Oil and Gas
Gazprom Neft

Strong results for 2018

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Ticker	SIBN RX
Recommendation	**Buy**
Current price, RUB/share	335
12M target price, RUB/share	416
Upside/Downside	**24%**
Expected dividend, RUB/share	30
Expected dividend return	**9%**

Ticker	GAZ LI
Recommendation	**Hold**
Current price, $/share	25
12M target price, $/share	32
Upside/Downside	**25%**
Expected dividend, $/share	0.5
Expected dividend yield	**2%**

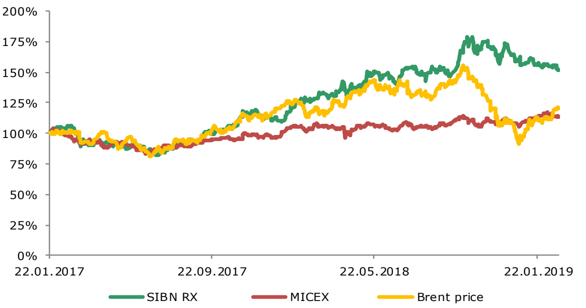
No. of ordinary shares (mn)	4718
Free float (%)	7.3%
3M av. daily turnover (RUB ths)	104
Market capitalisation (RUB bn)	1 591

Financials (₽ bn)	2018	2019F	2020F
Revenues	2 419	2 316	2 493
EBITDA	632	503	609
Net profit	401	309	403
EPS, RUB	1 840	2 032	2 282
Equity	517	493	401
Net debt	80	62	82

Valuation	2018	2019F	2020F
Net Debt/EBITDA (x)	0.82	0.98	0.66
Debt/Equity	0.39	0.34	0.26
EV/Sales (x)	0.87	0.90	0.80
EV/EBITDA (x)	2.64	3.29	2.64
P/E (x)	4.20	5.37	4.12

LKOH RM price dynamics	Abs.	Relative MICEX
1M	-2.5%	0.1%
3M	-4.4%	5.4%
6M	17.8%	-0.4%
Max 52 week	404.6	
Min 52 week	278.3	

LKOD LI price dynamics	Abs.	Relative FTSE 100
1M	-2.1%	3.9%
6M	-4.5%	3.1%
6M	0.4%	-1.7%
Max 52 week	30.40	
Min 52 week	22.10	



Source: company data, Bloomberg, Halyk Finance forecast

Noting the strong results of Gazprom Neft over the past year and the company's ambitious plans for the current one, we made changes to the valuation of the shares. We see good growth potential in oil production, justified by the expected decrease in restrictive measures by OPEC + participants and the company's readiness to increase production, which is due to the adequacy of resources and the intention to reach 100mn tons of oil production by 2020. According to our forecasts, a more than twofold increase in free cash flows, largely achieved due to an increase in oil prices, will also be supported by increased production. Current oil prices exceed the baseline optimal for the company at $60/bbl, which brings more optimism in forecasting revenue. Owing to a 49% yoy growth in profit, we expect a dividend of 30rub/share for the last year, and we expect SIBN RX to grow in the short term. We are raising our 12M target price from 347rub/share to 416rub/share and raising our recommendation on Gazprom Neft shares from Hold to ***Buy****.*

Strong dynamics in all financial parameters. Net profit growth of 49% yoy and strengthening EBITDA by 45% yoy in 2018 was the result of high oil prices (+ 32% yoy). The company also increased its physical sales of petroleum products (+ 6% yoy). Revenues reached 2489bn rub (+ 29% yoy). Despite the increase in tax expenses and expenses on the purchase of finished products, correlated with the rise in oil prices, operating income increased by 51% yoy to 457bn rubles. Free cash flow (FCF) increased 2.5 times to 162bn rubles. Adjusted EBITDA margin increased from 28.5% to 32.1%. The company's cash position strengthened significantly from 91bn rub to 248bn rubles. Net debt declined by 10% and the ratio of net debt to EBITDA narrowed from 1.2x to 0.7x.

