



Публічне акціонерне товариство  
"Національна акціонерна компанія "Нафтогаз України"

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АТ "Ощадбанк" код банку 300465  
код ЄДРПОУ банку 00032129

№ \_\_\_\_\_  
На № \_\_\_\_\_


**G7 Embassies**  
**EU Delegation to Ukraine**  
**International Monetary Fund**  
**World Bank**  
**European Bank for  
Reconstruction and Development**  
**and other relevant stakeholders**

Dear All,

Some of you I know well, others I have never met. I am writing as Chair of the Supervisory board of NATIONAL JOINT-STOCK COMPANY "NAFTOGAZ OF UKRAINE" (*Naftogaz*) since I am concerned that the integrity of the 'poster child' of good corporate governance in Ukraine is being threatened. We need your support and help in protecting the independence of the Supervisory board and in ensuring the continuation of our Chief Executive Officer (*the CEO*) and his team after their contracts come to an end on 22<sup>nd</sup> March 2019.

I attach a letter sent to the Prime Minister of Ukraine on Friday about the extension of Andriy Kobolyev's contract and that of the Executive board of Naftogaz.

First of all, it appears that the Government's decision to set the expiration date of all Naftogaz Executive board members' contracts on 22<sup>nd</sup> March 2019 could violate Ukrainian legislation which states that all terms of Naftogaz CEO and our Executive board members' contracts are within the exclusive authority of the Supervisory board, not the shareholder.

Наглядова рада  
Національна акціонерна компанія  
М2 "Нафтогаз України"  
№4/НРвих-19 від 26.02.2019  
арх. в 

The decision appears to be a direct challenge to the Supervisory board. The Government appears to want to use its decision to use the expiration date of the contracts as a lever on the Supervisory board, asking us to halve the salary of our CEO. It is clear that the Supervisory board has the exclusive authority over all the terms and conditions of our Executive board members' contracts. If the Supervisory board yields to this request, its integrity should be questioned by all stakeholders.

If the Government is allowed to meddle in matters which are by law the sole authority of the Supervisory board, it will be highly likely that Naftogaz could become, once again, a vehicle for monetising political influence through corruption.

In my letter, we ask for a meeting at the beginning of March in order to give the Cabinet of Ministers of Ukraine the opportunity to provide the continuity of management we all want.

The letter also points out that our CEO's salary is irrelevant to his remuneration this year as he has voluntarily given up all his salary and bonuses this year to give to three good Ukrainian charities.

Continuity of management is critical for 2019 as this is the year we will deliver unbundling. Naftogaz is on track to deliver a certifiable TSO by June. This gives the Government and regulator some time, in this difficult election year, to put in place the necessary legislation and regulation. Unbundling is highly unlikely to be delivered without our CEO in place. He has taken personal responsibility (as have I) to deliver.

I would like to add one comment on unbundling. I know some of you may be sceptical of Naftogaz's willingness to unbundle.

We have quarterly public meetings on progress, and our next one is due on Wednesday afternoon 27<sup>th</sup> March 2019. You are welcome to come yourselves, or to send any representative to this meeting, or to have separate meetings at any time. You can test our preparedness.

The Gazprom contract comes to an end at the end of 2019. Naftogaz has to put in place plans to cope with all eventualities to protect security of supply within Ukraine and transit to Europe and its other neighbours. For this, it needs its current management which has both the experience and capability to deliver the necessary security of supply. We have plans in place which we need to implement.

On other key matters. The dividend take by the Government has progressively increased from 30% in 2012 to 50% in 2017, 75% in 2018 and is now being proposed

to be set at 90% of net profit this year. Combined with not being compensated for our Public Service Obligations and not having support in collecting debts, it is becoming increasingly difficult to make the investments required. In particular, investments needed to maintain, never mind increase, oil and gas production. This makes no sense for the Ukrainian economy.

We need experienced and highly competent management in this complex environment.

The 22<sup>nd</sup> March is less than a month away. It is essential that the management team of Naftogaz is not disrupted.

It is also essential that in keeping our team we do not do so by permitting the Government to interfere with our judgements, hence abandoning our commitment to proper standards of good governance. It would reflect badly on Ukraine.

Naftogaz is the most important company in Ukraine. Naftogaz is also key to security of gas supply in Europe.

I would very much appreciate whatever support you can give us. Please do let me know if you are prepared and able to help. I am very happy to discuss with any of you the contents of this letter. As would Andriy Kobolyev.

Thank you.

Yours sincerely

**Clare Spottiswoode**  
Chair of the Supervisory board of Naftogaz

*Attachment: on 5 pages*



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№ \_\_\_\_\_  
На № \_\_\_\_\_

**Mr Volodymyr Groysman**  
**Prime Minister of Ukraine**

**Прем'єр-міністру України**  
**Гройсману В.Б.**

**CC: Ministry of Economic**  
**Development and Trade of**  
**Ukraine**

**Копія: Міністерство економічного**  
**розвитку і торгівлі України**

**Dear Mr Prime Minister,**

**Шановний пане Прем'єр-міністре!**

The Supervisory board of NATIONAL JOINT-STOCK COMPANY "NAFTOGAZ OF UKRAINE" (*Naftogaz or the Company*) presents its compliments and hereby informs about the following:

Наглядова рада Національної акціонерної компанії «Нафтогаз України (далі – Нафтогаз або Компанія) засвідчує Вам свою повагу та повідомляє про таке:

As we informed you during our last meeting on 20 December 2018 in Kyiv and confirmed in our letter dated 22 January 2019 (No. 2/НРвих-19), the Supervisory board came to the conclusion that it is in the best interest of the Company to ensure appropriate continuation of the management, i.e. to extend the tenure of the current CEO for three years starting 1 January 2019.

Як ми повідомили під час останньої зустрічі, яка відбулася 20 грудня 2018 року у м. Києві, та підтвердили у листі від 22 січня 2019 року (№ 2/НРвих-19), Наглядова рада дійшла висновку, що в найкращих інтересах Компанії буде забезпечити належні заходи задля продовження роботи керівництва, тобто продовжити строк повноважень

Наглядова рада  
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№3/НРвих-19 від 22.02.2019



чинного Голови Правління на три роки, починаючи з 1 січня 2019 року.

On 16 January 2019, the Cabinet of Ministers of Ukraine (*the CMU*) decided to: (a) terminate office of Naftogaz Executive board including the CEO, (b) instruct the Supervisory board of Naftogaz together with the Ministry of Economic Development and Trade of Ukraine to submit to the CMU relevant proposals with the aim to ensure continuity of office of the Executive board of Naftogaz. The above decisions by the CMU were accompanied by your public statements that the Government expects from the Supervisory board to reconsider the remuneration of the CEO of Naftogaz and that the remuneration of the CEO of Naftogaz should be market level.

The Nomination and Remuneration Committee, as well as the entire Supervisory board, have had numerous discussions of the matters of continuity of the Executive board office as well as what remuneration is market level. It should be noted that current remuneration of the CEO of Naftogaz was set by the Ministry of Economic Development and Trade of Ukraine and its annual level is fully compliant with the effective CMU Resolution No. 859 dated 19 May 1999. Despite the fact that this Resolution is not intended to regulate decisions on management compensation levels made by supervisory boards of SOEs, this is the only available indicator of

16 січня 2019 року Кабінет Міністрів України (далі – КМУ) вирішив: (а) припинити повноваження Правління Нафтогазу, у тому числі його Голови, (б) доручити Наглядовій раді Нафтогазу разом з Міністерством економічного розвитку і торгівлі України з метою забезпечення безперервності роботи виконавчого органу Нафтогазу внести КМУ відповідні пропозиції. Вищезазначені рішення КМУ супроводжувалися Вашими публічними заявами про те, що Уряд очікує від Наглядової ради перегляду розміру винагороди Голови Правління Нафтогазу, і що винагорода Голови Правління Нафтогазу повинна бути ринковою.

Комітет з призначень та винагород, а також Наглядова рада в цілому, проводять численні обговорення питань безперервності роботи Правління, а також стосовно того, який рівень винагороди є ринковим. Слід зазначити, що поточний розмір винагороди Голови Правління Нафтогазу був встановлений Міністерством економічного розвитку і торгівлі України, а її річний рівень повністю відповідає вимогам чинної Постанови КМУ № 859 від 19 травня 1999 року. Незважаючи на те, що ця Постанова не регулює порядок прийняття рішень про рівень компенсації менеджменту

Government's position as to what level of fixed remuneration is considered by the Government as market one.

наглядними радами підприємств державної форми власності, це єдине наявне свідчення позиції Уряду стосовно рівня фіксованої фінансової винагороди, який розглядається Урядом як ринковий.

The above mentioned Supervisory board decision to extend the CEO's tenure is based on the same level of fixed remuneration as provided in the CMU Resolution No. 859, which also complies with the Supervisory board decision approved in October 2018 to freeze current compensation levels of Naftogaz Executive board members for eight months which you should be aware of. Before establishing this level of fixed remuneration, the Nomination and Remuneration Committee conducted a review with the assistance of third party consultant into market levels of remuneration and we were satisfied that the proposed level was within the market.

Вищезгадане рішення Наглядової ради стосовно продовження строку повноважень Голови Правління ґрунтується на тому рівні фіксованої фінансової винагороди, який передбачено Постановою КМУ № 859, що також узгоджується із рішенням Наглядової ради, прийнятим у жовтні 2018 року про те, щоб заблокувати перегляд поточного рівня компенсації для членів Правління Нафтогазу протягом восьми місяців, як Вам має бути відомо. До того, як поточний рівень фіксованої фінансової винагороди було погоджено, Комітет з призначень та винагород із залученням зовнішнього консультанта провів огляд ринкових рівнів винагород, і ми отримали задоволення, що запропонований рівень відповідає ринку.

Having said all of the above, we do acknowledge Government's desire to amend existing compensation practices in SOEs and we reconfirm our readiness to engage into constructive discussion on this matter at your earliest convenience. We would like to draw your attention to the fact that Naftogaz CEO has committed to and is donating 100% of the income he derives from his employment until the end of this calendar year to charity, and therefore

Зважаючи на вищевикладене, ми беремо до уваги прагнення Уряду змінити існуючу практику винагороди на підприємствах державної форми власності, і вкотре підтверджуємо готовність взяти участь у конструктивному обговоренні цього питання у найближчий зручний для Вас час. Ми хотіли би звернути Вашу увагу на той факт, що Голова Правління Нафтогазу прийняв і виконує рішення про

he will not benefit personally from any decision.

спрямування 100% доходів, які він отримує як працівник до кінця цього календарного року, на благодійність, а тому не матиме особистого зиску внаслідок прийняття будь-якого рішення.

The Supervisory board is extremely concerned for the continuation of the management of the Company and therefore proposes that the CMU agree that the terms of contracts of members of the Executive board be extended for a period of time that would allow us and the CMU to reach a solution ensuring longer term contracts for members of the Executive board. The first priority of the Supervisory board is to ensure the continuation of the Executive board in the interest of the Company. Discussions we have on this matter should respect the duty of the Supervisory board to maintain good corporate governance standards within Naftogaz in the interest of the Company. We welcome dialogue with the CMU and are committed to arrange for a meeting with you or the Ministry of Economic Development and Trade of Ukraine as early as first week of March in order to resolve on these matters timely.

Наглядова рада вкрай стурбована питанням продовження роботи керівного складу Компанії, і тому пропонує, щоб КМУ надав згоду на продовження строку дії контрактів членів Правління на період часу, який дозволив би нам і КМУ знайти рішення, що забезпечить укладення контрактів з членами Правління на довший строк. Першочергове завдання Наглядової ради полягає у забезпеченні безперервності діяльності Правління в інтересах Компанії. Під час обговорення, яке проводитиметься з цього питання, повинен враховуватися обов'язок Наглядової ради дотримуватись належних стандартів корпоративного урядування в Нафтогазі в інтересах Компанії. Ми вітаємо діалог з КМУ та готові зустрітись із Вами або представниками Міністерства економічного розвитку і торгівлі України ще в перший тиждень березня з метою врегулювання цих питань своєчасно.

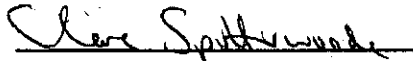
Finally, we also note that the laws have changed significantly since the date of Naftogaz's current Charter and it requires updating to comply with the laws. This will help us to ensure that the competence and thus decisions of the shareholder and other governing

Наостанок слід зауважити, що з моменту затвердження чинної редакції Статуту Нафтогазу законодавство зазнало суттєвих змін, і положення Статуту повинні бути приведені у відповідність до вимог закону. Це допоможе нам

bodies of the Company are compliant with the effective legal framework of Ukraine. забезпечити відповідність повноважень, а отже, і рішень акціонера та інших органів управління Компанії вимогам чинних нормативно-правових актів України.

Your faithfully,

З повагою,



**Spottiswoode Clare Mary Joan / Споттісвуд Клер Мері Джоан**  
Chairperson of the Supervisory board / Голова Наглядової ради



## Russian Oil and Gas Tickling Giants

- Lukoil has finally outlined its capital allocation policy simply and clearly. The company will share the majority of its free cash flows with shareholders, either through dividends or buybacks. It will reinvest 80% of its capex in the Russian business, where it enjoys greater competencies. We believe that if the management follows through on its promises, the market will have no cause to demand the current double-digit free cash flow yield from the shares. We reiterate our BUY recommendation. Our \$85 target price implies a circa 9.5% free cash flow yield at \$65/bbl oil. Lukoil shares present an especially good bargain whenever the market offers them at or below the oil price.
- Gazprom's investment program can best be understood as a way to employ the company's entrenched contractors at the expense of shareholders. The three major projects that will eat up half of the capex in the next five years – Power of Siberia, Nord Stream-2 and Turkish Stream – are deeply value-destructive. Moreover, we expect them to be followed by a large-scale revamp of the company's trunk pipeline infrastructure, which is aging fast. Such a project could keep capex elevated indefinitely. We retain our opportunistic BUY recommendation on the hope that a political reshuffle could bring about a reform effort, though we concede the chances are slim.
- Rosneft has announced it will aim to lower capex and reduce net debt by \$8 bln this year, or about 10%. This appears to address the concerns we expressed in our October 2017 report. It has also mentioned a \$2 bln, three-year buyback program. The buyback alone could lead to the repurchase of up to a third of Rosneft's entire free float at this price, squeezing the stock price higher. However, the company has not committed to reducing debt beyond this year. Moreover, the buyback has not yet received internal approval, and conversations after the announcement make us wonder whether Rosneft really intends to spend the entire \$2 bln over a three-year period. Until these points are addressed, we place our recommendation Under Review.
- We reset our models to \$65/bbl oil (up from \$60/bbl) but leave the target prices unchanged, as we also assume a higher discount rate after the escalation in the US sanctions on April 6.

### Stocks under coverage

	P/E		EV/EBITDA		Target price, \$		Rec	Current price, \$
	2018E	2019E	2018E	2019E	New	Previous		
Gazprom	2.9	2.6	2.6	2.5	3.25	3.25	BUY	2.30
Lukoil	4.5	4.6	2.8	2.8	85.00	85.00	BUY	65.65
Novatek	12.7	8.8	9.9	10.0	185	185	BUY	126
Gazprom Neft	3.4	3.7	3.4	3.9	7.00	7.00	BUY	4.90
Surgutneftegaz commons/prefs	3.3	3.8	neg	neg	0.50	0.50	HOLD	0.50
Tatneft	8.1	8.0	5.3	5.2	10.00	10.00	HOLD	10.55
Rosneft	11.1	6.5	5.7	5.1	UR	5.00	UR (from SELL)	6.20
Transneft	5.2	4.7	3.3	3.1	3.000	3.000	HOLD	2.725
Bashneft commons/prefs	3.5	3.1	2.6	2.4	45.00	45.00	HOLD/BUY	29.10

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Note: Prices as of May 4, 2018. Our target price for Surgutneftegaz tracks the market price as the investment cases for both share classes are not based on fundamentals (see our July 2016 report for more explanation).

Source: Sberbank OIB Investment Research

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In accordance with US SEC Regulation AC, important US regulatory disclosures and analyst certification can be found on the last page of this report.

