

Rating: Buy  
S&P 500: 1202

## Lukoil Oil Company Profits and Taxes Rising

<i>Symbol</i>	(LKOD)	LUKOY	<i>Ebitda Next Twelve Months ending 6/30/06 (US\$mm)</i>	10,200
<i>Rating</i>		Buy	<i>North American Natural Gas/Ebitda (%)</i>	0
<i>Price (US\$/sh)</i>		36.35	<i>Natural Gas and Oil Production/Ebitda (%)</i>	47
<i>Pricing Date</i>		6/29/05	<i>Adjusted Reserves/Production NTM</i>	20.0
<i>Shares (mm)</i>		830	<i>EV/Ebitda</i>	3.1
<i>Market Capitalization (US\$mm)</i>		30,200	<i>PV/Ebitda</i>	4.3
<i>Debt (US\$mm)</i>		900	<i>Undeveloped Reserves (%)</i>	0
<i>Enterprise Value (EV) (US\$mm)</i>		31,100	<i>Natural Gas and Oil Ebitda (US\$/boe)</i>	7.34
<i>Present Value (PV) (US\$mm)</i>		44,100	<i>Present Value Proven Reserves(US\$/boe)</i>	1.61
<i>Net Present Value (US\$/share)</i>		52	<i>Present Value Proven Reserves(US\$/mcf)</i>	0.27
<i>Debt/Present Value</i>		0.02	<i>Earnings Next Twelve Months (US\$/sh)</i>	6.85
<i>McDep Ratio - EV/PV</i>		0.71	<i>Price/Earnings Next Twelve Months</i>	5
<i>Dividend Yield (%/year)</i>		2.7	<i>Indicated Annual Dividend (US\$/sh)</i>	0.98

Note: Estimated cash flow and earnings tied to one-year futures prices for oil.

Reported results may vary widely from estimates. Estimated present value per share revised only infrequently.

### Summary and Recommendation

We continue to recommend purchase of the American Depositary Receipts of **Lukoil Oil Company (LUKOY)** as a leading equity participation in the unfolding value of Russian oil and gas. Recent quarterly results confirm progress along with high taxes. The Russian government is keeping most of the profit from export sales of crude oil and appears to be slowing oil exports to make oil production last longer. The company makes most of its money in an integrated profit from running half of its oil production through its own refineries. Lukoil stock has appreciation potential of 44% to reach our estimated net present value of \$52 a share.

### Oil Exports Heavily Taxed

Financial results for the first quarter of 2005 reported in recent days confirm a continuing split of profits favoring downstream rather than production (see table [Next Twelve Months Operations](#)). Earnings per share exceeded our most recent estimate by 2%. Ebitda was about 7% less than our estimate, mainly because we overestimated income taxes.

Higher expected oil price is offset by minerals tax, social tax, income tax and an onerous excise tax. We project that Lukoil would report cash flow (Ebitda) of just \$7.30 a barrel of production for the next twelve months.

In contrast, Lukoil reports downstream cash flow that amounts to about \$17 a barrel of crude oil refined. Contrast that with recent futures prices indicating a New York Harbor 3-2-1 crack spread, or refiner's margin of about \$9 a barrel. Lukoil's financial statements explain that most oil consumed in Russia is supplied by integrated producer/refiners and there is no domestic crude oil price determined in arms length transactions. As a result, profit on crude oil produced for domestic consumption shows up in the downstream segment. Some refined products are also exported and apparently are charged less of an export tax than is crude oil.

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**Lukoil Oil Company**  
**Next Twelve Months Operations**

