

## Russian Oil & Gas

### Alert: Natural monopoly tariff freeze now seems all but certain, effects larger for gas companies

News reports in recent days indicate that the Russian government has taken the decision to delay natural monopoly tariff increases for a year. We see this being more important for Russia's gas companies than its oil companies, even were Transneft to be included into the freeze. We disagree with the theory that this could be a blessing in disguise for Gazprom, although we remain very positive on that name for other reasons (booming exports, dividend increases, etc).

**Impact most obvious for gas companies:** Our base assumptions for gas prices and transport tariffs are, respectively, 7.5% and 7.0% annual ruble growth. While the price freeze affects Novatek more than Gazprom – given the former's larger relative exposure to the Russian gas market – freezing transport tariffs would largely even the score, impairing Gazprom's revenue growth from that line item while constraining the growth of Novatek's largest cost item (gas transport was c37% of Novatek total cost base the last 4 years). If we were to zero out tariff growth for 2014 in our models, but resume it in 2015, then both Gazprom and Novatek would see 3-4% net income impairments relative to our current assumptions in 2014 and 6%-7% in 2015, once the full-year effect has been factored in.

**We are wary of suggestions that this is positive for Gazprom:** We have received comments that a tariff freeze might be good for shareholders of Gazprom, as it might finally prompt management to engage in serious cost cutting. While we are long-standing Gazprom bulls, this view seems a bit over the top. A revenue loss from a tariff freeze might indeed prompt management to find some efficiencies, but we think the savings would be less than 100% of the revenue lost (cost savings are difficult, so why would management be incentivised to find more than absolutely necessary?), leaving a net-net cash flow reduction. However, this view does not apply to dividend increases: As the cash from higher dividends would be 100% returned to shareholders, any cost savings, even those that only partially offset the dividend, would remain within the company to work to shareholders' benefit. Gazprom remains a Best Idea for us, with the recommendation underpinned by booming European exports and increasingly likely dividend increases.

**Oil companies less affected....:** Other than its effects on their gas businesses – both Lukoil and Rosneft have ambitions to grow their domestic gas sales, and gas margins post-2014 will likely be lower than we currently have in our models – tariff freezes will have less effect on the oil companies. For example, in 2012 Rosneft spent some \$2.3bn on "railroad and mixed" transport. A one-year hiatus in ruble-based tariff increases would likely reduce the dollar-based cost increase by 3-4% (depending upon one's opinion of exchange rate moves), giving <\$100mn of savings relative to 2012 EBITDA of c\$21bn.

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

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**...although effect larger if Transneft gets swept up into the mix:** Although we have not yet seen it mentioned in the press, we think it likely that Transneft's tariffs will get included into the freeze. If so, Russia's oil companies could see somewhat larger savings (typical shipment costs via Transneft for exported crude are in the range of \$6-\$7/bbl, depending upon the route, the largest non-tax cost in producing and exporting a barrel of West Siberian crude). By way of comparison, in 2012 Rosneft spent \$4.3bn on pipeline charges, both crude and refined products, so a 4% dollar saving (again depending upon exchange rates) could save another \$170mn, maybe, on top of the <\$100mn estimated above for railroad savings. In other words, we think a tariff freeze would help oil companies, but would be unlikely to be a game changer.

## Novatek OAO

(NVTQ.L; US\$133.80; 1)

### Valuation

We derive our Novatek target price of \$163/ADR based on: 1) a 50% weighting to a DCF value of \$181/share (3% terminal growth rate, WACC of 8.3%); 2) 25% weighting to 2013E target P/E multiple of 14.8x (\$144/share); and 3) 25% weighting to a 11.4x 2013E target EV/EBITDA multiples (\$146/ADR).

