument – higher dividends for the sake of higher cash flows for government coffers.

…and improving Russia's investment environment

The Russian government began moving on most of the reforms recently enacted (the gas tax law, tight oil tax breaks, the offshore tax regime) immediately after President Putin's election in March of 2012, or more than a year before their passage. We think the primary impetus of these reforms was to attempt to accelerate economic growth from the 4%-5% pace seen after the average 7% pace seen between 2000 and the onset of the world financial crisis in 3Q08.

Figure 1. Russian GDP growth



Source: Bloomberg

If that was the impetus behind the reforms, then the subsequent sharp slowdown in the second half of 2012 (Figure 1) will have only underlined the government's need to restart economic growth. Given previous levels of growth, we sense the c1.3% growth rate seen in 2013 is unacceptable to either the government or the electorate.

Faced with a strong need to re-start economic growth and limited available macroeconomic tools (typical stimulus spending is of limited effect, we think, due to high leakage of such spending), we think the government has latched onto the perfectly logical idea of increasing the performance in the country's key sector – oil & gas – and of state-owned enterprises, which account for a large part of the country's GDP. The world's largest traded oil company (Rosneft) and gas company (Gazprom) are both SOEs, and there is obviously a high degree of overlap between the two categories.

If approved and implemented with even modest success, Rosimushestvo's proposed imposition of KPIs could materially improve corporate governance, with rising and significant dividends being a bright-line indicator of corporate governance improvements, in our view. We think the government has fixed its attention on

dividends not only because it raises near-term cash for government coffers and improves corporate governance, but because it is a reform that is relatively easily implemented and easily measured.

Evidence of progress on KPIs, dividends, buybacks

We have ample evidence of government intentions to improve, even if it must be compiled

The evidence we have been noting on the progress towards improving corporate governance is mostly made up of relatively small data points, either a comment by a manager here or a politician there. However, we also have a number of headline statements that help us illustrate why we think this is a serious initiative by the Russian government.

For example:

- Rosimushestvo's KPI proposal from late last year, as a formal proposal made in direct response to an order by Russian President Vladimir Putin, indicates high-level interest in improving corporate governance at state-owned companies (Russian corporate governance update: Government proposes tying management pay to Total Shareholder Return).
- Vedomosti's story[4] in January serves as a useful summary on how the various parts of the government are pushing for the next step in increasing dividends, and included statements indicating that the Ministry of Economics also backs the initiative of moving to a standard payout policy of 25% of IFRS net income. (Dividends back in the headlines, CEO in China: All 3 catalysts in play).
- On its 3Q13 IFRS conference call, Gazprom's management seemed accepting of the idea of paying 2015 dividends on 2014's IFRS rather than RAS accounts, and seemed to indicate that at this time they are just waiting for the official order.[5]
- A recent news story (Interfax) indicated that Gazprom's BoD is openly considering share buybacks, studying as a model ExxonMobil, and included comments to this effect from Deputy CEO and Head of Gazprom Export, Alexander Medvedev. While we would be a little surprised to see such a development in the near future, we think the fact that share buybacks are being discussed at all – and based on the example set by a company with one of the most sterling reputations for corporate governance globally – is a reflection of which way the wind is blowing at the top levels of the government and state-owned companies.
- Follow Sechin's lead: Since taking the CEO post at Rosneft in May of 2012, Igor Sechin has had Rosneft proactively adopting stated Kremlin policy on corporate governance, particularly on dividends and cost savings. We see this as setting an example that other SOEs – particularly Gazprom – are expected to follow.

  In particular:

  - Dividends: Immediately following Vladimir Putin's election to the Presidency, Igor Sechin has taken the lead on initiating government policies at the company level. In particular, upon his arrival in May of 2012, Mr. Sechin quite quickly set about increasing the company's payout to 25%

[4] http://www.vedomosti.ru/newspaper/article/608111/goskompaniyam-propishut-rost-dividendov

[5] Per Bloomberg's transcript, the translated comment to the question on moving to IFRS-based dividends was the following: "We are considering moving to this arrangement. We are currently in negotiation - in talks with relevant ministries on this, and we'll be ready to move to the new arrangement when we are instructed to do so."

of IFRS. With the BoD having already recommended a dividend of RUB3.45/share in April, and following a public direction from President Putin to raise dividends on June 15, Mr. Sechin asked for and received permission from the government to increase the dividend to a total of RUB7.53/sh, over double the initial recommendation. Since that time, Mr. Sechin has asserted on a number of occasions that the company's payout will be no less than 25% of IFRS net income going forward.

- Cost savings: After statements last year indicating the government would like to see SOEs achieve substantial unit costs savings on CAPEX and OPEX, Rosneft began sending letters to key suppliers requesting significant discounts on prices for contracts up for renewal. One of these contracts was with Eurasia Drilling, and ended up with Rosneft not renewing the contract (Eurasia Drilling (EDCLq.L) - Three Reasons to Curb Your Enthusiasm – Too Early to Step In).

Dates to watch – We should know on dividends by autumn

We feel increasingly convinced that the momentum behind improved corporate governance at Russia's SOEs is substantial, and that at the very least the dividend requirements for Gazprom will be materially increased in the near term. That said, we would not expect equity markets to price in that increase until it has been irrefutably confirmed. We think that will happen by year-end, could happen as early as July and most likely happens by late September:

Government budget deadlines – July 1, September 20, and October 1:

New regulations promulgated by the Ministry of Finance (MinFin), although yet to be signed by PM Dmitry Medvedev, set out concrete deadlines on the formation of the annual budget. If approved, which seems likely, the regulations will require the government to approve the draft budget by September 20 and submit it to the Duma by October 1.

Importantly, under the new regulations the government will not be allowed to change those parameters approved on or by Sept 20, compared with the current practice whereby the government can continue to approve programs to be financed via the budget through the end of the year. These new rules would also mean that the main budget parameters and a limit on expenditure must be approved by the government by July 1.

Based on the above, and given that dividends from state-owned companies have grown to be a material part of the Russian budget, we think that the government's policy for Gazprom's dividend will likely have to be finalized by September 20th, and possibly as early as July 1st. Additionally, should the government include the higher payout into the budget, the proposed rules against further tweaking of the budget past September 20th should help lock in investor expectations if and when the required payout is raised to 25% of IFRS net income.

We would expect key details at each of these steps, if not directly published by the government, at least to be reported in the Russian business press (Kommersant, Vedomosti, Bloomberg, etc.), such that the investment community should be informed in relatively short order after the events occur.

We would expect final confirmation of higher dividends to be received via Gazprom's initial 2015 capital budget, typically delivered around December 1st, which should set aside the amount of dividends that management expects to be required to pay in the upcoming year. It was this document that indicated in December 2011 that the 2012 dividend would be cRUB195bn, far above any dividend previously paid in the company's history.

Theme 2: Tight oil and offshore exploration under way

All eyes on tight oil progress

Tight oil – Not just the Bazhenov shale

After the passage of the collection of tight-oil tax breaks in July of last year, Russian oil companies stepped up their testing of the Bazhenov shale and other tight oil plays. In 2014 we should see substantial news flow on the results of those test wells and, by extension, on whether or not the play will be economic.

Currently, at the very least, Rosneft, Gazpromneft, Tatneft, and SurgutNG are all actively pursuing shale plays.

- Rosneft and partner ExxonMobil will be testing the Bazhenov this year and next, and may have the highest profile among the potential shale players.
- Gazpromneft may the best-positioned company gain materially from shale, as: a) its acreage around Salym, where it is testing the horizon with partner Shell, sits above a relative hot spot of the Bazhenov; and b) its relatively small size (c600kbd) would make a successful development program more meaningful for it than for 4.2mmbpd Rosneft.
- SurgutNG has been exploring the Bazhenov for years, so much so that it actually falls outside of the tax breaks granted last year, as they only apply if the horizon in question is less than 3% depleted. SurgutNG is applying for the law to be changed, and it would seem logical for this to be granted (the law as written only rewards companies that have never attempted Bazhenov production before, and therefore punishes a company such as SurgutNG which has been attempting to make the play economic). It is unclear what SurgutNG's upside might be with the Bazhenov, but the company's long experience with the play, large in-house drilling unit, relatively aged fields, and demonstrated proclivity to drill (SurgutNG accounts for c30% of all Russian drilling) all suggest that the company could be an enthusiastic shale oil producer if the tax breaks are sufficient to make the play economic.

Our house view on the shale opportunity remains unchanged for the time being. Although we think that the development of a significant Russian shale industry is a definite possibility, we don't include any shale upside in our industry assumptions for the oilfield services (OFS) sector at this point, as we await the results of early test drilling to confirm that the average shale well in the Bazhenov, Domanik or other target plays will make economic sense (see our report from last fall on the subject, Russian Oilfield Services, for more details of our view).

Offshore: Drilling to begin, a new province?

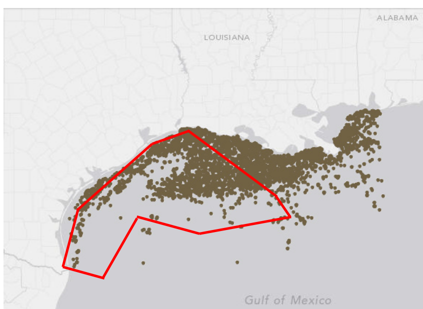
Rosneft and partner ExxonMobil are to drill two key exploratory wells on Russia's continental shelf in the coming year: one in the Kara Sea late this summer and one in the Black Sea in early 2015.[6] Although the results of the Kara Sea well will only be known late in the year, and the Black Sea well 4-6 months later, the level of success encountered – or not – with these wells will tell the market much about the potential inherent in Rosneft's 46 offshore licences. This is particularly true of the Kara Sea well, we think, as it will be the market's first glimpse of the potential of the offshore extension of the West Siberian basin, arguably the world's most prolific oil & gas basin. To date the Kara Sea, while promising on paper, has seen only limited actual drilling, with a small handful of wells sunk during the Soviet period.

Just to give a sense of the scale of Rosneft's core Kara Sea exploration acreage shown in Figure 2, in Figure 3 we overlay it on top of the Gulf of Mexico producing region. By our figures, those three licences cover roughly 42,000 square miles of territory, with the longest side being roughly the same length as Texas' coast line.