The resource potential and the mitigation of OPEC + measures will be conducive to plans to increase oil production to 100mn tons. This year, Gazprom Neft, taking into account agreements with OPEC +, expects growth in oil production by 2%. Even in the case of a prolongation of the reduction, the company boldly declares its intention to achieve a production level of 100mn tons by 2020 at the current 69mn tons. In turn, we expect more slowed production growth. At the same time, we are optimistic about the resource potential of the company and exclude the possibility of a decrease in production, which was the main risk in the previous assessment. Taking into account the company's readiness to increase production, we raise our forecast to 86mn tons by 2025 or + 6.3% CAGR.

The oil price at 60/bbl is comfortable for the company. The company focuses on the level of $60/bbl, which, according to our estimates, implies the stability of financial performance with increased volatility in oil prices. Bloomberg consensus on oil for the next five years exceeds $60/bbl, and we do not expect a strong price drop in the forecast horizon. We expect revenue to be strengthened both due to optimal oil prices (> $60 bbl) and due to the increase in sales.

Gazprom Neft "promises" a substantial increase in dividends. Based on the statements of the management, we expect payment of about 38% of the profits attributable to shareholders (377bn rub), which will amount to 30.34rub/share and will exceed the dividend for 2017 by 102%. In the future, we also observe that if 35% of payments are maintained due to the progressive dynamics of earnings, the dividend per share will be higher.

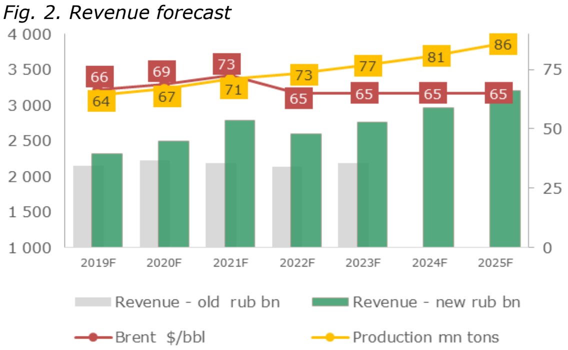
Increasing 12M TP to 416rub/share, Buy recommendation. Our new target price is 416rub/share. The 24% growth potential is justified by a strong resource base and aggressive company policy regarding the growth of oil production, which against the backdrop of comfortable oil prices will contribute to an increase in free cash flow and together with the expectation of higher dividends in the short-term horizon justify our recommendation to Buy.

Fig. 1. Financials

RUB bn	2017	2018	yoy
Revenue	**1 935**	**2 489**	**29%**
Cost of purchased oil	-456	-617	35%
Production costs	-217	-229	6%
General costs	-107	-115	8%
Transportation costs	-142	-147	4%
Depreciation	-141	-175	24%
Oil taxes	-492	-653	33%
Export duties	-77	-95	24%
Exploration	-0.96	-1.41	47%
Operating profit	**303**	**457**	**51%**
JV profit share	46	91	99%
Exchange difference	-0.2	-34	>100%
Financial income	10	8	-26%
Financial expenses	-25	-21	-15%
Other expenses	-8	-20	162%
Profit before tax	325	480	48%
Income tax	-56	-79	43%
Profit for the period	**270**	**401**	**49%**

Source: Company data

Fig. 2. Revenue forecast



Source: HF estimates

Financial results for 2018

In 2018, due to rising prices for oil and oil products on the world and domestic markets, as well as an increase in the volume of sales of petroleum products, Gazprom Neft revenues amounted to 2,489bn rub (+ 29% yoy). Income from sales of petroleum products amounted to 67% of revenue and showed an increase of 30% yoy, while the growth of physical production volumes by 6% yoy. Oil sales in tons fell by 9% yoy, but revenues from oil sales jumped 31% yoy and accounted for a third of the company's revenue. As expected, the main increase in revenues was due to the growth of both export and domestic sales prices, reflecting the strengthening of the average world oil price by 32% yoy. It also contributed to the rise in the cost of purchased oil, gas and petroleum products by 35.4% yoy to 617bn rubles.

