Oil and gas
Nostrum Oil and Gas

Recommendation «Hold»

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Shares	NOG LN
Recommendation	**Hold**
Current price, GBp/ share	92
12M target price, GBp/акцию	101
Upside/Downside	**10%**

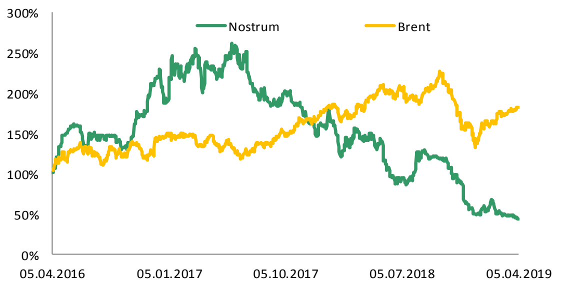
Share data	
Number of shares, mn	188
Average daily trading volume for 3M, $mn	0.32
Free float	43%
Market capitalisation ($ mn)	222

Major shareholders:	
Baring Private Equity Partners G	16%
Standard Life Aberdeen PLC	7%
Aberforth Partners LLP	5%

Financials ($ mn)	2018	2019F	2020F
Revenue	390	350	356
EBITDA	270	229	233
Net profit	-121	-6	-18
Equity	557	541	522
Net debt	965	1031	1029
EPS ($)	-0.6	-0.03	-0.1

Valuation	2018	2019F	2020F
Net debt/EBITDA (x)	3.6	4.5	4.4
Debt/Equity	1.9	2.0	2.0
EV/Sales	3.0	3.6	3.5
EV/EBITDA (x)	4.4	5.5	5.4
RoE	-22%	-1%	-3%

Share price performance	NOG LN	Relative FTSE 100
1M	-10.5%	-13.7%
3M	-9.3%	-17.9%
12M	-12.5%	-22.6%
52-week high	315.0	
52-week low	90.1	



Source: company data, Bloomberg, Halyk Finance forecasts

We recommend to Hold Nostrum Oil and Gas shares with a 12M target price of $101/share, assessing the company's financial results for 2018 as weak, at the same time noting the company's resource potential as sufficient to maintain the level of average daily production at 30-40ths boepd over the next 5 years. In anticipation of expert evaluation of the results of drilling, we remain uncertain about the future prospects of production and are committed to the most conservative forecasts. At the same time, we see the possibility of a sustained improvement in profitability for Nostrum in the event of a positive assessment of the wells, which will allow us to build higher production volumes.

Weak financial results for 2018 despite rising oil prices. According to the 2018 FY results, the company's net loss increased 5 times to $121 million, while the company's revenue fell by 4% to $390mn, and the company significantly reduced operating expenses. Thus, the cost of sales decreased by 7% yoy, general and administrative expenses decreased by 33% yoy and sales expenses by 25% yoy. The main pressure on the 2018 result was impairment at $150mn (38% of revenue), which the company attributed to a decrease in its 2P reserves (Proved and Probable). At the same time, even without taking into account the one-time impairment expense, we observe a lower net profit in comparison with our expectations.

Limited growth with low reserves. Reserves of category 2P (proven + probable) decreased by 16% to 410mn boe due to watering in the north-eastern part of the Biysk reservoir and the loss of reserves in the territory in its immediate vicinity. The company maintains production forecast for 2019 unchanged and expects to produce 30ths boepd, which do not include additional production volumes from new wells planned for drilling for the current year. We also do not believe that the results of drilling new wells in areas with unproven reserves will introduce additional volumes, on the basis of which we also do not expect the company to reach the level of average daily production in excess of 30ths boepd in the current year. Relevant assessment of reserves allows us to calculate the approximate level of production that a company is able to reach under current conditions. We expect to increase production from 30ths to 40ths to only by 2023 with maintaining this level without noticeable growth until the end of the forecast period. We believe that the current resource potential will not allow the company to accelerate the dynamics of production. We also observe an oil price forecast correction compared to the previous estimate and note that for a company experiencing technical difficulties in production, additional production in the absence of a rise in commodity prices may be economically inappropriate.