Figure 2. Rosneft's core Kara Sea licences

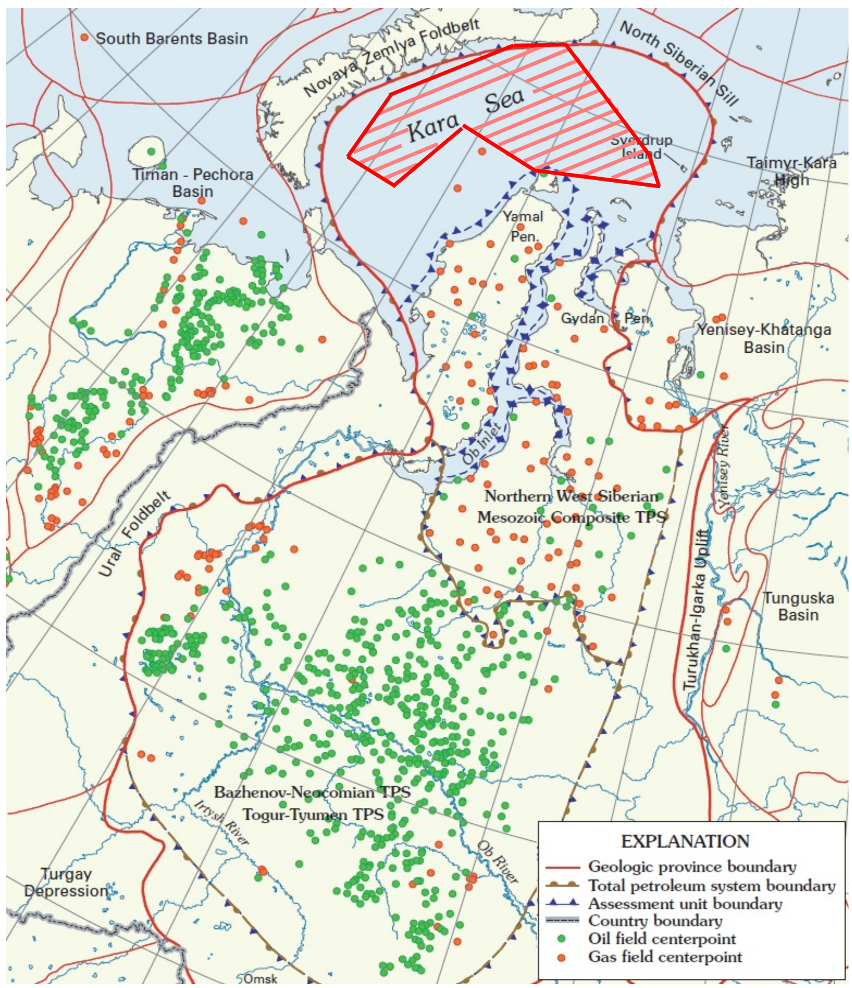
Source: Rosneft

Figure 3. Rosneft's core Kara Sea licences relative to active drilling area in US Gulf Of Mexico



Source: IEA, Rosneft, Citi Research

Figure 4. Rosneft's core Kara Sea licences relative to active drilling area in US Gulf Of Mexico



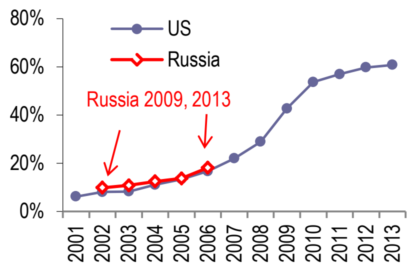
Source: US Geological Survey, Rosneft, Citi Research

6 Originally scheduled for this summer as well, this well has now reportedly been delayed by 6 months or so, according to Rosneft.

Theme 3: OFS growth yes, but watch for cannibalization

Our base case assumptions for the Russian OFS sector continue to foresee steady and strongly rising activity – drilling volumes, fracking, seismic, etc. – as the country's oil companies work ever harder to maintain current production levels as geological complexity rises. However, recent events have caused us to think there is a possibility that rising horizontal drilling activity could cannibalize vertical drilling to the extent that overall drilling volumes either stagnate or even decline.

Figure 5. Horizontal drilling as % of total



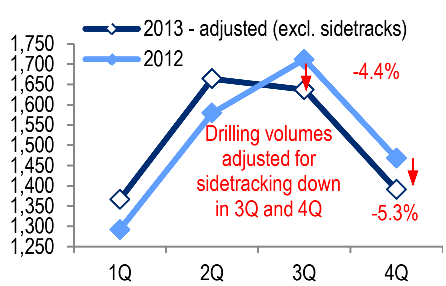
Source: Baker Hughes, Neftegazovaya Vertical, Citi Research

At this point we would classify this idea as more of a thesis than a theory – it's early days in this possible transition, but we will be watching data carefully for clues as the year progresses. Still, the sharp increase in horizontal drilling last year (Figure 5), coupled with the apparent sharp slowdown in EDC's overall volumes in the 2nd half of the year (accounting for c30% of Russia's drilling market, EDC can to some extent be seen as a proxy for the drilling market as a whole) led to an overall flattening of the company's drilling activity after several years of strong growth (Figures 6 and 7). Indeed, January's drilling numbers didn't appear positive (see link to note below).

In the Russian OFS space we continue to favor CAT oil and TMK over Eurasia Drilling, as the former, we think, have better exposure to increased horizontal and sidetracking activity and, in the case of TMK, trade at substantially lower 2014-15E P/E multiples than EDC. For more details, we'd suggest referring to our recent notes on the subject listed below.

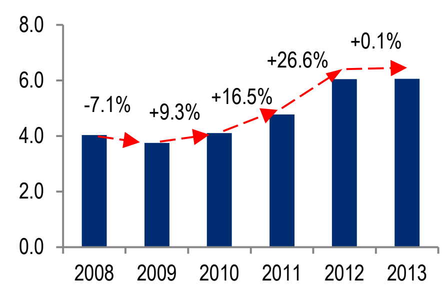
- Eurasia Drilling (EDCLq.L) - Jan 2014 drilling meters down 12.6%, wells off 21% y/y, but average depth jumped).
- TMK (TRMKq.L) - Preferred Play In Russian OFS: Leveraged To Rising Complexity
- CAT oil (O2C.DE) - New Growth Strategy Drives 40% TP Upgrade, Buy Reiterated
- Eurasia Drilling (EDCLq.L) - Three Reasons to Curb Your Enthusiasm – Too Early to Step In

Figure 6. EDC's quarterly drilling footage net of sidetracking, kkm



Source: Company data, BKE, SGK, Citi Research

Figure 7. Drilling volumes growth (excl. sidetracking) stalled in 2013...



Source: Company data, BKE, SGK, Citi Research

Summary of model, assumption adjustments

Oil price, ruble assumption adjustments

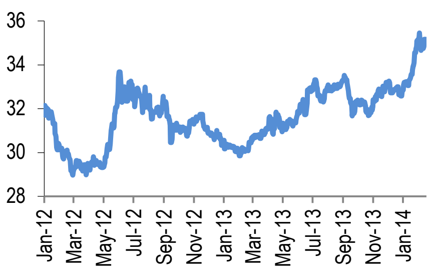
We lower our 2014 and 2015 oil price assumptions by $10/bbl to bring them into line with Citi's somewhat bearish commodity view published late last year. Our 2014 assumption falls from $107.5/bbl Brent to $97.5/bbl, and our 2015 assumption drops from $102.5/bbl to $92.5/bbl. As we tie our ruble assumptions directly to oil prices, this weakens our RUB/USD assumption by about one ruble on oil prices alone, before a further downward adjustment of several rubles to reflect the recent devaluation of the ruble vs the US dollar. Overall, our near-term ruble assumptions move from 32.8 to 36.2 for 2014 and from 33.5 to 36.7 for 2015 (Figure 10).

The ruble slides…

Since the start of the year the Russian ruble has slid by 2.5RUB/USD, or c7% (Figure 8), from 32.9RUB/USD to c35.3RUB/USD. Historically, the ruble has been highly correlated with oil prices in the short term, with relatively rapid, periodic devaluations followed by a return to an oil price linkage (Figure 9).

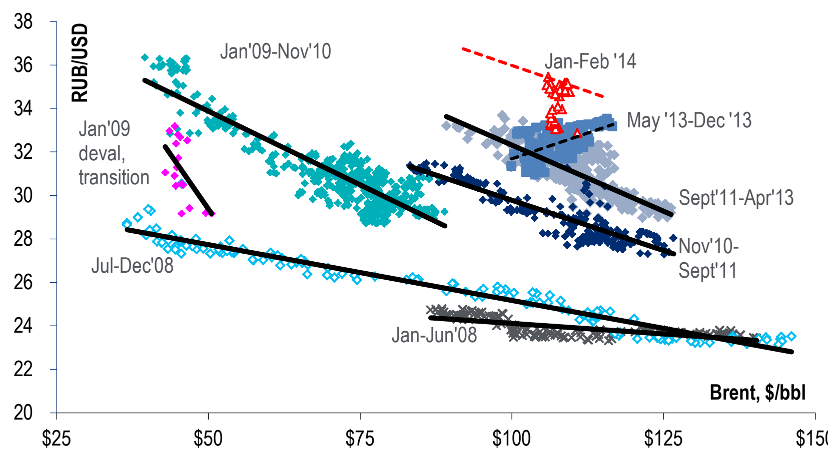
The most recent move by the ruble shown in Figure 9 may be merely the next in that series of mini-devaluations, to be followed by a re-linkage to oil prices, although from May to December of 2013 that correlation not only disappeared, but was reversed (see black dashed best-fit line). While the oil price is obviously not the only driver of the RUB/USD rate, there are strong logical reasons – most notably balance of payments implications for a large oil & gas exporter – why the ruble *should* be positively correlated with the dollar, all else being equal, and we would expect that relationship to reassert itself at some point, but at a weaker overall level. The red, dashed line in the chart below shows the sensitivity we have built into our models. Should the oil price indeed drop to c$92/bbl, then the ruble per our assumption would weaken to c36.7 per US dollar, or by c4.5% relative to today's level.

Figure 8. RUB/USD



Source: Bloomberg, Citi Research

Figure 9. RUB/USD vs. oil prices



Source: Bloomberg, Citi Research

…and oil companies benefit

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

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

For oil companies a weaker ruble generally helps at the EBITDA and net income lines. Revenues are effectively dollar-denominated (even in Russia, crude oil and oil products prices, while being nominally denominated in rubles, are actually tied to the global, dollarized price of oil), as are the major operating taxes, being directly linked to the price of oil. However, other operating costs such as salaries and locally-sourced services are typically 80-90% ruble-denominated. Therefore, secular ruble weakness (again, not linked to a drop in oil prices) helps Russian oil companies cut costs relative to revenues. If oil and the ruble drop together, as has typically been the case historically, the ruble drop partially offsets the fall in oil company profitability from the after-tax revenue loss.

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

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

Sensitivities: To generate the sensitivity table below, we lowered year-end ruble rates by 5% while holding everything else, including oil prices, constant:

- All of the oil companies benefit more or less equally at the EBITDA line in 2014E, seeing 4-5% increases based on the effective cost-cuts from the devaluation. At the net income line SurgutNG benefits more than Lukoil on SurgutNG's cash pile exposure, but Rosneft's higher leverage generates a big one-time, non-economic FOREX charge.
  - Note that SurgutNG's currency gain on the cash pile is only a paper, not an economic, gain for the company. However, it is a gain for preferred shareholders, as it boosts reported net income, which then also boosts the dividend the company is required to pay out per its charter to preferred shareholders, an effective 40% payout of pro-rata EPS.
  - On the other hand, Rosneft's EBITDA gain from the ruble effect, which should boost FCF in USD terms, has relatively large, real economic benefits for shareholders due to that company's higher leverage. However, the non-economic FOREX charge decrease would dividends (Rosneft's dividend policy is to pay out 25% of IFRS net income) for the one year, so we see this as being a wash for Rosneft shareholders in the near term (higher economic earnings, but lower near-term dividend), but positive overall as costs are meaningfully cut relative to revenues.
- The gas companies see a neutral to negative effect, with Novatek's EBITDA and net income both dropping c2%. Gazprom, however, due to its larger (than Novatek) oil-linked gas export business, is less affected by ruble moves.