Production costs increased by 6% yoy to 228bn rubles, which was caused by an increase in processing costs by 7% yoy due to an increase in processing costs.

Oil taxes showed a corresponding increase in oil dynamics by 33% yoy and accounted for the lion's share of all operating expenses (32%). As a result, total operating expenses increased by 25% yoy to 2033bn rubles.

Operating profit increased by 51% yoy to 457rub bn. Profit for the period amounted to 401bn rubles, showing an increase of 49% yoy, which was partially offset by an increase in foreign exchange loss by 139 times due to the revaluation of part of the loan portfolio in foreign currency.

Higher reserves return favors aggressive production growth plans of up to 100mn tons

In 2018, the total hydrocarbon reserves (including the share in the JV) of the 2P category (proved + probable) increased by 2.2% compared to 2017, reaching 2.84 bn tons of oil equivalent. Production recovery from new reserves was 163% (including acquisitions).

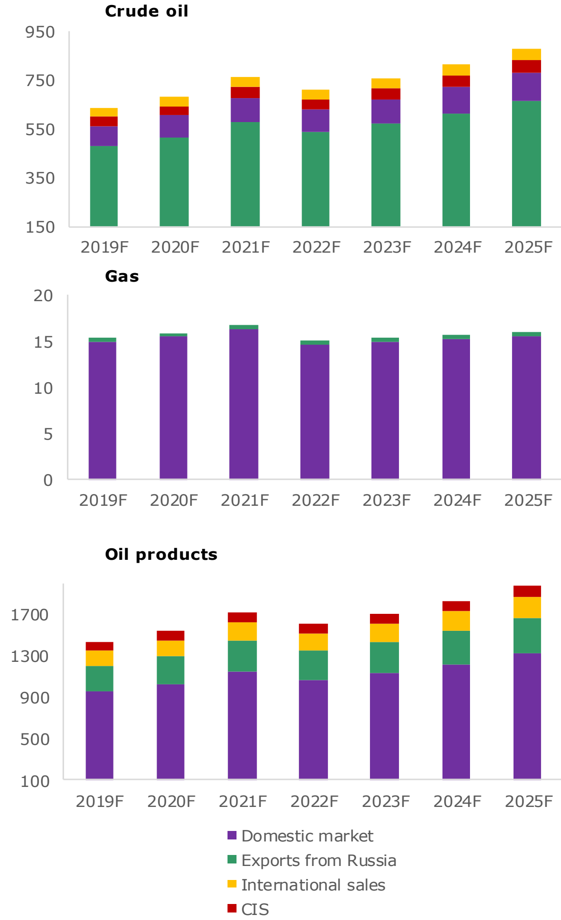
Hydrocarbon production, taking into account the share in the JV in 2018, increased by 3.5% to 92.88mn tons of oil equivalent due to increased production at the Novoportovskoye, Vostochno-Messoyakhskoye, Prirazlomnoye fields and in Iraq, as well as due to an increase in the share of ownership in Arctic Gas. Thus, daily production of hydrocarbons increased by 3.8% yoy. Oil and condensate production increased slightly by 0.9% yoy to 62.99mn tons (70% of Kazakhstan's production). The restrained dynamics is explained by the limitation of OPEC + production under the agreement on the stabilization of oil prices - in 4Q2018 production declined by 3% qoq to meet the production quotas for the Gazprom group under the OPEC + agreement. It is also worth noting that during 3Q2018 due to easing of restrictions, the company showed a more impressive growth in oil and condensate production by 5% qoq.

