Oil and Gas
Nostrum Oil and Gas

Fixed income and Equity analysis

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Bond issues	Price	YTM	Volume $mn
USD NOGLN 8.000% 'July - 22	65.9	22.5%	725.00
USD NOGLN 7.000% 'Febr - 25	62.0	17.3%	400.00

Рейтинги	Rating	Outlook	Date
S&P	B-	stable	29.11.2018
Moody's	B2	негатив.	02 фев 18

Shares	NOG LN
Recommendation	**Hold**
Current price, GBp/ share	118
12M target price, GBp/акцию	135
Upside/Downside	**14%**

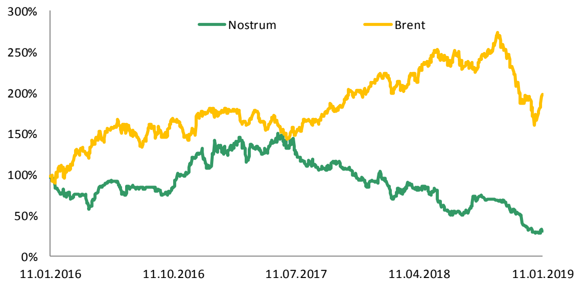
Share data	
Number of shares, mn	188
Average daily trading volume for 3M, $mn	0.90
Free float	43%
Market capitalisation ($ mn)	280

Major shareholders:	
Baring Private Equity Partners G	16%
Standard Life Aberdeen PLC	6%
Aberforth Partners LLP	5%

Financials ($ mn)	2017A	2018E	2019F
Revenue	406	415	381
EBITDA	252	312	284
Net profit	-24	44	24
Equity	670	690	735
Net debt	923	991	928
EPS ($)	-0.1	0.2	0.1

Valuation	2017A	2018E	2019F
Net debt/EBITDA (x)	3.7	3.2	3.3
Debt/Equity	1.6	1.6	1.4
EV/Sales	3.0	3.1	3.2
EV/EBITDA (x)	4.8	4.1	4.2
RoE	-4%	6%	3%

Share price performance	NOG LN	Relative FTSE 100
1M	0.8%	-1.3%
3M	-54.2%	-47.3%
12M	8.8%	5.1%
52-week high	374.0	0.0%
52-week low	97.5	0.0%



Source: Company data, Bloomberg, Halyk Finance forecast

Due to the ambiguous inventory estimates proposed by Nostrum in 9M2018, we lowered our expectations for oil production and adjusted the oil price forecast, taking into account the current state of commodity markets. Our changes were reflected in the 12M target price reduction from the previous 233 to 135 GBp/share. Uncertainty about drilling results continues to be a significant risk and we maintain our "Hold" recommendation for Nostrum shares. At the same time, we are neutral regarding the company's bonds and expect that, due to the inability of timely maturity of bonds, Nostrum will again resort to refinancing, and therefore also maintain the recommendation "Hold" on Nostrum bonds.

Main support for 9M2018 results has had the price of oil, however the positive price factor may be exhausted. Despite the low production and due to the increase in the average price of Brent by 38% yoy, revenue increased by 17% yoy to $406mn and EBITDA strengthened by 9% yoy to $188mn. It is expected that due to the price of oil the company will be able to reach a profit in 2018. In addition, with the exception of oil taxes, the main items of expenditure were reduced. As a result, Nostrum managed to complete 9M2018 with a net profit of $12mn against a loss for 9M2017 of $25mn. Nevertheless, we continue to point out that optimism regarding the strong price factor will be exhausted over time due to the lack of growth triggers on the oil price relative to 2016 levels. In this regard, we note the increased risk associated with the high uncertainty of the company achieving the optimal production level. With the consensus forecast of Bloomberg on the price of oil, suggesting an increase in the price to $74/bbl by 2022 and a decrease to $70/bbl by 2023, our expectations for the company's revenues were revised downwards by an average of 32%, mainly due to lower forecasts for production volumes.

Bore flooding and the risk of low recoil drilling contributed to the revision of forecasts. Disappointing mining results for 9M2018 were connected with problems in the exploitation of existing bores, as a result of which Nostrum lowered its drilling and production plans, and this year it expects to extract 30ths boepd while 40ths boepd were previously laid by us. We expect that production in 2019 will be a little bit lower than the level planned by the company and will not exceed 28ths boepd. In the absence of inventory estimates, the probability of disappointing drilling results, in our opinion, prevails. We are pledging a slow growth in production by an average of 3% by 2023.

