

Lukoil (LKOH.MM)

Raising TP on Passing Regulatory Risk, Maintain Buy

- **Upgrading TP to \$76.60/share, maintain Buy:** We upgrade our Lukoil TP from \$66.3/share to \$76.6/share on the strength of a lower risk assessment (+12%) and the impact of the advance of time in our DCF model and other minor, accumulated model adjustments. With a 33% Expected Total Return, including dividends, we see cause to maintain our Buy rating on Lukoil.
- **Post-election policy review improves oil companies' outlook:** Early in 2012 we anticipated a sweeping review of all policies of the Russian government, which in the oil sector means taxes. That review has indeed come to pass, but is actually breaking in *favor* of the Russian oil companies. While keeping the main revenue-generating part of the tax code stable, the government is reliably reported to be moving to address a number of long-outstanding issues in the oil taxation regime, including the development of a separate offshore taxation regime and breaks for hard-to-recover reserves, including a full waiver of the extraction taxes for West Siberia's Bazhenov shale.
- **Removing risk from discount rates:** With tax reform breaking in favor of oil companies – on the margin the system is being improved, and the core tax regime appears stable – we now remove the 75 basis points added to our equity risk premium (ERP) in February for increased post-election regulatory and other risks. We are making a similar change in assumptions for Rosneft (see separate note published today [Rosneft \(ROSN.MM\) - Upgrading TP to \\$9.1 on Deal Efficiencies, Gas Upside](#)). This risk reduction increases our DCF and overall TP by 12%, all else being equal.

- Company Update
- Target Price Change
- Estimate Change

Buy	1
Price (26 Oct 12)	US\$59.89
Target price	US\$76.60
	from US\$66.30
Expected share price return	27.9%
Expected dividend yield	4.7%
Expected total return	32.6%
Market Cap	US\$46,380M

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



Lukoil (USD)

Year to 31 Dec	2010A	2011A	2012E	2013E	2014E
Sales (\$M)	104,956.0	133,650.0	137,826.3	134,686.2	130,294.8
Net Income (\$M)	9,006.0	10,357.0	11,567.5	10,064.7	9,671.9
Diluted EPS (\$)	11.63	13.37	14.94	13.00	12.49
Diluted EPS (Old) (\$)	11.63	13.37	14.93	13.10	12.47
PE (x)	5.2	4.5	4.0	4.6	4.8
EV/EBITDA (x)	3.1	2.6	2.2	2.5	2.4
DPS (\$)	1.94	2.55	2.85	2.48	2.84
Net Div Yield (%)	3.2	4.3	4.8	4.1	4.7

