Rating: Buy
S&P 500: 1129

Lukoil Oil Company
ConocoPhillips Partner

Symbol	(LKOH) LUKOY	*Ebitda Next Twelve Months ending 9/30/05 (US$mm)*	8,700
Rating	Buy	*North American Natural Gas/Ebitda (%)*	0
Price (US$/sh)	119.00	*Natural Gas and Oil Production/Ebitda (%)*	54
Pricing Date	9/17/04	*Adjusted Reserves/Production NTM*	20.0
Shares (mm)	209	*EV/Ebitda*	3.1
Market Capitalization (US$mm)	24,800	*PV/Ebitda*	5.3
Debt (US$mm)	2,200	*Undeveloped Reserves (%)*	47
Enterprise Value (EV) (US$mm)	27,100	*Natural Gas and Oil Ebitda (US$/boe)*	7.50
Present Value (PV) (US$mm)	45,700	*Present Value Proven Reserves(US$/boe)*	1.24
Net Present Value (US$/share)	208	*Present Value Proven Reserves(US$/mcfe)*	0.21
Debt/Present Value	0.05	*Earnings Next Twelve Months (US$/sh)*	22.64
McDep Ratio - EV/PV	0.59	*Price/Earnings Next Twelve Months*	5
Dividend Yield (%/year)	2.8	*Indicated Annual Dividend (US$/sh)*	3.29

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

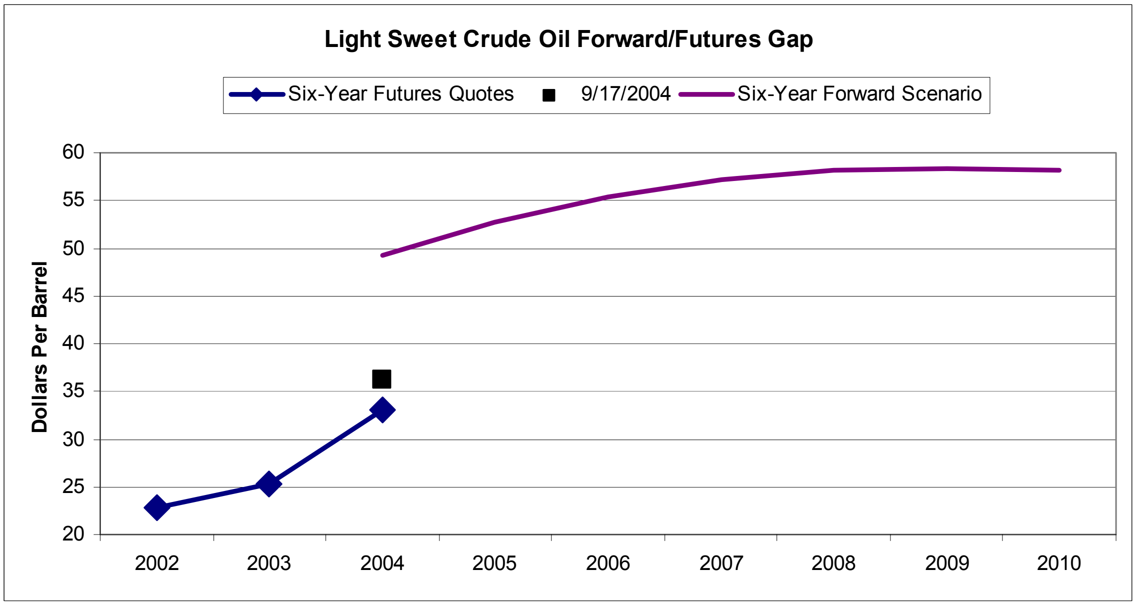
We continue to recommend current purchase of the American Depositary Receipts of Russian producer**, Lukoil,** for investment in giant resources at modest value subject to political risk. The company has the oil and gas reserves of a mega cap company with the stock market capitalization of a large cap company. Apparently **ConocoPhillips (COP)** sees similar opportunity as we may learn in a few weeks whether COP acquires the remaining 9.6% government interest in Lukoil up for auction on September 29. After valuing reserves at low present value and applying an almost equal discount for political risk we continue to estimate net present value of US$208 a share.

Moderate Oil Price Scenario

The value of the company depends in large part on the future price of crude oil. Publicly traded in the commodity markets, futures contracts for delivery over the next six years continue in a steep uptrend. Whether the trend will slow for awhile we cannot know. Our scenario is that a move that began in the low $20s and is now in the mid $30s could reach $50 (see chart <u>Light Sweet Crude Oil Forward/Futures Gap</u>).