Meanwhile, the volume of oil refining increased by 7% due to the completion of the program of scheduled capital repairs. Judging by the dynamics of production, naphtha (+ 41% yoy), class 5 diesel oil (+8 yoy) and fuel oil (+ 9% yoy) enjoyed the greatest demand.

Gas production increased by 9% yoy, reflecting the increase in the share in Arctic Gas and the launch of the UPG at the Novoportovskoye field.

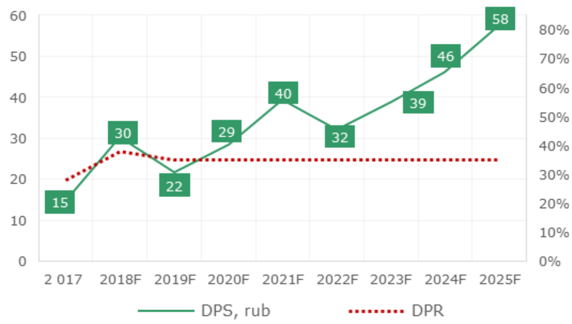
We expected the lag of production to a potential level within the limits of OPEC + restrictions. However, valid from January 2017 until the end of 2018 the conditions for a 1.8mn bbl reduction in

Fig. 3. Segment revenue forecast



Source: HF estimates

Fig. 4. Dividends



Source: HF estimates

oil production were changed in July 2018. Due to a strong drop in oil production in some countries (Venezuela, Mexico), the OPEC cut-off plan was exceeded by 150% for some of the participants, and as a result, it was decided to restore production by 1mn bps so that the level of performance would return to 100%.

In the current year, Gazprom Neft, taking into account agreements with OPEC +, expects growth in oil production by 2%. The exact figure depends on the parameters of the transaction in 2H2019, however, the company's position is such that even in the case of a prolongation of the reduction, the company is able to show production growth.

At the Novy Port field, oil production is planned to increase by 7% to 7.6mn tons, at the Prirazlomnoye field - by 3% to 3.3mn tons, and by Messoyakha - by 22% to 5.5mn tons.

The company intends to achieve a production level of 100mn tons, which, with the current 69mn tons, is, by our estimate, an extremely ambitious goal. We forecast a less aggressive increase in production to 86mn tons by 2025 (Fig. 2.). However, we are optimistic about the company's resource potential and allaying concerns about the failure to achieve production targets, which, based on the company's statements, prevailed earlier, we minimize in our assessment the risk of a “forced” production slowdown and raise our forecast for 2019-2025:

ths bpd	2019F	2020F	2021F	2022F	2023F	2024F	2025F
Oil production in the OPEC deal	1 299	1 320	1 330	1 348	1 379	1 419	1 487
Oil production - current forecast	1 313	1 361	1 447	1 499	1 564	1 641	1 748
Change, %	1%	3%	9%	11%	13%	16%	18%

The base oil price forecast in the company's budget has been increased from $50/bbl to $60/bbl

The company's development strategy until 2030 implies a base oil price of $60/bbl.

The company's conservative stance with regard to product prices implies the stability of financial performance with increased volatility in oil prices.

Given that Bloomberg’s consensus oil outlook for the next five years exceeds $60/bbl, the risk of unforeseen sales losses is minimized.

In the event of a decrease in the price of oil, the company is able to increase production with full compensation of the revenue part due to sales growth. We do not expect a strong oil drawdown in the forecast horizon. The levels we put in the model are comfortable for the company and provide revenue growth despite the correction of the expected oil price in 2019 at $2/bbl.

In 2020-2025 we expect revenue to be strengthened both due to the optimal oil prices (> $60/bbl) and due to the increase in sales (Fig. 2.). We expect to maintain the share of refined oil in production at 64% and conservatively approach the estimate of revenues from oil refining, taking the current yield of petroleum products as a base and not including the effect of refining capacity improvements. This allows us to focus on "net" income, based solely on the production capabilities of the company.