	<i>Q4</i>	<i>Year</i>	<i>Q1</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Next</i>
	<i>12/31/04</i>	<i>2004</i>	<i>3/31/05</i>	<i>6/30/05</i>	<i>9/30/05</i>	<i>12/31/05</i>	<i>2005E</i>	<i>3/31/06</i>	<i>6/30/06</i>	<i>Twelve</i>
										<i>Months</i>
										<i>6/30/06</i>
<b>Volume</b>										
Oil (mmb)	164	<b>635</b>	162	164	166	166	<b>657</b>	162	164	<b>657</b>
Oil (mmbd)	1,780	<b>1,739</b>	1,800	1,800	1,800	1,800	<b>1,800</b>	1,800	1,800	<b>1,800</b>
<b>Price</b>										
Oil (\$/bbl)										
WTI Cushing	48.31	<b>41.44</b>	49.65	53.02	60.80	61.94	<b>56.35</b>	61.97	61.51	<b>61.56</b>
Lukoil export	40.52	<b>34.50</b>	41.29	44.09	50.57	51.51	<b>46.90</b>	51.53	51.15	<b>51.19</b>
NY Harbor 3-2-1 (\$/bbl)	5.72	<b>7.74</b>	6.17	10.62	9.77	7.27	<b>8.46</b>	8.44	10.67	<b>9.04</b>
<b>Revenue (\$mm)</b>										
Oil	6,634	<b>21,896</b>	6,689	7,222	8,374	8,530	<b>30,815</b>	8,348	8,379	<b>33,631</b>
Other	2,993	<b>12,162</b>	3,927	3,927	3,927	3,927	<b>15,708</b>	3,927	3,927	<b>15,708</b>
Total	9,627	<b>34,058</b>	10,616	11,149	12,301	12,457	<b>46,523</b>	12,275	12,306	<b>49,339</b>
<b>Expense</b>										
Fixed	1,527	<b>4,838</b>	1,510	1,510	1,510	1,510	<b>6,039</b>	1,510	1,510	<b>6,039</b>
Variable	4,580	<b>14,514</b>	4,529	4,890	5,670	5,776	<b>20,866</b>	5,653	5,673	<b>22,772</b>
Other	1,509	<b>7,401</b>	2,593	2,593	2,593	2,593	<b>10,374</b>	2,593	2,593	<b>10,374</b>
<b>Ebitda (\$mm)</b>										
Exploration and Production	527	<b>2,543</b>	650	822	1,194	1,244	<b>3,911</b>	1,186	1,196	<b>4,820</b>
Other	1,484	<b>4,762</b>	1,334	1,334	1,334	1,334	<b>5,334</b>	1,334	1,334	<b>5,334</b>
Total Ebitda	2,011	<b>7,305</b>	1,984	2,156	2,528	2,578	<b>9,245</b>	2,519	2,529	<b>10,154</b>
Exploration	46	<b>171</b>	36	50	50	50	<b>186</b>	50	50	<b>200</b>
Deprec., Deplet., & Amort.	269	<b>1,075</b>	284	284	284	284	<b>1,136</b>	284	284	<b>1,136</b>
<b>Ebit</b>	1,696	<b>6,059</b>	1,664	1,822	2,194	2,244	<b>7,923</b>	2,185	2,195	<b>8,818</b>
Interest	21	<b>194</b>	19	19	19	19	<b>75</b>	19	19	<b>75</b>
<b>Ebt</b>	1,675	<b>5,865</b>	1,645	1,803	2,175	2,225	<b>7,848</b>	2,167	2,177	<b>8,743</b>
Income Tax	516	<b>1,585</b>	458	631	761	779	<b>2,629</b>	758	762	<b>3,060</b>
<b>Net Income (\$mm)</b>										
Exploration and Production	156	<b>1,229</b>	332	495	740	774	<b>2,341</b>	734	741	<b>2,989</b>
Other	934	<b>2,956</b>	983	803	826	829	<b>3,442</b>	826	826	<b>3,308</b>
Unallocated	69	<b>94</b>	(128)	(126)	(153)	(156)	<b>(563)</b>	(152)	(153)	<b>(613)</b>
Total	1,159	<b>4,279</b>	1,187	1,172	1,414	1,446	<b>5,219</b>	1,408	1,415	<b>5,683</b>
<b>Shares (millions)</b>	834	<b>834</b>	830	830	830	830	<b>830</b>	830	830	<b>830</b>
Per share (\$)	1.39	<b>5.13</b>	1.43	1.41	1.70	1.74	<b>6.29</b>	1.70	1.70	<b>6.85</b>
Ebitda Margin (E&P)	8%	<b>12%</b>	10%	11%	14%	15%	<b>13%</b>	14%	14%	<b>14%</b>
Tax Rate	31%	<b>27%</b>	28%	35%	35%	35%	<b>34%</b>	35%	35%	<b>35%</b>

**Present Value in a World Context**

Our estimate of present value of \$52 a share in place for more than a year implies a multiple of near-term cash flow, PV/Ebitda, of 4.3, that is at the low end of the range for producer/refiners (see table Functional Cash Flow and Present Value). Our segmentation of cash flow is consistent with company reporting while the classification of present value below is more consistent with the framework we use in valuing other companies.