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## Report Summary

We invert the common criticism of Gazprom and ask what needs to be assumed about the company to conclude that it actually serves its function well. We discover that Gazprom's decisions make perfect sense if the company is assumed to be run for the benefit of its contractors, not for commercial profit. The Power of Siberia, Nord Stream-2 and Turkish Stream are all deeply value-destructive projects that will eat up almost half of Gazprom's investments over the next five years. They are commonly perceived as being foisted on the company by the government pursuing a geopolitical agenda. A more important characteristic that they share, however, is the ability to employ a closely knit group of suppliers in Russia, with little outside supervision. On the other hand, forgone or delayed projects – Shtokman, Baltic LNG and Vladivostok LNG – would have been almost wholly constructed without the help of Gazprom's main current builders and with external oversight. This made them less attractive from the standpoint of the interests that really set the company's agenda.

Taking the contractors' perspective will help gauge Gazprom's future investment path. The rapid aging of trunk infrastructure presents an excuse to undertake an indefinite investment drive to revamp the network. This would play perfectly to the construction experience of Gazprom's current slew of suppliers. We see the emergence of Zagorsk Pipe Plant at the trough of the pipe market as a signal that Russian large-diameter pipe makers could soon get a major boost from an accelerated pipeline replacement program. Unfortunately, such a project would bring no new revenues to Gazprom.

A possible reshuffling of the government later this month may present a rare chance to break this pattern. We show that Gazprom, as a profit-oriented entity, would be worth almost \$200 bln, or almost four times its current market valuation.

Lukoil has finally stated its capital allocation policy simply and clearly. The company will share the vast majority of its free cash flow with shareholders, either through dividends or buybacks. It will reinvest 80% of its capex in the Russian business, where it enjoys competencies (not the least of which is extracting tax concessions). We believe that if the company follows through on its promises, the market will have no cause to demand the current double-digit free cash flow yields from the shares. The stock price should catch up with the Brent price and surpass it.

In the report, however, we also examine what may prevent this from happening. First and foremost, the market may simply take a wait-and-see attitude. The current management has failed to win investors' trust in the past, and has delivered a performance that ranks in the bottom half of the sector. Investors may also fear a change in control, especially since Vagit Alekperov's contingent legacy may rob his heirs of the flexibility needed to deal with a potential pursuer. Finally, the problem may simply lie in attracting the new class of investor. In particular, Lukoil is barely owned by global energy-oriented funds, which we ascribe to an unwillingness to deal with all the external risk factors that come with owning Russian stocks. This is something the company could partially address by simply showing up to meet with these investors.

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## **Gazprom: Performing As Designed**

“What if Gazprom were better run?” our predecessors at Troika Dialog, the progenitor of Sberbank CIB, asked in the title of a report back in 2002. That report came out less than a year after Gazprom’s current CEO, Alexei Miller, took the reins.

Since then, investors have continued posing this same question, with increasing resignation. The potential government reshuffle, expected later this month, has again given scope for some optimism. Some investors see Gazprom as the proverbial “low-hanging fruit” for any domestic reform effort. The eventual completion of the current slate of major pipeline projects appears to open a window for a reform effort to succeed. The ultimate desire of investors, of course, is the breakup of the company (which we will touch upon later), although they would gladly settle for something much more modest, such as a cap on annual capital expenditures.

In this report, we propose an alternative point of view. What if we were to presume that Gazprom *is* well-run – that is, that it perfectly serves its function, from the standpoint of the parties who really call the shots? And what if by these parties we meant not the government (the controlling shareholder), and, of course, not the minority shareholders, who own almost 40% of the company, but Gazprom’s main contractors?

Why them? Because power tends to be exercised by those who can coalesce their energies around a unifying objective. What is often generalized as “the government” is actually a collection of diverse and often contradictory interests. For instance, the Economics Ministry might prefer Gazprom to invest in Russia’s neglected Far East regions, the Finance Ministry could like it to direct available funds toward the dividend, while the Federal Antimonopoly Service may rather open up the export market to competing Russian gas – and thus cause Gazprom to earn less money down the line. The Kremlin, meanwhile, might prefer the company to focus on geopolitical projects, like expanding export infrastructure.

The contractors, however, face no such confusion of purpose. They are united in their desire to promote *any and all* boondoggles, at least within the boundaries of Russia, where their activities will face less scrutiny. Moreover, they are thought to be better connected to the ultimate node of power in Russia than anyone who might possibly be interested in running Gazprom for shareholders. They therefore probably exercise much more sway in Gazprom’s decision-making than does “the government.”

Once you take this contractor-oriented view, Gazprom’s choice of focus over the past 15 years – including projects the company ultimately rejected – starts to make perfect sense. More importantly, this viewpoint will help better inform a future outlook on the stock. In this section, we will disclose what Gazprom might embark on after its current three major projects are concluded. We believe this will include a major undertaking that the company has never aired in public, but which could tie up its cash flows indefinitely.

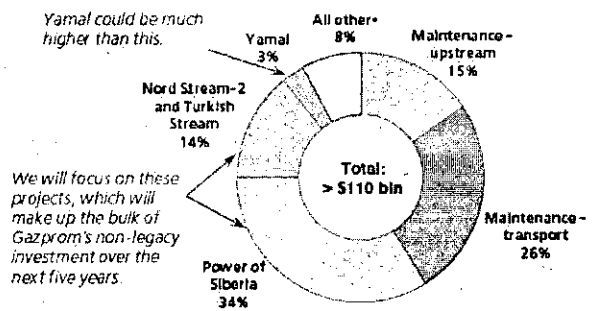
### And the villages dirty and charging high prices

*"Referring to your question about any particular protection mechanism [in the gas contract with CNPC] in association with an extremely low oil price environment, I would like to say that we have registered a high risk appetite for this particular contract and we do not envisage such an event."*

*Gazprom Export official, August 2015 conference call  
(Gazprom had signed the contract in May 2014, when the Brent price was \$110/bbl)*

We expect Gazprom's capital investments to reach at least \$130 bln during the next five years, or about \$110 bln ex-Gazprom Neft, though this could turn out to be an underestimate. Only about 40% of this expenditure is necessary to support the current business, with its comfortable surplus of both upstream and transport capacity.

#### Gazprom's capital expenditures (ex-Gazprom Neft) in 2018-22

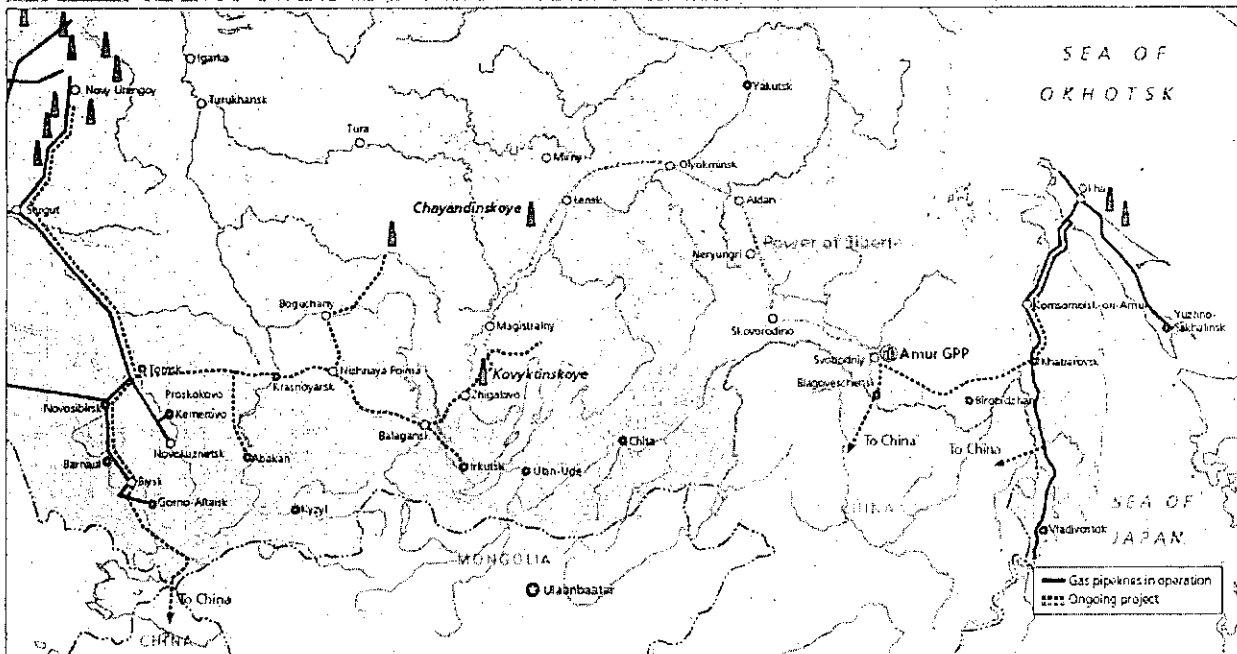


\* Including gas refining, power generation, gas storage, small-scale LNG and regasification (Portovaya/Kaliningrad), and sundry

Source: Sberbank CIB Investment Research

Almost half of all capex over this period, meanwhile, will be channeled to three major pipeline projects – Power of Siberia, Nord Stream-2 and Turkish Stream. None of them are anywhere near NPV-positive.

#### Gazprom's eastern project (Power of Siberia)



Source: Company, Sberbank CIB Investment Research

Power of Siberia had been chosen over what was originally a much cheaper project, called the Altai route (an idea that Gazprom has recently resurrected under the name Power of Siberia-2). While its length would have been roughly equivalent to Power of Siberia's 3,000 km, Altai had three key advantages. First, the gas would have come from the company's existing Nadym-Pur-Taz brownfield, which has spare capacity, requiring no upstream development. Second, the gas would have already been cleaned of impurities at Gazprom's existing gas processing plants, thus precluding the need to construct expensive processing infrastructure at the end point (although, as we argue later, there is still no need for that). Third, for most of its route the pipeline would have run alongside existing trunk infrastructure, lowering the cost. We estimate that Gazprom could have built Altai – supplying almost the same volumes as Power of Siberia at its peak – for about \$10 bln, against the almost \$60 bln that it will eventually plow into the Power of Siberia project.

**Proposed Altai pipeline route (postponed in favor of Power of Siberia)**



Source: Argus, Sberbank CIB Investment Research

The Altai pipeline's gas would have crossed the sliver of the Russian-Chinese border nudged between Kazakhstan and Mongolia, entering China in its sparsely populated western region. It then would have required transportation to the industrial eastern seaboard, costing about \$3-4/MMBtu via China's West-East pipeline. So the price at the border would have been that much lower. But Gazprom only had to get about \$7/MMBtu at the border to clear its own 12% hurdle rate. Given the prevailing LNG prices in the wake of the Fukushima disaster back in 2011-12, when the idea was discussed, this was perfectly achievable. The pipeline would have taken just three years to launch and six to reach peak

capacity (against the 12-year lead time between the start of construction of Power of Siberia and its reaching full capacity), and it would have paid back the invested capex by 2023-24, we calculate.

**Gazprom has chosen Power of Siberia over the more lucrative Altai option**

	Power of Siberia	Altai
Length, km	2,962	2,700
Sales volumes, bcm	38	30
First pipe to launch, years	6	3
Start to peak output, years	12	6
Cost, \$ bln	55.4	10.1
Break-even gas price, \$/MMBtu*	12.0	7.0
Likely gas price, \$/MMBtu**	7.1	7.3
Years to break-even (from launch)	16	7
NPV, \$ bln	(10.8)	1.0
IRR	5%	13%

\* to generate Gazprom's 12% hurdle rate of return on transportation projects

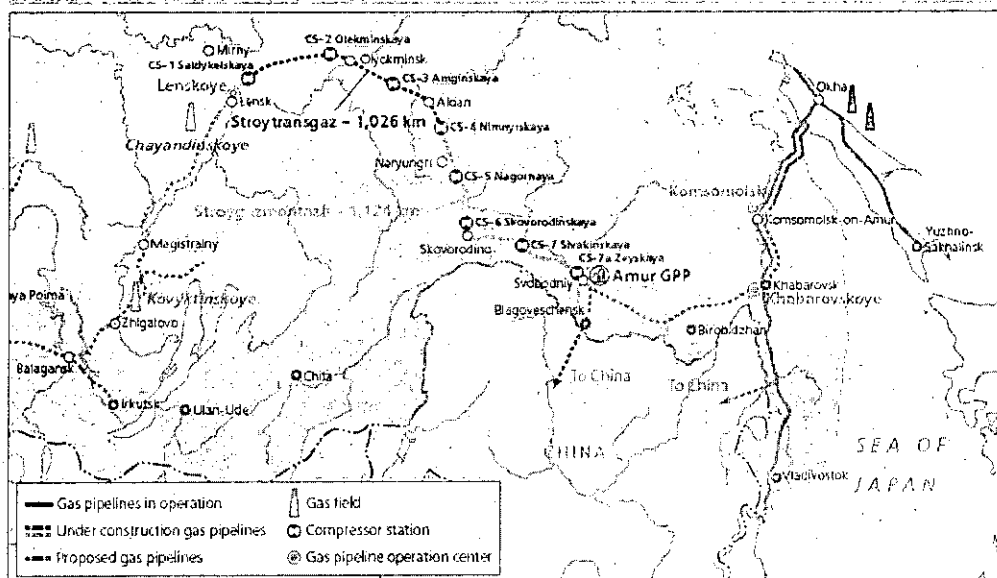
\*\* assuming a \$65/bbl oil price

Source: Sberbank CIB Investment Research

Why did Gazprom end up rejecting the route in favor of what we will see is the value-destructive Power of Siberia? The reason offered by Gazprom is that the Chinese partners were wary of being supplied from the same brownfields that sourced European deliveries and insisted on a dedicated source of gas for themselves. But the Chinese were willing to sign a deal for Altai gas as early as 2010 and, we are told, all but clamored for it after the Fukushima disaster in March 2011 drove up Japan's demand for LNG, causing gas prices to soar. (They would come to drive a harder bargain by 2014, when their consumption of gas began slowing down and other sources of gas imports appeared).

Approach this question, instead, from the point of view of a Gazprom contractor, and the answer becomes easier to grasp. The vaster project means fatter contracts. The entirety of the pipeline lies within the borders of Russia, with no outside oversight. While the Chinese side lobbied to participate in the construction, Gazprom flatly rejected that idea, leaving the construction of the main section divided almost evenly between its two long-term contractors: Stroytransgaz (controlled by Gennady Timchenko) and Stroygazmontazh (founded by Arkady Rotenberg). Alas, neither one is a publicly traded company that you could invest in.

**The construction of Power of Siberia from Chayanda to the border has been almost equally divided between the two chief contractors**

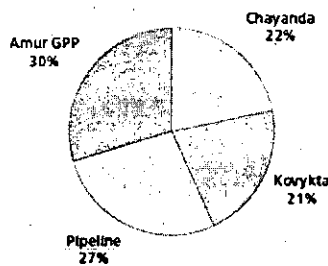


Source: IHS, Sberbank CIB Investment Research

The Power of Siberia requires the development of two difficult fields, Chayanda and Kovykta. The former is characterized by unusually low reservoir pressure, implying higher extraction costs. Both fields have high helium content, which takes effort and cost to separate. (Most of the helium will be ejected in concentrated form and pumped back into the reservoir.) We estimate the two fields will cost a combined \$20 bln to develop, twice as much as the Altai route would have cost alone. (Gazprom's latest guidance for Chayanda is slightly more than half of our estimate, but the annual capex disclosed so far leaves us with conviction about our estimates.)

The pipeline itself will pass a sparsely inhabited area – Gazprom refers to the locations of compression stations in relation to local villages, not cities. The heavy mix of methane, ethane, propane and helium will travel for almost 3,000 km to a town called Svobodny on the other side of the lump of Chinese territory that juts into Russian Siberia.