To construct the scenario we assumed oil would peak in 2010 at $50 in constant dollars. That is more moderate than the peak in early 1981 at more than $80 in constant dollars. Then we applied 3% per year inflation and calculated six-year averages to build a forward curve.

Economics support the price trends. Oil demand is strong with world economic growth paced by developing countries, especially China. Supply growth is limited as spare capacity has virtually disappeared. The largest producing fields in the Middle East are now mature. It will take time, large amounts of capital and a secure political climate to boost producing rates.



Monetary factors favor oil investment as interest rates below inflation drive investors to real assets for protection against the dollar losing value. If similar past periods are any guide, the authorities may not raise interest rates above inflation for the rest of the decade.

Environmental factors favor higher oil and gas price. Coal is still a quarter of world primary energy supply. Cleaner oil and gas are undervalued as long as we tolerate environmentally disadvantageous coal.

Political factors favor higher oil price in consuming countries and producing countries. Consuming governments often resort to artificial forces to hold down oil price that can appear to work temporarily.

In producing countries we have seen time and again that oil production goes down when international oil companies are not welcome. After Iran, Iraq and Venezuela, now Saudi Arabia appears vulnerable to political change that may bring about production decline.

Too much of a gain in oil price might cause problems of economic adjustment though we think much of the concern expressed is exaggerated. Nonetheless we have a threshold of 60% gain in monthly price compared to a year earlier when we start to become concerned about weak demand for oil. October futures currently near $45 a barrel would have to remain above $52 for the 60% threshold to be breached.

Cash Flow and Profits Depend on Access to International Markets

Lukoil's growing production volumes generate a projected cash flow margin of 21% that is just one-third of that for international peers (see table <u>Next Twelve Months Operations</u>). The most profitable production may be that which is accepted for transportation to international markets by the government controlled export pipelines. Rail transport is a high cost alternative for limited export volumes. Where Lukoil refines its own crude oil it can get the equivalent of an international price in some of its gasoline sales while some refined products are sold at prices limited by government regulation. Crude oil sold domestically receives a depressed price.

Lukoil Oil Company
Next Twelve Months Operations

	Q1 3/31/04	Q2E 6/30/04	Q3E 9/30/04	Q4E 12/31/04	Year 2004E	Q1E 3/31/05	Q2E 6/30/05	Q3E 9/30/05	Next Twelve Months 9/30/05
Volume									
Oil (mmb)	154	157	158	158	**627**	155	157	158	**628**
Oil (mbd)	1,706	1,721	1,721	1,721	**1,717**	1,721	1,721	1,721	**1,721**
Price									
Oil ($/bbl)									
WTI Cushing	35.23	38.34	43.46	45.40	**40.61**	43.87	42.28	40.90	**43.12**
Lukoil export	28.05	30.53	34.60	36.15	**32.37**	34.93	33.67	32.57	**34.33**
NY Harbor 3-2-1 ($/bbl)	6.98	11.72	7.85	7.35	**8.47**	7.93	7.96	7.96	**7.80**
Revenue ($mm)									
Oil	4,307	4,781	5,479	5,724	**20,291**	5,411	5,273	5,157	**21,565**
Other	2,275	2,275	2,275	2,275	**9,101**	2,275	2,275	2,275	**9,101**
Total	6,582	7,056	7,754	7,999	**29,391**	7,686	7,548	7,432	**30,665**
Expense									
Fixed	1,871	1,871	1,871	1,871	**7,485**	1,871	1,871	1,871	**7,485**
Variable	1,871	2,077	2,381	2,487	**8,816**	2,351	2,291	2,241	**9,370**
Other	1,391	1,091	1,287	1,318	**5,087**	1,280	1,279	1,279	**5,155**
Ebitda ($mm)									
Exploration and Production	564	832	1,227	1,366	**3,989**	1,189	1,111	1,045	**4,710**
Other	884	1,184	989	957	**4,014**	995	997	997	**3,946**
Total Ebitda	1,448	2,016	2,215	2,323	**8,003**	2,184	2,107	2,042	$\boxed{\textbf{8,655}}$
Exploration	30	30	30	30	**120**	30	30	30	**120**
Deprec., Deplet., & Amort.	248	248	248	248	**992**	248	248	248	**992**
Ebit	1,170	1,738	1,937	2,045	**6,891**	1,906	1,829	1,764	**7,543**
Interest	68	68	68	68	**272**	68	68	68	**272**
Ebt	1,102	1,670	1,869	1,977	**6,619**	1,838	1,761	1,696	**7,271**
Income Tax	276	585	654	692	**2,206**	643	616	593	**2,545**
Net Income ($mm)									**-**
Exploration and Production	286	444	667	748	**2,145**	644	598	559	**2,549**
Other	533	632	537	525	**2,226**	539	536	533	**2,133**
Unallocated	8	10	11	12	**41**	11	11	10	**44**
Total	827	1,086	1,215	1,285	**4,413**	1,194	1,145	1,102	**4,726**
Shares (millions)	209	209	209	209	**209**	209	209	209	**209**
Per share ($)	3.96	5.20	5.82	6.16	**21.14**	5.72	5.48	5.28	**22.64**
Ebitda Margin (E&P)	13%	17%	22%	24%	**20%**	22%	21%	20%	**22%**
Tax Rate	25%	35%	35%	35%	**33%**	35%	35%	35%	**35%**

