



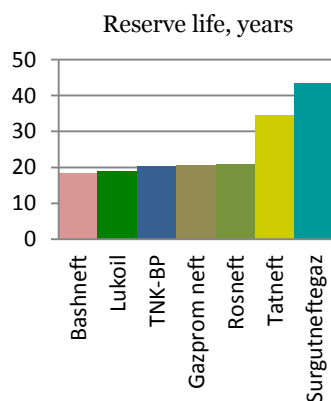
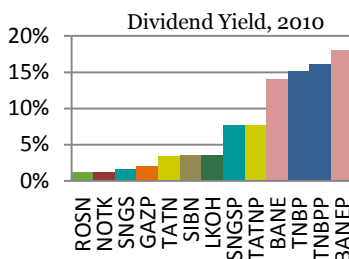
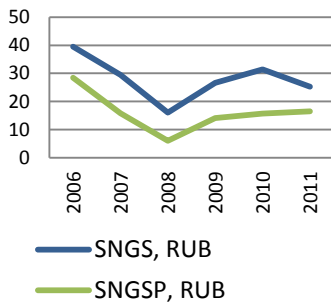
SURGUTNEFTEGAZ

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With this research note we initiate coverage of Surgutneftegaz, Russia's least transparent oil company. Company shares are currently valued fairly by the market; hence we assign a **HOLD** rating to Surgutneftegaz ordinary and preferred shares. Year-end 2012 target price is **RUB 30.63** for ordinary shares implying **upside potential of 6%** and **RUB 18.38** for preference shares, which are **overvalued by 4%**.

An enigma – Surgutneftegaz does not publish financials according to international accounting standards or issue a detailed MD&A note, limiting investors to RAS accounts, which are limited in scope and detail. The ownership structure of the company is unclear. Nor does the company disclose data on its reserves, limiting itself to a declaration of its C1+C2-category reserves growth from year to year.

Declining production - In 2010, Surgutneftegaz extracted 59.5 million tons of oil. Western Siberia is the company's main production area, where the company extracts about 66% of its oil by tapping ten fields at the stage of declining production. Meanwhile in 2011, production will rise by 2% to 60.8 mn tons, driven by a slowdown in decline in Western Siberia and higher production in Eastern Siberia. In 2011, Surgutneftegaz has produced 5.4 mn tons of oil in Eastern Siberia. By 2015, production there is to be brought up to 7.5 mn tons. However, fields there will only be able to compensate declining production in Western Siberia until 2013, whereupon the fall in production resume at a pace of 1-2% p.a. until 2020.

Weak downstream segment - In 2011, the Kirishi oil refinery, Surgutneftegaz's only facility of the kind, refined 21.5 mn tons of oil. Surgutneftegaz has an oil refining ratio of 35.8%, one of the lowest among Russian vertically integrated oil companies with in-house refining capacity. Oil product output from the company is dominated by fuel oil (54%). In 2013 a hydro-cracking unit will become operational at Kirishi, after which point light product output will increase to 65% from 42%. Refining capacity is expected to remain at its current level for the foreseeable future.

High margins - In 2010, Surgutneftegaz saw its EBITDA margin narrow from 43% to 42% and net income margin decrease from 23% to 21%. The company's profit margins are among the industry's highest and, although expected to decline in the future, will remain among the highest for the forecast period.

Attractive dividends - In 2010, a retrospective dividend yield on the company's common shares stood at about 2%, in line with the industry average, however, that on preferred shares amounted to a considerable 7.5%, which is among the highest among the peers. Dividend yield of preferred stock for 2011 is expected to exceed 10%.

Target price – derived using a DCF model stand at **RUB 30.63** per ordinary share and **RUB 18.38** per preference share.

Surgutneftegaz shares

Target price (SNGS)	RUB,	30.63
Current price (SNGS) 21/02/12	RUB,	28.86
Upside potential (SNGS)		6%
Number of common shares	mn	35,726
Free Float (commons)		16%
Target price (SNGSP)	RUB	18.38
Current price (SNGSP) 21/02/12	RUB	19.08
Upside potential (SNGSP)		- 4%
Number of (prefs)	mn	7,702
Free Float (prefs)		89%
Market capitalization	RUB bn	1,178
Enterprise Value	RUB bn	1,462

Source: MICEX, Surgutneftegaz data, Investcafe estimates

Financial and market ratios

	2010	2011E	2012E	2013E
Revenue (RUB mn)	596,915	695,072	749,443	811,374
EBITDA (RUB mn)	230,056	290,250	311,807	337,490
Net Income (RUB mn)	128,392	195,690	208,915	228,764
EBITDA margin (%)	39%	42%	42%	42%
Net margin (%)	22%	28%	28%	28%
EPS (RUB)	3.3	5.1	5.4	5.9
DPS - SNGS (RUB)	0.50	0.87	0.99	1.15
DPS – SNGSP (RUB)	1.18	1.80	1.93	2.11
P/E (x)	9.7	5.0	5.3	4.9
EV/S (x)	1.7	1.1	1.2	1.1
EV/EBITDA (x)	4.3	2.6	2.9	2.6
ROE (%)	10%	13%	13%	13%
Brent Price (\$/bbl)	79	100	109	115
Free Cash Flow (RUB mn)	185,187	134,721	117,045	132,495

Source: MICEX, Surgutneftegaz data, Investcafe estimates