The management of Gazprom Neft "promises" a substantial increase in dividends in 2018

At the end of 2017, the Company paid a record amount of dividends - about 28% of net profit, which amounted to 71bn rubles or 15rub/share (+ 40% yoy).

According to the results of 9M2018, payment of 35% of net profit was approved (22.05rub/share or 105bn rub).

During the teleconference yesterday, it was stated that, taking into account the adjustment of a number of financial indicators, "effective dividend payments for 2018 will be even slightly more than 35%." In the future, the company intends not to lower the payout ratio. Shareholder earnings (377 billion rubles), which will amount to 30.34rub/share and will exceed the dividend for 2017 by 102%.

Subsequently, we maintain a neutral forecast for dividends and lay 35% as the minimum guaranteed payment level (Fig. 4.). Nevertheless, we observe that such an approach will not put pressure on the dividend attractiveness of the company due to the progressive dynamics of profits. We also note Gazprom Neft's private loyalty to its main shareholder (Gazprom owns 95.7% of the company's shares), which will also encourage the company to pay the highest dividend possible.

Fair value calculation

When calculating the target price, we used a Beta value of 0.833, a risk-free rate of 8.3%, a market risk premium of 8%. We also included in our calculations country risk, which we estimate at 5%, given the continuing political tensions and threats of new sanctions, which are partially applicable to the Group. The WACC rate increased from the previous 11.2% to 15.5% and at the rate of terminal growth of 3% our new target price was 416rub/share. The 24% growth potential of the shares is justified by a strong resource base and aggressive company policy regarding the growth of oil production, which against the background of comfortable oil prices will contribute to an increase in free cash flow and together with the expectation of higher dividends in the short term, justify our recommendation **to Buy**.

Fig. 5. Target price calculation

RUB mn	2019F	2020F	2021F	2022F	2023F	2024F	2025F
EBIT	278	371	549	406	496	613	764
+ Depreciation	225	238	253	267	282	297	313
- Capex	-373	-389	-414	-425	-444	-468	-497
- Δ working capital	-19	-8	-13	9	-7	-9	-11
- Income tax	-79	-44	-57	-79	-64	-78	-93
FCF	32	169	317	178	263	355	477
DCF	**28**	**129**	**210**	**102**	**131**	**153**	**177**

WACC	16%
First stage DCF	930
Terminal value	3 925
PV of Terminal value	1 460
Joint ventures' dividends	91
Enterprice value	2 480
Net debt	-517
Equity value	1 964
Number of shares (mn)	4 718
Fair value RUB/share	**416**
Current price, RUB/share	335
Upside (downside)	24%
Rating	**Buy**