Reconciling the different segmentation for cash flow and present value we see an unrealistic cash flow multiple of 3.1 for the Downstream segment. A more consistent number for comparative purposes would be the median cash flow multiple of 6.1 for 14 companies in our coverage. The higher multiple would imply lower cash flow of \$2.8 billion. Since Lukoil refines about 325 million barrels of crude annually, the lower cash flow would still be about \$9 a barrel. That would be more comparable for the crude oil refined and could include marketing and other downstream activities. Remaining reported cash flow for downstream, \$2.6 billion, could be considered attributable to the oil production segment.

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**Lukoil**  
**Functional Cash Flow and Present Value**

	<i>NTM Ebitda</i> <i>(US\$mm)</i>	<i>Adjusted</i> <i>R/P</i>	<i>PV/</i> <i>Ebitda</i>	<i>Present</i> <i>Value</i> <i>(US\$mm)</i>	
Natural Gas					
Oil	4,800	19.8	5.7	27,200	62%
Downstream	5,400		3.1	16,900	38%
	10,200		4.3	44,100	100%
Debt (US\$mm)					900
Net Present Value (US\$mm)					43,200
Shares (mm)					830
Net Present Value (US\$/sh)					52

Instead of a 5.7 multiple for the Oil segment, the comparative number would be present value of \$27 billion divided by redefined production cash flow of \$7.4 billion, a multiple of only 3.6 times. Adjusted reserve life index need be just 6.2 years to justify a 3.6 multiple assuming recent futures prices. Yet Lukoil reports reserves that imply an adjusted life index of more than 20 years without counting natural gas. When the company reports reserves under more stringent Securities and Exchange Commission rules as promised, the adjusted life index is still likely to be long.

**Slow Oil, Speed Natural Gas**

President Putin may have had other reasons for shutting down Lukoil rival, Yukos, but one benefit for Russia was to slow down Yukos' pell-mell oil expansion. Since Russian oil production peaked about 20 years ago, it is more in the long-term interests of the country to make current production last rather than export the cream for temporary gain.

Meanwhile oil production profits should sort out to encourage optimal long-term investment. Low domestic prices need to be corrected. Eventually tax discrimination against exports also needs to be relieved.

In contrast, Russia has among the world's largest natural gas reserves that are barely tapped. Those should be developed more rapidly to the benefit of Russia and the environmental health of the world. Lukoil has natural gas reserves that we practically ignore, for now, but should be more valuable with time.

**Buy Oil and Gas Producers at Mid Decade**

Multi-fold gain potential for oil and gas price over the years ahead justifies investment in recommended oil and gas producers, in our opinion. A McDep Ratio of 1.0 normally implies that a stock would be priced at present value assuming a constant real oil price of US\$40 (see table Rank by McDep Ratio).

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**Rank by McDep Ratio: Market Cap and Debt to Present Value**

	<i>Symbol/</i>		<i>Price</i>		<i>Market</i>	<i>Net</i>	<i>Debt/</i>	
	<i>Rating</i>	<i>29-Jun</i>	<i>(\$/sh)</i>	<i>Shares</i>	<i>Cap</i>	<i>Present</i>	<i>Present</i>	<i>McDep</i>
		<i>2005</i>		<i>(mm)</i>	<i>(\$mm)</i>	<i>Value</i>	<i>Value</i>	<i>Ratio</i>
<b>Producer/Refiners - Large Cap and Mid Cap</b>								
Kinder Morgan, Inc.	KMI	S2	83.14	124	10,310	20.00	0.74	1.82
Imperial Oil Limited (30%)	IMO	B	83.91	105	8,800	64.00	0.11	1.28
Marathon Oil Corporation	MRO	B	53.82	349	18,760	42.00	0.30	1.20
Petro-Canada	PCZ	B	65.16	263	17,160	70.00	0.19	0.94
Suncor Energy	SU	B	47.57	461	21,930	54.00	0.10	0.89
ConocoPhillips	COP	B	57.95	1,420	82,300	70.00	0.21	0.86
Norsk Hydro ASA	NHY	B	90.10	251	22,610	110.00	0.13	0.84
PetroChina Company Ltd (10%)	PTR	B	74.74	176	13,140	94.00	0.05	0.81
Lukoil Oil Company	LUKOY	B	36.35	830	30,000	52.00	0.02	0.71
<i>Total or Median</i>					<i>225,000</i>		<i>0.13</i>	<i>0.89</i>

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