Second quarter results are due in the next few days or weeks. Investors who want calendar year estimates can find 2004 in the table. For 2005 we suggest using the next twelve months as a rough estimate. Estimates can change frequently along with oil markets.

Present Value at Real Price and Real Return

Next Twelve Months (NTM) estimates determine the first year of projected cash flow that we discount to present value (see table Present Value of Oil and Gas Reserves). The calculation is set up on the basis of a barrel of proven reserves, 0.53 developed and 0.47 undeveloped.

While there are many assumptions that could be discussed, discount rate and oil price are especially important. Price escalation and discount rate interact. We make the simplification of dealing in constant dollars. That assumes price escalation, cost escalation and discount rate are all net of inflation.

Lukoil Oil Company
Present Value of Oil and Gas Reserves

Volume Decline (%/yr):	5	Nymex Oil Price Post 2005 ($/bbl)	35
Volume Enhancement (%/yr):	12	Price/Nymex Post 2005 (%):	80
Variable Cost (%):	60	Real Discount Rate (%/yr):	7.0
Capex/Cash Flow (%):	30		

Year	Basic (bbl)	Volume Enhanced (bbl)	Total (bbl)	Price ($/bbl)	Revenue ($)	Fixed Cost ($)	Var. Cost ($)	Cash Flow ($)	Cap Ex ($)	Free CF ($)	Disc Factor	Present Value ($)
Total 2005 through 2034; years ending on 9/30												
	0.529	0.470	1.000	28.20	28.20	6.03	16.92	5.25	0.53	4.72	0.51	2.40
2005	0.032	0.000	0.032	34.33	1.11	0.20	0.66	0.24	0.07	0.17	0.97	0.16
2006	0.031	0.004	0.034	28.00	0.96	0.20	0.58	0.18	0.06	0.13	0.90	0.12
2007	0.029	0.007	0.037	28.00	1.03	0.20	0.62	0.21	0.06	0.15	0.84	0.12
2008	0.028	0.011	0.039	28.00	1.09	0.20	0.66	0.24	0.07	0.17	0.79	0.13
2009	0.027	0.015	0.042	28.00	1.17	0.20	0.70	0.27	0.08	0.19	0.74	0.14
2010	0.025	0.019	0.044	28.00	1.24	0.20	0.75	0.30	0.09	0.21	0.69	0.14
2011	0.024	0.023	0.047	28.00	1.32	0.20	0.79	0.33	0.10	0.23	0.64	0.15
2012	0.023	0.027	0.050	28.00	1.41	0.20	0.85	0.36	0.00	0.36	0.60	0.22
2013	0.022	0.026	0.048	28.00	1.35	0.20	0.81	0.34	0.00	0.34	0.56	0.19
2014	0.021	0.025	0.046	28.00	1.28	0.20	0.77	0.31	0.00	0.31	0.53	0.16
2015	0.020	0.024	0.044	28.00	1.23	0.20	0.74	0.29	0.00	0.29	0.49	0.14
2016	0.019	0.023	0.042	28.00	1.17	0.20	0.70	0.27	0.00	0.27	0.46	0.12
2017	0.018	0.022	0.040	28.00	1.11	0.20	0.67	0.25	0.00	0.25	0.43	0.11
2018	0.017	0.021	0.038	28.00	1.06	0.20	0.64	0.22	0.00	0.22	0.40	0.09
2019	0.017	0.020	0.036	28.00	1.01	0.20	0.61	0.20	0.00	0.20	0.37	0.08
2020	0.016	0.019	0.035	28.00	0.97	0.20	0.58	0.19	0.00	0.19	0.35	0.07
2021	0.015	0.018	0.033	28.00	0.92	0.20	0.55	0.17	0.00	0.17	0.33	0.06
2022	0.014	0.017	0.031	28.00	0.88	0.20	0.53	0.15	0.00	0.15	0.31	0.05
2023	0.014	0.016	0.030	28.00	0.84	0.20	0.50	0.14	0.00	0.14	0.29	0.04
2024	0.013	0.015	0.029	28.00	0.80	0.20	0.48	0.12	0.00	0.12	0.27	0.03
2025	0.013	0.015	0.027	28.00	0.76	0.20	0.46	0.10	0.00	0.10	0.25	0.03
2026	0.012	0.014	0.026	28.00	0.73	0.20	0.44	0.09	0.00	0.09	0.23	0.02
2027	0.011	0.013	0.025	28.00	0.70	0.20	0.42	0.08	0.00	0.08	0.22	0.02
2028	0.011	0.013	0.024	28.00	0.66	0.20	0.40	0.06	0.00	0.06	0.20	0.01
2029	0.010	0.012	0.023	28.00	0.63	0.20	0.38	0.05	0.00	0.05	0.19	0.01
2030	0.010	0.012	0.022	28.00	0.60	0.20	0.36	0.04	0.00	0.04	0.18	0.01
2031	0.009	0.011	0.021	28.00	0.58	0.20	0.35	0.03	0.00	0.03	0.17	0.00
2032	0.009	0.011	0.020	28.00	0.55	0.20	0.33	0.02	0.00	0.02	0.16	0.00
2033	0.009	0.010	0.019	28.00	0.52	0.20	0.31	0.01	0.00	0.01	0.15	0.00
2034	0.008	0.010	0.018	28.00	0.50	0.20	0.30	0.00	0.00	0.00	0.14	0.00

