

Rating: Buy  
 S&P 500: 1215

## Lukoil Oil Company Adapting to the New Russia

<i>Symbol</i>	(LKOD) LUKOY	<i>Ebitda Next Twelve Months ending 9/30/06 (US\$m)</i>	12,800
<i>Rating</i>	Buy	<i>North American Natural Gas/Ebitda (%)</i>	0
<i>Price (US\$/sh)</i>	56.45	<i>Natural Gas and Oil Production/Ebitda (%)</i>	53
<i>Pricing Date</i>	9/23/05	<i>Adjusted Reserves/Production NTM</i>	20.0
<i>Shares (mm)</i>	830	<i>EV/Ebitda</i>	3.8
<i>Market Capitalization (US\$m)</i>	46,900	<i>PV/Ebitda</i>	4.3
<i>Debt (US\$m)</i>	1,700	<i>Undeveloped Reserves (%)</i>	0
<i>Enterprise Value (EV) (US\$m)</i>	48,500	<i>Natural Gas and Oil Ebitda (US\$/boe)</i>	10.44
<i>Present Value (PV) (US\$m)</i>	55,600	<i>Present Value Proven Reserves(US\$/boe)</i>	2.28
<i>Net Present Value (US\$/share)</i>	65	<i>Present Value Proven Reserves(US\$/mcf)</i>	0.38
<i>Debt/Present Value</i>	0.03	<i>Earnings Next Twelve Months (US\$/sh)</i>	9.34
<i>McDep Ratio - EV/PV</i>	0.87	<i>Price/Earnings Next Twelve Months</i>	6
<i>Dividend Yield (%/year)</i>	1.7	<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

Buy-recommended **Lukoil Oil Company (LUKOY)** offers appreciation potential to global valuation levels and diversification of political risk. While Russia's high export tax discourages international sales of crude, profits on domestic crude oil and products are becoming more rational. As a result, Lukoil reported cash flow and earnings growth for the second quarter 2005 ahead of our cautious expectations. The stock has appreciation potential of 15% to reach our estimated net present value of \$65 a share. By international standards, cash flow ought to be more than twice reported and the cash flow multiple ought to be more than twice the current level, implying four-fold potential. Political risk of investing in Russia may be decreasing for now and it can be comforting for investors to have political diversification from oil bashing in Western Europe and North America.

### Profits Gain Domestically

Former Chevron executive and now a Director of Lukoil, Richard Matzke introduced Lukoil management for its presentation in London of financial results for the second quarter of 2005 on September 20. Both production and downstream gained. There remains a split of profits favoring downstream rather than production (see table Next Twelve Months Operations).

Oil price for Russian producers 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 \$10 a barrel of production for the next twelve months. More normal levels would be more than twice that.

In contrast, Lukoil reports downstream cash flow closer to international standards. Financial statements explain that most oil consumed in Russia is supplied by integrated producer/refiners and there is little domestic crude oil exchanged at market prices. As a result, profit on crude oil produced for domestic consumption shows up in the downstream segment.

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

	<i>Q4</i>	<i>Year</i>	<i>Q1</i>	<i>Q2</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Next Twelve Months</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>9/30/06</i>	<i>9/30/06</i>
<b>Volume</b>											
Oil (mmb)	164	<b>635</b>	162	164	166	166	<b>657</b>	162	164	166	<b>657</b>
Oil (mbd)	1,780	<b>1,739</b>	1,800	1,800	1,800	1,800	<b>1,800</b>	1,800	1,800	1,800	<b>1,800</b>
<b>Price</b>											
Oil (\$/bbl)											
WTI Cushing	48.31	<b>41.44</b>	49.65	53.05	62.59	66.55	<b>57.96</b>	67.23	67.51	67.26	<b>67.14</b>
Lukoil export	40.52	<b>34.50</b>	41.29	47.74	56.32	59.88	<b>51.37</b>	60.50	60.75	60.52	<b>60.41</b>
NY Harbor 3-2-1 (\$/bbl)	5.72	<b>7.74</b>	6.17	10.59	16.19	16.93	<b>12.47</b>	14.49	15.22	14.16	<b>15.20</b>
<b>Revenue (\$mm)</b>											
Oil	6,634	<b>21,896</b>	6,689	7,820	9,327	9,917	<b>33,753</b>	9,800	9,950	10,022	<b>39,690</b>
Other	2,993	<b>12,162</b>	3,927	5,814	5,814	5,814	<b>21,370</b>	5,814	5,814	5,814	<b>23,257</b>
Total	9,627	<b>34,058</b>	10,616	13,634	15,141	15,731	<b>55,122</b>	15,615	15,764	15,836	<b>62,947</b>
<b>Expense</b>											
Fixed	1,527	<b>4,838</b>	1,510	1,707	1,707	1,707	<b>6,632</b>	1,707	1,707	1,707	<b>6,830</b>
Variable	4,580	<b>14,514</b>	4,529	5,122	6,110	6,496	<b>22,257</b>	6,420	6,518	6,565	<b>25,999</b>
Other	1,509	<b>7,401</b>	2,593	4,318	4,318	4,318	<b>15,547</b>	4,318	4,318	4,318	<b>17,272</b>
<b>Ebitda (\$mm)</b>											
Exploration and Production	527	<b>2,543</b>	650	990	1,510	1,713	<b>4,863</b>	1,673	1,725	1,750	<b>6,861</b>
Other	1,484	<b>4,762</b>	1,334	1,496	1,496	1,496	<b>5,822</b>	1,496	1,496	1,496	<b>5,985</b>
Total Ebitda	2,011	<b>7,305</b>	1,984	2,486	3,006	3,210	<b>10,686</b>	3,169	3,221	3,246	<b>12,846</b>
Exploration	46	<b>171</b>	36	147	147	147	<b>477</b>	147	147	147	<b>588</b>
Deprec., Deplet., & Amort.	269	<b>1,075</b>	284	317	317	317	<b>1,235</b>	317	317	317	<b>1,268</b>
<b>Ebit</b>	1,696	<b>6,059</b>	1,664	2,022	2,542	2,746	<b>8,974</b>	2,705	2,757	2,782	<b>10,990</b>
Interest	21	<b>194</b>	19	34	34	34	<b>120</b>	34	34	34	<b>136</b>
<b>Ebt</b>	1,675	<b>5,865</b>	1,645	1,988	2,508	2,712	<b>8,853</b>	2,672	2,723	2,748	<b>10,854</b>
Income Tax	516	<b>1,585</b>	458	569	718	776	<b>2,521</b>	765	779	786	<b>3,106</b>
<b>Net Income (\$mm)</b>											
Exploration and Production	156	<b>1,229</b>	332	545	893	1,027	<b>2,797</b>	1,000	1,034	1,050	<b>4,111</b>
Other	934	<b>2,956</b>	983	865	885	896	<b>3,630</b>	894	897	898	<b>3,586</b>
Unallocated	69	<b>94</b>	(128)	9	12	13	<b>(94)</b>	12	13	13	<b>51</b>
Total	1,159	<b>4,279</b>	1,187	1,419	1,790	1,936	<b>6,332</b>	1,907	1,944	1,962	<b>7,748</b>
<b>Shares (millions)</b>	834	<b>834</b>	830	830	830	830	<b>830</b>	830	830	830	<b>830</b>
Per share (\$)	1.39	<b>5.13</b>	1.43	1.71	2.16	2.33	<b>7.63</b>	2.30	2.34	2.36	<b>9.34</b>
Ebitda Margin (E&P)	8%	<b>12%</b>	10%	13%	16%	17%	<b>14%</b>	17%	17%	17%	<b>17%</b>
Tax Rate	31%	<b>27%</b>	28%	29%	29%	29%	<b>28%</b>	29%	29%	29%	<b>29%</b>