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

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LKO.MM: Fiscal year end 31-Dec						Price: US\$59.89; TP: US\$76.60; Market Cap: US\$46,383m; Recomm: Buy					
Profit & Loss (US\$m)	2010	2011	2012E	2013E	2014E	Valuation ratios	2010	2011	2012E	2013E	2014E
Sales revenue	104,956	133,650	137,826	134,686	130,295	PE (x)	5.2	4.5	4.0	4.6	4.8
Cost of sales	-43,579	-59,694	-59,721	-56,993	-54,357	PB (x)	0.8	0.6	0.6	0.5	0.5
Gross profit	61,377	73,956	78,106	77,693	75,938	EV/EBITDA (x)	3.1	2.6	2.2	2.5	2.4
Gross Margin (%)	58.5	55.3	56.7	57.7	58.3	FCF yield (%)	11.3	9.3	4.1	-2.1	16.1
EBITDA (Adj)	15,687	17,628	19,975	18,733	18,546	Dividend yield (%)	3.2	4.3	4.8	4.1	4.7
EBITDA Margin (Adj) (%)	14.9	13.2	14.5	13.9	14.2	Payout ratio (%)	17	19	19	19	23
Depreciation	-4,154	-4,473	-4,742	-5,326	-5,745	ROE (%)	15.2	15.6	15.1	11.8	10.4
Amortisation	0	0	0	0	0	Cashflow (US\$m)					
EBIT (Adj)	11,533	13,155	15,233	13,407	12,801	EBITDA	15,687	17,628	19,975	18,733	18,546
EBIT Margin (Adj) (%)	11.0	9.8	11.1	10.0	9.8	Working capital	-2,192	-1,587	-635	-175	-72
Net interest	-538	-483	-443	-578	-489	Other	-1,818	-908	-2,701	-2,407	-2,194
Associates	472	690	503	443	423	Operating cashflow					
Non-op/Except	3	-243	58	58	58	Capex	-6,431	-10,820	-14,718	-17,123	-8,815
Pre-tax profit	11,470	13,119	15,352	13,331	12,793	Net acq/disposals	1,394	90	-1,749	465	494
Tax	-2,351	-3,293	-3,853	-3,335	-3,190	Other	37	-1,654	187	-14	-19
Extraord./Min.Int./Pref.div.	-113	531	69	69	69	Investing cashflow					
Reported net profit	9,006	10,357	11,568	10,065	9,672	Dividends paid	-1,556	-1,830	-2,421	-2,106	-2,418
Net Margin (%)	8.6	7.7	8.4	7.5	7.4	Financing cashflow					
Core NPAT	9,006	10,357	11,568	10,065	9,672	Net change in cash	94	385	-1,894	-359	-168
Per share data						Free cashflow to s/holders					
Reported EPS (\$)	11.63	13.37	14.94	13.00	12.49		5,246	4,313	1,922	-972	7,465
Core EPS (\$)	11.63	13.37	14.94	13.00	12.49						
DPS (\$)	1.94	2.55	2.85	2.48	2.84						
CFPS (\$)	15.08	19.54	21.48	20.85	21.02						
FCFPS (\$)	6.77	5.57	2.48	-1.26	9.64						
BVPS (\$)	78.74	92.85	104.66	114.94	124.31						
Wtd avg ord shares (m)	774	774	774	774	774						
Wtd avg diluted shares (m)	774	774	774	774	774						
Growth rates											
Sales revenue (%)	29.4	27.3	3.1	-2.3	-3.3						
EBIT (Adj) (%)	17.9	14.1	15.8	-12.0	-4.5						
Core NPAT (%)	28.5	15.0	11.7	-13.0	-3.9						
Core EPS (%)	40.4	15.0	11.7	-13.0	-3.9						
Balance Sheet (US\$m)											
Cash & cash equiv.	2,368	2,753	859	500	332						
Accounts receivables	8,219	8,921	9,389	9,361	9,235						
Inventory	6,231	7,533	7,852	7,755	7,581						
Net fixed & other tangibles	54,629	58,957	68,115	79,089	81,332						
Goodwill & intangibles	1,446	1,344	1,344	1,344	1,344						
Financial & other assets	11,124	13,838	16,118	16,071	15,968						
Total assets	84,017	93,346	103,677	114,120	115,791						
Accounts payable	5,607	5,995	6,071	5,823	5,528						
Short-term debt	2,125	1,792	2,171	2,438	2,664						
Long-term debt	9,069	7,300	7,088	9,090	3,174						
Provisions & other liab	5,820	6,519	7,530	8,063	8,535						
Total liabilities	22,621	21,606	22,860	25,414	19,900						
Shareholders' equity	60,985	71,912	81,058	89,016	96,270						
Minority interests	411	-172	-241	-311	-380						
Total equity	61,396	71,740	80,817	88,706	95,891						
Net debt	8,826	6,339	8,400	11,027	5,505						
Net debt to equity (%)	14.4	8.8	10.4	12.4	5.7						

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For definitions of the items in this table, please click [here](#).

