Rating: Buy
S&P 500: 1136

Lukoil Oil Company
Giant Resources, Modest Value

Symbol	(LKOH) LUKOY	*Ebitda Next Twelve Months ending 6/30/05 (US$mm)*	8,400
Rating	Buy	*North American Natural Gas/Ebitda (%)*	0
Price (US$/sh)	105.50	*Natural Gas and Oil Production/Ebitda (%)*	54
Pricing Date	6/30/04	*Adjusted Reserves/Production NTM*	20.0
Shares (mm)	210	*EV/Ebitda*	2.9
Market Capitalization (US$mm)	22,200	*PV/Ebitda*	5.4
Debt (US$mm)	2,200	*Undeveloped Reserves (%)*	47
Enterprise Value (EV) (US$mm)	24,400	*Natural Gas and Oil Ebitda (US$/boe)*	7.48
Present Value (PV) (US$mm)	45,900	*Present Value Proven Reserves(US$/boe)*	1.25
Net Present Value (US$/share)	208	*Present Value Proven Reserves(US$/mcfe)*	0.21
Debt/Present Value	0.05	*Earnings Next Twelve Months (US$/sh)*	21.73
McDep Ratio - EV/PV	0.53	*Price/Earnings Next Twelve Months*	5
Dividend Yield (%/year)	2.4	*Indicated Annual Dividend (US$/sh)*	2.56

Note: Estimated cash flow and earnings tied to one-year futures prices for oil and refined products.
Reported results may vary widely from estimates. Estimated present value per share revised only infrequently.

Summary and Recommendation

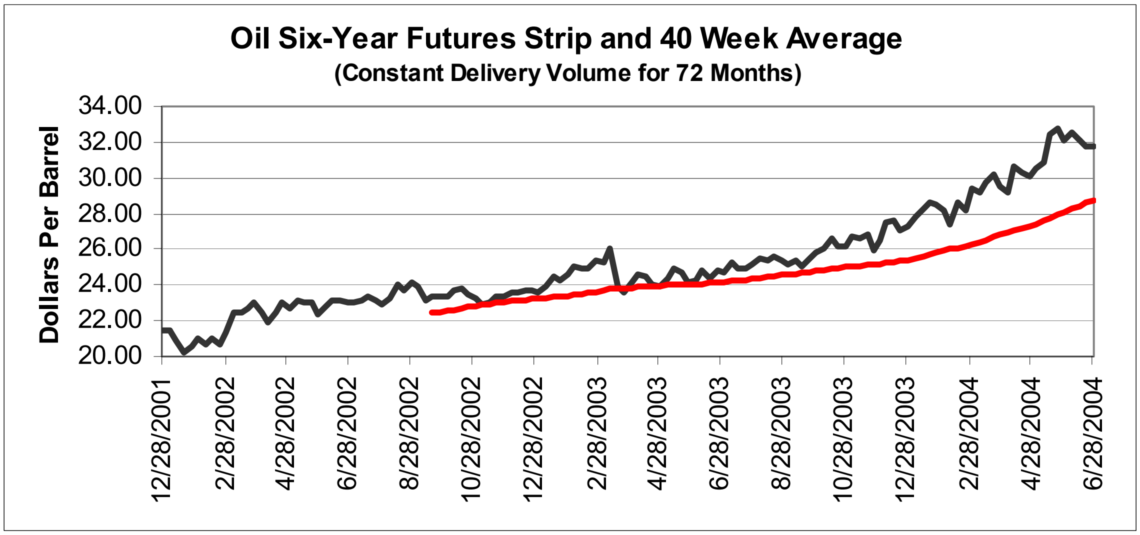
We continue to recommend current purchase of the American Depositary Receipts of Russian producer**, Lukoil,** for proven reserves of comparable magnitude to **ExxonMobil (XOM)** and a stock market capitalization less than a tenth of the largest company. Crediting the company only with the low cash flow per barrel currently reported and ignoring the growth potential of a long reserve life, we estimate a modest present value that is still well above enterprise value. That points to 97% appreciation potential to net present value of US$208 a share. Though investors have obvious concerns about the evolution of capitalism in Russia, there are signs of progress. Yet, to allow for political risk, we recommend that investors limit ownership to half a normal portfolio position.

Trends Positive in Basic Business of Oil Production

Six-year futures describe the commodity price trends most relevant to estimating resource value. The longer time horizon better matches the period during which more of current resources will actually be produced. The longer term measure also smoothes the frantic near-month fluctuations and has the potential to keep climbing even if near-month quotes drop back temporarily.

The plot of weekly results since the beginning of 2002 trace a trend of six-year oil price rising some 20% a year (see chart). We measure momentum with the 40-week moving average. The charts look good as long as the current six-year quote remains above the trailing average.

Economics support the price trends. Oil demand is strong with world economic growth paced by developing countries, especially China. Supply is tight as the Middle East is showing maturity with the workhorse giant fields on the verge of peaking.



