

### Recommendations

		Price*	Mkt. cap	P/E (x)		EV/DACF (x)		Fair	Upside
		(local)	(US\$ m)	2010F	2011F	2010F	2011F	value	(%)
Gazprom	Buy (maintained)	US\$ 6.03	143,935	5.8	4.6	4.2	3.6	US\$ 7.78	29.0%
Rosneft	Hold (upgraded)	US\$ 7.78	83,726	7.4	6.0	7.1	5.8	US\$ 8.10	4.2%
Lukoil	Buy (maintained)	US\$ 53.6	46,994	5.5	4.7	4.7	4.0	US\$ 68.0	26.9%
Gazprom Neft	Hold (maintained)	US\$ 5.02	23,756	7.2	5.9	5.6	4.7	US\$ 5.04	0.4%
Novatek	Hold (upgraded)	US\$ 72.4	18,611	18.5	14.0	15.9	12.2	US\$ 68.7	-5.1%

Source: Bloomberg, KBC Securities

\*Calculated on 27 January 2010 closing prices

Russian oils have surged 97.1% in the past twelve months in US\$ terms (RTSOG\$ Index), driven by the swing in the price of crude, wide-scale tax allowances and investors' rising confidence in Russia. However, the uptrend in the price of crude was broken in January and we doubt there is significant headroom in 2010. We expect the rise of consensus earnings estimates to slow down in the months ahead, putting valuations once again in the limelight. The sector now trades at an average 2010F P/E of 8.9x, 21.9% higher than six months ago and 8.5% above the historical average of 8.2x. We believe this is broadly fair given further expected increases in earnings on the back of the expected recovery of gas prices and volumes in 2011. We still see some value in stocks such as Gazprom (Buy, 29.0% upside) and Lukoil (Buy, 26.9% upside) but consider Rosneft (Hold, 4.2% upside), Novatek (Hold, 5.1% downside) and Gazprom Neft (Hold, 0.4% upside) as fully valued.

### Valuation update

- European gas demand recovers:** Russian crude oil production rose 1.5% in 2009, whilst gas output fell 16% due to subdued demand. However, we expect Russian gas production to jump 8.5% in 2010, as European demand recovers. Gas exports have already shown a 19% y/y increase in 4Q09, which suggests a turnaround and shows that a large part of the demand slump in 1H09 was due to speculation that prices would move lower in 2H09.
- Tax exemptions:** In a long-awaited move, the Russian government exempted 13 oil fields in Eastern Siberia from export duty as of December 2009. The duration is unclear, but the market expects the exemptions to last three to five years as this would allow firms to secure returns on capital intensive greenfield projects. In late January, however, the government suspended the tax allowance, citing formal problems with the claims. This has sparked speculation about the Kremlin's commitment to the regime due to budget problems.
- Rising cost inflation:** After a substantial decrease in unit production costs in 2009, we expect cost inflation to accelerate further in the years ahead on the back of rising energy prices, increasing transportation costs, and the expected strengthening of the Russian rouble against the US dollar. We forecast the Russian oil sector's operating costs (including operating expenses, transportation and general costs) to rise 9.5% to US\$ 17.3/bbl in 2010 but to slow down thereafter (CAGR of 7.6% between 2010-2012).
- Sector fairly valued:** Our Russian oil and gas universe trades at an average 2010F P/E of 8.9x, or a 37.2% discount to international peers on 14.2x. After an average discount of 25-30% in the past four years, we believe a moderately higher multiple is justified given the improving risk profile of the Russian oils sector. Our valuation models imply an average 14.4% upside for the sector.

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Oil & Gas				Current price*	US\$ 6.03		<b>Buy</b>	
Russia				Fair value	US\$ 7.78		Rating maintained	
<b>Performance over</b>	<b>1M</b>	<b>3M</b>	<b>12M</b>	<b>FY/e 31.12</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>
Absolute	-2%	-2%	80%	Sales (US\$ bn)	141.49	99.74	124.01	142.46
Rel. to MSCI Oil&Gas	3%	1%	58%	EBITDA (US\$ bn)	58.51	37.14	42.74	50.07
12M Lo/Hi	US\$ 4.03/6.88			EBIT (US\$ bn)	50.67	30.45	34.68	39.90
Reuters	GAZP.RTS			Net profit (US\$ bn)	29.87	21.88	24.73	30.78
Bloomberg	GAZP RU			EPS (US\$)	1.3	0.9	1.0	1.3
Market cap	US\$ 143.9bn			DPS (US\$)	0.0	0.1	0.1	0.2
Free float	43.2%			P/E (x) *	4.8	6.5	5.8	4.6
Next corporate event				Yield (%)	0.4	1.6	2.3	3.5
3Q09 results at February 2010				EV/EBITDA (x)*	3.3	5.0	4.4	3.7