A note on target prices

With this note we roll our multiple-based targets from 2013 to a blend of 2014 and 2015 expected earnings. With relatively low oil prices embedded in those years, this has generally resulted in a modest lowering of our target prices, which are 50% multiple-based, 50% DCF-based.

Note we are making some adjustments in our P/E-based valuations for SurgutNG, Rosneft, and Gazprom – all of which report in rubles but have large amounts of dollar-denominated debt (Gazprom, Novatek, and Rosneft) or cash (SurgutNG) on their respective balance sheets. Although we leave the FOREX effects from a weaker ruble in our forecast earnings numbers, we eliminate them in calculating our P/E-based valuation, as we think the market will (correctly) look through these non-economic gains or losses.

In general our TPs have been relatively resilient, with higher long-term economics for the oil companies offsetting lower near-term multiple-based indicators. Novatek is a special case, as rolling to 2014E-15E multiples help that faster-growing company more than its peers, even though we give a 25% haircut to its multiples to account for some compression as the company matures. Additionally, higher near-term earnings from the SeverEnergia stake increase give a small boost to Novatek's DCF, leading to a 3% increase in our TP for the stock. Gazprom's TP slides slightly on lower 2014E earnings, the decline of which is muted by the average 7-month lag built into its European gas prices relative to oil prices.

Tables

Figure 10. Oil, ruble assumptions, old and new

	2014	2015	2016	2017
Oil assumptions				
Before	$107.5	$102.5	$98.6	$101.8
After	$97.5	$92.5	$98.6	$101.8
Ruble assumptions				
Before	32.8	33.5	33.9	33.5
After	36.2	36.7	36.1	35.8

Source: Citi Research

Figure 11. Effect on earnings of a move in the RUB/USD rate from 32.9 to 34.5

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

Source: Citi Research estimates

Figure 12. Russian oil & gas comp table

Company Name	Target Price	Rating	Price 02/19/14	Return to TP	Market Cap	P/E 2013E	P/E 2014E	P/E 2015E	EV /EBITDA 2013E	EV /EBITDA 2014E	EV /EBITDA 2015E	Div yield 2012A	Div yield 2013E	Div yield 2014E	Total Return
BG	14.0	Buy	10.9	29%	$61.9	14.3x	17.7x	14.8x	7.1x	8.3x	7.0x	1.4%	1.6%	1.7%	30%
Eni	17.8	Neutral	17.3	2%	$86.6	15.1x	13.9x	13.6x	4.1x	3.8x	3.7x	5.9%	6.2%	6.5%	9%
Repsol	23.0	Buy	17.6	30%	$32.1	12.5x	14.7x	14.3x	4.4x	5.6x	5.4x	5.2%	5.3%	5.5%	36%
RD Shell Class A	22.5	Neutral	21.8	3%	$237.7	11.7x	12.2x	12.5x	4.9x	5.2x	5.3x	4.8%	5.0%	5.2%	8%
Statoil	160.0	Neutral	161.0	-1%	$85.0	10.9x	11.8x	12.1x	2.5x	3.2x	3.2x	4.4%	4.5%	4.5%	4%
Total	50.0	Buy	44.4	13%	$145.3	9.7x	10.0x	10.0x	4.1x	4.3x	4.4x	4.9%	5.2%	5.5%	18%
International majors						**11.9x**	**12.5x**	**12.3x**	**4.5x**	**4.9x**	**4.8x**	**4.6%**	**4.8%**	**5.0%**	
Petrobras	13.4	Neutral	11.1	21%	$74.3	6.8x	5.6x	5.2x	4.7x	4.9x	5.0x	4.3%	4.3%	5.3%	25%
Sinopec	7.9	Buy	6.1	30%	$90.9	8.3x	7.5x	7.1x	4.8x	4.5x	4.4x	4.7%	5.1%	5.6%	35%
EM comps						**7.6x**	**6.6x**	**6.2x**	**4.7x**	**4.7x**	**4.7x**	**4.6%**	**4.7%**	**5.5%**	
KMG EP	18.0	Neutral	15.9	13%	$6.4	6.3x	4.7x	5.9x	1.6x	1.8x	2.5x	11.7%	6.5%	8.7%	20%
Dragon Oil PLC	8.2	Buy	6.3	29%	$5.2	10.5x	7.8x	9.9x	3.3x	2.3x	2.1x	2.5%	3.1%	2.4%	32%
Nostrum Oil&Gas	14.9	Buy	10.7	39%	$2.0	8.5x	9.9x	12.4x	4.4x	4.8x	5.4x	3.0%	1.6%	2.3%	41%
FSU oil & gas						**8.2x**	**6.6x**	**8.4x**	**2.6x**	**2.4x**	**2.8x**	**6.9%**	**4.5%**	**5.4%**	
Bashneft ord	81.6	Buy	61.6	32%	$9.7	8.2x	7.3x	8.4x	4.5x	4.4x	4.1x	11.7%	6.6%	7.3%	39%
Gazprom	7.5	Buy	4.2	80%	$95.6	2.8x	3.3x	3.6x	2.1x	2.3x	2.3x	4.5%	5.3%	5.0%	85%
Gazpromneft	6.5	Buy	4.2	57%	$19.7	3.6x	4.1x	5.4x	2.2x	2.3x	2.8x	7.3%	7.0%	5.5%	64%
Lukoil	92.9	Buy	57.2	62%	$44.3	5.5x	4.3x	5.2x	2.1x	2.2x	2.4x	4.2%	4.9%	5.3%	67%
Novatek	173.0	Buy	128.1	35%	$38.9	14.4x	12.6x	10.8x	8.9x	8.0x	7.3x	1.7%	2.1%	2.4%	37%
Rosneft	11.3	Buy	7.0	62%	$74.1	4.5x	13.3x	7.3x	4.0x	5.0x	5.1x	3.7%	5.6%	1.9%	67%
Surgutneftegaz ord	0.87	Neutral	0.78	12%	$27.8	3.4x	3.4x	6.0x	nm	nm	nm	2.1%	2.8%	3.2%	15%
Surgutneftegaz (pref)	1.14	Buy	0.72	58%	$5.5	3.2x	3.1x	5.5x	n/m	n/m	n/m	6.6%	10.8%	11.3%	69%
Tatneft ord		Neutral	6.0	n/a	$13.2	5.7x	6.1x	5.1x	4.5x	4.5x	4.0x	4.6%	4.3%	3.8%	n/a
Tatneft (pref)		Neutral	3.5	n/a	$0.5	3.3x	3.5x	2.9x	2.6x	2.6x	2.3x	8.0%	7.5%	6.6%	n/a
Russian oil & gas						**5.2x**	**7.0x**	**6.0x**	**3.3x**	**3.5x**	**3.4x**	**3.9%**	**4.9%**	**3.9%**	
CAT oil	24.7	Buy	17.8	39%	$1.2	22.0x	19.7x	14.4x	8.2x	6.9x	5.6x	1.3%	2.1%	2.5%	41%
EDC	35.4	Neutral	25.9	37%	$3.8	8.6x	9.4x	9.4x	4.4x	4.3x	3.9x	1.6%	2.4%	2.7%	39%
TMK	16.9	Buy	10.0	70%	$2.3	8.5x	7.6x	6.8x	6.1x	5.7x	5.3x	2.6%	2.6%	2.4%	72%
Russian OFS						**10.8x**	**10.5x**	**9.3x**	**5.6x**	**5.2x**	**4.6x**	**1.9%**	**2.4%**	**2.6%**	
Tenaris	54.0	Buy	44.2	22%	$26.1	16.8x	14.6x	14.0x	9.1x	8.0x	7.4x	1.6%	1.8%	1.7%	24%
Vallourec	43.0	Neutral	37.4	15%	$6.6	19.4x	15.7x	12.4x	7.9x	7.3x	6.2x	1.6%	1.9%	2.3%	17%
TMK	16.9	Buy	10.0	70%	$2.3	8.5x	7.6x	6.8x	6.1x	5.7x	5.3x	2.6%	2.6%	2.4%	72%
OCTG pipe companies						**17.9x**	**15.4x**	**14.1x**	**9.3x**	**8.3x**	**7.5x**	**1.8%**	**2.0%**	**2.0%**	

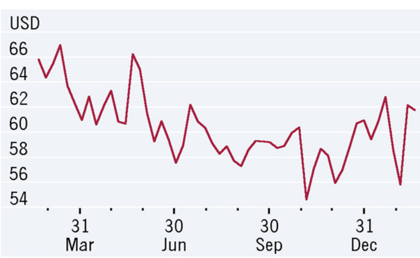
Source: Powered by dataCentral

Company Focus

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

Buy	**1**
Price (19 Feb 14)	US$61.62
Target price	US$81.60
from US$80.50	
Expected share price return	32.4%
Expected dividend yield	6.1%
Expected total return	**38.5%**
Market Cap	US$11,628M

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



Bashneft (BANE.MM)

A company run for its shareholders

- **Bashneft is a rare example of a Russian oil company run for its shareholders** (not for the state or a controlling shareholder as is the case with other companies in the Russian oil & gas space). The company's business is on a growth path. After establishing control in 2009, Sistema managed to increase Bashneft's brownfield output by 30% and won a new greenfield production licence for the Trebs and Titov fields, which were officially launched into production in October 2013. Trebs and Titov should contribute up to 20% of Bashneft's output in the longer run, but the financial contribution from the project will be recognized much faster due to the temporary exemption from extraction taxes. In 2014 we estimate the project will add 3% to production and 8% to EBITDA.

- **Attractive and sustainable dividend play:** Bashneft is well known for its generous dividend distribution policy, which we believe is sustainable going forward owing to a superior FCF generation capability and efficient CAPEX management. Bashneft has recently proved this thesis, approving a RUB199/share dividend in early November, yielding 10% on commons.

- **Investment thesis – anticipate the SPO:** Our investment thesis rests on the pre-SPO optimization/restructuring process, which is being conducted by Bashneft's main shareholder Sistema. The final step of elimination of the cross-ownership structure held through Sistema-Invest was announced on December 16th and should be finalized soon.

- **Target price adjustment:** Our TP for Bashneft rises modestly to $81.6, as the near-term multiple effects from weaker oil prices are slightly outweighed by the DCF improvements from a fundamentally weaker ruble.