For discount rate we use a 7% real return per year on an unlevered basis. That means a buyer who pays present value would earn 7% per year above inflation if all the projections were to materialize as stated.

First year oil price is from the futures market. We hold it constant at an arbitrary level thereafter. The assumed price listed in the upper right hand corner is the commonly quoted benchmark Light, Sweet Crude. A price of $35 a barrel leads to present value of future cash flow from a barrel of reserves equal to $2.40 (see box in right hand column). The estimate is particularly low mostly because limited access to export markets keeps much of Lukoil's production from realizing the price we project.

Low Present Value per Barrel Leads to High Present Value per Share

Lukoil has lots of barrels that help turn a low unit present value into billions of dollars and high net present value per share. We illustrate the calculation of Net Present Value (NPV) in a sensitivity table where each column is headed by a different oil price (see table Net Present Value Calculation). Oil price corresponds to present value per barrel which then leads step by step to the final result. The price of $35 a barrel corresponds to our standardized present value of $208 a share. Turn the comparison around and it is evident that if the stock price were $122, slightly higher than the current quote of $119, it would correspond to a constant real oil price of $28 a barrel.

Lukoil Oil Company
Net Present Value Calculation

Constant Oil Price ($/bbl):	28	35	40	50
Present Value per Barrel ($):	1.50	2.40	3.00	4.30
Oil and Gas Reserves (million barrels equivalent):	20,056	20,056	20,056	20,056
Present Value of Oil and Gas Reserves ($mm):	30,100	48,100	60,200	86,200
Political Risk ($mm):	(23,200)	(23,200)	(23,200)	(23,200)
Present Value of Other Businesses ($mm):	20,800	20,800	20,800	20,800
Total Present Value ($mm):	27,700	45,700	57,800	83,800
Debt ($mm):	2,200	2,200	2,200	2,200
Present Value of Equity ($mm):	25,500	43,500	55,600	81,600
Shares (mm):	209	209	209	209
Net Present Value ($/sh):	122	208	266	391

Sharp-eyed investors will spot an adjustment equal to almost half present value of oil and gas reserves at $35 a barrel. We call the penalty "political risk". The amount is that required to balance the more rigorous calculation just described with the more judgmental estimate we have been carrying since earlier in 2004.

Strategic Appeal and Political Risk

Investment in Russia requires a leap of faith and patience with the pace of evolution to a fully democratic and thriving capitalist society. Leading international oil companies see the opportunities and are proceeding at a controlled pace. Investors in **BP (BP)**, for example, see some 20% of the mega cap's production coming from Russia as a result of BP's investment in a competitor of Lukoil. Investors in ConocoPhillips may soon be participating in more Russian production as the large cap producer/refiner contemplates an investment in Lukoil with whom it already has joint operations. Investors in Lukoil can participate more directly on practically the same basis as through COP. We like the more direct investment approach and as the major oil companies do, we can control our risk by not having too much concentration in a single political jurisdiction.

Kurt H. Wulff, CFA

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