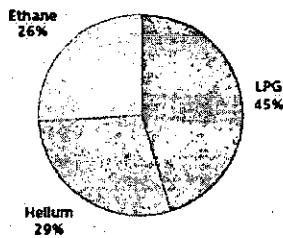
**Power of Siberia capex breakdown (total: \$55 bln)**



Source: Sberbank CIB Investment Research

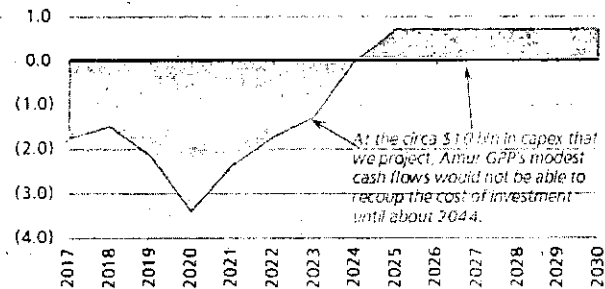
At this point, Gazprom could have simply supplied the energy-rich mix directly to the Chinese, but instead it has decided to build a gas processing plant (called Amur GPP) near Svobodny. The construction of the plant will cost Gazprom between \$14 bln (the company's latest guidance) and almost \$20 bln (according to Energy Minister Alexander Novak). No matter how much we tinker with our model for Amur GPP, we cannot make it work – that is, from Gazprom's standpoint. In fact, based on Novak's guidance, the breakeven point would not arrive in our probable lifetimes. Sibur, which is charged with constructing the plant and which will buy the ethane from Gazprom, intends to generate a profit on its end of the supply. Sibur is partly owned by Gennady Timchenko.

**Breakdown of Amur GPP revenues at peak, \$ bln**



Source: Company, Sberbank CIB Investment Research

**Amur GPP's free cash flow to Gazprom, \$ bln**



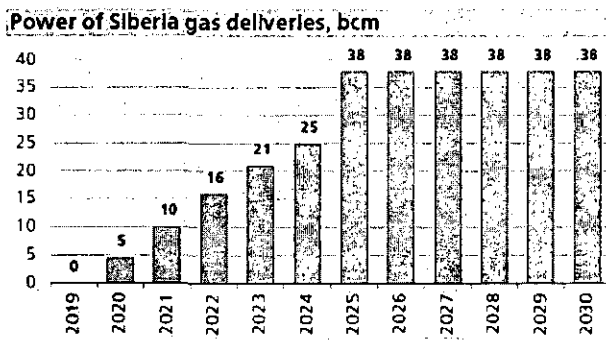
Source: Sberbank CIB Investment Research

Altogether, Gazprom's China project will run to at least \$55 bln, or R3.3 trln – a figure much higher than the R1.9 trln initially guided in 2014 in ruble terms, and about the same in dollar terms, as the ruble has halved in value since then. True, some of the equipment is imported – especially for Amur GPP – but much of it is Russian, and the pipes are priced in rubles.

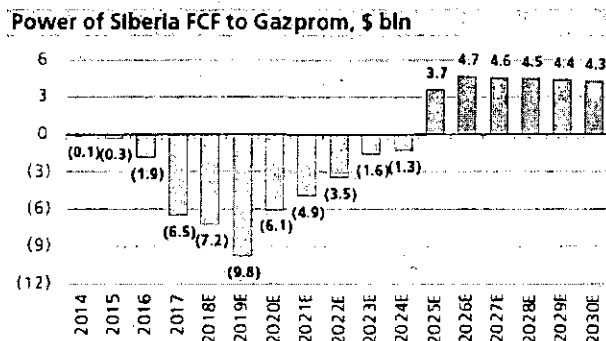
The very high price tag aside, another problem with the project is the lousy contract that Gazprom appears to have signed. As the company has admitted, there is no downside protection, only a straight link to oil products. Judging by initially disclosed figures – a \$400 bln contract for the

supply of 1,032 bcm over 30 years, signed at the \$100-110/bbl prevailing oil price – we calculate that Gazprom will be selling gas to China at a simple slope of between 10% and 11% to the oil price (for instance, \$6.0-6.6/MMBtu at a \$60/bbl oil price).

And the deal is much worse than it appears at first glance, because in reality, it can only benefit the buyer. As we have written before, China now faces a surplus of offers – from Gazprom, from Central Asia and via LNG (including from Novatek) – and can afford to pick and choose which gas it accepts. This is the opposite of the situation after the Fukushima disaster, when Chinese consumption was growing faster and the country was eager for guaranteed sources of gas. A dedicated project that aims at a single buyer puts the buyer in the driver's seat. China will accept Gazprom's gas when it is competitive with LNG. At higher oil prices, Gazprom would have to offer discounts or risk losing sales (this should be familiar to those who have followed Gazprom's European export business). If it refuses to sell at a discount, it should remember that China has been seen as ignoring contractual obligations when they prove inconvenient (as we suspect it did with Qatar in 2013-14). By signing a contract with China to sell gas from dedicated fields with no downside protection for itself, Gazprom has in effect given up all the upside but assumed all the risk.



Source: Company



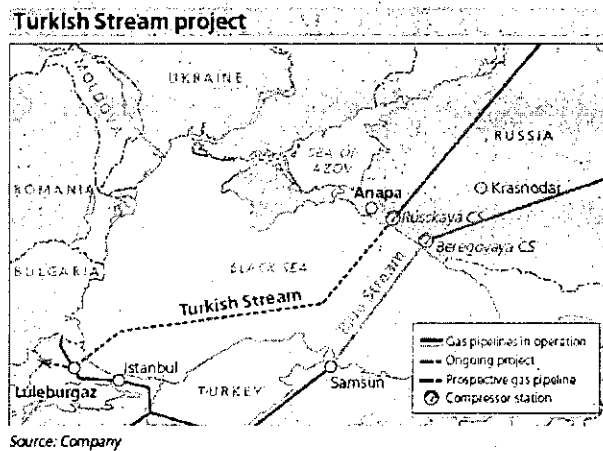
Source: Company, Sberbank CIB Investment Research

We see sales of gas (and ethane, LPG and helium from Amur GPP) plateauing by 2025. That will also be the first year the project generates positive free cash flow. At a \$65/bbl oil price, the gas will be sold at just over \$7.0/MMBtu and Power of Siberia will generate about a 5% rate of return. To reach Gazprom's 12% hurdle rate, the price would need to be \$12/MMBtu – which, under the contract, would happen at a \$110/bbl oil price (exactly the prevailing price in May 2014, when the deal was struck). But at that gas price, as we discuss above, China might begin rejecting Gazprom's volumes. At a \$65/bbl oil price and our standard 10% discount rate, the Power of Siberia is NPV-negative to the tune of about \$11 bln.

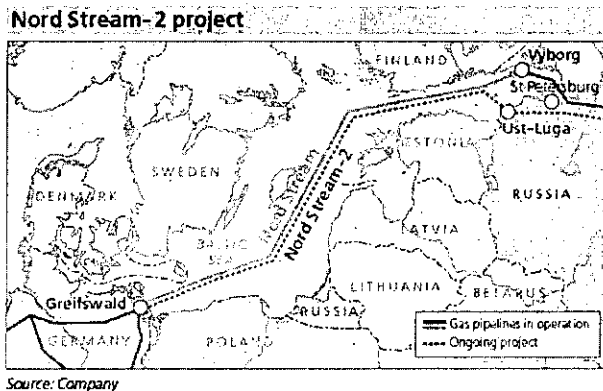
### The Ukraine pincer

It is therefore quite something to discover that Power of Siberia is actually not Gazprom's most value-destructive current venture – at least if historical costs are accounted for. That distinction goes to Turkish Stream, one of two projects designed to loop around the perfectly serviceable Ukrainian transit system to deliver gas to Europe.

It is commonly believed that the Russian government has been forcing Gazprom to construct the major Ukraine bypass routes, Turkish Stream and Nord Stream-2. After all, because they reach no new markets, these routes entail no marginal revenue whatsoever. Whatever benefit they derive comes from savings on transit costs, but their main rationale is probably a geopolitical one – to obviate the existing Ukrainian system.



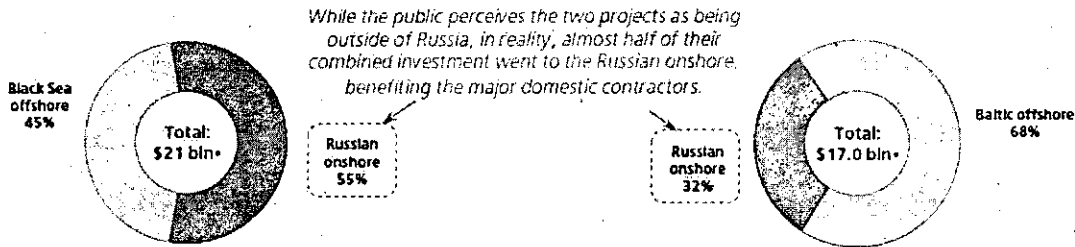
Conveniently enough, though, the projects also greatly benefit Gazprom's domestic contractors. Turkish Stream is often thought of as an offshore project, but the bulk of its cost stems from the Russian onshore section. The pipeline to deliver about 16 bcm of gas to Turkey required a major expansion of the southern portion of Gazprom's gas transport system, originally intended for the abandoned South Stream project. (There will also be a second 16 bcm link to take gas onward through the Balkans, but it will require infrastructure that does not yet exist.) The total cost of the project will come to over \$20 bln, although all but \$3.5 bln of that has already been invested. We estimate that more than half of that was spent onshore in Russia.



Nord Stream-2, also perceived as a purely offshore project, requires the expansion of the Russian onshore transit system: the new 970 km Ukhta-Torzhek-2 link between Ukhta and Gryazovets, and the extension of the Gryazovets-Volkhov route to the Slavyanskaya compressor station (the starting point of Nord Stream-2). The construction of the first 538 km of that link, according to Interfax, has just been awarded without open bidding to Sroytransneftegaz, a company partially owned by the same shareholder as Sroytransgaz, Gennady Timchenko. Gazprom has received EUR2.0 bln (\$2.5 bln) in outside financing, but will fund the rest of the almost \$17 bln in capex (including for Ukhta-Torzhek-2) by itself.

**Turkish Stream capex breakdown**

**Nord Stream-2 capex breakdown**



\* including the investments into the southern part of Gazprom's Russian onshore gas transit system, originally designed for South Stream but eventually used for its replacement project Turkish Stream

Source: Company, Sberbank CIB Investment Research

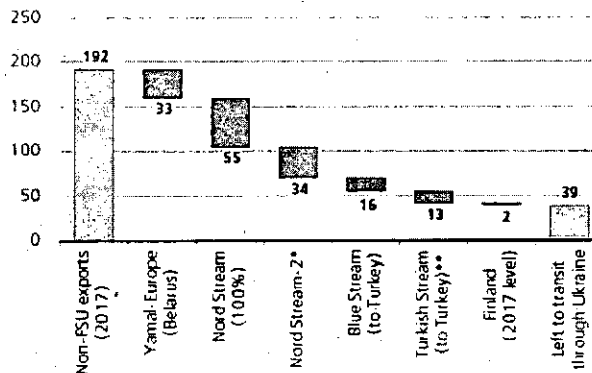
\* including the Ukhta-Torzhok-2 stretch and the extension of the pipeline from Gryazovets to the Slayanskaya compressor station; Gazprom has received \$2.5 bln in outside financing for this

Source: Company, Sberbank CIB Investment Research

The financial benefit from both projects consists of what is saved from not paying for transit through Ukraine after 2019, net of the expense of maintaining the pipelines. For Nord Stream-2, that comes to about \$0.8 bln and for Turkish Stream – under \$0.5 bln.

Interestingly, the two projects will not fully do away with the need for Ukrainian transit, unless Gazprom's European exports drop by about 20% from last year's level (that is, by almost 40 bcm). Turkey's gas market is becoming more competitive, with extra volumes expected from Azerbaijan by 2019, so it may be optimistic to even assume last year's levels of purchases from Gazprom (and those levels would leave the first link of Turkish Stream only partially utilized). There is also a question of how much of Nord Stream-2 will actually be usable, given that the key pipeline to take the gas onward through Germany (Eugal) will not be fully ready until after 2020.

**Gazprom will still need to transit some gas through Ukraine even after Nord Stream-2 and Turkish Stream are online**



\* assuming a 60% initial load for Nord Stream-2 in the absence of the second link of the Eugal system

\*\* total exports to Turkey are assumed to stay at the record 2017 level of 29 bcm

Note: In 2017, Gazprom transited 93 bcm through Ukraine.

Source: Company, IFRJ, Kommersant, Sberbank CIB Investment Research

We estimate that Turkish Stream will not break even for almost half a century, even ignoring inflation; its NPV is negative \$13 bln, worse than the much larger Power of Siberia. Nord Stream-2, assuming 60% capacity utilization, won't recoup investments for another 20 years – and transit through Ukraine will continue. But the contractors will have gotten paid all the same.

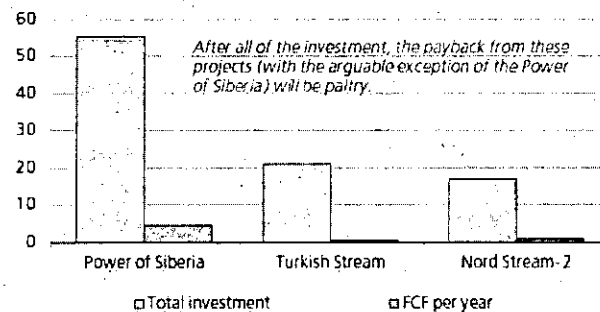
**Which of Gazprom's current projects is the worst?**

	Power of Siberia	Turkish Stream	Nord Stream-2
Length, km	2,962	1,137	1,200
Capacity, bcm	38	32	55
Likely throughput at peak, bcm	38	16	34
First pipe to launch, years	6	9	5
First pipe to peak output, years	12	9	7+
Cost, \$ bln	55.4	21.0	17.0
New sales of gas, bcm	38.0	-	-
Free cash flow at peak, \$ bln	4.6	0.5	0.7
Years to break-even (from launch)	16	47	20
NPV, \$ bln	(10.8)	(12.8)	(6.0)
IRR	5%	n/a	3%

Source: Sberbank CIB Investment Research

**Soon to come: A \$250 bln investment program**

One possible objection to the analysis above is that once construction costs are sunk, projects begin adding value upon their launch. But free cash flow from the Power of Siberia will only commence in 2025, while the FCF of Turkish Stream and Nord Stream-2 – equivalent to the cost savings from forgoing some of the Ukraine transit – will be paltry.

**Annual free cash flow versus total investment, \$ bln**

Note: Free cash flow per year at peak.

Source: Sberbank CIB Investment Research

More importantly, such optimism is contingent on Gazprom's not undertaking any new wasteful investments. In our 2011 report, "Great Expirations," we made a case that while three quarters of gas-related capex was wasteful, the big projects (back then, mostly Yamal and Sakhalin) were set for completion by the following year.

As we know now, those projects were simply succeeded by newer ones, no less wasteful from the perspective of investors.

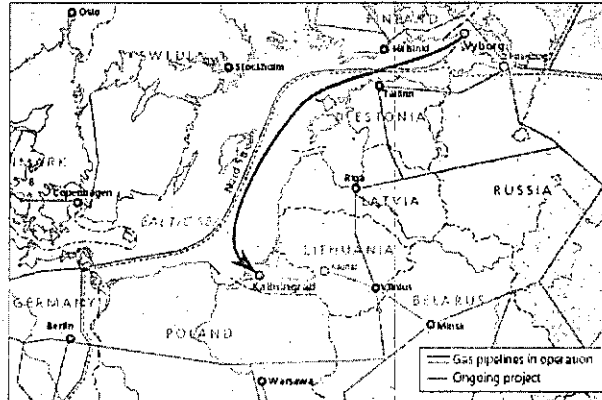
We believe that unless the incentive structure radically changes, Gazprom will extend its elevated investment even beyond our forecast period.

What will be the next projects? We will disclose a major one shortly, but we first want to warn that it is futile to apply ratiocination to assess Gazprom's future spending program. The relatively small twin project at Portovaya and Kaliningrad by the Baltic Sea is a good example of that.