### 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.

## Lukoil

(LKOH.MM; US\$61.60; 1)

### Valuation

We set our target price at \$81, which is a blend of our DCF value (\$82, 50% weighting, which assumes WACC of 10.6%, long-term growth of 3.0%), and a return to adjusted historical, 12-month mean P/E and EV/EBITDA ratios of 5.2x and 3.5x, respectively, which indicate valuations of \$76/ADR and \$83/ADR respectively, each of which we weight at 25%.

### 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.

## Rosneft

(ROSN.MM; US\$7.89; 1)

### Valuation

Our target price of \$9.20 is a mix of long-term DCF and near-term multiples. Our DCF value of \$9.42/share (50% weighting) reflects the company's access to relatively good investment opportunities in legacy regions as well as substantial growth opportunities on Russia's continental shelf (offshore) and in the gas business. We use a WACC of 8.8%, a long-term growth rate of 3.0% and beta of 1.0. Our near-term multiple valuations (25% weighting each) include an implied price of \$6.85/share on a P/E basis (2013E) and a more attractive \$7.15/share on an EV/EBITDA basis. We add \$0.99 to our base valuation of \$8.21/share to account

for the value of the offshore opportunity, which we do not have explicitly in our DCF model.

## 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.

## Transneft

(TRNF\_p.MM; Rbl81,575.00; 2H)

## Valuation

We set our TP for Transneft prefs at RUB71,500/share based on a weighted average of three widely divergent potential outcomes on dividend policy. If current policy is continued indefinitely, then the stock is worth only cRUB12,500/sh, an outcome to which we assign a 25% probability. The blue-sky option (10% of IFRS net income) would give the stock a current value of 158,600/sh (also 25% probability). Finally, a proposed intermediate policy, a much likelier scenario, would boost dividends to 5-6% and imply a value of around 57,500/share (50% probability).

## Risks

We see Transneft's equity as having risks above the Russian oil & gas universe in general due to the wide range of potential outcomes on dividend policy, with a potential 20x swing from the current policy. The potential swing from one plausible extreme to the other is very large. This more than offsets the relative low risk of the underlying business model (a government-owned utility providing a critical monopoly service -oil transport to a cash-rich clientele) to make the stock a high-risk investment. Should the development in dividend policy vary from what we assume in our base case scenario the shares could fail to reach our target price.

## Gazprom

(GAZP.MM; US\$4.43; 1)

## Valuation

We derive our Gazprom target price of \$7.0 based on: 1) a DCF valuation of \$7.0, using a WACC of 10.4% and terminal growth of 3.0% (50% weight); 2) 2013E EV/EBITDA target price of \$6.7 based on a target multiple of 3.6x (25%); and 3) 2013E P/E target price of \$7.3 based on a target multiple of 5.4x (25%).

## 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.

# Appendix A-1

## Analyst Certification

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### 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	14-Jan-11	1M	*9.50	6.53
2	11-Mar-11	1M	*10.30	7.29
3	16-Jun-11	1M	*11.00	7.28
4	6-Sep-11	1M	*10.30	5.66

\* Indicates change

	Date	Rating	Target Price	Closing Price
5	7-Oct-11	Stock rating system changed		
6	7-Oct-11	*1	10.30	4.70
7	9-Feb-12	1	*8.00	6.36
8	20-Mar-12	*2	*6.50	6.36

	Date	Rating	Target Price	Closing Price
9	30-Apr-12	*1	*7.50	5.76
10	22-May-12	1	*7.20	4.59
11	30-May-13	1	*6.80	3.78
12	18-Jul-13	1	*7.00	4.01