Source: HF estimates

Appendix 1. Forecast of financial statements

mn rubles, unless otherwise specified

Consolidated statement of financial position	2017	2018	2019F	2020F	2021F	2022F	2023F	2024F	2025F
ASSETS									
Cash and cash equivalents	90 608	247 585	237 120	224 396	362 427	363 435	414 326	592 472	866 440
Receivables	102 262	129 150	121 317	130 576	146 005	135 953	144 658	155 142	168 061
Inventories	118 322	149 956	145 235	150 887	159 068	153 961	158 861	164 355	170 630
Prepayment on current income tax	2 540	3 179	3 179	3 179	3 179	3 179	3 179	3 179	3 179
Other current assets	98 406	132 412	124 548	129 395	136 411	132 032	136 233	140 945	146 326
Total current assets	422 587	663 129	631 398	638 434	807 091	788 560	857 258	1 056 093	1 354 636
Fixed assets	2 052 275	2 366 069	2 514 179	2 664 671	2 825 989	2 983 764	3 146 024	3 316 519	3 500 190
Goodwill and other intangible assets	74 187	80 139	80 139	80 139	80 139	80 139	80 139	80 139	80 139
Investments in associates	256 758	328 937	328 937	328 937	328 937	328 937	328 937	328 937	328 937
Long-term receivables	901	980	980	980	980	980	980	980	980
Long-term financial assets	31 293	10 345	10 345	10 345	10 345	10 345	10 345	10 345	10 345
Deferred tax assets	17 867	19 127	19 127	19 127	19 127	19 127	19 127	19 127	19 127
Other noncurrent assets	74 140	52 200	52 200	52 200	52 200	52 200	52 200	52 200	52 200
Total non-current assets	2 507 421	2 857 797	3 005 907	3 156 399	3 317 717	3 475 492	3 637 752	3 808 247	3 991 918
TOTAL ASSETS	**2 930 008**	**3 520 926**	**3 637 305**	**3 794 833**	**4 124 808**	**4 264 052**	**4 495 010**	**4 864 340**	**5 346 554**
LIABILITIES AND CAPITAL									
Short-term loans and borrowings	131 760	90 923	107 659	17 198	8 066	37 674	39 666	53 402	21 681
Accounts payable	194 438	307 604	268 544	278 996	294 124	284 681	293 741	303 899	315 502
Other current liabilities	33 897	41 339	40 815	42 404	44 703	43 268	44 645	46 189	47 952
Current income tax liabilities	4 534	3 328	3 328	3 328	3 328	3 328	3 328	3 328	3 328
Other tax liabilities	84 833	99 085	99 085	99 085	99 085	99 085	99 085	99 085	99 085
Short-term reserves	29 873	20 043	20 043	20 043	20 043	20 043	20 043	20 043	20 043
Liabilities associated with assets held for sale									
Total current liabilities	479 335	562 322	539 475	461 055	469 349	488 079	500 508	525 946	507 591
Long-term loans and borrowings	548 654	684 530	632 334	618 310	593 874	433 524	312 227	250 397	246 350
Other long-term financial liabilities	69 395	68 511	68 511	68 511	68 511	68 511	68 511	68 511	68 511
Deferred tax liabilities	102 583	127 448	127 448	127 448	127 448	127 448	127 448	127 448	127 448
Long-term reserves	62 574	67 192	67 192	67 192	67 192	67 192	67 192	67 192	67 192
Other long-term liabilities	8 334	19 104	19 104	19 104	19 104	19 104	19 104	19 104	19 104
Total long-term liabilities	791 540	966 785	914 589	900 565	876 129	715 779	594 482	532 652	528 605
Authorized capital	98	98	98	98	98	98	98	98	98
Own shares redeemed from shareholders	-1 170	-1 170	-1 170	-1 170	-1 170	-1 170	-1 170	-1 170	-1 170
Extra capital	62 256	60 397	60 397	60 397	60 397	60 397	60 397	60 397	60 397
Retained earnings	1 431 931	1 680 978	1 872 401	2 122 372	2 468 489	2 749 352	3 089 179	3 494 901	3 999 517
Other reserves	60 142	99 874	99 874	99 874	99 874	99 874	99 874	99 874	99 874
Capital attributable to shareholders of the company	1 553 257	1 840 177	2 031 600	2 281 571	2 627 688	2 908 551	3 248 378	3 654 100	4 158 716
Minority interest	105 876	151 642	151 642	151 642	151 642	151 642	151 642	151 642	151 642
Total capital	1 659 133	1 991 819	2 183 242	2 433 213	2 779 330	3 060 193	3 400 020	3 805 742	4 310 358
TOTAL LIABILITIES	**2 930 008**	**3 520 926**	**3 637 305**	**3 794 833**	**4 124 808**	**4 264 052**	**4 495 010**	**4 864 340**	**5 346 554**

