

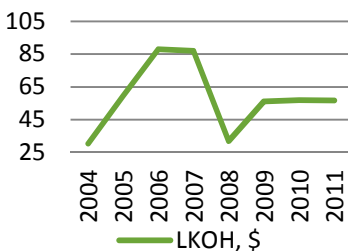


Analysts: oil and gas

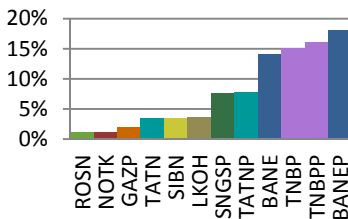
Dmitry Adamidov, PhD
+7 985 766 05 74
da@investcafe.co.uk

Grigory Birg, MiF, ACA
+7 903 720 03 65
gb@investcafe.co.uk

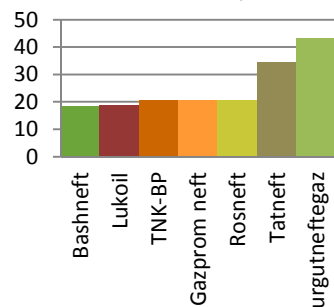
Vitaly Mikhailchuk
+7 916 060 03 92
vm@investcafe.co.uk



Dividend Yield, 2010



Reserve life, years



We initiate the coverage of LUKOIL with this research. Our valuation model for the company indicates that the stock has virtually no upside potential left for investors. As a result of this, Investcafe assigns a **HOLD** rating on LUKOIL common shares with a target price of **\$66.9**, implying a growth potential of **18%**.

Limited opportunities to replenish Russian resource base. The presence of the US partner ConocoPhillips in the LUKOIL share capital has long held back the latter's prospects for the replacement of its Russian resource base. The departure of ConocoPhillips has facilitated the Russian company's access to Russian oilfields, but there are practically no promising undeveloped fields left in Russia. Subsequently, LUKOIL expects to replenish its reserves via its share in the Iraqi West Qurna-2 field (LUKOIL owns 56.25% in the project, leaving Statoil with 18.75% and North Oil with 25%) and other oil fields home and abroad. The Iraqi field holds an estimated geological oil reserve of 2.05 billion tons. However, production in Iraq is scheduled to begin no earlier than 2013.

LUKOIL is trying to stabilize falling production. The west Siberian oilfields that account for more than half of the company's Russian oil production are mostly in the decline stage (production in the region contracted by 4% in 2010; subsequently, the company aims to slow the rate of production decline to 2%). Given this, LUKOIL needs to take action to stabilize oil production in this and other regions. The development of new fields and the employment of advanced oil recovery techniques have so far only allowed the company to slow oil production decline rates in Russia, while oil production within its overseas projects in 2005-2010 has been growing at a CAGR of 10%.

The company has one of the lowest profitability levels. In addition to having one of the lowest levels of profitability among Russian oil companies, Lukoil has been showing a contraction of operating margins. In 2010, the EBITDA margin decreased by more than 3% compared to 2009. We are upbeat that Lukoil will subsequently manage to widen its margins, albeit at a very slow pace. The EBITDA margin is estimated to reach 15% by 2020.

LUKOIL has the most effective tax rate in the industry. It is no secret that the main problem of the Russian oil industry is the excessive tax burden. In 2010, the effective income tax rate for Lukoil was 18.3%, which is much lower than for its rivals. In the forecast period, LUKOIL is estimated to have an effective income tax rate of around 20%, which is 5% below the respective rate for Rosneft, an industry leader in profitability terms. LUKOIL qualifies for this rate because many of its assets are located outside Russia. Meanwhile LUKOIL's Russian operations were no exception to the growing tax burden imposed on the oil companies by the government, paying out 49% of revenues in taxes. The imposition of the new 60-66-90 taxation system is to enable the company to boost its profits by more than USD 500 mn.

The company has a large gas production potential. The group is now in talks with Gazprom on its gas future in Russia and they have been quite successful. LUKOIL has already signed an agreement with Gazprom on access to the gas transport system in 2012 through 2016. Subsequently, the development of the gas business by LUKOIL is in the hands of the state and Gazprom.

Lukoil shares, LKOH

Target price per common	USD	66.9
Current price per common	USD	56,7
Upside potential	%	+18
Number of common shares	mn	851
Free Float (commons)	%	85.3
MCap	USD bn	48,2
Enterprise Value	USD bn	55,5

Sources: MICEX, LUKOILdata, Investcafe estimates

Financials and market ratios

	2010	2011П	2012П	2013П
Revenue (USD mn)	\$104,956	\$140,991	\$135,396	\$144,271
EBITDA (USD mn)	\$16,162	\$20,958	\$18,595	\$20,014
Net income (USD mn)	\$9,006	\$13,045	\$11,093	\$12,092
EBITDA margin	14.9%	14.6%	13.5%	13.7%
Net margin	9%	9%	8%	8%
EPS (USD)	\$11	\$15	\$13	\$14
P/E (x)	5.4	3.7	4.0	4.3
EV/S (x)	0.55	0.39	0.40	0.36
EV/EBITDA (x)	3.55	2.65	2.93	2.62
ROE (%)	16%	20%	15%	14%

Sources: MICEX, LUKOILdata, Investcafe estimates