Loan portfolio of Nostrum remains attractive at a current yield of 22%. At the estimated total debt to EBITDA in 2018 at 3.5x, the expected future cash flows may not be sufficient to bonds maturity in 2022 ($725mn). The risk of a shortage of free cash is fairly estimated by the market with a current yield of 22% (2022 repayment) and we estimate a high probability of partial refinancing of Eurobonds with a maturity of 2022, because we do not note visible accelerators for the growth of cash flows in the foreseeable future. Noting the disappointing production forecasts that are putting pressure on the company's credit profile, on the one hand, and the relatively attractive market yield of bonds, on the other, we maintain our "Hold" recommendation for Nostrum bonds.

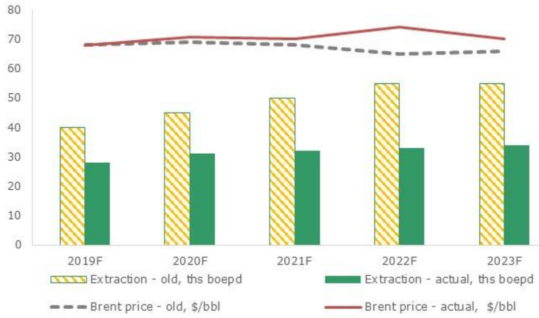
Hold recommendation with 12M TP GBp135/share. Our new target price is GBp135/share. If there is a risk of low production, we positively estimate the optimization of expenses beyond comparable reduction in sales level. Despite the low reasonableness of assessing the resource potential of the company and the existing problems in exploration of existing bores, we do not exclude progress in production in the case of successful drilling of new bores, which, however, cannot act as a full-pledged growth trigger. In the view of the high uncertainty, we maintain our "Hold" recommendation for Nostrum shares.

Fig. 1. Financials

$mn	9M2017	9M2018	yoy
Revenue	304	311	2%
Cost of sales	-131	-126	-4%
Gross profit	**173**	**186**	**8%**
General and administrative costs	-26	-19	-27%
Sales and transportation costs	-52	-39	-25%
Oil taxes	-15	-23	53%
Financial costs	-47	-38	-19%
Exchange loss	-0.1	-1	68%
Derivative loss	-7	-13	86%
Interest income	0.3	0.2	-33%
Other income	4	3	-25%
Other costs	-20	-4	-80%
Profit before taxes	**9**	**52**	**478%**
Income taxes	-33	-40	21%
Net profit	**-25**	**12**	**-148%**

Source: Company data

Fig. 2. Production forecast



Source: Halyk Finance forecast

Oil prices support revenue growth

For 9M2018 the average price of Brent crude oil increased by 38% yoy, providing substantial support to Nostrum's revenue, which, despite a decline in average daily production by 29% yoy, increased by 2% yoy and amounted to $311mn. So, despite the decline in sales volume by 23% yoy to 30.5ths boepd, the relatively high price of oil strengthened the company's EBITDA by 9% yoy to $188mn. In addition, lower sales volumes have affected to expenses: the company reduced operating expenses by an average of 26%, with the exception of oil taxes (+51% yoy). The main decrease is observed in the expenses on the wage fund (-17% yoy), professional services (-38% yoy). Due to low loading volumes, sales and transportation expenses narrowed by 25% yoy. Other expenses were also significantly reduced (-80% yoy), which we associate with a possible reduction expenses in business development, staff training and other charges. Net income for the period was $12mn against a loss for 9M2017 at $25mn.

Forecasts have changed

Contrary to the improved in financial performance, the decline in production forecasts more strongly affected the value of the company's shares. Due to unforeseen circumstances during the development of the Biysk gas condensate collector and the natural reduction of production volumes, Nostrum lowered its forecast for the average daily sales from the main productive collector by more than 10ths boepd. In addition, according to the plans of the Company, in 2019 the number of existing drilling facilities will be reduced by two (from three), in connection with which Nostrum adjusted its daily production forecast for 2019 from 32ths to 30 thsa boepd, which corresponds to sales volumes at 28ths boepd.

Due to the complexity of the assumptions on reserves due to their unproven, the Company's forecast of production levels for 2019 takes into account the performance of existing bores only.

We expect that production in 2019 will be a little bit lower than the level planned by the company and will not exceed 28ths boepd. In the absence of reserve estimates, the probability of disappointing drilling results, in our opinion, prevails. We are pledging a slow growth in production by an average of 3% by 2023 (Fig. 2.). Our expectations for production as a whole over the five-year period have narrowed from the previous 245ths boepd to 158ths boepd.

Considering the low return from existing bores, we expect that a significant part of the company's funds will be spent on drilling operations and total capital expenses will be $130mn in each of 2019-2023 years.

According to Nostrum, this year the commissioning of the GTU-3 is expected. At this stage, mechanical-assembly work is completed.

Completion of the GTU-3 project was postponed repeatedly from the originally planned time limit in 2016.