Recommendation «Hold» with 12M TP, GBp101/share. We enlarged the discount rate from 13% to 14% by increasing the risk premium due to the possibility of unforeseen circumstances, which the company may declare on the basis of a retrospective. Our production forecasts have risen from a total of 28-36ths boepd, while the median price has been adjusted according to Bloomberg forecasts from the range of $68-$74 to $65-$67 per barrel in 2019-2025. Our new target price fell from the previous GBp135/share to GBp101/share. With a 10% upside potential, we maintain our Hold recommendation pending Shlumberger's valuation results and assessing high uncertainty regarding production prospects. On the one hand, we remain cautious, observing the company's vulnerability to production levels due to the fact that oil has exhausted its positive impact on cash flows, weakening the growth rate. On the other hand, in the case of justified sufficiency of reserves in the licensed area, after peer review, we see good opportunities for Nostrum to increase cash flows, because from a financial point of view, the company demonstrates rapid adaptation (significant cost reduction) and sustainability of profitability.

Fig. 1. Financial indicators

$mn	2017	2018	yoy
Revenue	406	390	-4%
Cost of sales	-177	-165	-7%
Gross profit	**228**	**225**	**-2%**
General and administrative costs	-33	-22	-33%
Sales and transportation costs	-66	-50	-25%
Oil taxes	-20	-30	49%
Impairment charge	-	-150	n/d
Financial costs	-60	-49	-17%
Interest income	0.4	1	37%
Exchange loss	-1	-1	42%
Derivative loss	-7	-12	86%
Other income	4	4	7%
Other costs	-20	-7	-64%
Profit before taxes	**26**	**-92**	**n/d**
Income taxes	-50	-29	-43%
Net loss	**-24**	**-121**	**405%**

Source: Company Data

Results 2018 fell short of expectations

The company's revenue for 2018 amounted to $390mn, a decrease of 4% yoy. The increase in the average oil price by 31% in 2018 was completely offset by a decrease in production volumes to 31ths boepd in 2018 from 39ths boepd in 2017 (-21% yoy).

Cost of sales was reduced by 7% yoy to $165mn as a result of savings in repair and maintenance costs by 15% yoy and depreciation by 5% yoy.

According to the results of 2018 we observe significant savings in operating expenses of the company, noting a decrease in general and administrative expenses by 33% yoy and sales costs by 25% yoy. However, the effect of optimizing operating expenses was leveled compared with oil prices, by increasing oil taxes (+49% yoy) and recognizing impairment costs in a significant amount of $150mn (38% of revenue) that the company incurred in the result of the reduction of reserves category 2P (Proved and probable). The need to forecast reserves of category 2P, taking into account a larger number of factors, led to impairment.

The net loss of the company increased 5 times to $121mn. Cash position at the end of 2018 decreased by 4% since the beginning of the year, reaching $122mn with a net debt level of $1008mn.

Limited growth with low reserves

An updated reserves report compiled by Ryder Scott, an independent company, indicates a decrease in total category 2P reserves (proved + probable) by 16% to 410mn boe and a decrease in 2P reserves in the main Chinarevskoye field by 17% to 294mn boe. Nostrum's proven reserves fell by 21% to 98mn boe. The main reason for the decline in reserves was the watering in the north-eastern part of the Biysk reservoir and, accordingly, the loss of reserves in the territory in its immediate vicinity.

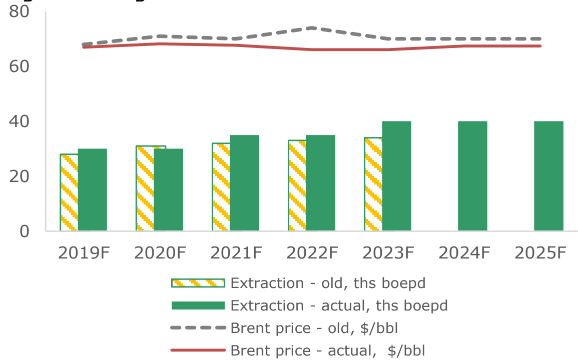
At the end of last year, production is carried out at 45 wells of the Chinarevskoye field, and up to six wells are planned to be drilled during this year. According to the company, drilling activity in the current year will be concentrated in the northern part, where, it is important to note, the company does not yet have a production license. In 2020 Nostrum plans to resume drilling in the north-east and west.