Post-election policy review positive for oils

Tax risk reduced, partially offset by additional leverage

Early in 2012 ([Russian Oil & Gas in 2012 - Policy Risk In Oil & Gas Is Real — Looking For Signposts](#)) we added substantial amounts of risk to our Equity Risk Premiums (ERPs) for our Russian oil & gas coverage to allow for increased policy risk after March's presidential elections. That risk indeed came, as the turnover and rotation at the Presidential and Ministerial levels brought about a full review of all major policies. In oil & gas, policy means tax, and the government since the election has taken a long, hard look at taxes in both the gas and oil sectors.

As anticipated, gas taxes are indeed going up, and quite materially, from this year's RUB509/mcm for Gazprom to RUB788/mcm in 2015, and from RUB251/mcm to RUB552/mcm for independent producers, although the Ministry of Finance (MinFin) in the end backed off of some of its more radical positions staked out earlier in the year.

We still don't know what taxes will look like after 2015, but the government is reliably reported in the press to be working on a long-term gas tax mechanism, hopefully to be introduced in the new year (and maybe to be preliminarily released in the coming weeks), which should materially increase the certainty around our long-term earnings estimates for Russian gas companies.

We did not expect any particular outcome on oil taxes – the sector is already heavily taxed, and provides around half the government's revenues, two facts which constrain the government's range of possible actions, as they make both material increases and decreases in the tax burden unlikely.

Tax reform breaking in favor of oil companies

That being said, tax reform is breaking in favor of oil companies as, rather than moving to raise or lower the overall tax burden or, for that matter, to tweak the existing tax regime for the bulk of conventional production, the government has instead turned its attention to a number of long-outstanding issues, including a set of MET breaks for hard-to-produce reserves and a comprehensive offshore tax regime. In particular, we were pleased to see the government make a proposal (which we think will be passed) to fully waive the MET for the Bazhenov shale in West Siberia ([Russian Oil Tax Reform - MET breaks on Bazhenov shale: Sufficient for a West Siberian renaissance?](#)).

Increasing TP 16% to \$76.6/share, retain Buy rating

Because of this focus on improving the tax regime, even on the margin, we now feel comfortable reducing our base ERPs back to the conventional 6% we use as a starting point for our Russian oil & gas companies. For Lukoil and Rosneft (see our separate note published concurrently with this one) this means the removal of 75 basis points of risk premium. This reduction of risk increases our DCF and overall TP by 12%, all else being equal. Note that our multiple-based TPs improve as well as our DCF, as we had reduced our multiples in parallel with our increase in risk in February, which we likewise reverse here. Additionally, the advance of time since our last update and minor model tweaks has increased our DCF value by about 3%.

With a total return to our TP, including dividends, of 33% to the current market price, we maintain our recommendation of Buy on Lukoil's shares.