Monetary factors favor oil investment as interest rates below inflation drive investors to real assets for protection against currency debasement. Oil price is likely to rise more than the official U.S. government determined inflation measure.

Environmental factors favor higher oil and gas price. Coal is still a quarter of world primary energy supply. As long as large quantities of coal are burned, oil and gas must be undervalued because of the potential to displace environmentally disadvantageous coal.

Political factors favor higher oil price as conditions in leading producing countries evolve in different directions. Now Saudi Arabia appears vulnerable to a change in control.

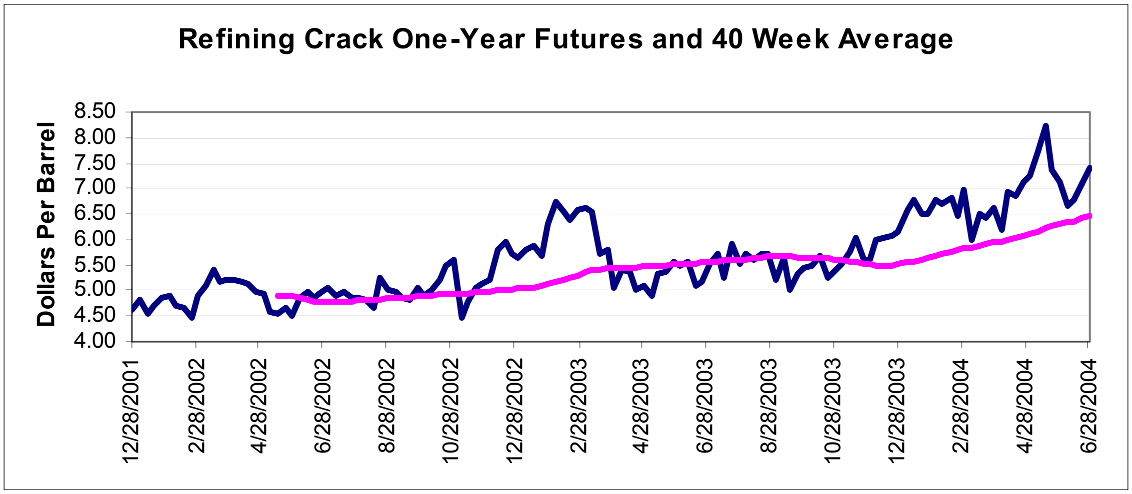
Nor can the U.S. military enforce an artificially low oil price for long. During the Arab oil embargo in 1973 some consumers advocated sending the troops. Thirty years later we have sent the troops only to see security deteriorate further, it seems.

At some point oil price could be too strong and economic activity would be adversely affected. In that sense it is a relief to see the recent pullback from a strong short-term price advance. Six times in the past thirty years the annual gain in monthly price exceeded 70% briefly. September futures near $36 a barrel for Light, Sweet Crude Oil would have to exceed $48 a barrel to trigger a 70% warning.

Downstream Trends Also Strong

Industry people like to refer to the oil producing business as upstream and the oil refining/marketing business as downstream. Strong upstream business prospects captured in the rising trend of six-year futures are complemented by improving downstream prospects captured in the trend of one-year refining crack futures (see chart).

The crack spread we measure is the price of two/thirds barrel of gasoline plus one/third barrel of heating oil minus a barrel of crude oil. While there are innumerable varieties of crude oil and products quoted around the world there is only one source of transparent, public quotes of futures prices for the next year, the New York Mercantile Exchange. As a result we use the Nymex quotes as an indicator of future downstream profitability globally, recognizing that markets are linked meaningfully, if not perfectly. Finally, the crack spread should be seasonally neutral because it always includes twelve months.



Low Domestic Oil Price Inhibits Cash Flow

Our process of estimating company-specific present value begins with an estimate of next twelve months cash flow (see table). We concentrate on unlevered cash flow, also known as Ebitda, short for earnings before interest, tax, depreciation and amortization.

For the next twelve months we project constant oil volume at the first quarter 2004 level. That is sufficient for our valuation calculation. Lukoil has reported first quarter volume on a preliminary basis in tons that we convert to barrels.

We take the futures market at face value in projecting price for the next twelve months. Light Sweet Crude quotes guide our projections of oil revenue.

The refinery crack futures guide our projections of downstream cash flow. The crack spread may be for New York Harbor, but it is the world benchmark for the year ahead. Because futures are constantly changing, our projection is adjusted accordingly. As a result, the specific amounts we project today may not be the amounts realized when the company next reports.

From Lukoil's disclosures, just released for the year 2003, we estimate a relatively low proportion of cash flow from production, 54%. As an exporting country, Russia has more crude oil than it refines domestically. Because Lukoil has refineries to take some of its domestic production it can recover in refining profit some of the profit it would normally earn on crude oil. The low domestic crude oil transfer price also contributes to a low upstream cash flow per unit of about $7 a barrel, less than half that achieved by most international producers.