**Present Value in a World Context**

Our estimate of present value of \$65 a share implies a low 4.4 multiple of cash flow, PV/Ebitda (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. Producers with long life reserves might justify cash flow multiples of twice Lukoil's.

**Russia May Become World's Richest Energy Producer**

Oil production profits in Russia 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. The objective verification of Russia's rise to energy wealth is likely to be higher stock prices for Russian energy stocks like Lukoil.

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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	6,800	19.8	5.1	34,800	62%
Downstream	6,000		3.5	20,900	38%
	12,800		4.4	55,700	100%
Debt (US\$mm)				1,700	
Net Present Value (US\$mm)				54,000	
Shares (mm)				830	
Net Present Value (US\$/sh)				65	

**Windfall Whine**

Inevitably along with the recent investment success of oil and gas producers we hear the occasional political call in the U.K., France and the U.S. for a tax on “windfall profits”. Let us hope that cooler heads prevail. Fortunately the world has become increasingly competitive globally. High tax rates in one country can mean opportunity in another.

Russia appears to be completing a bout with excessive taxes and may be moving into a more stimulative direction. Lukoil believes it has settled all back tax issues. The export tax could not be much higher.

The government has reasserted its presence in the industry through half-owned Gazprom, a recent McDep buy recommendation. With tax issues and ownership matters more under control, the government can get on with encouraging the development of Russian energy wealth.

**Buy Producer/Refiners and Diversify Political Risk**

Lukoil and its buy-recommended peers offer diversification of political risk among Russia, China, Norway, Canada and the U.S. (see table Rank by McDep Ratio) 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\$50. The ranking has lowest ratios on the bottom connoting “buy low, sell high”.

Kurt H. Wulff, CFA

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

	<i>Symbol/</i>	<i>Rating</i>	<i>Price</i> <i>(\$/sh)</i>	<i>Shares</i>	<i>Market</i>	<i>Net</i>	<i>Debt/</i>	<i>McDep</i>
			<i>23-Sep</i>	<i>(mm)</i>	<i>Cap</i>	<i>Present</i>	<i>Present</i>	<i>Ratio</i>
			<i>2005</i>		<i>(\$mm)</i>	<i>Value</i>	<i>Value</i>	
<b>Producer/Refiners - Large Cap and Mid Cap</b>								
Kinder Morgan, Inc.	KMI	S2	93.90	123	11,560	20.00	0.76	1.90
Imperial Oil Limited (30%)	IMO	B	111.00	104	11,500	84.00	0.09	1.29
Marathon Oil Corporation	MRO	B	68.57	367	25,170	65.00	0.27	1.04
Petro-Canada	PCZ	B	40.73	526	21,420	42.00	0.19	0.98
Norsk Hydro ASA	NHY	B	113.50	251	28,490	130.00	0.13	0.89
Lukoil Oil Company	LUKOY	B	56.45	830	47,000	65.00	0.03	0.87
Suncor Energy	SU	B	57.51	461	26,520	68.00	0.10	0.86
ConocoPhillips	COP	B	68.29	1,419	96,900	100.00	0.15	0.73
PetroChina Company Ltd (10%)	PTR	B	81.20	176	14,270	120.00	0.01	0.68
Gazprom (50%)	OGZPF	B	60.00	1,022	61,300	90.00	0.03	0.68
	<i>Total or Median</i>				<i>344,000</i>		<i>0.11</i>	<i>0.88</i>

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