Rating/target price changes above reflect Eastern Standard Time

### Gazprom (GAZP.MM)

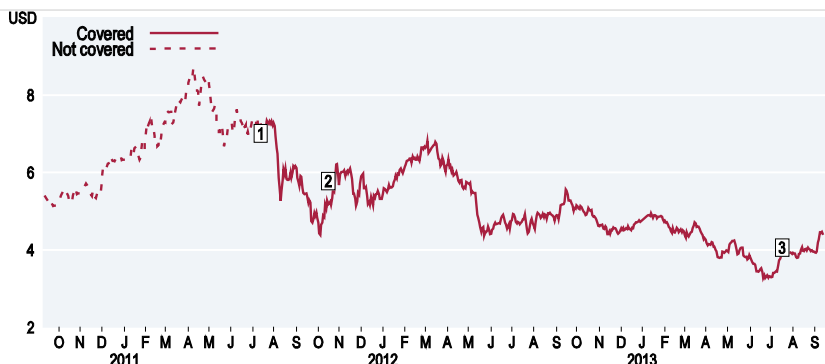
#### Ratings and Target Price History

#### 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

\* Indicates change

	Date	Rating	Target Price	Closing Price
2	17-Oct-11	*REM MP	-	5.18

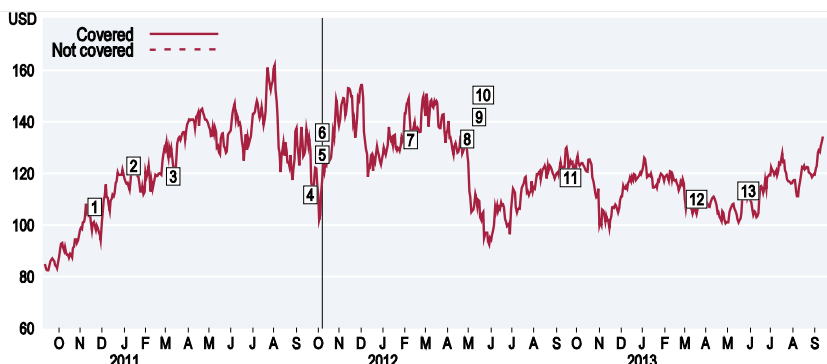
	Date	Rating	Target Price	Closing Price
3	17-Jul-13	*ADD MP	-	4.08

Rating/target price changes above reflect Eastern Standard Time

## Novatek OAO (NVTQ.L)

### Ratings and Target Price History Fundamental Research

Analyst: Ronald Paul Smith  
Covered since September 13 2011



	Date	Rating	Target Price	Closing Price
1	22-Nov-10	*2M	*107.00	99.90
2	14-Jan-11	2M	*125.00	120.70
3	11-Mar-11	2M	*130.00	122.70
4	21-Sep-11	*1M	*170.00	128.00
5	7-Oct-11	Stock rating system changed		

\* Indicates change

	Date	Rating	Target Price	Closing Price
6	7-Oct-11	*1	170.00	118.00
7	9-Feb-12	*2	*153.00	135.50
8	30-Apr-12	2	*149.00	127.10
9	16-May-12	*1	149.00	109.30
10	22-May-12	1	*139.00	105.00

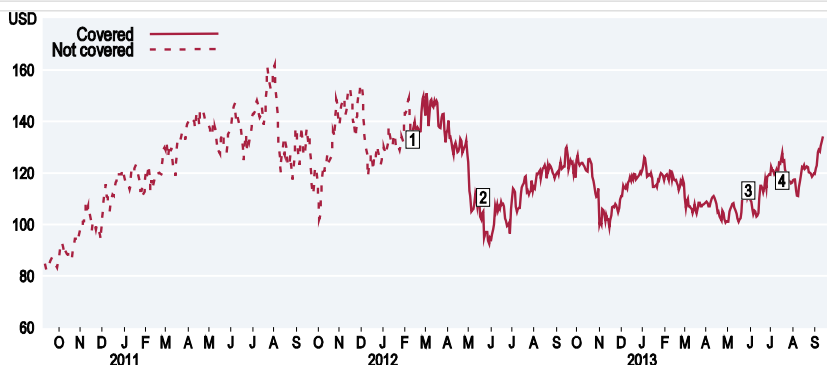
	Date	Rating	Target Price	Closing Price
11	21-Sep-12	1	*153.00	125.00
12	19-Mar-13	1	*151.00	104.30
13	30-May-13	1	*163.00	112.00