Lukoil Oil Company
Next Twelve Months Operations

	Q4 12/31/03	***Year 2003***	*Q1E 3/31/04*	*Q2E 6/30/04*	*Q3E 9/30/04*	*Q4E 12/31/04*	***Year 2004E***	***Next Twelve Months 6/30/05***
Volume								
Oil (mmb)	155	**592**	151	153	155	155	**614**	**614**
Oil (mbd)	1,686	**1,622**	1,682	1,682	1,682	1,682	**1,682**	**1,682**
Price								
Oil ($/bbl)								
WTI Cushing	31.19	**31.13**	35.23	38.38	36.26	36.06	**36.48**	**35.61**
Lukoil export	23.35	**24.72**	26.37	28.73	27.15	27.00	**27.31**	**26.67**
NY Harbor 3-2-1 ($/bbl)	5.30	**6.42**	6.98	10.91	9.20	6.96	**8.51**	**7.40**
Revenue ($mm)								
Oil	3,621	**14,636**	3,994	4,399	4,203	4,179	**16,774**	**16,377**
Other	2,404	**7,663**	2,404	2,404	2,404	2,404	**9,615**	**9,615**
Total	6,025	**22,299**	6,398	6,803	6,606	6,583	**26,390**	**25,992**
Expense								
Fixed	2,297	**9,986**	2,297	2,297	2,297	2,297	**9,187**	**9,187**
Variable	574	**2,497**	633	698	666	663	**2,660**	**2,597**
Other	1,626	**4,900**	1,502	1,248	1,339	1,469	**5,558**	**5,777**
Ebitda ($mm)								
Exploration and Production	750	**2,153**	1,064	1,405	1,239	1,219	**4,927**	**4,592**
Other	778	**2,763**	902	1,156	1,065	935	**4,058**	**3,839**
Total Ebitda	1,528	**4,916**	1,965	2,560	2,305	2,154	**8,985**	**8,431**
Exploration	59	**136**	59	59	59	59	**236**	**236**
Deprec., Deplet., & Amort.	235	**920**	235	235	235	235	**940**	**940**
Ebit	1,234	**3,860**	1,671	2,266	2,011	1,860	**7,809**	**7,255**
Interest	59	**273**	59	59	59	59	**236**	**236**
Ebt	1,175	**3,587**	1,612	2,207	1,952	1,801	**7,573**	**7,019**
Income Tax	294	**897**	564	773	683	630	**2,650**	**2,457**
Net Income ($mm)								**-**
Exploration and Production	429	**1,114**	619	859	744	723	**2,945**	**2,712**
Other	533	**1,714**	525	707	640	555	**2,426**	**2,266**
Unallocated	(80)	**(137)**	(95)	(131)	(116)	(107)	**(448)**	**(416)**
Total	881	**2,691**	1,048	1,435	1,269	1,171	**4,922**	**4,562**
Shares (millions)	210	**210**	210	210	210	210	**210**	**210**
Per share ($)	4.20	**12.80**	4.99	6.83	6.04	5.58	**23.44**	**21.73**
Ebitda Margin	25%	**22%**	31%	38%	35%	33%	**34%**	**32%**
Tax Rate	25%	**25%**	35%	35%	35%	35%	**35%**	**35%**

Assess Low Present Value Multiple despite Long Reserve Life

The important variables in the valuation of future production are captured in base year cash flow and a multiple of that cash flow that depends on reserve life. Indeed investors do differentiate on that basis as reflected in a high correlation of unlevered cash flow multiple with adjusted reserve life for North American producers. We convert the market relationship to a formula that produces an anticipatory value with somewhat more sensitivity to reserve life.

The adjusted reserve life index is the sum of developed and half undeveloped reserves divided by next twelve months production. When we last did an industry-wide upward revaluation on March 23, we estimated cash flow multiple equal to 2.5 plus 0.5 times reserve life. That approximates present value assuming constant commodity price near the one-year quotes at that time, about $35 a barrel for crude oil. Higher commodity prices since then imply higher cash flow and lower multiple.

In calculating an adjusted reserve life for Lukoil we ignore proven natural gas reserves as current production is slight. The resulting 21.3 years for oil alone exceeds our arbitrary limit of 20 years for valuation purposes. Nor do we use the 11 multiple that a long reserve life might imply. As it has evolved the present value we estimated for Lukoil in our March 23 industry revaluation now implies a low multiple of only 5.4 times cash flow. That in turn is higher than the market cash flow multiple (EV/Ebitda) of just 2.9 times, illustrating apparent undervaluation.

Kurt H. Wulff, CFA

Research Methodology/Ratings Description: McDep Associates is an independent research originator focused on oil and gas stocks exclusively. The firm applies the thirty years of experience of its analyst to estimate a present value of the oil and gas resources and other businesses of covered companies. That value is compared with a company's stock market capitalization and debt. Stocks with low market cap and debt relative to present value tend to outperform stocks with high market cap and debt relative to present value. Buy recommendations are expected to deliver a total return better than 7% per year above inflation. Hold recommendations assume the attributes of the underlying business are more than fully reflected in the current price of the stock. Sell recommendations are expected to deliver a negative total return less than 7% per year including the effects of inflation.