

Lukoil Oil Company
Buy Russian Oil Giant on Rising Credibility

Symbol	Price	Shares	Market Cap	Net	Debt/ Present	McDep	EV/	EV/	P/E	Div'd	PV/
	(\$/sh)			Value			Sales	Ebitda		NTM	NTM
	16-Jan			Value	Value	Ratio	NTM	NTM	NTM	(%)	NTM
	2004	(mm)	(\$mm)	(\$/sh)							
LUKOY	96.40	211	20,300	140	0.07	0.71	0.9	3.8	5.9	2.7	5.4

McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses

EV = Enterprise Value = Market Cap and Debt:

\$mm 22,400

Ebitda = Earnings before interest, tax, depreciation and amortization:

\$mm 5,890

NTM = Next Twelve Months Ended December 31, 2004; P/E = Stock Price to Earnings

PV = Present Value of energy businesses:

\$mm 31,600

Intraday quote of 99.20 on January 20 for LKOHq in London indicates higher price for LUKOY than January 16 close in New York.

Summary and Recommendation

We recommend current purchase of the shares of Russian oil producer, Lukoil, on the basis of growing credibility that the company can achieve valuation near that of leading oil companies. After analyzing results through September 30, 2003, reported January 13, we raise our present value of equity to \$140 from \$105 an American Depositary Receipt. If we were to have as much confidence in Lukoil as we have in the five mega cap oil leaders, we might justify an unlevered multiple of cash flow perhaps twice that implied by current stock price. Moreover, as Lukoil brings its costs down further and the domestic Russian oil price approaches the international price, the company may be able to generate cash flow per barrel twice the current level. The potential quadrupling eventually in unlevered valuation seems to justify taking on the volatility that is likely to continue to characterize share price. To hedge the risk, we recommend a half, rather than a full, position for Lukoil in a portfolio of McDep energy recommendations.

Giant Oil Producer

At more than 1.6 million barrels a day in the third quarter of last year, Lukoil produces about three-fourths as much oil as the Mega Cap oil producer median. Lukoil's adjusted reserve life index exceeds the 20 years that we arbitrarily assign to it. That is twice the 10 years for the Mega Cap median. Production volume should be an auditable number while reserves can be more subjective as has been widely discussed recently. We believe that reserve life in Russia is greater than in the U.S. and that Russian production can grow somewhat beyond today's levels. At the same time we believe that world oil price is in a long-term uptrend.

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On our new present value estimate, Lukoil has an unlevered cash flow multiple (EV/Ebitda) of just 3.8 times. That compares to 6.7 times for the Mega Cap median. For Lukoil's long reserve life, a present value to cash flow multiple more than twice 3.8, or more than 7.6, could be justified. On the 5.4 times that we assess for now, Lukoil has a low McDep Ratio.

Low Domestic Price

After selling about 40% of its crude oil production in the export market at international prices, Lukoil refines the remainder or sells it in the domestic market for low prices. The company also sells as much in products as it does crude oil in the international market though some of those products may be made from higher price crude oil.

The domestic crude oil price is less than half the international price. The domestic refined product price is three-fourths the international price. The higher, but still low, domestic product price gives Lukoil the opportunity to make up some of the lost realization on domestic crude oil by processing it in Lukoil refineries.

While we do not fully understand why domestic oil price is low in Russia, we expect that ultimately the difference compared to international price will mostly disappear as it has in the U.S. During the 1970s when oil prices were going up as they are now, price controls held back U.S. domestic prices.

Robber Barons

The larger political issue than low domestic oil price appears to be the concentration of ownership of oil resources in the hands of a few "oligarchs". Investors seemed surprised by the jailing of Mr. Mikhail Khodorkovsky, the dominant owner of Lukoil's largest competitor, Yukos. The government may have moved against Mr. Khodorkovsky because he was too active supporting political opposition to the party in power. In view of the questions surrounding his sudden accumulation of wealth, Mr. K. may have overplayed his hand.

Mr. Vagit Alekperov, the president of Lukoil, is also one of the oligarchs. Mr. Alekperov may be more politically aware and apparently has not attempted to use his corporate or personal wealth to oppose the Russian political leader, Mr. Putin. Lukoil stock is also more widely held than that of Yukos.

The rough analogy in the U.S. might be the era of the Standard Oil Trust. Mr. Rockefeller obviously went too far for some with his tactics in building his empire and brought down political wrath. Since the U.S. Supreme Court broke up Standard Oil in 1911, most of the pieces have gone on to be successful investments and some have even recombined.