Bashneft (USD)

Year to 31 Dec	2011A	2012A	2013E	2014E	2015E
Sales ($M)	16,549.0	17,122.3	17,546.3	16,554.8	16,148.2
Net Income ($M)	1,696.0	1,674.9	1,420.2	1,605.7	1,384.9
Diluted EPS ($)	9.07	9.13	7.50	8.48	7.32
Diluted EPS (Old) ($)	9.07	9.13	9.28	9.39	10.11
PE (x)	6.8	6.7	8.2	7.3	8.4
EV/EBITDA (x)	5.1	4.6	4.6	4.9	5.4
DPS ($)	3.36	7.18	4.05	4.48	3.65
Net Div Yield (%)	5.5	11.6	6.6	7.3	5.9

Company Focus

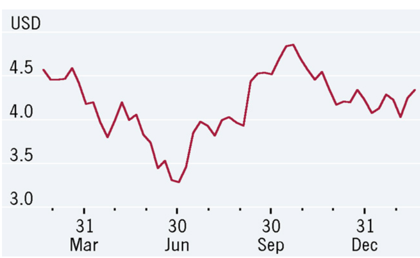
Gazprom (GAZP.MM)

Favoured play, most levered to corporate governance improvement

- Target Price Change
- Estimate Change

Buy	**1**
Price (19 Feb 14)	US$4.16
Target price	US$7.50
from US$7.80	
Expected share price return	80.1%
Expected dividend yield	4.8%
Expected total return	**84.9%**
Market Cap	US$95,552M

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



- **Still watching all 3 catalysts:** Gazprom remains one of our favourite stocks in Russian oil & gas based on what we see as both compelling upside potential and the presence of 3 distinct near-term catalysts: 1) As we outline below, European exports should remain firm in 2014E, which we do not think the market is pricing in; 2) The Chinese contract seems likely to be signed this year, with Putin's scheduled visit to Beijing in May a date to watch; and 3) As we explore in detail in this note, we see a significant chance that Gazprom's dividend policy will be raised materially in the course of 2014.

- **Continued strength in European exports, but probably not at record levels:** Assuming normal weather and weak underlying demand, we would expect European gas consumption to decline a bit in 2014 vs. 2013. However, non-Russian sources of gas will also continue to fade as: a) yet more LNG gets pulled to Asia's premium market; and b) European production continues to slide, especially in the Netherlands (production at the key Groningen field will drop by c10-12bcm), while Norway looks set to move sideways after declining last year and the UK will likely extend its decade-long production decline. Our forecast, however, could be at risk if oil prices do indeed begin to swoon or if the European winter continues to be warmer than normal. Our 2014 forecast of 155bcm sits within what we see as a reasonable range of 150bcm to 165bcm.

- **Smaller FSU volume rebound on only modestly lower prices:** The deal negotiated in mid-December with Ukraine did not go as far as we had anticipated, dropping prices from c$400/mcm to 'only' $268.5/mcm (albeit still linked to oil prices), rather than the c$210/mcm – full netback parity to the Russian-Ukrainian border – we had assumed. Also, the social unrest seen in the country in the past couple of months has raised doubts about the sustainability of the current government and, therefore, about any of the deals it may have signed or may be in the process of negotiating with Russia. We model a modest 4bcm volume increase to 28bcm for 2014 on that price cut.

- **Valuation and recommendation:** Gazprom remains a Buy and one of our two favoured ideas in the blue-chip Russian oil & gas space. We lower our TP by 3% from $7.8/sh to $7.5/sh ($15.0/ADR), with a 5% increase in our DCF to $8.5/sh (after rolling forward to 2014E) partially offsetting 7-11% declines in our multiple-based valuations.

Gazprom (USD)

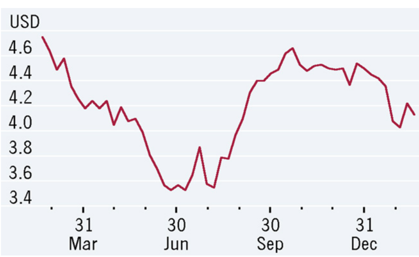
Year to 31 Dec	2011A	2012A	2013E	2014E	2015E
Sales ($M)	157,661.0	153,414.6	163,282.7	147,038.1	142,411.7
Profit Before Tax ($M)	57,083.4	48,621.2	44,590.0	37,437.1	33,965.7
Diluted EPS ($)	1.93	1.66	1.50	1.27	1.15
Diluted EPS (Old) ($)	1.93	1.66	1.46	1.42	1.34
PE (x)	2.2	2.5	2.8	3.3	3.6
EV/EBITDA (x)	1.7	2.2	2.1	2.5	2.6
DPS ($)	0.30	0.19	0.23	0.22	0.28
Net Div Yield (%)	7.3	4.6	5.5	5.2	6.7

Company Focus

- Target Price Change
- Estimate Change

Buy	**1**
Price (19 Feb 14)	US$4.16
Target price	US$6.52
from US$6.48	
Expected share price return	56.7%
Expected dividend yield	5.3%
Expected total return	**62.0%**
Market Cap	US$19,722M

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



Gazpromneft (SIBN.MM)

Best-in-class growth, but CAPEX comes first

- **Best-in-class growth profile, Buy:** Gazpromneft offers arguably the best growth opportunities in Russian oil and gas space, targeting total hydrocarbon production to increase by 60% to 100mmtoe by 2020 from its current 62.6mmtoe. We rate Gazpromneft Buy and consider it one of the best opportunities in the sector for those able to tolerate the relatively poor liquidity of its stock.

- **Refining modernization lags behind unfavorable tax changes:** The majority of Gazpromneft's modernization projects aimed at improving conversion rates (light product yield) are scheduled to be completed by 2017, lagging two years behind the scheduled increase in heavy products export duty. This is reflected in our 2015-16 earnings estimates. However, we cannot exclude the possibility that the export duty hike may be postponed by a couple of years, to give more time to the industry to readjust and finish modernization works.

- **Valuation:** Our target price for Gazpromneft increases slightly to $6.52/sh, with the long-term improvement in our DCF slightly outweighing the near-term multiple compression from lower oil price assumptions.

Gazpromneft (USD)

Year to 31 Dec	2011A	2012A	2013E	2014E	2015E
Sales ($M)	43,887.8	48,820.8	46,426.7	43,839.0	44,544.5
Net Income ($M)	5,449.0	5,673.4	5,446.0	4,817.2	3,638.7
Diluted EPS ($)	1.15	1.20	1.15	1.02	0.77
Diluted EPS (Old) ($)	1.15	1.20	1.15	1.13	0.79
PE (x)	3.6	3.5	3.6	4.1	5.4
EV/EBITDA (x)	na	2.4	2.1	2.5	3.0
DPS ($)	0.25	0.30	0.29	0.22	0.17
Net Div Yield (%)	6.0	7.2	6.9	5.4	4.1

Company Focus

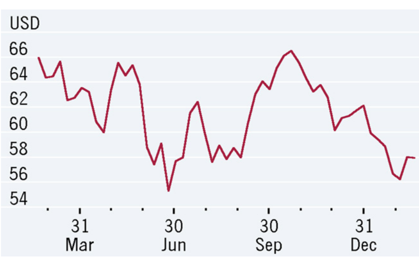
Lukoil (LKOH.MM)

Solid, quiet performance – We need a catalyst

- Target Price Change
- Estimate Change

Buy	**1**
Price (19 Feb 14)	US$57.22
Target price	US$92.90
from US$95.00	
Expected share price return	62.3%
Expected dividend yield	5.2%
Expected total return	**67.6%**
Market Cap	US$44,316M

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



- **Still a Buy, and a good example of how Russian oil & gas is undervalued:** Our Lukoil TP falls slightly to $92.9/share as ruble weakness boosts our DCF almost as much as weaker near-term oil assumptions lower earnings. We keep our Buy rating intact. Lukoil is a relatively quiet company with a relatively modest earnings growth profile. However, we see material upside potential to its fundamental value (based on multiples, DCF) and think the company, like most of its Russian peers, is undervalued. The hard part, in our view, is finding a catalyst that might make Lukoil re-rate relative to those peers, barring what we see as a chance that the company will increase its dividend payout.

- **Growth is minimal to modest … so where's the cash?:** Production growth depends on Lukoil's ability to hit company guidance in all brownfield regions past 2015 as well as to execute in key greenfield opportunities in the Caspian Sea and the 1.4bn bbl (C1+C2) Imilorskoye field in West Siberia received in late 2012. Even allowing for those opportunities, however, we think growth opportunities are modest in the near term and Lukoil has, therefore, the wherewithal to pay significantly higher dividends than it will under its current policy of a minimum 15% annual increase in RUB/share.

- **A chance, we think, of a dividend increase:** While based on a different payout policy, Lukoil's payout somewhat lags Rosneft's 25% of IFRS net income dividend policy. Additionally, with a strong balance sheet and limited growth opportunities, we see little reason for Lukoil to keep its payout below Rosneft's, and think there is a chance management will re-base its policy to at least in line with peers. Lukoil's dividend policy led to a RUB90/share dividend in 2013 on 2012 results, a 20% increase in payout and c22% of net income. Hence, while our forecast dividend is RUB105/share – slightly over the minimum 15% increase – we see the chance of a higher increase, particularly as the company reports in US dollars and as the ruble has fallen by c6% since the start of the year.

- **We don't usually chart-watch, but…:** Lukoil's share price is c$57/sh, about in the middle of its trading range since oil prices recovered in late 2009 after the financial crisis. Additionally, the company's strong balance sheet and positive gearing to ruble weakness – which can help offset earnings reductions from oil price declines – has traditionally made Lukoil one of the more defensive names in the sector, and therefore we think the stock could appeal to investors looking for exposure to the Russian oil & gas sphere but worried about the sustainability of oil prices.

Lukoil (USD)

Year to 31 Dec	2012A	2013A	2014E	2015E	2016E
Sales ($M)	139,171.0	141,452.0	133,761.9	133,219.9	148,006.2
Net Income ($M)	11,004.0	7,832.0	9,971.5	8,318.7	10,375.6
Diluted EPS ($)	14.58	10.38	13.21	11.02	13.74
Diluted EPS (Old) ($)	14.58	15.54	14.05	11.50	12.48
PE (x)	3.9	5.5	4.3	5.2	4.2
EV/EBITDA (x)	2.2	2.8	2.6	2.7	2.2
DPS ($)	2.41	2.82	3.05	2.93	3.66
Net Div Yield (%)	4.2	4.9	5.3	5.1	6.4

Company Focus

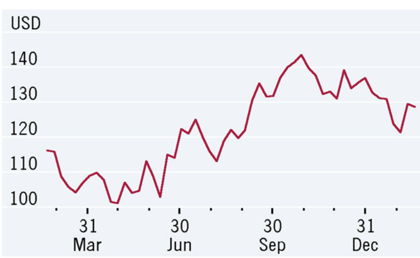
Novatek OAO (NVTKq.L)

A Buy, but keep an eye on Yamal LNG execution risk

- Target Price Change
- Estimate Change

Buy	1
Price (19 Feb 14)	US$127.05
Target price	US$173.00
from US$168.00	
Expected share price return	36.2%
Expected dividend yield	2.6%
Expected total return	**38.8%**
Market Cap	US$38,539M

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



- **SeverEnergia consolidation boosts liquids growth:** We incorporate Novatek's acquisition of ENI's SeverEnergia stake and the swap of 51% of Sibneftegaz for Rosneft's SeverEnergia stake. Our liquids production forecast for 2014 is now for growth in the range of 45% y-o-y, in the middle of guidance recently given by CEO Leonid Mikhelson. We keep our gas growth assumption at around 7% pa for the medium term.