Kaliningrad is a Russian exclave that is supplied with Gazprom's gas by a pipeline that runs through Lithuania. In order to "ensure reliable gas supplies" to Kaliningrad, Gazprom is constructing a 2 bcm regasification terminal there. Regas terminals come pretty cheap nowadays. But Gazprom is pairing this one with a gas liquefaction facility by the Portovaya compressor station near Vyborg, on the other end of the Baltic Sea, which would in theory provide the supply. The thinking must be that the other major LNG suppliers to Europe – Qatar, Algeria, Nigeria and maybe even Novatek – would refuse to deliver to Kaliningrad's regas facility when needed. The project is relatively small by Gazprom's

standards – it will cost \$2-3 bln – but it is even more devoid of commercial logic than Nord Stream-2 or Turkish Stream. Its main contractor on the Kaliningrad side is Timchenko’s Stroytransneftegaz.

**Portovaya LNG facility and Kaliningrad regasification terminal**

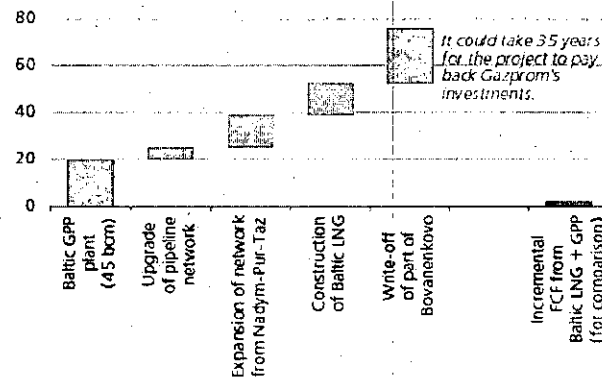


Source: Company, Sberbank CIB Investment Research

More recently, Vedomosti reported that Gazprom and Ruzgazdobycha, a company previously connected to another Gazprom contractor, Arkady Rotenberg, were mulling a 45 bcm gas processing plant, Baltic GPP, near Ust-Luga on the shores of the Baltic Sea – in effect, another Amur GPP. We have already discussed the poor economics of Amur GPP. The new idea appears to be even worse, because it would require the supply of ethane-rich gas (11% ethane content) from the Nadym-Pur-Taz fields. That is something that the current gas pipelines to Ust-Luga, designed to supply relatively low-ethane (3%) gas from the Bovanenkovo field on the Yamal Peninsula for the Nord Stream project, cannot handle without a major upgrade. Moreover, the project would require the expansion of the entire 3,000 km trunk network from Nadym-Pur-Taz toward northwest Russia.

Where would about 40 bcm of the extracted methane (natural gas) go? Gazprom is thinking of using 10-15 bcm for the future Baltic LNG project (to which we’ll return briefly). The rest is probably going to supplant Bovanenkovo gas in the Nord Stream pipeline, depreciating much of the \$80 bln invested in that field’s development over the years.

**How much Baltic GPP could ultimately cost Gazprom, \$ bln**



Note: These figures are estimates that have not been officially confirmed by the company.

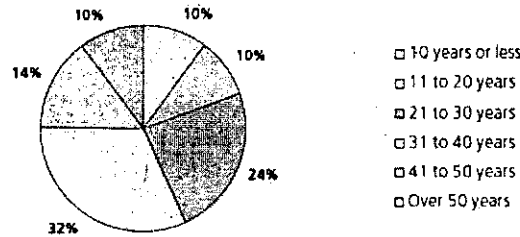
Source: Vedomosti, Sberbank CIB Investment Research

So the \$20 bln preliminary price tag for the standalone Baltic GPP, cited by the newspaper, would swell massively if the project is undertaken. Gazprom has officially guided that the plant would cost

just \$5 bln, but given that the smaller Amur GPP will cost three to four times as much, this much lower guidance strains credulity.

If Gazprom were ever to “run out” of investment ideas as its current trio of projects expires, then we would expect it to launch a major pipeline upgrade program. Well over half of Gazprom’s 172,000 km trunk infrastructure is over 30 years old – up from just 15% at the turn of the century – while almost a quarter is older than 40 years.

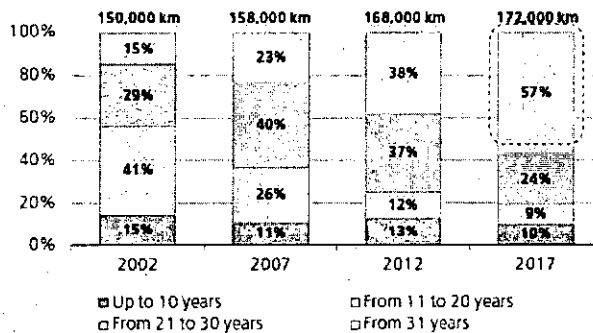
**Breakdown of Gazprom’s trunk gas pipelines by age**



Source: Company

The aging into the 30+ cohort has accelerated recently, indicating that the last major trunk replacement program happened at the tail end of the Soviet period. A well-informed source at Gazprom tells us that there is no hard-and-fast rule for how old trunk pipelines have to get before they need to be replaced. Some are judged to need capital repairs after just 20 years, while others are left in operation 50 years or more (which is the case for 10% of the current system). So Gazprom’s management has full discretion over the size of the annual trunk replacement program and its expansion, which is limited only by the capacity of Russian companies to produce and lay down pipes and erect compressor stations.

**Breakdown of Gazprom’s trunk pipelines by age**

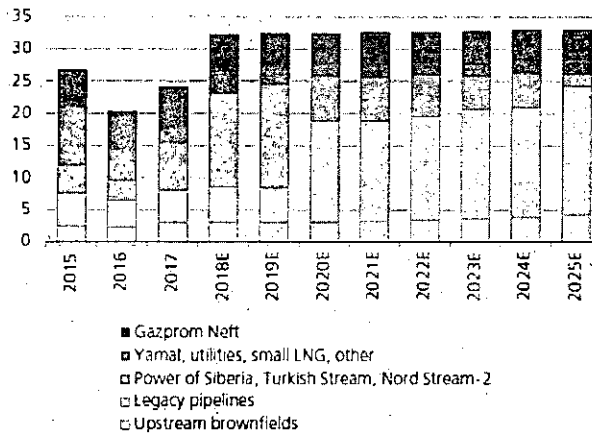


Well over half of Gazprom’s trunk infrastructure is now over 30 years old, and less than a fifth is less than 20 years old. The company has been spending like mad over the past two decades on new projects, but has allowed its core transport infrastructure to age considerably.

Source: Company

A large ramp-up in trunk pipeline replacement would perfectly suit the current major contractors, and this, if you follow us thus far, would be the key determination for receiving the green light. How much would it cost? We estimate that Gazprom spent an average of about \$4.5 bln per year over the past five years to replace or repair about 3,000 km of trunk pipeline per annum. Gradually quadruple that pace and you would get a 15-year, \$250 bln investment project, or \$15-20 bln per year of upgrades. That would help keep investment, which is elevated in 2018-19, from subsequently sagging as the Power of Siberia, Turkish Stream and Nord Stream-2 projects expire. Gazprom could claim it as necessary “maintenance” capex. Unfortunately for shareholders, this would generate not a dime of incremental revenues.

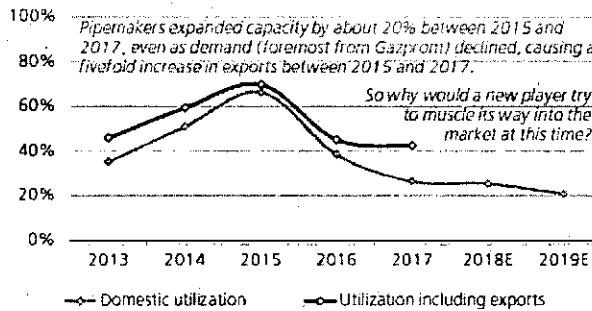
**Gazprom's investment into legacy pipelines could quadruple to maintain the elevated investment program, \$ bln**



Source: Company, Sberbank CIB Investment Research

The Russian makers of large-diameter pipes certainly have enough capacity to satisfy Gazprom's needs. The domestic utilization of large-diameter pipe capacity fell to just 27% last year and is expected to decline to little more than 20% by 2019. This has forced producers to increase their exports, but they were still unable to utilize more than half of their capacities.

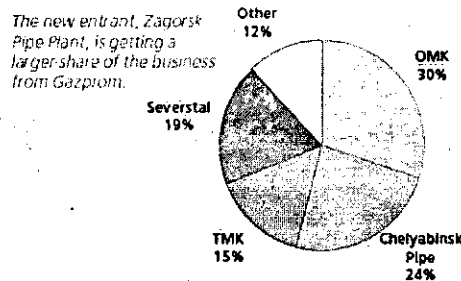
**Capacity utilization for producing large-diameter pipes**



Source: Metall Expert, Pipe Industry Development Fund, Vedomosti, Sberbank CIB Investment Research

The best indicator that Gazprom may be planning a large transport program is that, despite this being the trough of the market, a brand-new large-diameter pipe producer has managed to emerge – the Zagorsk Pipe Plant. A major Zagorsk shareholder is Nikolai Egorov, a lawyer and the university classmate of the Russian president. Zagorsk was successful in grabbing a share of Gazprom's orders for large-diameter pipes from the four large Russian producers last year.

**Russia's large-diameter pipe producers in 2017 (total: 1.6 mln tonnes)**



Source: Chelyabinsk Pipe, Vedomosti

Experts cited in the newspaper Kommersant voiced concern about the new competitor arriving in an already declining market. But it may be that, instead, Zagorsk's entrance is a sign that the large-diameter pipe market will soon get a major boost.

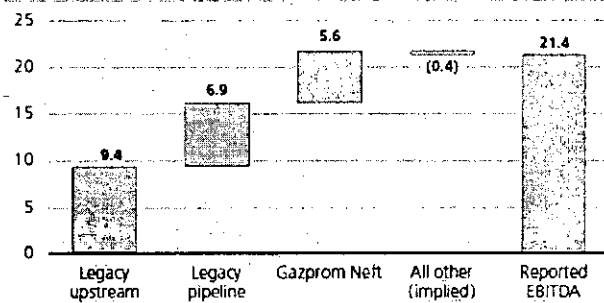
We have outlined so far that Gazprom's focus seems to be heavily influenced by its domestic contractors, more so than by pure profit-seeking on its own behalf. The projects that Gazprom has managed to *forgo* also testify to this. Gazprom's luckiest miss, cited by its top managers at one of the recent investor days, was to have abandoned in time the Arctic offshore Shtokman project, which had aimed to deliver up to 33 mln tonnes of LNG to the US market just as the US was pivoting toward becoming a net exporter of gas. We reckon that it was partners Total and Statoil who stayed Gazprom's hand. But it is of note that Gazprom's main onshore contractors could not have profited much from the offshore project, which would have required most of the equipment to be imported and would have been closely overseen by foreign partners. The same logic might explain the delay in the investment decision for Baltic LNG, a modest-sized liquefaction facility that Gazprom plans on building with Shell (but may in the end construct anyway as part of a larger Baltic GPP program – see the discussion above).

### Quantifying a dream

Let's finish our discussion with a bit of a tease. What would Gazprom be worth in a blue-sky scenario – if it were broken up into parts and these parts were to cease undertaking new projects?

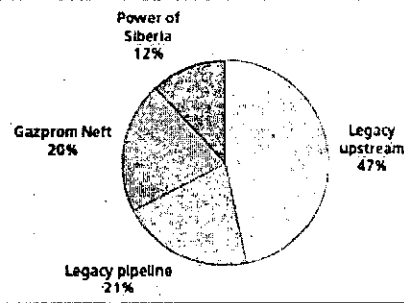
The company basically consists of four businesses: brownfield upstream; a transportation arm; Gazprom Neft, the crude oil producer and refiner; and, soon, the Power of Siberia, which is physically separated from the rest of Gazprom's network. Modeling these four parts separately gives us a pretty close approximation of Gazprom's reported operating earnings. There are also sundry assets in power generation, local gas distribution, gas processing and trading, a finance arm and even an airline – the underlying profitability of these assets is hard to derive but seems to be slightly negative on the whole. Finally, there is a 9.9% stake in Novatek.

Gazprom's 2016 EBITDA breakdown, \$ bln



Note: EBITDA presented ex-provisions (differs from the number in the financial table in the back)  
Source: Company, Sberbank CIB Investment Research

Gazprom's EBITDA split by 2025 (total: \$49 bln)



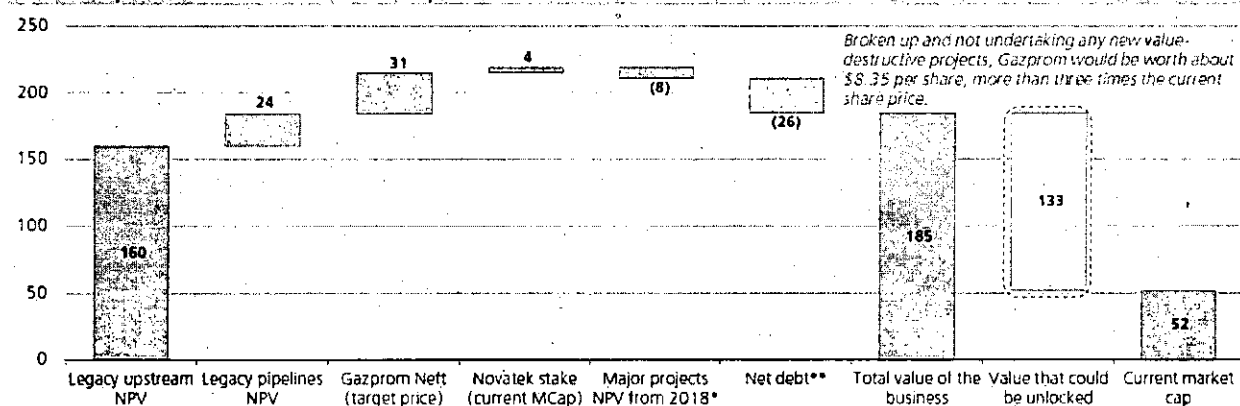
Source: Sberbank CIB Investment Research

- Upstream legacy.** This business sells gas both for export and in the domestic market, and also monetizes the associated condensate. If we look at it as a standalone entity, it would generate about \$18 bln of EBITDA this year, double that of the trough year of 2016 and representing over half of Gazprom's consolidated total. The business requires just \$3 bln of annual capex to run (these numbers align with Gazprom's own disclosures). The cost of production comes to about \$0.17 of capex to generate \$1 of EBITDA.
- Pipeline business.** Gazprom's pipeline business can be modeled by assuming that as a standalone entity it would get to charge Gazprom's upstream business for gas transportation, just as it currently charges the independent producers. Its main operating costs are materials (for pipeline repairs), the technical gas it uses to power compressor stations and the cost of employing some 120,000 staff. This business charges a ruble-based regulated tariff, and therefore its

profitability sustained a significant hit with the devaluation of the ruble in 2014-15. We estimate that it made about \$8.5 bln in EBITDA in 2017 (thanks to higher export volumes) but needs to invest almost \$5 bln per year to replace older pipelines. Thus, its derived NPV of below \$25 bln is less than a third of what we would have estimated before the ruble devaluation.

- **Gazprom Neft.** This is of course a traded entity and boasts almost half of Gazprom's entire market cap, although we estimate it contributes less than a third to the group's consolidated EBITDA. Gazprom has accumulated a 96% stake in Gazprom Neft and refuses to place some of the shares in the market to make the stock more liquid; Gazprom Neft's free float is just \$1 bln. The interesting question is what Gazprom Neft would be worth with a proper free float of at least 15-20%, which would make it a constituent in the leading equity indexes. We think it would be worth at least our target price valuation, some 40% north of the current market share price (see the discussion in our February 2018 report, "Six Easy Pieces"). The same cannot be said for Gazprom's stake in Novatek, the price of which should not be much affected were Gazprom to sell it to other holders.
- **Power of Siberia.** This may be an NPV-negative project, but it will be worth more every year that the development capex is sunk: we already forecast the NPV will rise to approximately zero in 2019. Still, most of the investment has yet to come, so we assign a negative value to it.

#### What Gazprom could be worth broken up, \$ bln



Note: We assume a 10% discount rate on the different parts of the business and a \$65/boe oil price.