Source: KBC Securities

\* Priced at COB 27 January 2010

We maintain our Buy rating on Gazprom due to expectations for a rebound in gas exports in 2010-2011. Implementing our new oil and currency macro scenario into our Gazprom model has lowered our net income estimate by 1.5% to US\$ 24.7bn (+13.0% y/y) for 2010 but lifted by 5.1% to US\$ 30.8bn (+24.5% y/y) for 2011. Meanwhile, we have cut our capital expenditure forecasts as we expect the management to trim out the least rational projects. Factoring-in our lifted earnings estimates but lowered capital expenditure forecasts and a decrease in the Russian risk-free rate, our fair value estimate has jumped 28.0% to US\$ 7.78 per share, which implies 29.0% upside.

### Buy rating maintained

- **Gas demand on the rise:** Despite a decline of almost 16% in 2009, Gazprom's gas production is expected to jump 8.5% in 2010 as European demand recovers. The decline in gas production had already stopped on a year-on-year basis in 4Q09, which suggests a turnaround and shows that a big part of the demand slump in 1H09 was due to speculation on lower prices in 2H09.
- **Capex rationalization:** Gazprom's preliminary capital expenditure program aims to spend RUB 800bn in 2010 versus our original forecast of RUB 990bn. Although the details are still unknown, we believe the firm has rationalized earlier investment plans by delaying/trimming the least rational projects.
- **Russian gas market liberalization:** Domestic gas tariffs in Russia are currently well below international levels and are expected to increase to the level of exports netback by 2015. Despite common concerns, the government is sticking to its tariff hike plans, which represents significant upside for Gazprom's earnings.
- **Favourable business model:** Combining its various businesses into a holding, Gazprom has a relatively decent risk profile compared to pure oil and gas companies. Earnings diversification helps to smooth out the seasonality of cash-flow while the nine-month time lag in the calculation of export gas price provides sufficient time for the firm to react to market challenges.
- **Attractive valuation:** On a 2010F EV/DACF of 5.5x Gazprom trades at a 18.6% discount to Russian and international upstream oils. Given Gazprom's promising medium-term earnings growth potential and relatively safe business model, we believe the discount should narrow in the years ahead.

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Oil & Gas		Current price*	US\$ 53.6	<b>Buy</b>
Russia		Fair value	US\$ 68.0	Rating maintained
<b>Performance over</b>	<b>1M</b>	<b>3M</b>	<b>12M</b>	
Absolute	-6%	-11%	57%	
Rel. to MSCI Oil & Gas	-1%	-8%	38%	
12M Lo/Hi	US\$ 40.2/67.2			
Reuters	LKOH.RTS			
Bloomberg	LKOH RU			
Market cap	US\$ 47.0bn			
Free float	13.16%			
Next corporate event	4Q09 results in 1Q10			
	<b>FY/e 31.12</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>
<b>Sales (US\$ m)</b>	107,680	78,372	97,894	109,890
<b>EBIT (US\$ m)</b>	16,667	13,739	15,267	17,380
<b>Pre-tax (US\$ m)</b>	13,709	9,839	11,113	12,924
<b>Net profit (US\$ m)</b>	9,144	7,431	8,286	9,688
<b>EPS (US\$)</b>	10.8	8.7	9.7	11.4
<b>DPS (US\$)</b>	1.6	1.3	1.9	2.8
<b>P/E (x) *</b>	5.0	6.1	5.5	4.7
<b>Yield (%)</b>	4.6	2.3	3.6	5.3
<b>EV/EBITDA (x)*</b>	3.3	4.0	3.5	3.0

Source: KBC Securities

\*Priced at COB 27 January 2010

We reiterate our Buy rating on Lukoil after seeing new potential for the company, primarily the recently acquired West Quarna 2 exploration project in Iraq. Implementing our new oil and currency macro scenarios has pushed up our net income estimates by 1.2% to US\$ 8.29bn (+11.5% y/y) for 2010 and 8.4% to US\$ 9.69bn (+16.9% y/y) for 2011. Incorporating our new earnings forecasts and a lower Russian risk-free rate into our valuation model, our fair value estimate has increased by 9.3% to US\$ 68.0 per share, which offers 26.9% upside.