Rating/target price changes above reflect Eastern Standard Time

## Novatek OAO (NVTQ.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

\* Indicates change

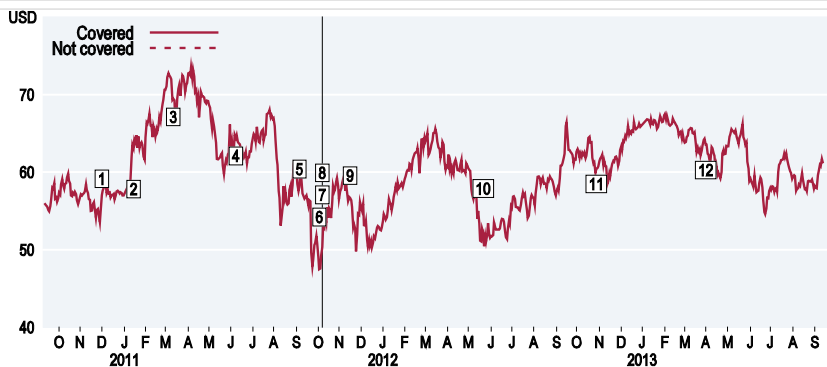
	Date	Rating	Target Price	Closing Price
3	30-May-13	*ADD MP	-	112.00
4	17-Jul-13	*REM MP	-	127.70

Rating/target price changes above reflect Eastern Standard Time

## Lukoil (LKO.HK)

### Ratings and Target Price History Fundamental Research

Analyst: Ronald Paul Smith  
Covered since June 8 2011



	Date	Rating	Target Price	Closing Price
1	1-Dec-10	1L	*74.00	57.07
2	14-Jan-11	1L	*84.00	63.09
3	11-Mar-11	1L	*81.00	68.45
4	8-Jun-11	*1M	*76.30	64.43

\* Indicates change

	Date	Rating	Target Price	Closing Price
5	6-Sep-11	*2M	*63.90	58.08
6	4-Oct-11	*1M	63.90	47.48
7	7-Oct-11	Stock rating system changed		
8	7-Oct-11	*1	63.90	50.36

	Date	Rating	Target Price	Closing Price
9	16-Nov-11	1	*70.60	56.67
10	22-May-12	1	*66.30	52.16
11	29-Oct-12	1	*76.60	60.44
12	1-Apr-13	1	*81.00	63.53

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

\* Indicates change

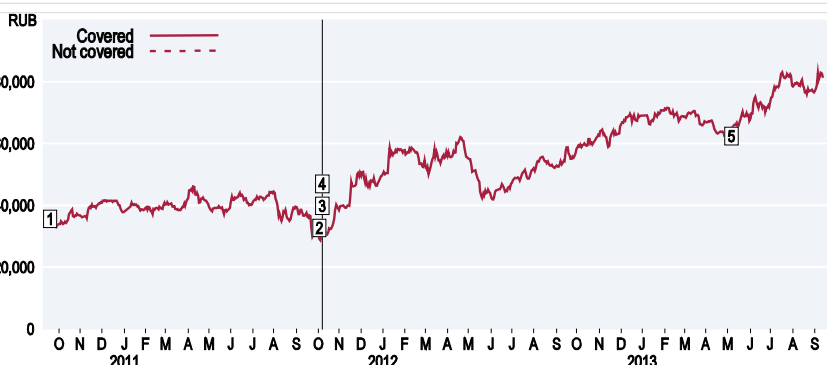
	Date	Rating	Target Price	Closing Price
3	18-Oct-11	*ADD MP	-	55.38
4	22-May-12	*REM MP	-	52.16

	Date	Rating	Target Price	Closing Price
5	29-May-12	*ADD MP	-	53.40
6	21-Sep-12	*REM MP	-	62.61