We do not exclude changes in the company's plans in the current year. Even in the case of timely completion of the project, we believe that the launch of the GTU-3 at current low production levels will not have an effect on the company's sales. We believe that an increase in production at the GTU-3 will require the presence of additional volumes, which the company currently does not produce - our forecasts do not assume production volumes higher than 40ths boepd until 2023.

Positive oil price factor can be exhausted

As we noted earlier, high oil prices were an anchor at disappointing production levels in the reporting period and it is expected that due to oil prices, the company in 2018 will be able to go to profit. Nevertheless, we continue to point out that optimism regarding the strong price factor will eventually be exhausted due to the lack of growth triggers for the price of oil regarding to 2016 levels. In this regard, we note the increased risk connecting with the high uncertainty of achieving the optimal level of production.

With the consensus forecast of Bloomberg on the price of oil, suggesting an increase in the price to $74/bbl by 2022 and a decline to $70/bbl by 2023, our expectations for the company's revenues were revised downwards by an average of 32%:

$ mn, except other	2019F	2020F	2021F	2022F	2023F
Daily production	28	31	32	33	34
Brent price	68	71	70	74	70
Revenue	381	434	444	484	471
Revenue - prevoius forecast	549	619	674	716	730

Fig. 3. WACC calculation

WACC	13%
Risk free rate	3%
Beta	0.966
Market risk premium	9%
Extra risk premium	13%
Cost of Equity	**24%**
Debt	1 093
Equity	690
Cost of debt after tax	**6%**

Source: Halyk Finance estimates

Hold recommendation with 12M TP GBp135/share. The WACC value increased from the previous 11.7% to 13.0%, reflecting changes in the calculation parameters from June of last year, including risk factors due to weakening support for high oil. At zero long-term growth rates, our new target price amounted to GBp135/per share.

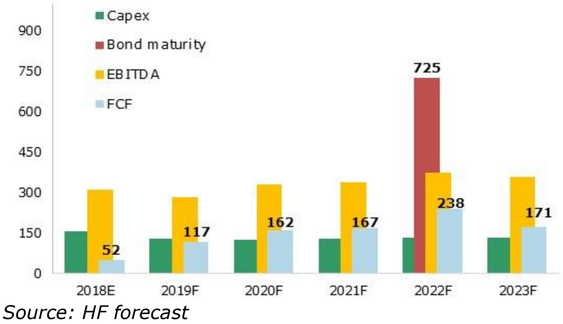
If there is a risk of low production, we positively estimate the optimization of expenses beyond comparable reduction in sales level. Despite the low reasonableness of assessing the resource potential of the company and the existing problems in exploration of existing bores, we do not exclude progress in production in the case of successful drilling of new bores, which, however, cannot act as a full-pledged growth accelerator. In the view of the high uncertainty, we maintain our “Hold” recommendation for Nostrum shares.

$ mn, except other	2019F	2020F	2021F	2022F	2023F
Daily production	28	31	32	33	34
Brent price	68	71	70	74	70
Revenue	381	434	444	484	471
Revenue - prevoius forecast	549	619	674	716	730
Operating cost	(239)	(246)	(248)	(252)	(254)
EBIT	142	188	195	232	217
+ Depreciation	142	143	142	141	140
- Corporate Taxes	(34)	(35)	(38)	(55)	(53)
- Capital Expenditures	(131)	(127)	(130)	(131)	(134)
- Change in working capital	(3)	(7)	(1)	51	0
Free cash flows	**117**	**162**	**167**	**238**	**171**

WACC	12.93%
Sum of PV	588
Gordon growth - TV	1 326
PV of Terminal Value	724
Enterprise value	1 312
Net debt	(991)
Equity Value	321
Number of shares (mn):	188
Fair Value GBp/share	**135**
Current price, GBp/share	118
Potential upside (downside)	14%
Rating	**Hold**

Source: HF estimates

Fig 4. Cash flows



Source: HF forecast

Credit ratings and bond valuation

In November, the S&P lowered the Nostrum rating from "B" to "B-", with a stable outlook. The rating action is due to the planned decrease in the company's production in 2019 up to 30ths boepd (compared to previous estimates of the agency - 40ths boepd), and also reflects the agency's expectations that due to low production levels, the company will not be able to demonstrate a significant reduction in debt load. The S&P also notes that the agency's previous assumptions regarding production growth rates of 15–25% per year in 2019 – 2020, leading to significant improvements in credit characteristics, probably will not be implemented. In revised base scenario, the S&P allows only a very small recovery in oil and gas production volumes - up to 38ths boepd in 2020, which, according to the agency, will allow the company to maintain its credit performance at a stable level. At the same time, the S&P does not note the reasons for the drop in production volumes below 30ths boepd – level, that allows generating at least a neutral FOCF value.