\* negative remaining NPV of Power of Siberia, Turkish Stream and Nord Stream-2

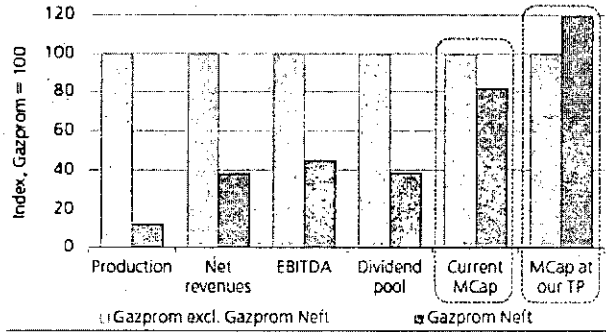
\*\* net debt excluding Gazprom Neft's net debt (already expressed in Gazprom Neft's market equity value)

Source: Sberbank CIB Investment Research

Tying all this together with our 10% discount rate implies a break-up value of \$185 bln, or \$8.35 per Gazprom share – over three times the price at which the shares trade today. In other words, the market is discounting over \$130 bln from the value of Gazprom's future cash flows. We have already demonstrated why it is doing that: the value-destructive investments are unlikely to abate. But if, by some miracle, they were to stop, our estimate gives some idea of the true latent value of the company.

Today, the market values Gazprom Neft, Gazprom's well-run liquids subsidiary, at almost as much as it values Gazprom's entire gas business. This is despite the fact that few institutional investors can even buy Gazprom Neft's stock due to its low free float. Such a situation demonstrates that the blue-sky valuations outlined above are not unreasonable. The market will reward Gazprom if it sees any movement in the right direction.

**Gazprom Neft is now almost more highly valued than Gazprom, despite being a much smaller company**



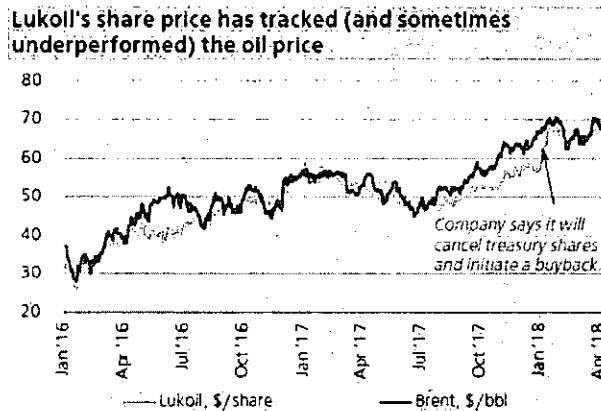
*The well-run Gazprom Neft – despite its low free float and the fact that it is answerable to Gazprom – is valued much higher than its parent company.*

Source: Companies, Bloomberg, Sberbank CIB Investment Research

If contractors continue to set Gazprom's agenda, however, the company won't be rewarded. We note, however, that the government reshuffle, which is possible later this month, may well present the best opportunity for the next six years to reorient Gazprom's priorities. This is why we have retained a low-conviction, speculative BUY on the stock – though we are not much hopeful of a change.

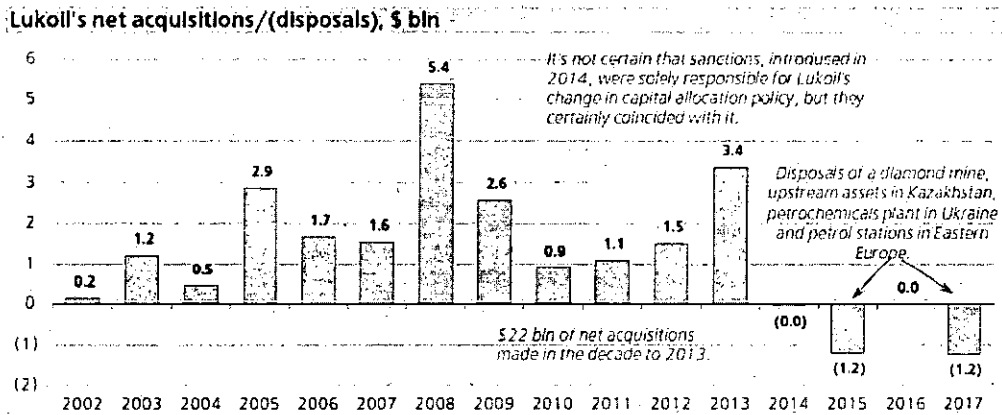
## Lukoil: Will They Walk the Walk?

For the past two years, Lukoil's stock has largely been trading in line with the oil price. Sometimes it has underperformed for a stretch, including since the new US sanctions news in early April. Never, however, has it broken out above the oil price for more than a few days.



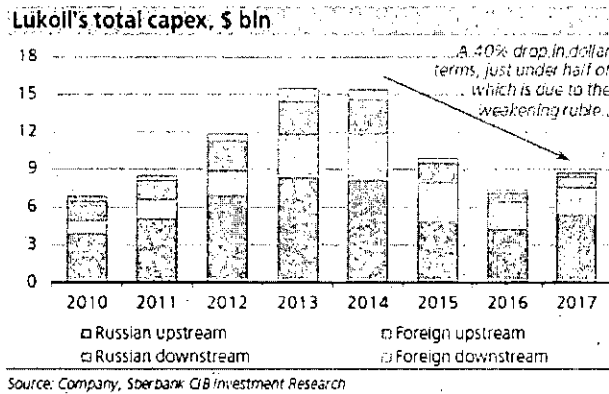
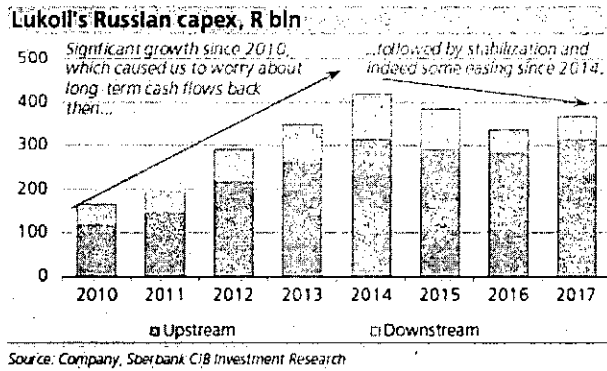
Note: Chart stops before the market response to sanctions in early April.  
Source: Bloomberg, Sberbank CIB Investment Research

Meanwhile, Lukoil's business and cash flows have remained strong, and the management has continued to exercise discipline in allocating capital. The company has purchased very little since the \$2 bln acquisition of Samara-Nafta in 2013, and in fact over 2014-17 it disposed of non-core assets, including small-scale upstream facilities in Kazakhstan in 2015 and a diamond mine in 2017.

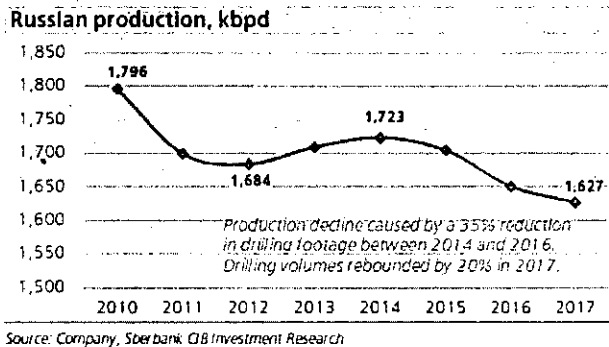
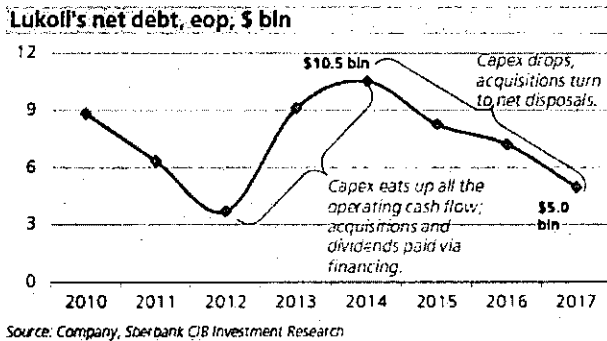


Source: Company, Sberbank CIB Investment Research

Capex in Russia dropped by about 12% in ruble terms between 2014 and 2017, though Russian crude production also declined, by about 5%. Total capex has dropped by 40% in dollar terms since 2014, of which less than half can be attributed to the fall in the ruble since then (which reduced Russian capex in dollar terms).

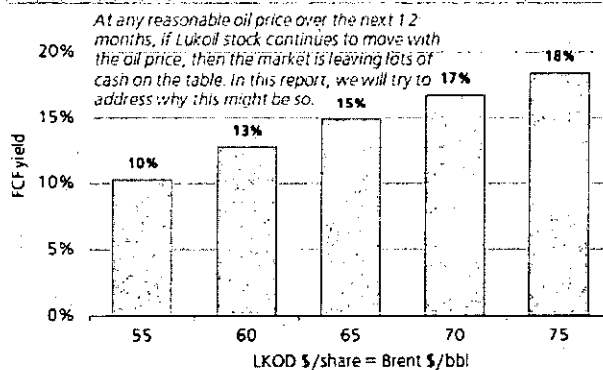


The steady cash flow generation that this policy has brought about has helped to halve the net debt since 2014 to below \$5 bln, or about a third of annual EBITDA.



Within the recent oil price range, when Lukoil's stock price has been reflecting the oil price, it has offered a free cash flow yield to EV of 13-17%. Meanwhile, in January, Lukoil said it would cancel 100 mln of its treasury shares, removing a major overhang some investors had been worrying about.

### Lukoil's FCF yield at various prices, assuming the stock trades with Brent



Note: Free cash flow yield to EV, excluding WC adjustments. EV is calculated as the number of shares ex-treasury (710 mln) times the share price, plus net debt (\$5.0 bln). Assumes core \$8 bln capex.  
Source: Sberbank CIB Investment Research

We see three possible reasons why the market is leaving so much cash on the table: uncertainty over capital allocation, uncertainty over the company's future, or some issue preventing global energy funds from becoming new investors.

The management, as we discuss below, convincingly addressed the first point at the recent investor day. Its guidance should help the stock to re-rate over the next 12 months, in our view.

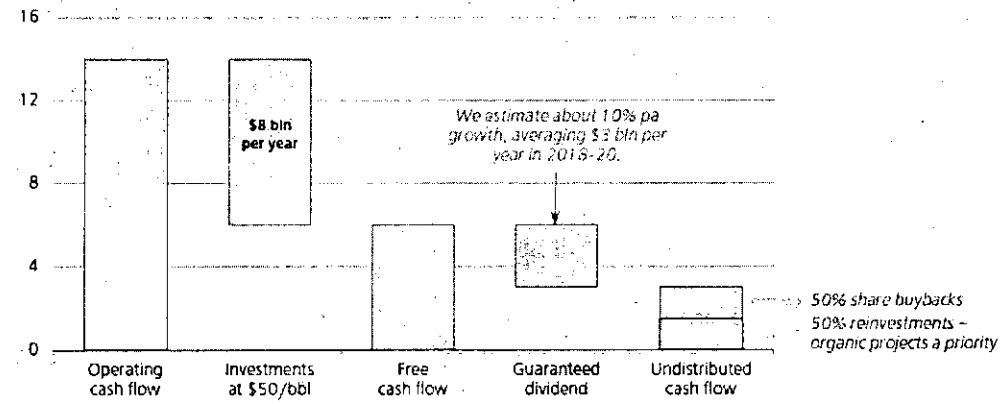
If the stock doesn't rerate, this could signal that the market does not yet fully believe the management. Or it could mean that it is lending greater weight to some unspecified dangers lurking for what is Russia's largest remaining private company. We will address why that might be the case, and to what extent it would be justified.

Finally, a problem of sentiment preventing energy funds from acquiring the name should be easier for the company to address than concerns over who will control Lukoil in the future.

**Putting its cards on the table**

Lukoil has now outlined its capital allocation policy simply and clearly. Capex will be \$8 bln per year at an oil price of \$50/bbl. The company will also increase the dividend in line with Russian inflation at the very least (for 2017 the hike was 10%). It then promises to split the balance of cash flows after capex and dividends equally between share buybacks on the open market and additional investments. The buyback will total at least \$3 bln over five years, though if the company sticks by its promise, we expect it to be much higher.

**Lukoil's new capital allocation policy in a nutshell**

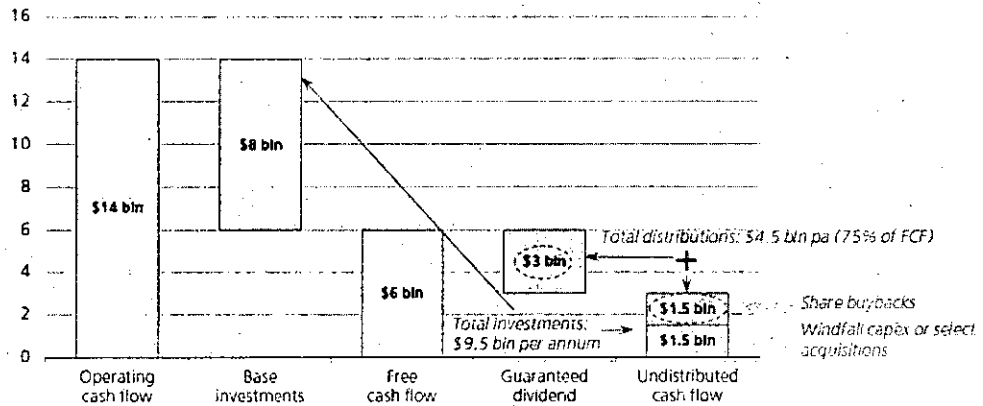


Source: Company

In 2018-20, we expect Lukoil to generate roughly \$6 bln per year in free cash flow at a conservative oil price assumption of \$60/bbl and the \$8 bln guided capex. Half of that will go to dividends, which implies buybacks of up to \$1.5 bln per year and additional investments of \$1.5 bln.

The upshot is that three quarters of the free cash flow is planned to be distributed. Even if we assume half of the additional \$1.5 bln in annual capex is wasted, this would still imply that nearly 90% of the roughly 15% free cash flow yield generated by the company will find its way to shareholders, most of it via distributions and some of it via investments that improve the company's ability to generate cash in the future. There is little here to suggest that shareholders should be discounting this free cash flow so much as to demand a 15% yield.

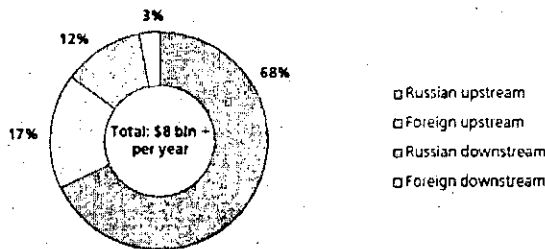
**Lukoil's new capital allocation policy at \$60/bbl oil price**



Source: Company, Sberbank CIB Investment Research

Lukoil has de-risked its cash flows in another way: by outlining a breakdown of its capex over the next 10 years. Investments will be heavily skewed toward the Russian upstream, where the company has a competitive advantage. The foreign downstream, where Lukoil's management has arguably shown the least competency, will receive just 3% of Lukoil's investments, the company has promised.

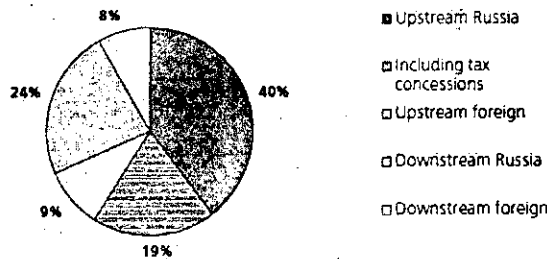
**Base Investments in 2018-27**



Note: Half of the free cash flow left over after these base investments and after the dividend will be directed to additional investments, either capex or acquisitions.  
Source: Company

The Russian upstream capex will have two main aims: supporting brownfield production and harvesting greenfield tax breaks. We discussed the sources of Lukoil's earnings in our October 2016 report "Lukoil: Ward of the State." Upstream tax breaks of various kinds make up a third of the earnings of the company's Russian upstream, and over 20% of Lukoil's total EBITDA.