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Cash Flow Expansion

The Mega Cap median cash flow per equivalent barrel of production is about \$24 including about \$18 for production and \$6 for refining and other activities. Lukoil's comparative numbers per barrel of oil production are about \$10, \$5 and \$5. There may be less royalty subtracted from Lukoil volumes that makes the Lukoil cash flow multiple appear a little lower than otherwise. Also the Mega Caps typically have more non-production operations than Lukoil. Nonetheless it looks like Lukoil's cash flow per barrel could double to be more in line with international measures.

Since Lukoil was formed in 1993, investors have tried to approximate what the value of the company could be by industry standards. The results usually looked promising. The difference today is that the company now has an operating history and has increasingly attempted to be more transparent to investors. The country of Russia has also gone through critical times and now appears to be enjoying economic growth. The improving price of oil has been a large contributing factor.

Projected cash flow for 2004 may be understated as we hold volumes flat for valuation purposes though the trend seems to be up (see table). We see gains that reflect higher crude oil price as quoted in the futures market. The price we show for Lukoil is the international price that currently applies only to crude oil exported.

It is unusual that Lukoil earns half of its cash flow from refining and chemical operations even though it is dominantly an oil producer. Some of the cash flow that would normally be associated with oil production shows up associated with downstream operations. Being an integrated company that produces and refines oil appears to be of great value to Lukoil currently.

The company's income tax rate at about 25% is low compared to 35% that we use in estimating pre-tax cash flow for most companies. While that seems favorable, we would not be surprised to see the general level of taxation of Russian oil increase as profitability increases. Indeed, there are additional taxes such as an excise tax on exports not detailed in our projection.

Anticipate Further Successful Emulation

The record of leading global energy companies has long provided a model for others to copy and improve upon. Among Russian companies Lukoil has made great strides and we believe, with a bit of optimism, can make large further gains. Yet there can always be negative surprises, hopefully only temporary, in an industry subject to economic, political, financial and business risk.

Kurt H. Wulff, CFA

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Lukoil Oil Company
Next Twelve Months Operations

	<i>Q1</i>	<i>Q2</i>	<i>Q3</i>	<i>Q4E</i>	<i>Year</i>	<i>Next</i>
	<i>3/31/03</i>	<i>6/30/03</i>	<i>9/30/03</i>	<i>12/31/03</i>	<i>2003E</i>	<i>Twelve</i>
						<i>Months</i>
						<i>12/31/04</i>
Volume						
Oil (mmb)	142	145	150	150	587	597
Oil (mbd)	1,577	1,589	1,635	1,635	1,609	1,635
Price						
Oil (\$/bbl)						
WTI Cushing	34.03	29.07	30.22	31.19	31.13	31.53
Lukoil export	26.00	22.62	26.95	27.81	25.88	28.11
NY Harbor 3-2-1 (\$/bbl)	6.96	5.83	7.61	5.30	6.42	6.73
Revenue (\$mm)						
Oil	3,690	3,271	4,054	4,184	15,198	16,776
Other	1,408	1,864	1,987	1,987	7,246	7,949
Total	5,098	5,135	6,041	6,171	22,445	24,724
Expense						
Fixed	2,621	2,305	2,763	2,763	10,453	11,052
Variable	655	576	691	713	2,635	2,859
Other	587	1,369	1,317	4,801	8,075	18,838
Ebitda (\$mm)						
Exploration and Production	414	389	600	708	2,111	2,865
Other	820	495	670	662	2,647	3,022
Total Ebitda	1,234	884	1,270	1,369	4,758	5,886
Exploration	26	28	23	23	100	92
Deprec., Deplet., & Amort.	229	226	230	230	915	920
Other non cash				-	-	-
Ebit	979	630	1,017	1,116	3,743	4,874
Interest	62	78	74	74	288	296
Ebt	917	552	943	1,042	3,455	4,578
Income Tax	229	138	236	261	864	1,145
Net Income (\$mm)						
Exploration and Production	195	166	324	435	1,120	1,802
Other	561	183	437	407	1,588	1,893
Unallocated	(68)	65	(54)	(59)	(116)	(261)
Total	688	414	707	782	2,591	3,434
Shares (millions)	210	210	211	211	210	211
Per share (\$)	3.27	1.97	3.36	3.71	12.32	16.31
Ebitda Margin	24%	17%	21%	22%	21%	24%
Tax Rate	25%	25%	25%	25%	25%	25%

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