At the end of 9M2018 loans amounted to $1,093mn, including bonds in the amount of $712mn, with a maturity of 2022 and bonds in the amount of $400mn with a maturity of 2025. The company has cash in the amount of $50mn and including short-term investments ($45mn) and restricted cash ($7mn), the total cash position is $102mn. We estimate the ratio of Total Debt to EBITDA in 2018 at 3.5x acceptable.

The expected future cash flows may not be sufficient to pay off bonds in the amount of $725mn by 2022. We believe that high investment in drilling operations will spend a significant portion of free cash flow in the medium term, which will complicate debt servicing. The risk of a shortage of free cash increases due to the probability of bores flooding and other technical causes that we believe may repeat in the future. These risks are fairly priced by the market with the current yield of Nostrum bonds at 22% (2022 maturity). For comparison, the yield on NC KMG Eurobonds with a maturity of 2022 and with a BB rating amounted to 4%. Considering the retrospective, we estimate the high probability of partial refinancing of Eurobonds with a maturity of 2022, since we do not note visible accelerator for the growth of cash flows in the foreseeable future. According to our calculations, the level of necessary funds will be about $420mn, which the company, as we expect, will attract in 2022.

At the same time, there is a high uncertainty regarding the results of drilling. In the case of successful results of drilling operations at existing and new fields at the current level of oil prices, the company's ability to timely repay bonds increases significantly, reflecting a reduction in capital expenses and the expediency of launching GTU-3. Noting the disappointing production forecasts that are putting pressure on the company's credit profile, on the one hand, and the comparably attractive market yield of bonds, on the other, we maintain our "Hold" recommendation for Nostrum bonds.

Appendix 1. Nostrum Oil and Gas financials forecast, in $mn, excluding data per share

$mn	2018F	2019F	2020F	2021F	2022F	2023F
Sales	415	381	434	444	484	471
Cost of sales (incl. depreciation)	168	170	172	172	172	171
Gross Profit	247	211	261	272	312	300
G&A expenses	35	37	39	41	43	45
Sale & Transportation Costs	39	31	35	36	37	38
Operating income	173	142	188	195	232	217
Depreciation	139	142	143	142	141	140
EBITDA	312	284	331	337	373	358
Interest expense	50	50	71	70	61	51
	(0.2)	(0.2)	(0.9)	(1.5)	(0.7)	(0.2)
FX losses	1	1	1	1	1	1
Other tax expenses	41	38	43	44	48	46
Other nonoperating expenses	4	4	4	4	5	5
Pretax income	86	58	77	85	127	124
Income tax expenses	42	34	35	38	55	53
Net income	44	24	42	47	73	71

Balance sheet	2018F	2019F	2020F	2021F	2022F	2023F
Cash and cash equivalents	50	57	87	177	48	71
Current investments	45	64	87	54	-	50
Trade receivables	72	32	37	38	20	19
Inventories	28	19	20	20	9	8
Prepayments and other current assets	22	22	22	22	22	22
Income tax prepayment	4	3	4	4	0	0
Total current assets	222	198	257	315	99	171
PP&E, net	2 021	1 964	1 948	1 937	1 927	1 920
Goodwill	32	32	32	32	32	32
Exploration and evaluation assets	50	34	38	39	39	39
Restricted cash	7	7	7	7	7	7
Advances for noncurrent assets	11	10	12	12	12	12
Total assets	2 343	2 247	2 293	2 342	2 116	2 181
Trade payables	35	36	38	38	39	39
Other current liabilities	71	17	18	18	16	16
Total current liabilities	106	54	56	57	55	55
Long term debt	1 093	1 057	1 057	1 057	752	752
Deferred tax liabilities	425	382	382	382	382	382
Other long terms liabilities	30	19	21	21	22	22
Total liabilities	1 653	1 511	1 515	1 516	1 210	1 210
Share capital, net of treasury	2	2	2	2	2	2
Retained earnings and reserves	688	734	777	825	898	969
Share capital and reserves	690	735	778	826	900	971
Total equity and liabilities	2 343	2 247	2 293	2 342	2 110	2 181

Cash Flow Statement	2018F	2019F	2020F	2021F	2022F	2023F
Operating cash flows	127	171	176	187	266	212
Investment Cash Flows	-203	-150	-150	-97	-77	-184
Financial cash flow	-22	-22	0	0	-299	-6
Net change	(98)	(1)	26	90	(109)	23
Cash at the beginning of the period	116	18	17	43	133	24
Cash at the end of the period	18	17	43	133	24	47

Source: Company data, Halyk Finance forecast

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