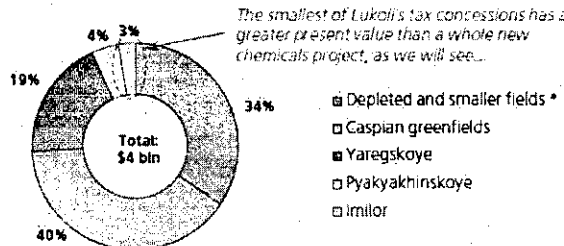
**Lukoil's EBITDA breakdown in 2017**



Source: Company, Sberbank CIB Investment Research

To illustrate their continued relevance, let's compare the recent tax concessions captured by Lukoil for its Imilor field with the only new project it mooted at its investor day: the \$2 bln gas chemicals plant at Budyonnovsk in the Caucasus.

**Breakdown of tax concessions to be enjoyed by Lukoil by 2020**



Note: at \$60/bbl oil price  
 \* including some smaller greenfields, such as Usinskoye and Vingradov  
 Source: Sberbank CIB Investment Research

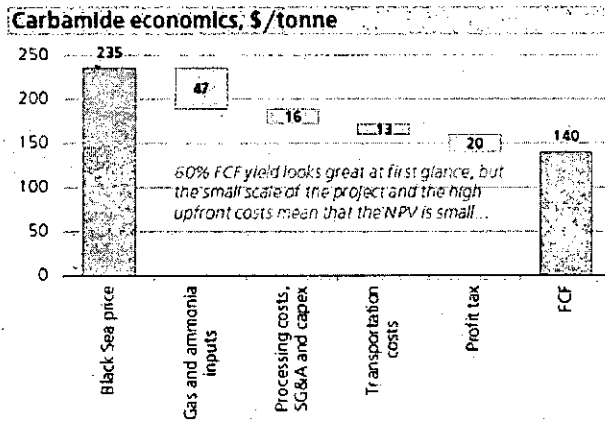
In our October 2016 report, we identified Imilor, a new field in West Siberia, as Lukoil's least profitable acreage. However, with the new tax breaks just recently won, Imilor has become more profitable than the average brownfield development, at least after the development capex. The field qualified for what is in practice a circa 50% MET discount over 15 years after Lukoil succeeded in reclassifying Imilor's reserves as low permeability. This is worth about \$10.5/bbl of pretax savings. We estimate that this one change will add almost \$2 bln to the field's operating earnings over the next 15 years – and even more if Lukoil manages to extract oil from the field's tight oil layers, which pay almost no MET. These tax savings will start flowing immediately and require no capital investment, and we estimate their net present value to Lukoil (post-tax) at almost \$800 mln, or about \$1.1 per share.

**Profitability of Lukoil's different crudes in 2019, \$/bbl**

	Revenues	MET	Export duty	Lifting cost	Transport cost	EBITDA	Profit tax****	OCF	OCF brownfield ratio	Tax burden*****
<b>Standard Russian brownfield</b>	<b>60.0</b>	<b>22.7</b>	<b>14.5</b>	<b>4.1</b>	<b>4.0</b>	<b>14.7</b>	<b>2.9</b>	<b>11.8</b>		<b>67%</b>
Yaregskoye	60.0	-	1.5	7.2	3.0	48.4	9.7	38.7	2.9	19%
Filanovskoye	62.8	9.0	-	2.8	3.5	47.4	9.5	37.9	2.9	29%
Rakushechnoye	62.8	9.0	-	2.8	3.5	47.4	9.5	37.9	2.9	29%
Pyakyakhinskoye *	68.7	9.4	14.5	3.6	5.9	35.3	7.1	28.2	2.1	45%
Yury Korchagin **	60.0	9.5	14.5	2.8	3.5	29.7	5.9	23.7	1.8	50%
Imilor ***	60.0	12.1	14.5	7.1	4.0	22.3	4.5	17.8	1.3	52%
<b>Lukoil's brownfield</b>	<b>60.0</b>	<b>19.3</b>	<b>14.5</b>	<b>5.7</b>	<b>4.0</b>	<b>16.5</b>	<b>3.3</b>	<b>13.2</b>	<b>1.0</b>	<b>62%</b>

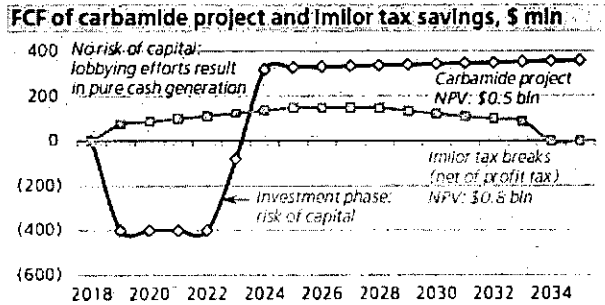
Note: Assumes tax rates at \$60/bbl oil price  
 \* oil, gas, condensate average at Pyakyakhinskoye  
 \*\* Yury Korchagin field to pay the full export duty from 2019  
 \*\*\* Imilor has qualified for MET tax breaks from 2019  
 \*\*\*\* profit tax estimates assume no regional discounts  
 \*\*\*\*\* tax burden as a percent of revenues  
 Source: Company, Sberbank CIB Investment Research

Compare this purely administrative coup to what Lukoil would get from its gas petrochemicals project in the Caucasus. The idea is to better monetize the gas cap of Lukoil's crude oil fields in the offshore Caspian, Yury Korchagin and Filanovskoye (and by 2023, Rakushechnoye). Gas would be processed into ammonia and then into carbamide (urea), a nitrogen source for fertilizers.



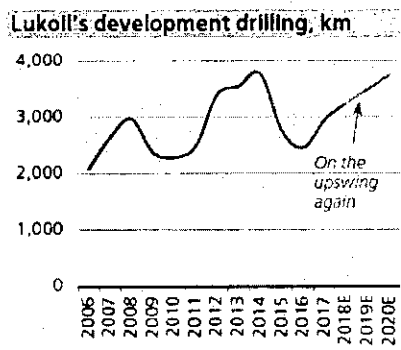
Source: Sberbank CIB Investment Research

Constructed at a cost of \$2 bln over five years, the plant would generate about \$0.3 bln in annual cash flows, we estimate. The current NPV of the project comes to about \$0.5 bln, or about \$0.7 per Lukoil share: roughly 60% of the value that shareholders would reap from Imilor's tax breaks.

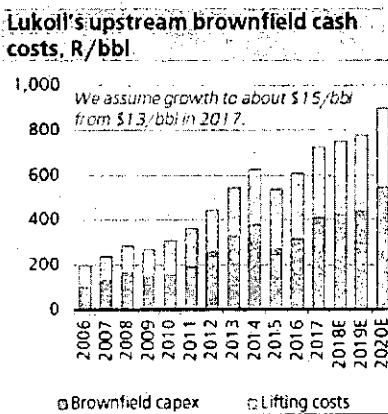


Source: Sberbank CIB Investment Research

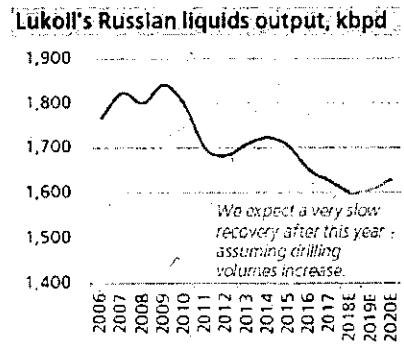
So one part of Lukoil's continued focus on the Russian upstream will necessarily involve seeking out acreage where production can be converted into more tax benefits. Another part will entail slowing down the decline rate at the brownfields from about 8% recently to 2-3% by 2020, which would necessitate more drilling (part of the brownfield capex). We estimate that brownfield capex per barrel has been rising at about 15% per year since 2010, and it rose by 30% in 2017 as the company intensified drilling. While we have long been worried about Lukoil's growing production costs, it remains the case that brownfield investments still provide double-digit returns, on our estimates. They are a better proposition than most new foreign projects.



Source: CDUTEK, Sberbank CIB Investment Research



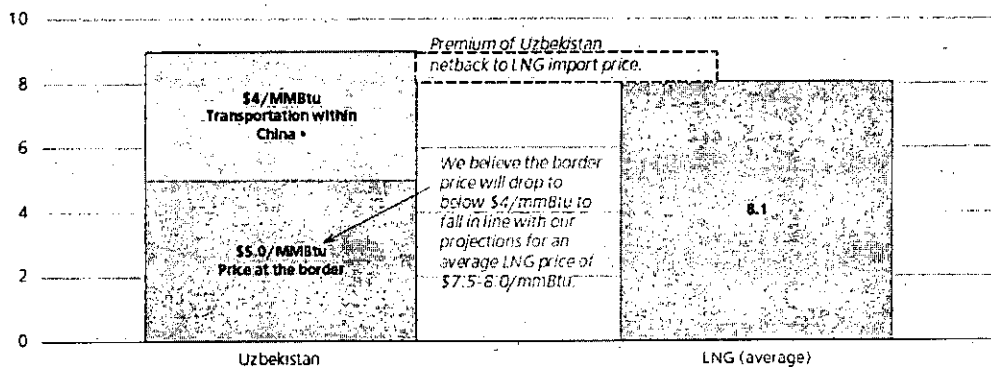
Note: Excluding Iraq.  
Source: Company, Sberbank CIB Investment Research



Source: CDU TEK, Company, Sberbank CIB Investment Research

Lukoil plans to devote just 20% of its capex to foreign projects, and we think the bulk of that, at least over the next three years, will continue to go to gas production in Uzbekistan. We might be underestimating this opportunity: we calculate free cash flow to Lukoil averaging about \$0.3 bln per year from 2020, while Lukoil is guiding for about twice that much. However, our estimates are based on the expectation that China (where most of the gas will soon be heading) will start driving a harder bargain on Central Asian pricing in the future as it tries to bring the pipeline export netback to the eastern seaboard roughly in line with that of the plentiful LNG. We discussed this in relation to the Turkmenistan imports in our October 2017 report.

**China gas import price by source in 2017, \$/MMBtu**



\* via the West-East Gas Pipeline to Shanghai.  
Source: IHS CERA, Oxford Institute for Energy Studies, Sberbank CIB Investment Research

Elsewhere abroad, Lukoil has said it will seek out exploration projects but will be accompanied by partners (for instance, by Chevron in West African exploration). We raised flags about Lukoil's questionable practices in its previous West African ventures in our October 2016 report. Being chaperoned by partners should in theory prevent such practices in the future. Finally, the company said that acquisitions would not be a priority. CFO Alexander Matytsyn said Lukoil has reduced its appetite for risk.

Over the years, we have written several reports arguing that Lukoil's stubbornly high FCF and dividend yield were due to uncertainty about capital allocation. We urged the company to do something about this – and now it has.

So if the stock fails to rerate, the answer as to why must be sought elsewhere. Below we offer several suggestions on what might prevent it.

### The market might not believe the management

It might simply be that the market will take a “we’ll believe it when we see it” approach to Lukoil’s newfound capital discipline. After all, the management hasn’t exactly built up a sound reputation. The equity-linked notes (ELN) affair, which unfolded as recently as 2015, involved the company converting ELNs into Lukoil shares for its treasury at above-market prices; we discussed in our August 2015 report why we believe Lukoil top managers could have been the ultimate beneficiaries of this transaction.

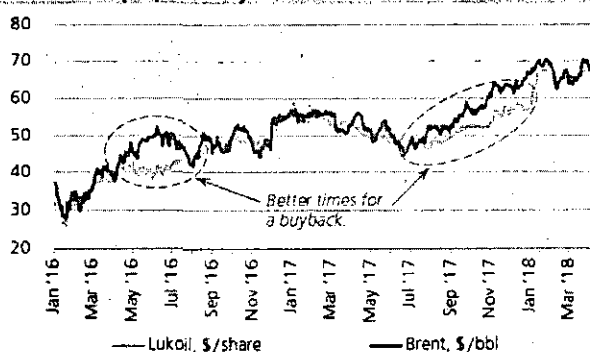
The previous buyback, announced in 2012, was designed to scoop up the Conoco-owned shares Lukoil hadn’t bought yet, and involved those ELNs. We have heard investors wondering whether the recently announced buyback, too, may be designed to reward an exclusive group of shareholders. (Lukoil says this time around it will be buying stock on the open market.)

Small inconsistencies have crept into the recently unveiled program, too. The share cancellation announced in January and promised to be implemented in 2018 has been pushed back to 2019, for technical reasons. And the company has presented no clear plan for how it will conduct the buyback, or who will oversee it.

On the other hand, it has confirmed that the initial \$3 bln share repurchase program will be renewed upon completion. As we discuss above, the company should be spending \$1.5 bln on buybacks at an oil price of \$60/bbl to fulfill its guidance to channel 50% of free cash flow after dividends to share repurchases, thus going through the program in two years rather than the targeted five. Lukoil has also confirmed the repurchased shares will be cancelled.

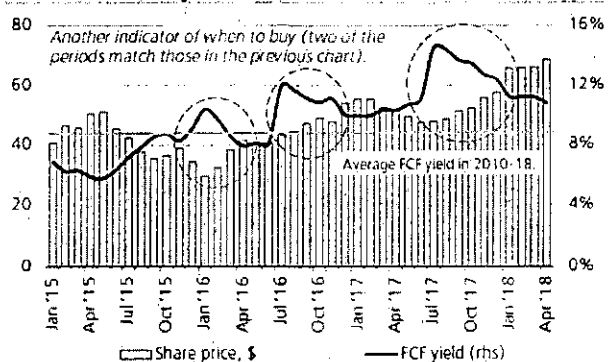
Experience suggests that a successful buyback can either be regular, as beloved by the cash-churning tobacco companies, or opportunistic. The latter approach ultimately creates much more value – it is associated with such CEOs as John Malone and Henry Singleton, whose returns to shareholders blew the competition out of the water (William Thorndike’s book, *The Outsiders*, discusses their strategies). But we wonder whether investors can rely on Lukoil’s management to identify when to step up share purchases and when to ease off. Lukoil’s president and CEO Vagit Alekperov has repeatedly stated that the market undervalues the company, but the market presumably undervalues it more at some times than others, such as when the stock price trades significantly below Brent, implying a higher FCF yield. For instance, the market correction in early April on the back of new US sanctions would have been a perfect time to intensify the buyback, but sadly the company was not yet ready to do that (we will return to sanctions later). History also suggests that Lukoil can be picked up at higher yields when Brent is breaking out, since the stock typically lags it.

**Lukoil's share price v crude oil could be one indicator for when to step up the buyback.**



Source: Bloomberg, Sberbank CIB Investment Research

**... free cash flow yield could be another**



Note: Free cash flow yield based on next 12 months' average free cash flow stripped of working capital changes.

Source: Bloomberg, Sberbank CIB Investment Research.

If, as Alekperov said at the March investor day, the market has always undervalued the company, year in and year out – and its average FCF yield of almost 9% in the past decade would seem to confirm that – then isn't it about time that Lukoil's management reflect upon its role in this? The CEO is an example of the curious phenomenon among the leaders of Russian energy companies: they tend to perform the function of a chief operating officer (COO, or what goes under the equivalent title of "president" in some companies), rather than the function of chief executive officer. In other words, they spend their time actually running the company, often delving into the minutiae of production and logistics instead of delegating that responsibility and devoting their energy to thinking how to best allocate capital. Below we divide the top executives into broad categories of perceived primary focus, based purely on our subjective assessment after more than a decade following their companies. As becomes apparent, those leaders who focus on capital allocation tend to outperform those who primarily direct their time to operations.