### Buy rating maintained

- **High potential in Iraq:** Lukoil won an 85% stake in the West Quarna 2 exploration licence in southern Iraq, which has an estimated reserve base of 12.9bn barrels. The company offered to pay a fee of US\$ 1.15 per barrel produced and aims to reach a production plateau of 1.8 MMbbl/d. This will allow Lukoil to nearly double its current production level, improve well economics and margins and diversify exploration risks. We do not yet include the project in our valuation due to uncertainties related to timing and capital expenditures, but it does offer significant potential for Lukoil, which has excellent geographical knowledge of the region.
- **Crude price leverage strengthened:** Lukoil plans to invest US\$ 4.5bn in developing the West Quarna 2 field in the next five years which leaves the stock more leveraged to the crude price. As our crude price estimates are above the market for the years ahead, we expect Lukoil to deliver some positive earnings surprises.
- **Low-risk business profile:** We like Lukoil's strong vertical integration in Russia and sizeable international asset portfolio, as these provide a more balanced earnings structure compared to local peers.
- **Exposure to the downstream cycle:** Thanks to refinery acquisitions in the last 10 years, Lukoil has a significant exposure to the downstream cycle. In view of the expected margin improvement in 2010-2011, we expect Lukoil's international refinery portfolio to start to deliver sizeable profits.
- **Strong balance sheet:** Lukoil had a gearing ratio of 16.4% at the end of 3Q09, one of the lowest in our EMEA oils universe. Although gearing will certainly increase in the years ahead due to capital expenditures related to West Quarna 2, we see ample room for the planned hike of the dividend pay-out ratio to 30%.
- **Our top pick in the Russian oil and gas sector:** Trading on a 2010F EV/DACF of 4.7x puts Lukoil at a 19.6% discount to Russian upstream oils and an even larger 31.2% discount to international peers. Given the firm's low-risk business model, we believe a valuation premium to Russian oils is warranted.

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Oil & Gas		Current price*	US\$ 72.4	<b>Hold</b>
Russia		Fair value	US\$ 68.7	Rating upgraded
<b>Performance over</b>	<b>1M</b>	<b>3M</b>	<b>12M</b>	
<b>Absolute</b>	10%	43%	214%	
<b>Rel. to MSCI Oil&amp;Gas</b>	15%	47%	177%	
<b>12M Lo/Hi</b>	US\$ 19.7/75.8			
<b>Reuters</b>	NVTK.MM			
<b>Bloomberg</b>	NOTK.RM			
<b>Market Cap</b>	US\$ 18.6bn			
<b>Free float</b>	41.1%			
<b>Next corporate event</b>	4Q09 results in 1Q10			
	<b>FY/e 31.12</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>
	<b>Sales (US\$ m)</b>	3,187	2,702	3,762
	<b>EBITDA (US\$ m)</b>	1,471	1,151	1,800
	<b>EBIT (US\$ m)</b>	1,291	967	1,560
	<b>Net profit (US\$ m)</b>	921	733	1,188
	<b>EPS (US\$)</b>	3.0	2.4	3.9
	<b>DPS (US\$)</b>	1.0	0.7	1.2
	<b>P/E (x) *</b>	21.8	27.4	16.9
	<b>Yield (%)</b>	5.3	1.1	1.6
	<b>EV/EBITDA (x)*</b>	15.6	19.6	12.5

Source: KBC Securities

\* Priced at COB 27 January 2009

**We upgrade Novatek from Sell to Hold after implementing our new oil and currency macro scenarios but adjusting our gas production forecasts for the firm downwards. We have cut our net income estimates by 7.4% to US\$ 1.19bn (+62.2% y/y) for 2010 but increased by 0.8% to US\$ 1.58bn (+32.6% y/y) for 2011. Our longer term estimates, however, have increased substantially due to our lifted condensate and gas price forecasts. Factoring-in our new earnings estimates, a significant cut in our capital expenditure forecast and a decrease in the Russian risk-free rate has boosted our fair value estimate by 107.4% to US\$ 68.7 per share, which implies 5.1% downside.**