- **Yamal LNG - One CAPEX increase done…:** In December Novatek increased its estimate of the expected private side cost of the Yamal LNG project from $20bn to c$27bn, of which $2.6bn has already been spent. However, as CEO Mikhelson indicated that most of the CAPEX will actually be borne by its partners, CNPC and Total, rather than by Novatek itself, it is difficult for the outside observer to judge the impact of increase.

- **…should we expect more?:** One worry of ours is that equity markets may be less willing than in the past to put high multiples on Novatek's earnings going forward due to the perceived risk of further CAPEX hikes at Yamal LNG. This concern would mostly be based on the history of LNG projects globally, which seemingly have an unfortunate tendency to run billions of dollars over budget. In addition to the budget increase mentioned above, another problem was revealed in mid-February, when Vedomosti reported that a key object for the public side of Yamal LNG – the Sabetta port – is over budget to the tune of RUB20bn ($570mn).

- **Keeping Yamal LNG valuation at $16/sh:** Lacking better information on the nature of the Yamal LNG contracts and CAPEX-sharing arrangements, for the time being we leave our valuation of the Yamal LNG project at $16/ADR.

- **Valuation and recommendation:** We raise our Novatek TP c3% to $173/ADR and keep our recommendation at Buy, given a c39% ETR. However, we note this is one of the lowest levels of ETR in our universe, and we favour Gazprom (+85% and with active potential catalysts) and SurgutNG prefs (excellent dividend yield and a potential catalyst to drive further outperformance come this summer) over Novatek.

Novatek OAO (USD)

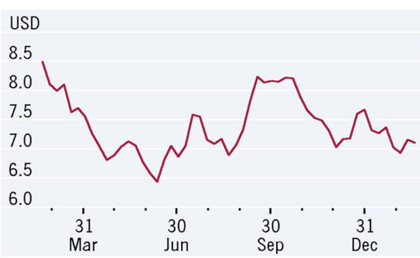
Year to 31 Dec	2011A	2012A	2013E	2014E	2015E
Sales ($M)	5,955.7	6,789.3	9,727.2	11,172.9	12,521.9
Net Income ($M)	2,346.2	2,235.2	2,699.3	3,086.8	3,583.4
Diluted EPS ($)	7.74	7.37	8.90	10.18	11.82
Diluted EPS (Old) ($)	7.74	7.38	9.52	10.34	11.12
PE (x)	16.4	17.2	14.3	12.5	10.8
EV/EBITDA (x)	13.2	11.8	8.9	7.4	6.6
DPS ($)	2.04	2.21	2.67	3.05	3.55
Net Div Yield (%)	1.6	1.7	2.1	2.4	2.8

Company Focus

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

Buy	**1**
Price (19 Feb 14)	US$6.99
Target price	US$11.30
from US$11.00	
Expected share price return	61.6%
Expected dividend yield	5.2%
Expected total return	**66.8%**
Market Cap	US$74,104M

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



Rosneft (ROSN.MM)

Positive exposure to ruble weakness despite FOREX issue

- **Valuation and recommendation:** Because we are now expecting a material (c$6bn) FOREX charge to be booked in 2014, we think its effect on the P/E multiple applied to reported net income is misleading, so we back that charge out of our TP-setting mechanism. Our TP rises by 3%, from $11.0/sh to $11.3/sh, as near-term multiple compression from the reduction in our oil price assumptions is more than offset by a somewhat higher DCF valuation due to increased earnings power from a secularly weaker ruble. Of our revised TP of $11.3/sh, $0.99/sh is accounted for by our estimate of the current value of Rosneft's offshore opportunity.

- **Remember that refining upgrades = big FCF swing in 2016E:** Rosneft is currently spending around $5bn-$6bn per annum on its refinery portfolio as part of a $25bn upgrade program. Beginning roughly in 2016, if all goes according to schedule, Rosneft should see a large boost to free cash flow as that CAPEX winds down and the various upgrade modules (hydrocrackers and the like) come on-line, boosting refining margins significantly. On our estimates, in a $100/bbl world, operating profit from refining should increase by $4bn as a result of increasing refining margins relative to today (leaving aside the effect of avoidance of export duties on fuel oil from the scheduled duty increase on that product in 2015). Even if Rosneft were to continue to invest above maintenance levels into its refineries, the potential FCF swing would likely be large, in the order of $6-8bn, we estimate. While the swing is set to occur well beyond our 12-month investment horizon, we think investors should keep it in mind when looking at Rosneft's long-term value (our DCF, of course, includes this effect) vs. its near-term multiples.

- **Exposure to ruble devaluation positive, ignore potential one-off, non-economic FOREX loss:** Economically, it is clear that Rosneft stands to benefit as much as or more than its Russian oil peers from a secularly weaker ruble. All else being equal, a secularly weaker ruble (i.e. while oil prices remain constant) should boost Rosneft's EBITDA and FCF in USD terms in the current year, which has relatively large, real economic benefits for shareholders even as it reduces net income for one year via a non-economic FOREX charge. While this would decrease dividends (per Rosneft's 25% payout policy) for the one year, EBITDA, net income, and FCF would be sustainably boosted going forward, all else equal. Note that if Rosneft presented its accounts in US dollars, as it used to do and as Lukoil still does, there would be no looming FOREX charge on USD-denominated debt.

Rosneft (USD)

Year to 31 Dec	2012A	2013A	2014E	2015E	2016E
Sales ($M)	98,667.2	146,742.2	138,460.9	133,539.1	149,097.9
Net Income ($M)	12,582.8	16,642.5	5,584.7	10,135.5	14,961.1
Diluted EPS ($)	1.25	1.57	0.53	0.96	1.41
Diluted EPS (Old) ($)	1.23	1.40	1.08	0.97	1.37
PE (x)	5.6	4.5	13.3	7.3	5.0
EV/EBITDA (x)	4.8	4.0	5.4	5.3	4.5
DPS ($)	0.26	0.39	0.13	0.24	0.42
Net Div Yield (%)	3.7	5.6	1.9	3.4	6.1

Company Focus

Surgutneftegaz (SNGS.MM)

No reason to prefer the ord

- Target Price Change
- Estimate Change

Neutral	2
Price (19 Feb 14)	US$0.78
Target price	US$0.87
from US$0.88	
Expected share price return	12.0%
Expected dividend yield	2.6%
Expected total return	**14.5%**
Market Cap	US$33,311M

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

- **TP down slightly to $0.87 from $0.88/sh, maintain Neutral:** We keep our new methodology for setting SurgutNG ordinary and preferred TPs, whereby we now forecast the pref to trade at a 30% *premium* to the ords instead of the historical discount. We maintain our Neutral recommendation on the ords, and remind investors that we explicitly favour SurgutNG's prefs over its ords, and see no reason for investors to opt for the ord if the pref is available.

- **Backing FOREX gain out of P/E multiple target:** As with Rosneft, we back out of our P/E-based valuation mechanism the non-economic FOREX gains and charges that come from those companies reporting in rubles rather than USD. In SurgutNG's case, we remove the gain we would expect it to book in 2014 on the effect a weaker ruble would have on its mostly USD-denominated $32bn cash pile. However, we leave that gain in our reported numbers and, of course, our preferred dividend calculation.

Surgutneftegaz (USD)

Year to 31 Dec	2011A	2012A	2013E	2014E	2015E
Sales ($M)	25,635.2	26,246.1	25,646.9	25,489.9	24,281.3
Net Income ($M)	7,613.8	4,646.3	8,067.7	8,279.1	4,663.3
Diluted EPS ($)	0.21	0.13	0.23	0.23	0.13
Diluted EPS (Old) ($)	0.21	0.13	0.23	0.20	0.14
PE (x)	3.7	6.0	3.5	3.4	6.0
EV/EBITDA (x)	0.6	0.3	0.0	-0.2	-0.3
DPS ($)	0.02	0.02	0.02	0.02	0.01
Net Div Yield (%)	2.6	2.1	2.8	3.2	1.9

Company Focus

■ **Target Price Change**

Buy	1
Price (19 Feb 14)	US$0.72
Target price	US$1.14
from US$1.15	
Expected share price return	58.2%
Expected dividend yield	9.9%
Expected total return	**68.1%**
Market Cap	US$33,311M

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

Surgutneftegaz(pref) (SNGS_P.MM)

Still a favourite – Watch the dividend rise on a weaker ruble

- **Preferred TP down slightly to $1.14/sh, keep at Buy and as a favourite:** Our target price for SurgutNG's preferred share drops slightly – from $1.15/sh to $1.14/sh – on the mixed effect of lower near-term oil prices and a secularly weaker ruble. The stock remains one of our two favourite stocks in Russian oil & gas – and that among a relatively heavy concentration of Buy-rated stocks. To reiterate, however, we *explicitly favour the prefs over the ords, and see no reason to opt for the latter if the former is available.*

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

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

- **A review of why the preferred should trade at a premium:** SurgutNG's charter ensures: 1) a minimum 40% pro-rata payout for the prefs; and 2) that the pref must receive a dividend at least as large as that paid to the ord. In reality, the prefs are usually paid 2-3x more. Add to that the fact that we think the ord deserves no control premium, and we conclude that the pref should trade at a significant premium, not a discount, to the ord.

Surgutneftegaz(pref) (USD)

Year to 31 Dec	2011A	2012A	2013E	2014E	2015E
Sales ($M)	25,635.2	26,246.1	25,646.9	25,489.9	24,281.3
Net Income ($M)	7,613.8	4,646.3	8,067.7	8,279.1	4,663.3
Diluted EPS ($)	0.21	0.13	0.23	0.23	0.13
Diluted EPS (Old) ($)	0.21	0.13	0.23	0.20	0.14
PE (x)	3.4	5.5	3.2	3.1	5.5
EV/EBITDA (x)	0.6	0.3	0.0	-0.2	-0.4
DPS ($)	0.07	0.05	0.08	0.08	0.05
Net Div Yield (%)	10.1	6.6	10.8	11.3	6.7

Company Focus

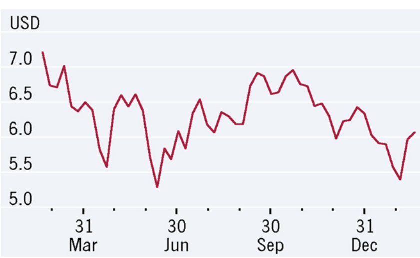
Tatneft (TATN.MM)

Oil price adjustments – Watch ETF flows

- **Estimate Change**

Neutral	2
Price (19 Feb 14)	US$6.04
Target price	-
Expected share price return	-
Expected dividend yield	-
Expected total return	**-**
Market Cap	US$13,665M

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



- **Still Neutral:** We continue to have a Neutral recommendation on Tatneft without a target price, on both common and preferred shares. Changes in our oil price, ruble, and inflation assumptions have had some modest impact on our model, but not enough to change our basic view.