#### How have Russian energy executives performed for shareholders?

Company	Head	Background	Primary focus*	Annual TSR**	RTS TR**	Relative performance	Note
Tatneft	Nail Maganov	Industry	Capital allocation / operations	16%	1%	15%	Significant dividend increase.
Novatek	Leonid Mikhelson	Industry (energy transportation)	Operations/capital allocation/government relations	20%	8%	12%	Focus on risk management in major projects.
Bashneft	Alexander Korsik (former)	Foreign relations, finance	Capital allocation	7%	-3%	10%	Preparations for London listing.
Transneft	Nikolai Tokarev	Political appointee	Government relations	7%	-1%	8%	Much of free float captured by select investors.
Bashneft	Andrey Shishkin (current)	Finance, government	Not clear	29%	22%	7%	Preferred shares raked from a low base.
Gazprom Neft	Alexander Dyukov	Political appointee/Sibur	Government relations	7%	1%	6%	Good operating performance hampered by small free float.
<b>Lukoil</b>	<b>Vagit Alekperov</b>	<b>Industry, government</b>	<b>Operations</b>	<b>18%</b>	<b>18%</b>	<b>0%</b>	
Rosneft	Igor Sechin	Political appointee	Operations/government relations	-1%	1%	-2%	
Surgutneftegaz	Vladimir Bogdanov	Industry	Operations	16%	18%	-2%	
Gazprom	Alexei Miller	Political appointee	Not clear	11%	18%	-7%	

\* determining the primary focus involves a subjective analysis based on press reports and our own assessment

\*\* total annual dollar shareholder return (including dividends) during the tenure, since the company's IPO or since the start of this century if the IPO happened before 2001; RTS return based on the identical period; current period ended March 31, 2018

Note: Returns based on the most liquid share class performance: common shares for Tatneft; simple average of common and preferred shares for Surgutneftegaz; common shares for Bashneft during Korsik's tenure; preferred shares for Bashneft during Shishkin's tenure.

Source: Companies, Bloomberg, Sberbank CIB Investment Research

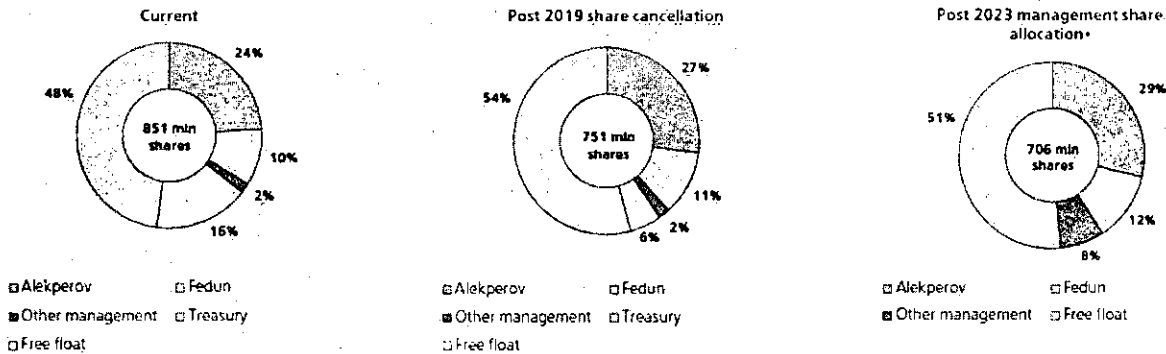
It might take some time for Lukoil to generate investor confidence this time around. Specifically outlining the rules or a schedule for share repurchases and subsequent share cancellation would represent an important step forward, in our view.

#### The market might fear a change in control

Even if the company strengthens investor confidence in its new capital allocation program, the market might continue demanding higher yield from the shares, fearing an eventual change of control. Admittedly there is little that the management could do to address this point. However, Alekperov's decisions announced so far could lead to a worse outcome for minority shareholders, in our view.

Alekperov has reiterated several times now, most recently at the March investor day, that he has bequeathed his shares in a trust to his family as part of a contingent legacy. Family members will be unable to sell any part of the stake. Alekperov's stake by then may well include Leonid Fedun's 10% share, too: Lukoil's CEO has in the past stated that if Fedun ever decides to sell, he would be required to sell to Alekperov.

**Lukoil shareholders**

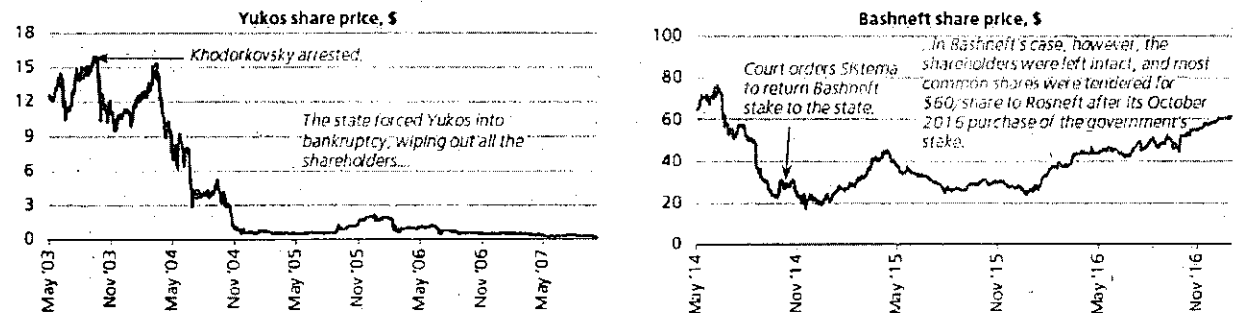


\* assuming \$3 bln in total buybacks by then, at a share price of \$67.50; the company's guidance leaves room for a bigger buyback  
 Source: Company, Sberbank CIB Investment Research

We discussed a potential problem with this arrangement – as far as minority shareholders are concerned – in our October 2016 report. Let's say a politically powerful entity makes an offer for the heirs' stake. If they are unable to sell, the pursuer could then try to drive the company into bankruptcy or force it to shed its assets at low prices (what we termed the "Yukos scenario"). One way to do that would be via tax claims; another way would be by going after Eurasia Drilling Company (EDC), which is contracted to provide almost all of Lukoil's drilling. Diverting EDC's services could cripple Lukoil's business. Either tactic would harm all Lukoil shareholders.

On the other hand, if the heirs were able to sell, the share price could undergo short-term volatility related to the change of control but might ultimately recover (the "Bashneft scenario").

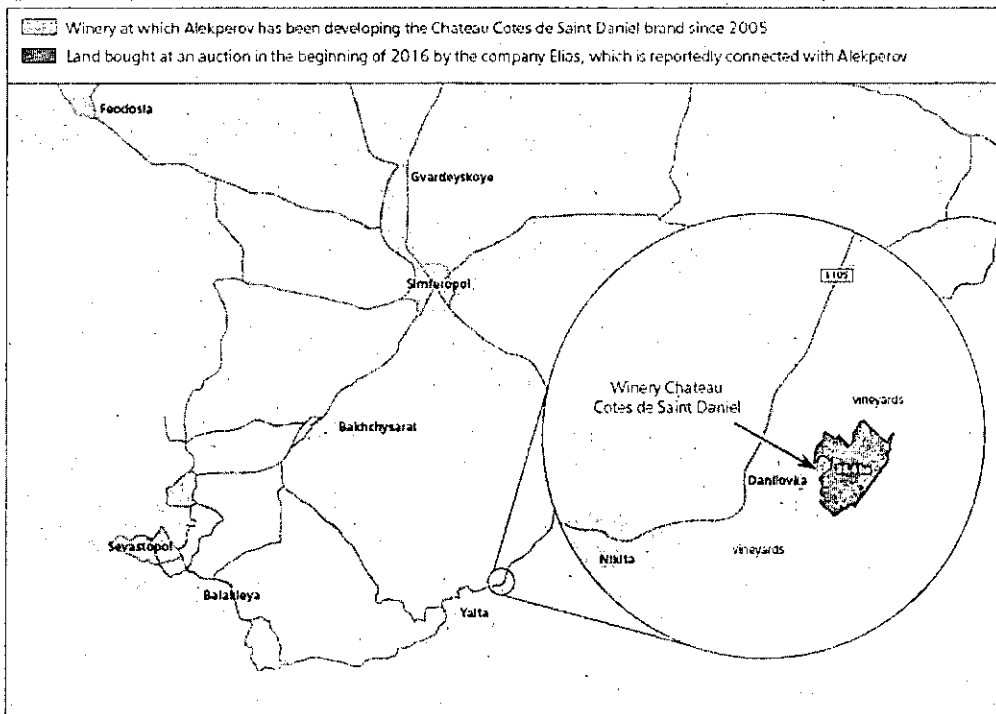
**A tale of two confiscations – from the perspective of minority shareholders**



Source: Bloomberg, press reports, Sberbank CIB investment Research

This is not an imminent threat. Alekperov, who is 67 years old, could end up controlling and running Lukoil for many years to come. Moreover, a politically powerful pursuer would probably have some influence with the Russian courts, which could well nullify the contingency and allow the inheritors to dispose of their shares.

A more pertinent risk related to Lukoil's main shareholders could emerge from Crimea. RBC reported in 2016 that Elias, a firm it says has ties to Alekperov, had bought 36 hectares (90 acres) of vineyards in the peninsula, near Alekperov's existing winery there. This was two years after the US had prohibited making "new investments" in Crimea, although it is applicable specifically to US persons, which Alekperov does not appear to be.

**Crimean properties tied to Lukoil's CEO**

Note: Ownership reported by RBC and not confirmed.  
Source: RBC

Until recently, this transaction would have been of no concern to minority shareholders, as any potential risk from it would have been confined to Alekperov and Elias. But on April 6, the US Treasury Department for the first time announced that US persons must cease transacting in securities in three companies controlled by Oleg Deripaska, a sanctioned person. If America's displeasure ever extends to Alekperov, it now has set a precedent for forcing its investors (which in practice includes non-US funds catering to US investors) to dispose of Lukoil shares, because a case could be made that Alekperov controls Lukoil in practice.

We have no way of assessing the likelihood of this. However, such a drastic step cannot be ruled out precisely because US investors in practice own so few Lukoil shares, so the pain this would cause them would be limited. Americans who do own Lukoil tend to hold it as emerging markets exposure; Lukoil composes just 0.45% of the MSCI EM index.

### The market might be starved of the marginal investor

Perhaps the key reason why Lukoil's stock might find it hard to break out of parity with Brent is low demand from big energy funds.

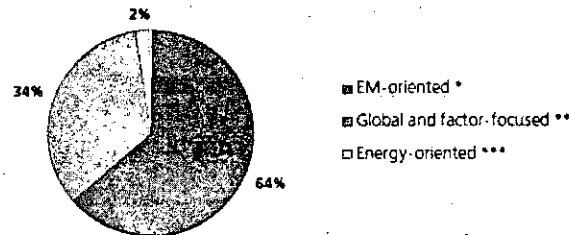
There are two basic mechanisms through which a stock price can go up. One involves relative reallocations within a given space – say, the Russian energy sector. The pool of money doesn't change. So for Lukoil's stock to go up, the stock price of Rosneft or another company would need to come down (as investors holding the same amount of cash would need to sell down Rosneft to afford paying more for Lukoil). As sector analysts, relative exposure and performance within the sector is what we spend all of our time trying to advise and forecast.

In real life, however, a more powerful mechanism is at work: allocations to or from entire sectors, geographies and asset classes represented through fund flows. This explains why over most time periods, Lukoil and Rosneft shares tend to move in the same direction. Flows are the only way the

sector as a whole can move up or down. It is then up to sector portfolio managers (or tracker funds) to decide whether to buy or sell more of one stock or another as they receive inflows or face outflows.

For Lukoil and other Russian energy companies, one particular problem appears to be the unwillingness of global energy funds to buy their shares. These stocks are well represented in EM indexes, but global energy funds have almost no exposure to them. As a result, stock prices inordinately depend on flows to and from EM-oriented funds.

#### Lukoil's ownership among tracked global funds



\* focus on emerging markets, Eastern Europe or Russia

\*\* international funds, typically non-biased, value-focused or dividend-focused

\*\*\* funds focused on energy, commodities or natural resource sectors

Note: Factset data tracks about 45% of Lukoil's free float.

Source: FactSet, Sberbank CIB Investment Research

There are several reasons for this. The first and foremost is that most energy funds are specifically focused on companies in developed markets, particularly in North America. Another is that some shun Russia. Both of these restrictions will be hard for Lukoil to address. But the third reason is that many energy PMs are not restricted from investing in Russia but don't want to take exposure to what has historically been a difficult market to cover. Assuming they don't want to leave money on the table either, the new capital allocation policy presents an opening for Lukoil to change minds. The management could devote less time selling the company to EM funds and instead could reach out to the folks they have never met before.

## Valuations

### Expected dividend yields for companies we cover

	2017	2018E	2019E	2020E
Gazprom	6%	6%	6%	6%
Lukoil	6%	6%	7%	7%
Rosneft	3%	5%	8%	8%
Novatek	2%	2%	3%	4%
Gazprom Neft *	5%	10%	11%	14%
Surgutneftegaz commons	2%	2%	2%	2%
Surgutneftegaz prefs **	5%	1%	9%	9%
Tatneft commons	6%	6%	7%	7%
Tatneft prefs	9%	9%	9%	9%
Bashneft commons ***	8%	13%	15%	14%
Bashneft prefs ****	10%	16%	19%	18%
Transneft prefs ****	4%	5%	5%	6%

\* for Gazprom Neft assume gradual increase in payout to 50% by 2020 (from 28% for 2017).

\*\* Surgutneftegaz preferred dividend for 2018 is based on the assumption of R60/USD closing rate for the year.

\*\*\* For Bashneft, assume a 50% IFRS payout from 2017 onwards.

\*\*\*\* Transneft dividend assumes a 25% IFRS payout.

Note: For other assumptions used in calculating yields, please inquire with Sberbank CIB Investment Research team.

Source: Sberbank CIB Investment Research

### Expected free cash flow yields for companies we cover

	2017	2018E	2019E	2020E
Gazprom	neg	neg	neg	8%
Lukoil	11%	12%	13%	13%
Novatek	5%	6%	5%	10%
Gazprom Neft	6%	10%	9%	13%
Surgutneftegaz *	24%	17%	18%	18%
Tatneft	8%	7%	9%	10%
Rosneft	neg	9%	9%	10%
Transneft	2%	7%	10%	11%
Bashneft	8%	9%	14%	16%

\* FCF of Surgutneftegaz is divided by market cap, because the enterprise value is impaired by a large cash position. FCF is influenced by monetary gains and losses through tax payments

Note: Free cash flow yield is actual or expected free cash flow divided by enterprise value (EV).

Source: Sberbank CIB Investment Research

### Comparative multiples-based valuations

	P/E			EV/EBITDA		
	2018E	2019E	2020E	2018E	2019E	2020E
<b>Russia</b>						
Gazprom	2.9	2.6	2.6	2.6	2.5	2.4
Lukoil	4.5	4.6	4.7	2.8	2.8	2.8
Novatek	12.7	8.8	6.9	9.9	10.0	8.8
Gazprom Neft	3.4	3.7	3.6	3.4	3.9	3.8
Surgutneftegaz	3.3	3.8	3.9	neg	neg	neg
Tatneft	8.1	8.0	8.0	5.3	5.2	5.1
Rosneft	11.1	6.5	6.0	5.7	5.1	5.1
Transneft	5.2	4.7	4.2	3.3	3.1	2.9
Bashneft	3.5	3.1	3.2	2.6	2.4	2.4
<b>Emerging markets</b>						
Sinopec	11.2	10.8	10.8	3.8	3.6	3.4
CNOOC	10.2	10.0	9.5	4.5	4.4	4.4
PetroChina	25.2	23.3	23.3	5.0	4.7	4.4
Petrobras	10.5	8.7	7.3	5.1	4.5	3.9
ONGC	7.8	7.4	-	3.9	3.7	-
<b>Developed markets</b>						
Royal Dutch Shell	14.9	13.8	12.7	5.8	5.6	5.5
BP	16.4	15.7	13.9	5.4	5.1	4.8
ChevronTexaco	19.7	19.1	17.4	6.8	6.5	6.0
ConocoPhillips	22.5	21.5	20.9	7.5	7.0	6.9
ENI	16.9	16.2	15.0	4.1	3.9	3.6
Exxon Mobil	16.2	16.1	15.0	7.1	6.8	6.6
Statoil	16.3	15.9	14.3	3.8	3.5	3.1
Total	12.8	12.4	11.7	5.5	5.1	5.1

Note: Based on prices as of May 4, 2018. Bloomberg consensus estimates are used for foreign companies and Sberbank CIB Investment Research estimates for Russian and FSJ companies.