### Rating upgraded to Hold

- **Decent volume growth in 2009, but slowdown expected in 2010:** Novatek posted gas production growth at 6.6% in 2009, a modest decline from 7.7% in 2008. It implies for us that Novatek managed to sell its new volumes despite a contraction in domestic gas demand. However, we expect gas production growth to show a further slow down to 4.3% in 2010 as Russia faces a growing gas oversupply on the back of subdued industrial demand and weak export opportunities. Also, it remains to be seen how Gazprom, 20% owner of Novatek, will react to Novatek's growing production figures after its own figures fell 16% in 2009.
- **Gains on 2010 domestic gas price hike:** The Russian Federal Tariff Service approved a 15.0% increase in domestic gas prices for 2010, while the permitted rise in Gazprom's transportation fees for independent gas producers was only 12.3%. This extra profit will push up Novatek's EBITDA by 1.6% for 2010.
- **Lower transportation distance improves netback:** Thanks to optimization measures, Novatek lowered the aggregate delivery distance to customers by some 15% in 2009 which significantly reduced transportation costs. We see little room for further improvement in the years ahead as Novatek's gas production is expected to increase more rapidly than demand in the neighbouring areas.
- **Impressive earnings growth profile:** Novatek offers an impressive net earnings CAGR of 32.3% in the period 2009 and 2014, the highest in our CEE and Russian oils universe. The strong growth should be fuelled by accelerating production from 2011 onwards and projected hikes in domestic gas tariffs.
- **Fairly valued:** On a 2010F EV/DACF of 15.9x Novatek trades at a 100%+ premium to Russian and international peers. The valuation premium is fully justified by Novatek's impressive earnings growth prospects: 3Y-CAGR of EBITDA is forecast at 34.0% for 2009-2012 versus the sector average at 15.8%.

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*The definitions of terms applied in the publication:*

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EBITDA = EBIT + amortization and depreciation

EPS = Net profit / No of shares outstanding

DPS = Dividend per Share

NBV per share = Net Book Value / No of shares outstanding

EBITDA margin = EBITDA / Revenue

EBIT margin = EBIT / Revenue

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CFPS = Cash flow / No of shares outstanding

Net Financial Debt = Financial debt – Cash equivalents

ROE = Net profit / Average Equity

EV = Market Capitalization + Net Financial Debt

P/E = Stock Price / EPS

P/CF = Stock Price / (Net Profit + amortization and depreciation)

P/BV = Stock Price / NBV per share

P/S = Market Capitalization / Revenue

Gross Dividend Yield = Dividend per share / Stock

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**List of recommendations concerning Gazprom issued by KBC Securities in Hungary during the last 12 months**

	Valuation (US\$)	Market price (US\$)	Recommendation	Date of issue
Gazprom	7.54	2.90	Buy	29 Oct. 2008
Gazprom	6.26	3.15	Buy	11 Feb. 2009
Gazprom	6.08	4.66	Buy	09 Jul. 2009
Gazprom	7.78	6.03	Buy	01 Feb. 2010

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**List of recommendations concerning Rosneft issued by KBC Securities in Hungary during the last 12 months**

	Valuation (US\$)	Market price (US\$)	Recommendation	Date of issue
Rosneft	4.91	2.70	Buy	29 Oct. 2008
Rosneft	4.19	3.02	Buy	11 Feb. 2009
Rosneft	4.25	5.27	Sell	09 Jul. 2009
Rosneft	8.10	7.78	Sell	01 Feb. 2010

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**List of recommendations concerning Lukoil issued by KBC Securities in Hungary during the last 12 months**

	Valuation (US\$)	Market price (US\$)	Recommendation	Date of issue
Lukoil	74.1	24.9	Buy	29 Oct. 2008
Lukoil	66.1	31.1	Buy	11 Feb. 2009
Lukoil	62.2	42.9	Buy	09 Jul. 2009
Lukoil	68.0	53.6	Buy	01 Feb. 2010

**List of recommendations concerning Gazprom Neft issued by KBC Securities in Hungary during the last 12 months**

	Valuation (US\$)	Market price (US\$)	Recommendation	Date of issue
Gazprom Neft	3.07	1.50	Buy	29 Oct. 2008
Gazprom Neft	2.72	1.94	Buy	11 Feb. 2009
Gazprom Neft	2.91	2.93	Hold	09 Jul. 2009
Gazprom Neft	5.04	5.02	Hold	01 Feb. 2010

**List of recommendations concerning Novatek issued by KBC Securities in Hungary during the last 12 months**

	Valuation (US\$)	Market price (US\$)	Recommendation	Date of issue
Novatek	42.6	28.1	Buy	29 Oct. 2008
Novatek	33.7	26.0	Buy	11 Feb. 2009
Novatek	33.1	43.0	Sell	09 Jul. 2009
Novatek	68.7	72.4	Hold	01 Feb. 2010

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Stock rating	Definition
Buy	Expected total return (including dividends) of 10% or more over a 6-month period
Hold	Expected total return (including dividends) of between -5% and +5% over a 6-month period
Sell	Expected total return (including dividends) of -10% or worse over a 6-month period

(\*) Only used for Belgian, French and Dutch financial instruments

(\*\*) Expected total return (including dividends) of between -10% and +10% over a 6-month period for financial instruments in emerging markets

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Stock rating	% of covered universe	% of covered universe with investment banking relationship during last year
Buy	50.00%	0.00%
Hold	29.55%	0.00%
Sell	20.45%	0.00%

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