- **Key issue we see? ETF dominance of trading activity**: We think Tatneft is overrepresented in certain indexes used by Russia-focused Exchange Traded Funds, meaning that when those funds get inflows, their program buying is heavy for Tatneft relative to that stock's typical daily trading activity. This can lead to unexplained outperformance when Russian ETFs are attracting new funds, and underperformance when they experience outflows. As fund flows are fundamentally unpredictable – or at least are outside of our competence as oil & gas analysts – we are more hesitant to make investment recommendations on Tatneft based on financial and operating fundamentals.

Tatneft (USD)

Year to 31 Dec	2011A	2012A	2013E	2014E	2015E
Sales ($M)	20,931.9	20,163.2	20,270.2	18,798.4	17,434.6
Net Income ($M)	2,085.1	2,330.9	2,249.7	2,111.1	2,489.9
Diluted EPS ($)	0.98	1.10	1.06	0.99	1.17
Diluted EPS (Old) ($)	0.98	1.10	0.95	0.91	1.01
PE (x)	6.1	5.5	5.7	6.1	5.1
EV/EBITDA (x)	na	4.4	4.2	4.2	3.5
DPS ($)	0.24	0.28	0.26	0.23	0.27
Net Div Yield (%)	4.0	4.6	4.3	3.8	4.5

Company Focus

Tatneft(pref) (TATN_p.MM)

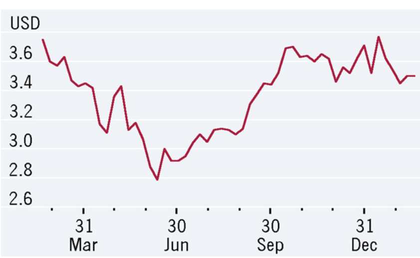
Oil price adjustments – Watch ETF flows

- **Still Neutral:** We continue to have a Neutral recommendation on Tatneft without a target price, on both common and preferred shares. Changes in our oil price, ruble, and inflation assumptions have had some modest impact on our model, but not enough to change our basic view.

- **Key issue we see? ETF dominance of trading activity**: We think Tatneft is overrepresented in certain indexes used by Russia-focused Exchange Traded Funds, meaning that when those funds get inflows, their program buying is heavy for Tatneft relative to that stock's typical daily trading activity. This can lead to unexplained outperformance when Russian ETFs are attracting new funds, and underperformance when they experience outflows. As fund flows are fundamentally unpredictable – or at least are outside of our competence as oil & gas analysts – we are more hesitant to make investment recommendations on Tatneft based on financial and operating fundamentals.

Neutral	**2**
Price (19 Feb 14)	US$3.45
Target price	-
Expected share price return	-
Expected dividend yield	-
Expected total return	**-**
Market Cap	US$13,665M

Price Performance
(RIC: TATN_p.MM, BB: TATNP RM)



Tatneft(pref) (USD)

Year to 31 Dec	2011A	2012A	2013E	2014E	2015E
Sales ($M)	20,931.9	20,163.2	20,270.2	18,798.4	17,434.6
Net Income ($M)	2,085.1	2,330.9	2,249.7	2,111.1	2,489.9
Diluted EPS ($)	0.98	1.10	1.06	0.99	1.17
Diluted EPS (Old) ($)	0.98	1.10	0.95	0.91	1.01
PE (x)	3.5	3.1	3.3	3.5	2.9
EV/EBITDA (x)	na	4.4	4.2	4.2	3.5
DPS ($)	0.24	0.28	0.26	0.23	0.27
Net Div Yield (%)	7.0	8.0	7.5	6.7	7.9

Bashneft

Company description

Bashneft is the seventh-largest integrated oil producer in Russia. Accounting for c.3% of Russia's total crude output, Bashneft develops the very mature reserve base located in the Bashkortostan region of Russia. At the same time, after Sistema took over the company back in April 2009, Bashneft managed to demonstrate outstanding production results and win the license for the Trebs and Titov project, which is set to become the most important production growth driver for the company going forward.

Investment strategy

We rate Bashneft a Buy. Bashneft is one of the rare examples in the Russian oil and gas universe of a company run exclusively for its shareholders, equally benefitting core shareholder Sistema and the minorities. With the increasingly likely resumption of generous dividends and elimination of the Sistema-Invest circular ownership, the pre-IPO optimisation process is arguably occurring. With a number of potential catalysts remaining to boost Bashneft's shareholder value, we continue to see value in the shares.

Valuation

We derive our Bashneft target price of $81.6 based on: 1) DCF valuation ($92.2, 50% weighting, based on a WACC of 10.1% and terminal growth of 3.5%) and 2) Near-term multiple valuations (25% weighting each), with implied valuations of $70.2/share on a P/E basis and $71.6/share on an EV/EBITDA basis. The target multiples used reflect historical average multiples this stock has traded at on the Russian market, and use an average of 2014E and 2015E expected earnings.

Risks

Bashneft's primary risks are the same ones facing other Russian oil companies: oil price and ruble volatility, oilfield inflation, and a heavy tax burden. We also highlight the risk of a faster-than-expected production decline at the legacy asset base. Additionally, there is a risk that Bashneft investors could face unfavorable treatment of minorities by the controlling shareholder Sistema. These risks could impede the share price from reaching our target price.

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 1-Buy. With Gazprom having largely resolved gas taxation issues, the key issues facing the company today are contract pricing negotiations

with Ukraine and the European supply/demand balance. The latter is now breaking decidedly in Gazprom's favour, and the equity market is just beginning to realise that, we think. 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.

Valuation

We set our target price at $7.5, which we derive using a blend of our DCF valuation ($8.5, 50% weighting, based on a WACC of 10.3%, long-term growth of 3.0%), our P/E-based valuation ($6.6, 25% weighting, target multiple of 5.4x) and our EV/EBITDA-based valuation ($6.5, 25% weighting, target multiple of 3.6x). The target multiples used reflect historical average multiples this stock has traded at on the Russian market, and use an average of 2014E and 2015E expected earnings. Finally, for companies that report in rubles (including Gazprom) we eliminate non-economic FOREX gains and losses in calculating our P/E-based valuation.

Risks

Among the downside risks which could impede the shares from achieving our target price, we highlight potentially lower European gas export prices, faster-than-expected market share losses domestically as independent producers gain traction; a potential a slowdown in domestic gas price growth; and, given the significant levels of capex for bringing new fields on stream to replace declining production at core West Siberian fields, execution risk.

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 a Buy. Gazpromneft offers one of the best growth opportunities in the Russian oil and gas space, in our view, aiming to increase hydrocarbon production by 67% in 2020 as compared with 2012 and growing at a CAGR of 7%. We argue that Gazpromneft's outstanding growth prospects, coupled with solid dividends yielding more than 5%, make it one of the most attractive oil and gas stocks in Russia.

Valuation

We derive our Gazpromneft target price of $6.52 based on: 1) DCF valuation ($7.24, 50% weighting, based on a WACC of 9.9% and terminal growth of 3.0%) and 2) Near-term multiple valuations (25% weighting each), with implied valuations of $5.52/share on a P/E basis and $6.08/share on an EV/EBITDA basis. The target multiples used reflect historical average multiples this stock has traded at on the Russian market, and use an average of 2014E and 2015E expected earnings.

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

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. We also see Lukoil as providing solid exposure to the developing Russian independent gas industry among Russian oil majors. Iraq will absorb cash in 2013E, but will begin returning it in 2014E, meaning that, after contracting to around zero in 2013E, FCF generation should bounce back to around $5bn/yr, on our estimates. We like Lukoil at these levels, rating it a 1-Buy.

Valuation

We set our target price at $92.9, which we derive using a blend of our DCF valuation ($114, 50% weighting, based on a WACC of 10.6%, long-term growth of 3.0%), our P/E-based valuation ($64/sh, 25% weighting, target multiple of 5.2x) and our EV/EBITDA-based valuation ($79, 25% weighting, target multiple of 3.5x). The target multiples used reflect historical average multiples this stock has traded at on the Russian market, and use an average of 2014E and 2015E expected earnings.

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.

Novatek OAO

Company description

Novatek is the largest independent gas producer in Russia, selling 59bcm in 2012. 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.

Investment strategy

Novatek is a growth play, in our view, with gas output expected to rise to c75bcm in 2017E from a net 59bcm in 2012, including increased production from equity stakes in Sibneftegas and SeverEnergia, but excluding the effect on operating numbers from Yamal LNG. The latter project will allow Novatek to export Russian gas to overseas markets, but first production will come only in 2017 or so. We believe the growth potential is not yet fully priced into the stock, in spite of seemingly still-lofty multiples. We rate the stock a 1-Buy.

Valuation

We set our target price at $173/ADR, which we derive using a blend of our DCF valuation ($199/ADR, 50% weighting, based on a WACC of 8.3%, long-term growth of 3.0%), our P/E-based valuation ($145/ADR, 25% weighting, target multiple of 12.4x) and our EV/EBITDA-based valuation ($150/ADR, 25% weighting, target multiple of 9.5x). The target multiples used are calculated on an average of 2014E and 2015E expected earnings, while the multiples used reflect historical average multiples this stock has traded at on the Russian market, discounted at 25% to reflect multiple compression we expect from a maturing fast-growing company. Finally, for companies that report in rubles (including Novatek) we eliminate non-economic FOREX gains and losses in calculating our P/E-based valuation.

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) Potential further delays in its key Yamal LNG project; 3) Standard oil & gas company risks relating to oil price and exchange rate volatility.

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

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 are 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 recently announced cooperation agreements with ExxonMobil, ENI, and Statoil. The company's $25bn refinery modernisation programme, while ambitious, appears to us set to earn returns well in excess of its cost of capital. We rate Rosneft's stock a 1-Buy.

Valuation

We set our target price for Rosneft at $11.3/sh, which is the sum of our base valuation of $10.3/sh plus $0.99/sh to account for the value of the offshore opportunity, which we do not include explicitly in our DCF. Our base valuation of $10.3/sh is derived using a blend of our DCF valuation ($13.0/sh, 50% weighting, based on a WACC of 8.8%, long-term growth of 3.0%), our P/E-based valuation ($6.7/sh, 25% weighting, target multiple of 6.7x) and our EV/EBITDA-based valuation ($8.6/sh, 25% weighting, target multiple of 5.1x). The target multiples used reflect historical average multiples this stock has traded at on the Russian market, and use an average of 2014E and 2015E expected earnings. Finally, for companies that report in rubles (including Rosneft) we eliminate non-economic FOREX gains and losses in calculating our P/E-based valuation.

Risks

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

Surgutneftegaz

Company description

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

Investment strategy

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

Valuation

Our $0.87 target price for SurgutNG’s common share is achieved by applying a 23% discount to our $1.13/share preferred TP (inversely, we continue to assume the preferred should trade at a 30% premium to the common).