Figure 1. Comp table

Company Name	Target Price	Rating	Price 10/27/12	Return to TP	Market Cap	2011A	P/E 2012E	2013E	EV /EBITDA 2011A	2012E	2013E	Div yield 2011A	2012E	2013E	Total Return
BG	15.3	Buy	13.2	16%	\$72.5	16.7x	15.6x	14.5x	7.7x	7.5x	6.8x	1.1%	1.2%	1.3%	17%
Eni	20.0	Buy	17.5	14%	\$82.3	9.5x	9.7x	9.2x	3.3x	3.0x	3.0x	6.4%	6.1%	6.2%	20%
Repsol	18.0	Buy	15.1	20%	\$24.5	8.9x	8.7x	9.0x	4.7x	5.2x	4.4x	8.3%	5.3%	5.7%	25%
RD Shell Class A	22.0	Neutral	21.1	4%	\$218.9	8.6x	8.1x	8.3x	3.2x	2.9x	3.0x	5.0%	5.1%	5.3%	10%
Statoil	150.0	Neutral	141.4	6%	\$78.1	9.2x	8.6x	9.2x	2.1x	1.9x	2.0x	4.7%	4.8%	5.1%	11%
Total	40.0	Neutral	38.7	3%	\$118.5	7.1x	7.6x	7.7x	2.6x	2.7x	2.9x	6.3%	6.0%	6.1%	9%
Weighted average						9.5x	9.2x	9.2x	3.6x	3.4x	3.4x	5.1%	4.9%		
Petrobras	28.0	Buy	22.4	25%	\$144.1	7.3x	12.5x	10.6x	4.7x	6.4x	6.8x	4.7%	5.8%	4.0%	31%
KMG EP	30.0	Buy	18.2	65%	\$7.4	5.1x	3.7x	4.0x	1.2x	0.6x	0.4x	5.0%	8.1%	11.1%	73%
Sinopec	7.4	Neutral	8.0	-8%	\$89.8	8.2x	10.9x	7.2x	4.7x	5.6x	4.4x	4.5%	2.3%	3.5%	-5%
Weighted average						7.6x	11.6x	9.1x	4.6x	5.9x	5.7x	4.6%	4.6%		
Alliance Oil	107.0	Buy	51.3	109%	\$1.3	3.5x	5.2x	2.2x	3.3x	4.4x	2.3x	0.0%	0.0%	0.0%	109%
Bashneft ord	62.5	Buy	57.01	10%	\$9.7	6.3x	6.3x	7.8x	4.4x	3.9x	4.5x	5.9%	8.7%	5.9%	18%
Gazprom	7.2	Buy	4.8	49%	\$110.8	2.5x	3.1x	3.5x	2.0x	2.5x	2.7x	6.4%	5.5%	4.8%	55%
Gazpromneft	5.77	Buy	4.92	17%	\$23.3	4.3x	4.9x	5.7x	2.7x	2.8x	3.0x	5.0%	4.5%	3.8%	22%
Lukoil	76.6	Buy	59.9	28%	\$46.4	4.5x	4.0x	4.6x	2.6x	2.2x	2.4x	4.3%	4.8%	4.1%	33%
Novatek	153	Buy	112.0	37%	\$34.0	14.5x	14.8x	12.9x	6.4x	9.1x	7.8x	1.8%	1.7%	1.5%	38%
Rosneft	9.1	Buy	7.37	24%	\$68.3	5.7x	7.0x	8.6x	3.8x	4.3x	5.1x	3.5%	3.6%	2.9%	27%
Surgutneftegaz ord	1.17	Buy	0.88	33%	\$31.4	4.1x	5.5x	4.5x	0.9x	0.5x	0.2x	2.3%	2.8%	4.0%	36%
Tatneft ord		Neutral	6.36	n/a	\$13.9	6.6x	6.0x	6.0x	5.2x	5.1x	5.0x	3.8%	3.9%	3.9%	
TNK-BP Hld ord	2.55	Neutral	2.17	18%	\$32.5	3.6x	3.7x	4.4x	2.6x	2.4x	2.2x	19.3%	0.0%	0.0%	18%
Bashneft (pref)	46.8	Buy	40.77	15%	\$1.4	4.5x	4.5x	5.6x	3.1x	2.8x	3.2x	8.3%	12.2%	8.2%	27%
Surgutneftegaz (pref)	0.88	Buy	0.65	36%	\$5.0	3.0x	4.0x	3.3x	0.7x	0.4x	0.2x	11.3%	9.0%	10.5%	45%
Tatneft (pref)		Neutral	3.25	n/a	\$0.5	3.3x	3.1x	3.1x	2.7x	2.6x	2.6x	7.4%	7.7%	7.7%	
TNK-BP (pref)	2.26	Neutral	1.82	24%	\$0.8	3.0x	3.2x	3.7x	2.2x	2.0x	1.8x	22.9%	0.0%	0.0%	24%
Weighted average						5.0x	5.5x	5.9x	3.0x	3.3x	3.4x	5.9%	3.9%		
Total weighted average						7.7x	8.5x	8.2x	3.6x	3.9x	3.8x	5.2%	4.6%		

Source: Citi Research

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, even after the introduction of the 60/66 tax reform in October, should remain rather profitable and the company should see substantial earnings gains from its refinery upgrade programme. We also see Lukoil as providing the best exposure to the developing Russian independent gas industry among Russian oil majors. Net-net, we expect earnings for Lukoil to be roughly stagnant going forward, but every stock has its price, and we like Lukoil at these levels, rating it a 1-Buy.