Rating/target price changes above reflect Eastern Standard Time

## **Transneft (TRNF\_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	20-Sep-10	1H	*60,000.00	34,815.26
2	4-Oct-11	*1M	60,000.00	29,250.00

\* Indicates change

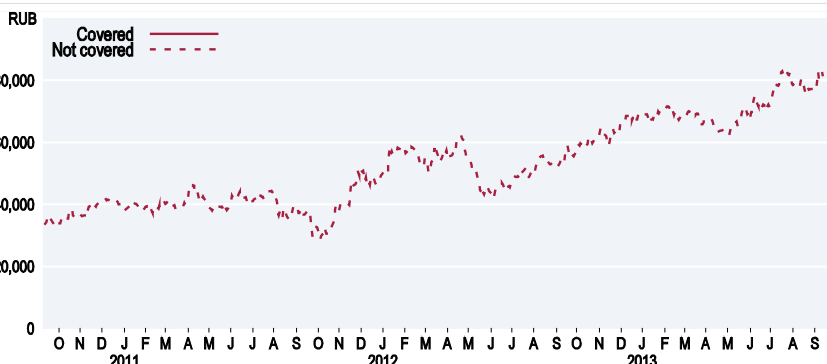
	Date	Rating	Target Price	Closing Price
3	7-Oct-11	Stock rating system changed	-	-
4	7-Oct-11	*1	60,000.00	30,406.00

	Date	Rating	Target Price	Closing Price
5	7-May-13	*2H	*71,500.00	64,650.00

Rating/target price changes above reflect Eastern Standard Time

## **Transneft (TRNF\_p.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



## 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	14-Jan-11	1L	*9.90	7.75
2	11-Mar-11	*2L	*9.30	8.85
3	7-Jun-11	*1M	*11.30	8.78
4	6-Sep-11	1M	*9.30	7.49
5	7-Oct-11	Stock rating system changed		

\* Indicates change

	Date	Rating	Target Price	Closing Price
6	7-Oct-11	*1	9.30	5.99
7	16-Nov-11	1	*9.90	7.30
8	9-Feb-12	*2	*8.20	7.14
9	19-Apr-12	*1	8.20	7.28
10	22-May-12	1	*7.30	6.35

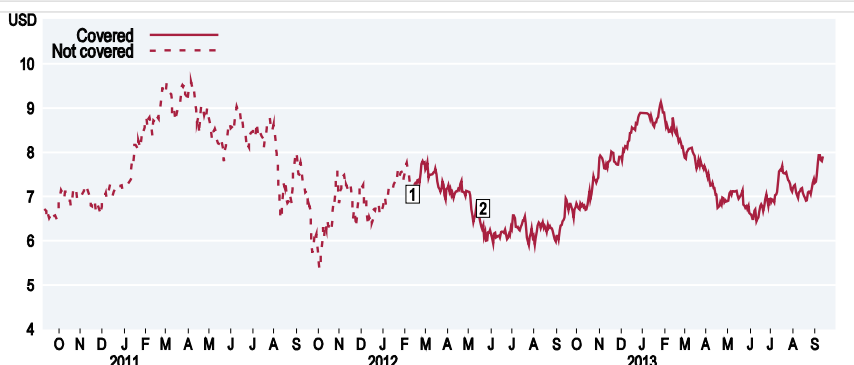
	Date	Rating	Target Price	Closing Price
11	29-Oct-12	1	*9.10	7.32
12	17-Apr-13	1	*9.45	6.74
13	24-Apr-13	1	*9.53	6.98
14	30-May-13	1	*9.20	6.79

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

\* Indicates change

	Date	Rating	Target Price	Closing Price
2	22-May-12	*REM LP	-	6.35

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 30 Jun 2013

	12 Month Rating			Relative Rating		
	Buy	Hold	Sell	Buy	Hold	Sell
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% of companies in each rating category that are investment banking clients	53%	50%	45%	58%	51%	49%

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Ronald Paul Smith; Alexander Bepalov, CFA

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