Our $1.14 target price for Surgutneftegaz preferred shares is based on: 1) A DCF valuation of $1.26, based on a 14.2% WACC and a 3.0% terminal growth rate; and 2) Near-term multiple valuations (25% weighting each), with implied valuations of $0.89/share on a P/E basis and $1.13/share on an EV/EBITDA basis. The target multiples used reflect historical average multiples this stock has traded at on the Russian market, and use an average of 2014E and 2015E expected earnings. Finally, for companies that report in rubles (including SurgutNG) we eliminate non-economic FOREX gains and losses in calculating our P/E-based valuation.

Risks

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

Surgutneftegaz(pref)

Company description

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

Investment strategy

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

Valuation

Our $0.87 target price for SurgutNG’s common share is achieved by applying a 23% discount to our $1.13/share preferred TP (inversely, we continue to assume the preferred should trade at a 30% premium to the common).

Our $1.14 target price for Surgutneftegaz preferred shares is based on: 1) A DCF valuation of $1.26, based on a 14.2% WACC and a 3.0% terminal growth rate; and 2) Near-term multiple valuations (25% weighting each), with implied valuations of $0.89/share on a P/E basis and $1.13/share on an EV/EBITDA basis. The target multiples used reflect historical average multiples this stock has traded at on the Russian market, and use an average of 2014E and 2015E expected earnings.

Finally, for companies that report in rubles (including SurgutNG) we eliminate non-economic FOREX gains and losses in calculating our P/E-based valuation.

Risks

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

Tatneft

Company description

Tatneft is the fifth-largest producer in Russia; some 60% of output comes from fields in operation for over 53 years, hence it suffers from higher opex and poor crude quality. Tatneft until recently had no refining capacity, but has been reportedly having problems bringing on-line its brand-new Nizhnekamsk plant. The local government owns 34% and has a material influence on the management.

Investment strategy

We rate Tatneft Neutral. Fundamentally, we argue that Tatneft's performance is unimpressive, with flat production and higher-than-average operating costs, which are a function of its mature asset base. However, low refining exposure implies higher leverage to the oil price, making Tatneft one of the biggest beneficiaries in a bull market which is amplified by its hefty weights in various stock market indexes.

Valuation

This company has a Neutral rating. We have not assigned a target price and therefore no valuation methodology is applicable.

Risks

Tatneft is exposed to all of the same industry-specific risks as its peers. Corporate governance and transparency issues are an issue, but by and large are not as important as the broader industry risks of oil prices and moves in the RUB/USD exchange rate.

Tatneft(pref)

Company description

Tatneft is the fifth-largest producer in Russia; some 60% of output comes from fields in operation for over 53 years, hence it suffers from higher opex and poor crude quality. Tatneft until recently had no refining capacity, but has been reportedly having problems bringing on-line its brand-new Nizhnekamsk plant. The local government owns 34% and has a material influence on the management.

Investment strategy

Fundamentally, Tatneft's performance is unimpressive, with flat production and higher-than-average operating costs, which are a function of its mature asset base. However, low refining exposure implies higher leverage to the oil price, making Tatneft one of the biggest beneficiaries in bull market which is amplified by its hefty weights in various stock market indexes.

Valuation

This company has a Neutral rating. We have not assigned a target price and therefore no valuation methodology is applicable.

Risks

Tatneft is exposed to all of the same industry-specific risks as its peers. Corporate governance and transparency issues are an issue, but by and large are not as important as the broader industry risks of oil prices and moves in the RUB/USD exchange rate.

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
Covered since June 8 2011

	Date	Rating	Target Price	Closing Price
1	11-Mar-11	1L	*81.00	69.45
2	8-Jun-11	*1M	*76.30	64.43
3	6-Sep-11	*2M	*63.90	58.08
4	4-Oct-11	*1M	63.90	47.48
5	7-Oct-11	Stock rating system changed		
6	7-Oct-11	*1	63.90	50.36
7	16-Nov-11	1	*70.60	56.67
8	22-May-12	1	*66.30	52.16
9	29-Oct-12	1	*76.60	60.44
10	1-Apr-13	1	*81.00	63.53
11	16-Sep-13	1	*88.00	62.77
12	22-Oct-13	1	*95.00	66.52

* 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
Covered since June 8 2011

	Date	Rating	Target Price	Closing Price
1	13-Jul-11	*ADD LP	-	64.99
2	17-Oct-11	*REM LP	-	54.13
3	18-Oct-11	*ADD MP	-	55.38
4	22-May-12	*REM MP	-	52.16
5	29-May-12	*ADD MP	-	53.40
6	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
Covered since June 30 2011

	Date	Rating	Target Price	Closing Price
1	11-Mar-11	1H	*0.67	0.57
2	4-Oct-11	*1M	0.67	0.41
3	7-Oct-11	Stock rating system changed		
4	7-Oct-11	*1	0.67	0.42
5	9-Feb-12	1	*0.71	0.63
6	5-Mar-12	1	*0.96	0.68
7	22-May-12	1	*0.88	0.48
8	30-Jan-13	1	*0.99	0.77
9	2-Sep-13	1	*1.11	0.67
10	16-Sep-13	1	*1.18	0.71
11	29-Jan-14	1	*1.15	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
Covered since June 30 2011

	Date	Rating	Target Price	Closing Price
1	18-Oct-11	*ADD MP	-	0.45
2	10-Feb-14	*REM MP	-	0.73

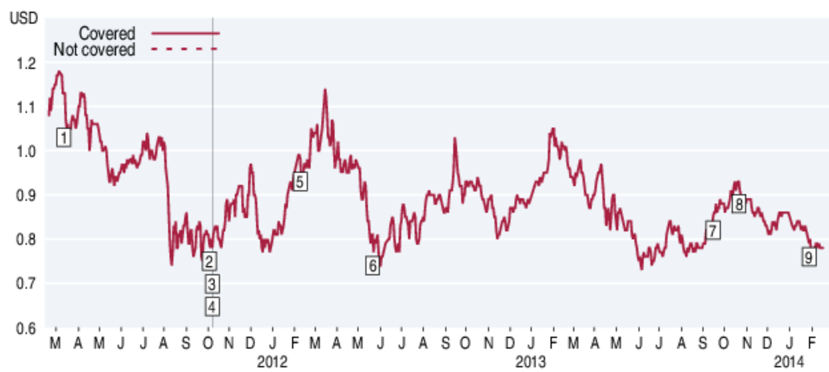
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Surgutneftegaz (SNGS.MM)

Ratings and Target Price History
Fundamental Research

Analyst: Ronald Paul Smith
Covered since June 30 2011



	Date	Rating	Target Price	Closing Price
1	11-Mar-11	2H	*1.21	1.13
2	4-Oct-11	*1M	1.21	0.79
3	7-Oct-11	Stock rating system changed		
4	7-Oct-11	*1	1.21	0.78
5	9-Feb-12	1	*1.28	0.98
6	22-May-12	1	*1.17	0.81
7	16-Sep-13	1	*1.24	0.85
8	22-Oct-13	1	*1.25	0.93
9	29-Jan-14	*2	*0.88	0.79

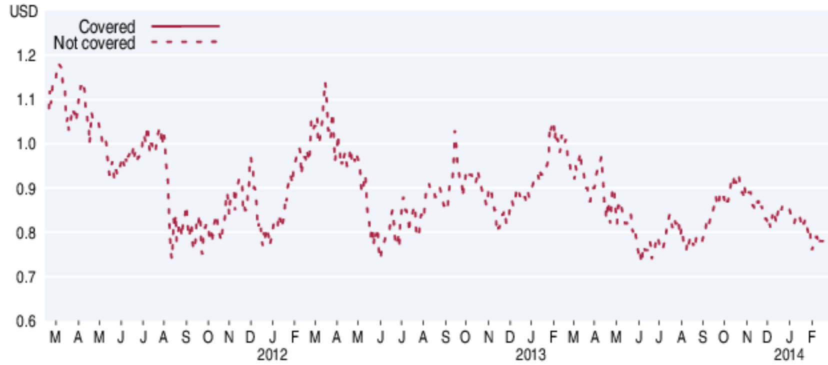
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Surgutneftegaz (SNGS.MM)

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

Analyst: Ronald Paul Smith
Covered since June 30 2011



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Novatek OAO (NVTKq.L)

Ratings and Target Price History
Fundamental Research

Analyst: Ronald Paul Smith
Covered since September 13 2011

	Date	Rating	Target Price	Closing Price
1	11-Mar-11	2M	*130.00	122.70
2	21-Sep-11	*1M	*170.00	129.00
3	7-Oct-11	Stock rating system changed		
4	7-Oct-11	*1	170.00	118.00
5	9-Feb-12	*2	*153.00	135.50
6	30-Apr-12	2	*149.00	127.10
7	16-May-12	*1	149.00	109.30
8	22-May-12	1	*139.00	105.00
9	21-Sep-12	1	*153.00	125.00
10	19-Mar-13	1	*151.00	104.30
11	30-May-13	1	*163.00	112.00
12	22-Oct-13	1	*168.00	141.50

* 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
Covered since September 13 2011

	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
Covered since June 30 2011

Date	Rating	Target Price	Closing Price
1 7-Oct-11	Stock rating system changed		
2 7-Oct-11	*1	6.30	3.42
3 22-May-12	1	*5.77	4.22
4 16-Sep-13	1	*6.31	4.43
5 22-Oct-13	1	*6.48	4.66

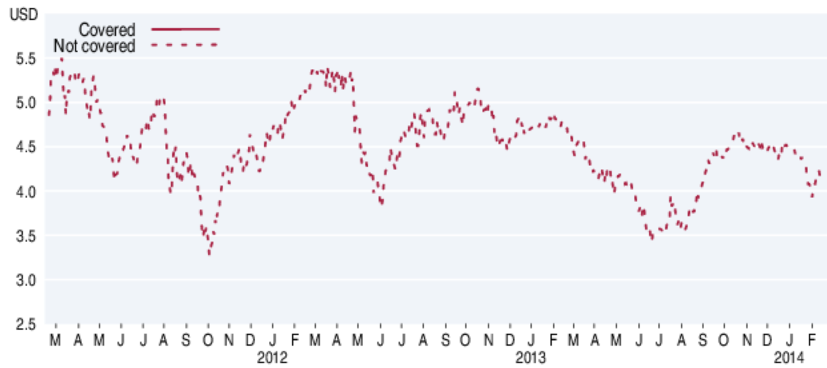
* Indicates change

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
Covered since June 30 2011



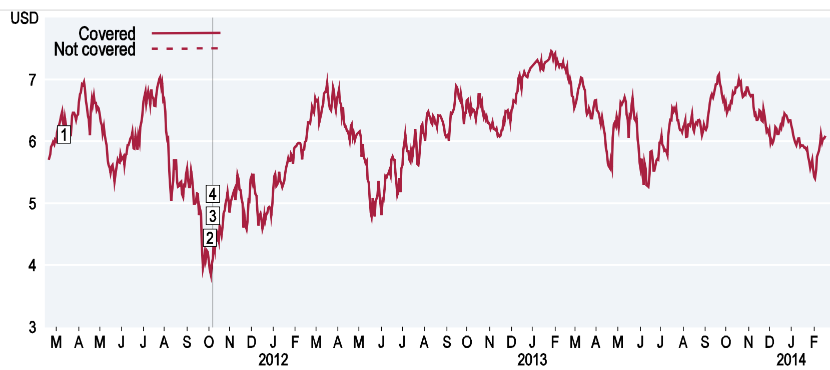
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Tatneft (TATN.MM)