Nevertheless, the company maintains a forecast of production levels for 2019 without change and expects to get 30ths boepd. For Nostrum, it is still difficult to plan the full potential of production due to the incompletion of additional wells assessment work to this day. In other words, the company’s expected 30ths boepd exclude additional production volumes from new wells, which are planned to be drilled for the current year.

It is assumed that the results of drilling new wells in areas with unproved reserves will be disappointing, on the basis of which we also do not expect the company to reach the level of average daily production in excess of 30ths boepd of oil in the current year.

The Ryder Scott report estimates the average Nostrum production for 2020. at the level of 42ths boepd, the achievement of which in our opinion is not possible.

Fig. 2. Changes in the model



Source: Halyk Finance Forecasts

We recalculated production levels in 2019-2025 based on the value of proved reserves and were convinced of the reachability of the company to 40ths boepd only by 2023 with maintaining this level without noticeable growth until the end of the forecast period. In addition, the remaining conservatism with regard to oil prices in the next five-year period will restrain the possibility of a more accelerated increase in production, gradually weakening as a factor stimulating drilling activity. Thus, the price of oil according to Bloomberg forecasts in 2019-2025 will be in the range of $65-$67 per barrel, showing a deterioration in the previous estimate of $68-$74 per barrel. For a company experiencing technical difficulties in mining, additional production in the absence of a rise in prices for raw materials may not be economically feasible.

The long-running completion of the GTU-3 loses its relevance with low production volumes

The company completed the mechanical installation work at GTU-3, but final commissioning is still expected only in 3Q2019. After the completion of GTU-3, the company is still optimistic about the increase in aggregate capacity to a level above 100 ths boepd.

Nevertheless, the risks and prospects assessment associated with the timely launch of the GTU-3 faded into the background. Unforeseen difficulties in mining in the north-eastern part of the Biysk reservoir and in the western section of the Chinarevskoye field last year, which led to a reduction in reserves, were a more significant risk for Nostrum. The company intends to provide in 3Q2019 report from an independent expert (Shlumberger), including a technical study of the main layers, as well as the best drilling method at an estimated 234 well (81 mn barrels of probable reserves) in the western part of the reservoir.

The further drilling strategy will depend on the results of technical studies, in connection with which at the moment there is a high uncertainty regarding the prospects for production.

Target price calculation

We calculate the target price based on a discount rate of 14% which exceeds the previous WACC value of 13%, reflecting our increase in additional risk premium in the event of a disappointing outcome of drilling estimates in the north of the Chinarevskoye field.

Changes in the model include higher production levels, which we consider adequate at the current level of reserves, a correction in oil prices, reflecting a change in the median price value according to Bloomberg forecasts and a correction in financial items, taking into account actual data for 2018.

Our new target price has been adjusted from the previous GBp135/share to GBp101/share. With an upside potential of 10%, we maintain our “Hold” recommendation pending Shlumberger appraisal results and appreciating high uncertainty regarding production prospects. On the one hand, we remain cautious, observing the company's vulnerability to production levels due to the fact that oil has exhausted its positive impact on cash flows, weakening the growth rate. On the other hand, in the case of justified sufficiency of reserves in the licensed area, after peer review, we see good opportunities for Nostrum to increase cash flows, because from a financial point of view, the company demonstrates rapid adaptation (significant cost reduction) and sustainability of profitability.