Consolidated statement of comprehensive income	2017	2018	2019F	2020F	2021F	2022F	2023F	2024F	2025F
Revenue	**2 003 575**	**2 418 717**	**2 316 482**	**2 493 289**	**2 787 904**	**2 595 962**	**2 762 175**	**2 962 362**	**3 209 038**
Total sales revenue	1 934 589	2 489 292	2 316 482	2 493 289	2 787 904	2 595 962	2 762 175	2 962 362	3 209 038
Cost of sales and other expenses									
Procurement of oil, gas and petroleum products	-456 037	-617 306	-571 583	-591 990	-624 281	-561 250	-572 475	-583 924	-595 603
Production and operating expenses	-216 530	-228 618	-233 396	-242 612	-257 344	-266 594	-278 169	-292 561	-310 806
Commercial and administrative expenses	-106 629	-114 882	-121 201	-126 655	-131 721	-136 990	-142 469	-148 168	-154 095
Transportation costs	-141 982	-147 182	-155 277	-162 264	-168 755	-175 505	-182 525	-189 826	-197 420
Depreciation	-140 998	-175 451	-224 643	-238 265	-252 643	-267 088	-281 724	-297 007	-313 354
Taxes, except for income tax	-492 269	-652 784	-638 865	-663 794	-702 177	-683 412	-706 184	-732 452	-763 382
Expenses for geological exploration work	-963	-1 411	-963	-963	-963	-963	-963	-963	-963
Total operating expenses	**-1 632 066**	**-2 032 550**	**-2 038 319**	**-2 122 411**	**-2 239 274**	**-2 189 897**	**-2 265 716**	**-2 349 738**	**-2 444 775**
Operating profit	**302 523**	**456 742**	**278 163**	**370 878**	**548 630**	**406 064**	**496 459**	**612 624**	**764 262**
Share of profit of associates	45 504	90 704	90 704	90 704	90 704	90 704	90 704	90 704	90 704
Financial income	10 098	7 506	37 691	54 019	51 435	65 400	80 895	86 679	112 205
Financial expenses	-25 127	-21 476	-34 505	-35 807	-34 046	-25 528	-22 912	-23 600	-18 779
Other income (expenses)	-7 557	-19 796	-19 796	-19 796	-19 796	-19 796	-19 796	-19 796	-19 796
Total other income / (expenses)	22 677	23 380	74 093	89 120	88 297	110 780	128 891	133 987	164 334
Profit / (loss) before taxation	325 200	480 122	352 256	459 998	636 926	516 844	625 350	746 611	928 596
Current income tax expense	-43 695	-59 585	-43 716	-57 088	-79 045	-64 142	-77 608	-92 657	-115 242
Total income tax expense	-55 522	-79 129	-43 716	-57 088	-79 045	-64 142	-77 608	-92 657	-115 242
Profit / (loss) for the period	**269 678**	**400 993**	**308 540**	**402 911**	**557 881**	**452 702**	**547 742**	**653 954**	**813 354**
to shareholders of the Company	253 274	376 667	294 496	384 572	532 488	432 096	522 810	624 188	776 333
to minority shareholders	16 404	24 326	14 044	18 339	25 393	20 606	24 931	29 766	37 021

Consolidated statement of cash flows	2017	2018	2019F	2020F	2021F	2022F	2023F	2024F	2025F
Net cash from operating activities	421 700	537 523	502 093	597 187	794 851	644 587	765 861	898 939	1 069 163
Net cash used in investing activities	-312 889	-335 038	-354 902	-370 906	-396 110	-407 012	-426 133	-449 651	-479 174
Net cash generated from / (used in) financing activities	-50 521	-56 543	-168 690	-250 040	-271 744	-247 603	-299 871	-282 177	-327 056
Net increase / (decrease) in cash for the period	58 290	145 942	-21 500	-23 759	126 996	-10 028	39 857	167 111	262 933
Cash and cash equivalents at the beginning of the period	**33 621**	**90 608**	**247 585**	**237 120**	**224 396**	**362 427**	**363 435**	**414 326**	**592 472**
Cash and cash equivalents at the end of the period	**90 608**	**247 585**	**237 120**	**224 396**	**362 427**	**363 435**	**414 326**	**592 472**	**866 440**

Source: Company Data, Halyk Finance Forecasts

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