Ratings and Target Price History
Fundamental Research

Analyst: Ronald Paul Smith
Covered since June 30 2011



Date	Rating	Target Price	Closing Price
1 11-Mar-11	3H	*4.69	6.22
2 4-Oct-11	*2M	4.69	3.93
3 7-Oct-11	Stock rating system changed		
4 7-Oct-11	*2	-	4.11

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Tatneft (TATN.MM)

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

Analyst: Ronald Paul Smith
Covered since June 30 2011

	Date	Rating	Target Price	Closing Price
1	13-Jul-11	*ADD LP	-	6.84
2	17-Oct-11	*REM LP	-	4.39
3	18-Oct-11	*ADD LP	-	4.63
4	13-Feb-12	*REM LP	-	5.86
5	22-May-12	*ADD LP	-	4.97
6	21-Sep-12	*REM LP	-	6.77
7	16-Oct-13	*ADD LP	-	6.87
8	20-Jan-14	*REM LP	-	5.90

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Tatneft(pref) (TATN_p.MM)

Ratings and Target Price History
Fundamental Research

Analyst: Ronald Paul Smith
Covered since June 30 2011

	Date	Rating	Target Price	Closing Price
1	11-Mar-11	*3H	*2.72	3.66
2	4-Oct-11	*2M	2.72	2.19
3	7-Oct-11	Stock rating system changed		
4	7-Oct-11	*2	-	2.33

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Tatneft(pref) (TATN_p.MM)

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

Analyst: Ronald Paul Smith
Covered since June 30 2011

	Date	Rating	Target Price	Closing Price
1	18-Oct-11	*ADD LP	-	2.52
2	13-Feb-12	*REM LP	-	3.27
3	22-May-12	*ADD LP	-	2.42
4	10-Feb-14	*REM LP	-	3.50

* 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
Covered since June 16 2011

#	Date	Rating	Target Price	Closing Price
1	11-Mar-11	1M	*10.30	7.29
2	16-Jun-11	1M	*11.00	7.28
3	6-Sep-11	1M	*10.30	5.66
4	7-Oct-11	Stock rating system changed		
5	7-Oct-11	*1	10.30	4.70
6	9-Feb-12	1	*8.00	6.36
7	20-Mar-12	*2	*6.50	6.36
8	30-Apr-12	*1	*7.50	5.76
9	22-May-12	1	*7.20	4.59
10	30-May-13	1	*6.80	3.78
11	18-Jul-13	1	*7.00	4.01
12	16-Sep-13	1	*7.50	4.50
13	22-Oct-13	1	*7.80	4.86

* 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
Covered since June 16 2011

#	Date	Rating	Target Price	Closing Price
1	13-Jul-11	*ADD MP	-	7.24
2	17-Oct-11	*REM MP	-	5.18
3	17-Jul-13	*ADD MP	-	4.06
4	20-Jan-14	*REM MP	-	4.14

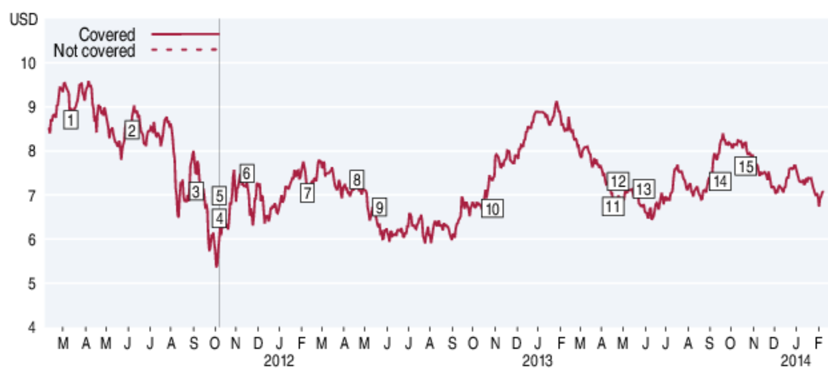
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Rosneft (ROSN.MM)

Ratings and Target Price History
Fundamental Research

Analyst: Ronald Paul Smith
Covered since June 8 2011



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

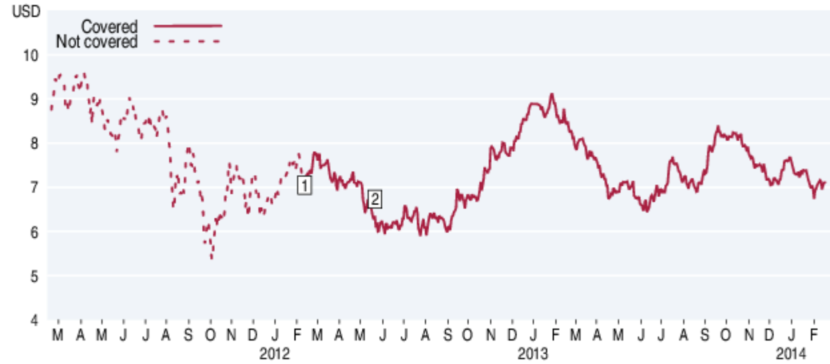
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Rosneft (ROSN.MM)

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

Analyst: Ronald Paul Smith
Covered since June 8 2011



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

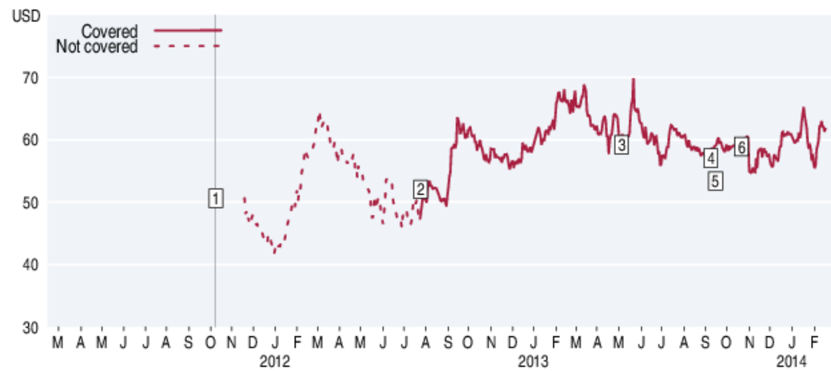
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Bashneft (BANE.MM)

Ratings and Target Price History
Fundamental Research

Analyst: Alexander Bespalov, CFA
Covered since July 25 2012



	Date	Rating	Target Price	Closing Price
1	8-Oct-11	Stock rating system changed		
2	25-Jul-12	*1	*62.50	48.08
3	6-May-13	*2	*60.30	60.55
4	9-Sep-13	*1	*74.20	58.50
5	16-Sep-13	1	*79.20	59.03
6	22-Oct-13	1	*80.50	59.93

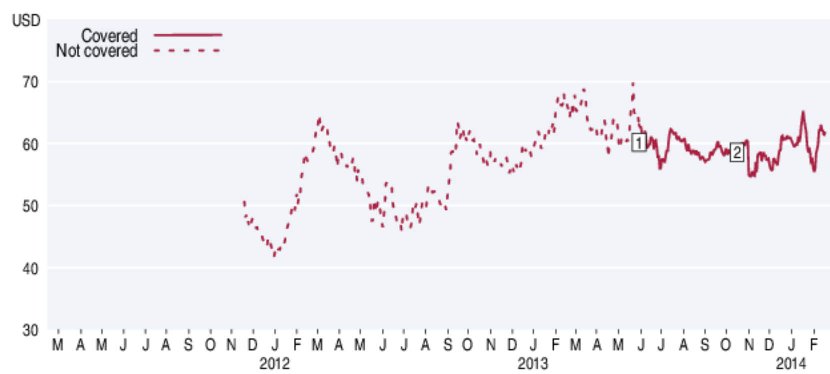
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Bashneft (BANE.MM)

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

Analyst: Alexander Bespalov, CFA
Covered since July 25 2012



	Date	Rating	Target Price	Closing Price
1	30-May-13	*ADD LP	-	63.06
2	16-Oct-13	*REM LP	-	59.39

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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

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

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

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

Within the past 12 months, Citigroup Global Markets Inc. or its affiliates has acted as manager or co-manager of an offering of securities of Petrobras, Lukoil, TMK, Total, Sinopec.

Citigroup Global Markets Inc. or its affiliates has received compensation for investment banking services provided within the past 12 months from Petrobras, Vallourec, Lukoil, TMK, KazMunaiGas E&P, Tenaris, Nostrum Oil & Gas, Total, Eni, Sinopec, Gazpromneft, Dragon Oil, Gazprom, BG Group, Statoil, Rosneft, Repsol, Royal Dutch Shell, Bashneft, Russian Federation, Ukraine.

Citigroup Global Markets Inc. or its affiliates expects to receive or intends to seek, within the next three months, compensation for investment banking services from Petrobras, Lukoil, KazMunaiGas E&P, Eni, Sinopec, Gazpromneft, Dragon Oil, Gazprom, BG Group, Statoil, Rosneft, Bashneft, Russian Federation.

Citigroup Global Markets Inc. or an affiliate received compensation for products and services other than investment banking services from Petrobras, Vallourec, Lukoil, TMK, KazMunaiGas E&P, Novatek OAO, Tenaris, Nostrum Oil & Gas, Total, Eni, Sinopec, Gazpromneft, Eurasia Drilling, Dragon Oil, Gazprom, BG Group, Statoil, Rosneft, Repsol, Royal Dutch Shell, Bashneft, Russian Federation, Ukraine in the past 12 months.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following as investment banking client(s): Sinopec, Petrobras, Vallourec, Lukoil, TMK, KazMunaiGas E&P, Tenaris, Nostrum Oil & Gas, Total, Eni, Gazpromneft, Dragon Oil, Gazprom, BG Group, Statoil, Rosneft, Repsol, Royal Dutch Shell, Bashneft, Russian Federation, Ukraine.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following as clients, and the services provided were non-investment-banking, securities-related: Petrobras, Vallourec, Lukoil, Surgutneftegaz, TMK, KazMunaiGas E&P, Novatek OAO, Tenaris, Nostrum Oil & Gas, Total, Eni, Sinopec, Gazpromneft, Dragon Oil, Gazprom, BG Group, Statoil, Rosneft, Repsol, Royal Dutch Shell, Bashneft, Russian Federation, Ukraine.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following as clients, and the services provided were non-investment-banking, non-securities-related: Petrobras, Vallourec, Lukoil, TMK, KazMunaiGas E&P, Novatek OAO, Tenaris, Nostrum Oil & Gas, Total, Eni, Sinopec, Gazpromneft, Eurasia Drilling, Dragon Oil, Gazprom, BG Group, Statoil, Rosneft, Repsol, Royal Dutch Shell, Bashneft, Russian Federation, Ukraine.

Citigroup Global Markets Inc. or an affiliate received compensation in the past 12 months from Sinopec.

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