Fig. 3. Target price calculation

$ mn, except other	2019F	2020F	2021F	2022F	2023F	2024F	2025F
Daily production	30	30	35	35	40	40	40
Brent price	67	68	68	66	66	67	67
Revenue	350	356	412	403	460	469	469
Operating cost	(264)	(267)	(276)	(276)	(285)	(287)	(289)
EBIT	85	89	136	126	175	182	181
+ Depreciation	144	144	143	142	141	140	139
- Corporate Taxes	(12)	(3)	(10)	(10)	(21)	(23)	(24)
- Capital Expenditures	(129)	(124)	(125)	(129)	(128)	(132)	(133)
- Change in working capital	14.4	0.2	(8.8)	1.5	(8.7)	(0.6)	0.7
Free cash flows	**102**	**107**	**135**	**130**	**158**	**166**	**164**

WACC	**14.00%**
Sum of PV	584
Gordon growth - TV	1 506
PV of Terminal Value	623
Enterprise value	1 207
Net debt	(965)
Equity Value	242
Number of shares (mn):	188
Fair Value GBp/share	**101**
Current price, GBp/share	92
Potential upside (downside)	10%
Rating	**Hold**

Source: Halyk Finance estimates

Appendix 1. Nostrum Oil and Gas financial indicators forecast, in $ million, in addition to data per share

Income Statement	2018	2019F	2020F	2021F	2022F	2023F	2023F	2023F
Sales	390	350	356	412	403	460	469	469
Cost of sales (incl. depreciation)	165	193	195	194	193	193	194	194
Gross Profit	225	157	162	218	209	267	276	275
G&A expenses	22	23	25	26	27	28	29	30
Sale & Transportation Costs	50	48	48	56	56	64	64	64
Operating income	153	85	89	136	126	175	182	181
Depreciation	117	144	144	143	142	141	140	139
EBITDA	270	229	233	279	268	315	322	320
Interest expense	49	50	80	80	70	79	77	74
	-1	-0.3	-0.5	-1	-1	-1	-0.5	-1
FX losses	1	1	1	1	1	1	1	1
Other tax expenses	187	33	34	39	38	44	44	44
Other nonoperating expenses	4	4	4	5	5	5	5	5
Pretax income	-92	6	-21	22	23	57	66	68
Income tax expenses	29	12	-3	10	10	21	23	24
Net income	-121	-6	-18	12	12	36	43	44

Balance sheet	2018	2019П	2020П	2021П	2022П	2023П	2024П	2025П
Cash and cash equivalents	122	140	142	165	161	184	188	188
Trade receivables	36	30	30	35	34	39	40	40
Inventories	30	26	26	27	27	28	28	29
Prepayments and other current assets	20	20	20	20	20	20	20	31
Income tax prepayment	-	3	3	3	3	4	4	4
Total current assets	207	218	222	250	246	275	280	292
PP&E, net	1 920	1 983	1 964	1 946	1 933	1 920	1 913	1 906
Exploration and evaluation assets	50	48	48	56	56	56	56	56
Restricted cash	7	7	7	7	7	7	7	7
Advances for noncurrent assets	15	15	15	17	17	17	17	17
Total assets	2 199	2 272	2 256	2 276	2 259	2 276	2 273	2 279
Trade payables	53	49	50	51	52	53	54	55
Other current liabilities	67	200	201	205	500	456	410	412
Total current liabilities	120	249	251	257	551	509	464	467
Long term debt	1 094	1 057	1 057	1 057	752	752	752	752
Deferred tax liabilities	401	401	401	401	382	401	401	401
Other long terms liabilities	27	25	25	28	28	32	32	32
Total liabilities	1 642	1 731	1 734	1 742	1 713	1 693	1 648	1 651
Share capital, net of treasury	2	2	2	2	2	2	2	2
Retained earnings and reserves	555	539	521	532	545	581	624	626
Share capital and reserves	557	541	522	534	546	583	625	627
Total equity and liabilities	2 199	2 272	2 256	2 276	2 259	2 276	2 273	2 279

Cash Flow Statement	2018	2019П	2020П	2021П	2022П	2023П	2024П	2025П
Operating cash flows	214	154	126	139	136	191	182	183
Investment Cash Flows	-172	-129	-124	-125	-129	-128	-132	-133
Financial cash flow	-47	-5	1	9	-11	-40	-46	-50
Net change	-5	19	3	22	-4	23	4	0
Cash at the beginning of the period	126	121	140	143	165	161	184	188
Cash at the end of the period	121	140	143	165	161	184	188	188

Source: Company Data and Halyk Finance Forecasts

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