

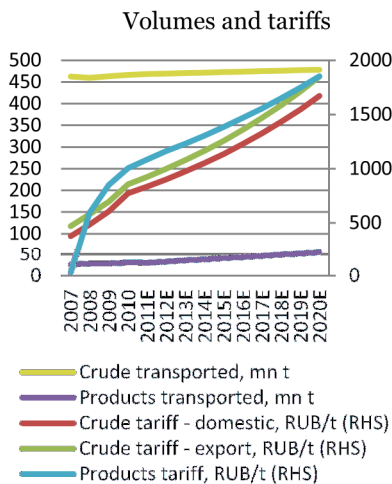
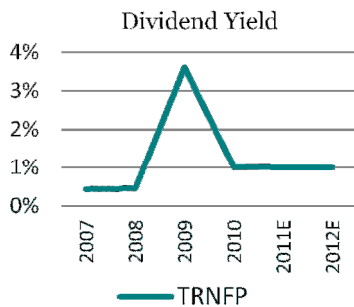
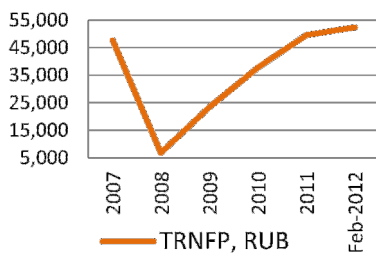


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We are initiating coverage of Transneft, the Russian crude oil transport network's monopoly operator. Only Transneft preferred shares are quoted on the stock market and our estimates show that the shares are fairly priced. Our rating on Investcafe preferred shares is **HOLD**. The target price level is RUB 55,900, which implies an upside potential of 7% from end of Feb-2012 prices.

Transneft – natural monopoly. Transneft's pipeline system transports around 90% of all crude oil produced in Russia. Length of the crude oil transportation pipelines under control exceeds 50,000 km, while that of oil product transportation pipelines is close to 19,000 km. In 2011 crude transportation capacity reached 470 mn tonnes p/a (+0.75% y-o-y growth). In the next 4 years capacity will grow due to completion of on-going ESPO-2 and Purpe-Samotlor projects, as well as construction of the new BTS-2 and Zapolarye-Purpe.

No new major crude pipelines are planned. Transneft will complete current projects and will not endeavor major crude transportation pipelines in the next 10 years. Ongoing projects include ESPO-2 (due in the end of 2012), Zapolarye-Purpe (2017) and a second line of Tikhoretsk-Tuapse, which will allow to pump more oil to the Tuapse refinery. The largest long term project is the completion of the Zapolarye-Purpe-Samotlor pipeline. Thus CAPEX will almost half in the next 10 years from 240 bn RUB level.

Increasing oil product transportation capacity – a priority till 2020. In 2012 Transneft published its long term strategy till 2020. It reflected the latest developments in the Russian oil sector: crude oil production will stabilize and after completion of on-going and planned pipeline construction projects, Transneft's system will reach excessive capacity. Construction of new oil product transportation pipelines will become a priority for the company going forward. Transneft plans to invest in excess of RUB 125 bn in order to pump 54.5 mn tons of products by 2020 (+77% to 2010). The largest project is Yug (South) which costs RUB 85 bn (Sizran-Saratov-Volgograd-Novorossiysk), which will transport products of Rosneft, Lukoil and TNK-BP refineries.

Finances – operating expenses in profitability's way. Transneft still finds it difficult to control expenses, which combined with slower than historical tariff growth rates will mean lower margins going forward. Operating margin decreased from 48% in 2009 to 37% in 2010 and according to our projections will drop further down to 34% in 2011. However, margins will recover in 2013 as the completions of ESPO-2 will mean no more rail road transportation expenses.

Dividends – room for growth. While the dividend yield of Transneft's preference shares is extremely low, not exceeding 1%, in absolute terms the payout will triple in the next three years. Completion of major projects will help improve the FCF.

Valuation: We valued Transneft's shares using DDM, which yielded a target price of **RUB 55,900**, implying an **upside potential of 7%**. We note that for some time now, Transneft's shares have been priced by the market based on the future share value potential after the planned IPO of common shares. To test this hypothesis we constructed a DCF model assuming reduction of government ownership to a controlling stake in 2014 and equalization of dividends on preferred and common shares, payout ratio increase from 10% to 11.5% in 2020 as well as a 50% discount of preferred shares to common. Under these assumptions the target price for the prefs is RUB 83,573 with an upside potential of 59%. However this is a largely optimistic scenario with too many unknowns over the next few years, therefore we maintain our **HOLD** recommendation until more certainty is achieved in questions surrounding the potential IPO.

Transneft shares, TRNFP

Target price (TRNFP)	RUB	55,900
Current price (TRNFP) 28/02/12	RUB	52,439
Potential (TRNFP)		7%
Number of preferred shares	mn	1,555
Free Float – (TRNFP)		100%
Market capitalization	RUB mn	81,536
Enterprise Value	RUB mn	543,789

Source: MICEX, Transneft data, Investcafe estimates

Financial and market indicators

	2010	2011П	2012П	2013П
Revenue (RUB mn)	447,532	571,395	607,874	658,031
EBITDA (RUB mn)	237,359	260,851	278,511	338,267
Net income (RUB mn)	125,531	132,867	42,361	183,408
EBITDA margin	53.0%	45.7%	45.8%	51.4%
Net margin	28%	23%	23%	28%
EPS (RUB)	21,430	23,810	25,511	32,867
DPS - pref (RUB)	237	513	549	708
P/E (x)	n/a	n/a	n/a	n/a
EV/S (x)	0.8	0.9	0.9	0.8
EV/EBITDA (x)	1.4	2.1	2.0	1.6
ROE	14.8%	14.0%	13.0%	14.3%
Urals price (\$/bbl)	78	110	105	110

Source: MICEX, Transneft data, Investcafe estimates