Valuation

We set our target price at \$76.6, which is a blend of our DCF value (\$71.9, 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 5.3x and 3.5x, respectively, which indicate valuations of \$83.4/ADR and \$79.2/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.

Appendix A-1

Analyst Certification

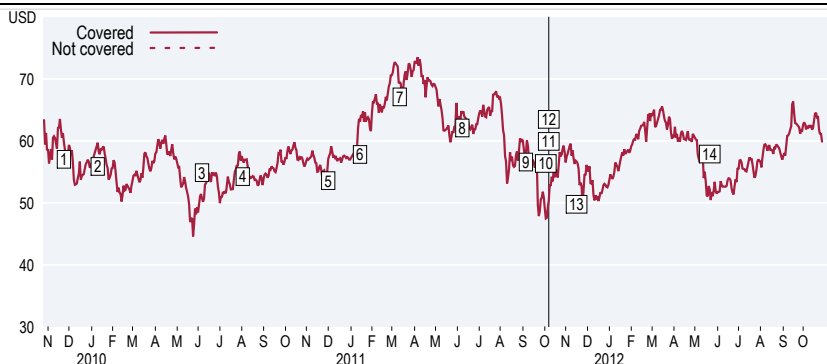
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Lukoil (LKO.MM)

Ratings and Target Price History Fundamental Research

Analyst: Ronald Paul Smith
Covered since June 8 2011



Date	Rating	Target Price	Closing Price
1 24-Nov-09	*2L	*67.00	59.76
2 11-Jan-10	2L	*63.00	59.71
3 7-Jun-10	*1L	63.00	50.69
4 3-Aug-10	1L	*69.00	56.93
5 1-Dec-10	1L	*74.00	57.07

* Indicates change

Date	Rating	Target Price	Closing Price
6 14-Jan-11	1L	*84.00	63.09
7 11-Mar-11	1L	*81.00	69.45
8 8-Jun-11	*1M	*76.30	64.43
9 6-Sep-11	*2M	*63.90	58.08
10 4-Oct-11	*1M	63.90	47.48

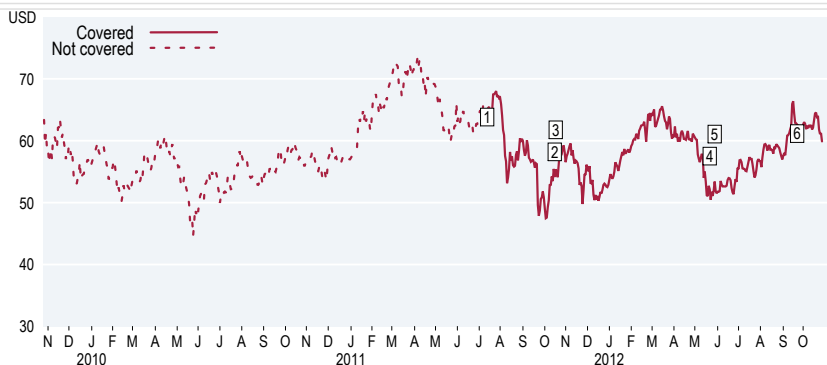
Date	Rating	Target Price	Closing Price
11 7-Oct-11	Stock rating system changed		
12 7-Oct-11	*1	63.90	50.36
13 16-Nov-11	1	*70.60	56.67
14 22-May-12	1	*66.30	52.16

Rating/target price changes above reflect Eastern Standard Time

Lukoil (LKO.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

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<i>Data current as of 4 Oct 2012</i>	12 Month Rating			Relative Rating		
	Buy	Hold	Sell	Buy	Hold	Sell
Citi Research Global Fundamental Coverage	51%	38%	11%	7%	85%	7%
% of companies in each rating category that are investment banking clients	50%	47%	45%	59%	47%	50%

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