Source: Bloomberg, Sberbank CIB Investment Research

## Financial Profiles

### Bashneft

#### Income statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>Revenues</b>	<b>16,765</b>	<b>10,061</b>	<b>8,942</b>	<b>11,509</b>	<b>14,057</b>	<b>14,436</b>	<b>15,072</b>
Operating costs	14,670	8,504	7,627	9,821	11,553	11,723	12,500
<b>EBIT</b>	<b>2,095</b>	<b>1,557</b>	<b>1,316</b>	<b>1,689</b>	<b>2,504</b>	<b>2,712</b>	<b>2,572</b>
Depreciation	618	546	644	846	794	870	961
<b>EBITDA</b>	<b>2,714</b>	<b>2,103</b>	<b>1,960</b>	<b>2,535</b>	<b>3,298</b>	<b>3,582</b>	<b>3,533</b>
Net interest expenses	(215)	(198)	(164)	(197)	(236)	(240)	(228)
FX gain	6	(58)	(87)	1	-	-	-
Net other expenses	(273)	(24)	(95)	1,565	(160)	(160)	(160)
<b>EBT</b>	<b>1,613</b>	<b>1,277</b>	<b>970</b>	<b>3,059</b>	<b>2,108</b>	<b>2,312</b>	<b>2,185</b>
Tax	(380)	(280)	(191)	(630)	(434)	(476)	(450)
Income before minority interest	1,233	997	779	2,429	1,674	1,836	1,735
Minority interest	1	(24)	10	20	14	15	15
<b>Net income</b>	<b>1,235</b>	<b>973</b>	<b>789</b>	<b>2,449</b>	<b>1,688</b>	<b>1,852</b>	<b>1,749</b>

Source: Company, Sberbank CIB Investment Research

#### Balance sheet (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>Fixed assets and investments</b>	<b>6,902</b>	<b>5,756</b>	<b>7,581</b>	<b>8,235</b>	<b>8,578</b>	<b>8,914</b>	<b>8,939</b>
<b>Current assets</b>	<b>2,406</b>	<b>1,380</b>	<b>2,050</b>	<b>4,444</b>	<b>5,803</b>	<b>6,528</b>	<b>7,485</b>
Stock and inventories	469	303	482	594	558	588	626
Account's receivable	967	551	1,001	1,460	2,091	2,543	3,109
Cash and securities	939	452	124	433	1,196	1,440	1,792
Other current assets	32	75	443	1,958	1,958	1,958	1,958
<b>Total assets</b>	<b>9,308</b>	<b>7,136</b>	<b>9,631</b>	<b>12,680</b>	<b>14,381</b>	<b>15,442</b>	<b>16,424</b>
<b>Current liabilities</b>	<b>1,977</b>	<b>1,299</b>	<b>1,804</b>	<b>2,592</b>	<b>2,787</b>	<b>2,886</b>	<b>3,086</b>
Accounts payable	992	759	1,380	1,969	2,058	2,157	2,358
Short-term debt	508	329	399	596	700	700	700
Other current liabilities	477	211	26	28	28	28	28
<b>Long-term liabilities</b>	<b>3,712</b>	<b>2,480</b>	<b>3,465</b>	<b>3,470</b>	<b>3,838</b>	<b>3,809</b>	<b>3,781</b>
Long-term debt	2,783	1,775	2,405	2,249	2,644	2,644	2,644
Other long-term liabilities	928	704	1,060	1,221	1,194	1,165	1,137
<b>Total liabilities</b>	<b>5,689</b>	<b>3,779</b>	<b>5,269</b>	<b>6,062</b>	<b>6,625</b>	<b>6,695</b>	<b>6,867</b>
Minority interest	139	127	47	29	15	(1)	(15)
<b>Equity</b>	<b>3,481</b>	<b>3,231</b>	<b>4,314</b>	<b>6,589</b>	<b>7,741</b>	<b>8,748</b>	<b>9,572</b>
Share capital	1,483	1,145	1,375	1,448	1,448	1,448	1,448
Retained earnings	1,997	2,087	2,939	5,141	6,293	7,300	8,124
<b>Total liabilities and equity</b>	<b>9,308</b>	<b>7,136</b>	<b>9,631</b>	<b>12,680</b>	<b>14,381</b>	<b>15,442</b>	<b>16,424</b>

Source: Company, Sberbank CIB Investment Research

#### Cash flow statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>EBT</b>	<b>1,613</b>	<b>1,277</b>	<b>970</b>	<b>3,059</b>	<b>2,108</b>	<b>2,396</b>	<b>2,271</b>
Provisions and non-cash items	1,183	884	1,012	(301)	1,058	1,176	1,267
Taxes	(387)	(346)	(241)	(306)	(461)	(524)	(496)
Interest paid	(313)	(275)	(100)	9	(264)	(306)	(306)
Decrease in working capital	(70)	153	(694)	(479)	(506)	(383)	(404)
Increase in other assets	754	(130)	511	(210)	-	-	-
<b>Operating cash flow</b>	<b>2,780</b>	<b>1,563</b>	<b>1,459</b>	<b>1,771</b>	<b>1,936</b>	<b>2,360</b>	<b>2,332</b>
Capital expenditures	(1,230)	(1,026)	(1,261)	(1,101)	(1,136)	(1,207)	(985)
Other investments	(1,060)	60	216	(131)	1,667	-	-
<b>Free cash flow</b>	<b>491</b>	<b>597</b>	<b>414</b>	<b>539</b>	<b>2,466</b>	<b>1,153</b>	<b>1,346</b>
Increase in debt	1,696	(504)	(301)	90	500	-	-
Dividends	(981)	(302)	(437)	(153)	(537)	(844)	(959)
Additional share issues/(purchases)	(511)	-	(48)	(170)	-	-	-
<b>Net cash flow</b>	<b>694</b>	<b>(210)</b>	<b>(371)</b>	<b>305</b>	<b>2,429</b>	<b>309</b>	<b>387</b>
FX and monetary effects on cash	249	3	(58)	(6)	-	-	-
<b>Change in cash position</b>	<b>943</b>	<b>(208)</b>	<b>(429)</b>	<b>299</b>	<b>2,429</b>	<b>309</b>	<b>387</b>

Source: Company, Sberbank CIB Investment Research

## Gazprom

## Income statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>Revenues</b>	<b>145,880</b>	<b>98,994</b>	<b>91,320</b>	<b>111,890</b>	<b>126,529</b>	<b>130,756</b>	<b>130,947</b>
Operating costs	111,233	78,948	80,681	96,977	102,925	106,386	106,417
<b>EBIT</b>	<b>34,647</b>	<b>20,046</b>	<b>10,638</b>	<b>14,913</b>	<b>23,604</b>	<b>24,370</b>	<b>24,530</b>
Depreciation	12,385	8,465	8,573	10,515	11,779	13,057	14,493
<b>EBITDA</b>	<b>47,033</b>	<b>28,511</b>	<b>19,211</b>	<b>25,428</b>	<b>35,383</b>	<b>37,427</b>	<b>39,023</b>
Net interest expenses	515	757	326	520	(182)	(390)	(563)
FX gain	(24,492)	(6,923)	6,707	(245)	(2,540)	-	-
Net other expenses	1,464	1,899	1,276	2,189	3,027	3,202	3,338
<b>EBT</b>	<b>12,134</b>	<b>15,779</b>	<b>18,948</b>	<b>17,377</b>	<b>23,909</b>	<b>27,183</b>	<b>27,306</b>
Tax	(4,528)	(2,135)	(4,254)	(4,290)	(5,903)	(6,711)	(6,742)
Income before minority interest	7,606	13,644	14,694	13,086	18,006	20,471	20,564
Minority interest	(88)	(311)	(686)	(901)	(865)	(984)	(988)
<b>Net income</b>	<b>7,518</b>	<b>13,333</b>	<b>14,008</b>	<b>12,186</b>	<b>17,140</b>	<b>19,487</b>	<b>19,576</b>

Source: Company, Sberbank CIB Investment Research

## Balance sheet (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
Fixed assets and investments	208,259	179,169	225,607	256,414	277,164	300,348	310,935
Current assets	61,522	54,797	53,322	60,230	62,388	62,604	72,482
Stock and inventories	11,943	11,036	11,725	13,408	14,369	14,717	14,441
Accounts receivable	18,592	15,288	17,887	19,492	22,042	22,778	22,811
Cash and securities	18,454	18,648	14,784	15,087	13,734	12,865	22,986
Other current assets	12,533	9,825	8,926	12,243	12,243	12,243	12,243
<b>Total assets</b>	<b>269,781</b>	<b>233,966</b>	<b>278,928</b>	<b>316,644</b>	<b>339,552</b>	<b>362,952</b>	<b>383,417</b>
Current liabilities	32,990	29,152	31,683	44,957	49,053	51,145	51,932
Accounts payable	24,728	20,284	24,313	29,769	31,617	32,381	31,839
Short-term debt	8,262	8,869	7,371	15,188	16,427	17,667	18,907
Long-term liabilities	56,907	55,057	58,613	63,086	67,064	71,072	75,081
Long-term debt	39,533	38,361	39,279	41,523	45,283	49,043	52,803
Deferred profit tax liability	10,560	8,485	11,351	12,143	12,361	12,608	12,857
Other long-term liabilities	6,814	8,211	7,983	9,421	9,421	9,421	9,421
<b>Total liabilities</b>	<b>89,897</b>	<b>84,210</b>	<b>90,296</b>	<b>108,043</b>	<b>116,117</b>	<b>122,218</b>	<b>127,013</b>
Minority interest	5,394	4,460	5,726	6,708	7,574	8,557	9,546
Equity	174,491	145,296	182,906	201,893	215,861	232,177	246,858
Share capital	5,780	4,462	5,361	5,646	5,646	5,646	5,646
Retained earnings	168,710	140,834	177,545	196,247	210,216	226,531	241,213
<b>Total liabilities and equity</b>	<b>269,781</b>	<b>233,966</b>	<b>278,928</b>	<b>316,644</b>	<b>339,552</b>	<b>362,952</b>	<b>383,417</b>

Source: Company, Sberbank CIB Investment Research

## Cash flow statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>EBITDA</b>	<b>47,033</b>	<b>28,511</b>	<b>19,211</b>	<b>25,428</b>	<b>35,383</b>	<b>37,427</b>	<b>39,023</b>
Provisions and non-cash items	8,674	3,596	2,505	(408)	(2,540)	-	-
Taxes	(5,512)	(1,710)	(1,431)	(3,919)	(5,685)	(6,464)	(6,493)
Decrease in working capital	(4,613)	(2,310)	361	3,197	(1,663)	(320)	(300)
Increase in other assets	4,308	4,871	2,366	(3,894)	1,008	89	(1,633)
<b>Operating cash flow</b>	<b>49,890</b>	<b>32,958</b>	<b>23,012</b>	<b>20,404</b>	<b>26,503</b>	<b>30,732</b>	<b>30,597</b>
Capex	(33,164)	(26,740)	(20,326)	(24,101)	(31,317)	(34,854)	(23,556)
Other investments	(4,401)	(418)	(1,079)	612	1,904	1,721	1,571
<b>Free cash flow</b>	<b>16,726</b>	<b>6,218</b>	<b>2,686</b>	<b>(3,697)</b>	<b>(4,814)</b>	<b>(4,122)</b>	<b>7,041</b>
Increase in debt	(1,022)	1,107	(1,551)	6,481	5,000	5,000	5,000
Interest paid	(818)	(663)	(737)	(586)	(271)	(295)	(319)
Dividends	(4,922)	(2,732)	(2,886)	(3,257)	(3,172)	(3,172)	(3,172)
Additional share issues/(purchases)	(0)	-	(2,036)	-	-	-	-
<b>Net cash flow</b>	<b>5,562</b>	<b>3,512</b>	<b>(5,602)</b>	<b>(447)</b>	<b>(1,353)</b>	<b>(868)</b>	<b>10,121</b>
FX and monetary effects on cash	3,012	1,328	(1,840)	70	-	-	-
Other sources/(uses) of funds	(360)	1	(29)	(6)	-	-	-
<b>Change in cash position</b>	<b>8,213</b>	<b>4,841</b>	<b>(7,471)</b>	<b>(382)</b>	<b>(1,353)</b>	<b>(868)</b>	<b>10,121</b>

Source: Company, Sberbank CIB Investment Research

MAY 2018

RUSSIAN OIL AND GAS – TICKLING GIANTS

## Gazprom Neft

## Income statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>Revenues</b>	<b>44,414</b>	<b>27,269</b>	<b>25,566</b>	<b>34,345</b>	<b>42,538</b>	<b>43,562</b>	<b>44,850</b>
Operating costs	38,601	23,592	21,972	29,160	34,886	37,326	38,625
<b>EBIT</b>	<b>5,814</b>	<b>3,676</b>	<b>3,593</b>	<b>5,185</b>	<b>7,652</b>	<b>6,237</b>	<b>6,225</b>
Depreciation	2,257	1,615	1,962	2,417	2,599	2,829	3,034
<b>EBITDA</b>	<b>8,070</b>	<b>5,291</b>	<b>5,556</b>	<b>7,602</b>	<b>10,251</b>	<b>9,066</b>	<b>9,259</b>
Net interest expenses	(208)	(309)	(345)	(258)	(217)	133	387
FX gain	(1,191)	(1,031)	433	(8)	-	-	-
Net other expenses	(96)	264	245	649	1,156	1,540	1,903
<b>EBT</b>	<b>4,319</b>	<b>2,600</b>	<b>3,927</b>	<b>5,568</b>	<b>8,590</b>	<b>7,909</b>	<b>8,515</b>
Tax	(626)	(509)	(758)	(951)	(1,467)	(1,351)	(1,703)
Income before minority interest	3,693	2,092	3,169	4,617	7,123	6,558	6,812
Minority interest	(122)	(108)	(149)	(281)	(434)	(400)	(430)
<b>Net income</b>	<b>3,571</b>	<b>1,984</b>	<b>3,020</b>	<b>4,336</b>	<b>6,689</b>	<b>6,159</b>	<b>6,382</b>

Source: Company, Sberbank CIB Investment Research

## Balance sheet (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>Fixed assets and investments</b>	<b>28,917</b>	<b>27,095</b>	<b>35,486</b>	<b>43,531</b>	<b>46,934</b>	<b>50,041</b>	<b>51,789</b>
<b>Current assets</b>	<b>8,371</b>	<b>7,008</b>	<b>6,534</b>	<b>7,337</b>	<b>10,436</b>	<b>12,390</b>	<b>15,928</b>
Stock and inventories	1,825	1,405	1,660	2,054	2,204	2,269	2,318
Accounts receivable	1,831	1,307	1,905	1,775	2,199	2,252	2,318
Cash and securities	945	1,567	554	1,573	4,099	5,935	9,357
Other current assets	3,770	2,729	2,414	1,934	1,934	1,934	1,934
<b>Total assets</b>	<b>37,287</b>	<b>34,102</b>	<b>42,020</b>	<b>50,868</b>	<b>57,370</b>	<b>62,431</b>	<b>67,716</b>
<b>Current liabilities</b>	<b>4,457</b>	<b>4,789</b>	<b>4,772</b>	<b>8,322</b>	<b>8,921</b>	<b>9,304</b>	<b>9,509</b>
Accounts payable	2,313	2,126	2,723	4,927	5,526	5,909	6,114
Short-term debt	1,086	2,021	1,322	2,287	2,287	2,287	2,287
Other current liabilities	1,057	642	727	1,107	1,107	1,107	1,107
<b>Long-term liabilities</b>	<b>12,748</b>	<b>12,183</b>	<b>13,439</b>	<b>13,742</b>	<b>13,742</b>	<b>13,742</b>	<b>13,742</b>
Long-term debt	8,929	9,204	9,829	9,525	9,525	9,525	9,525
Other long-term liabilities	3,820	2,979	3,610	4,217	4,217	4,217	4,217
<b>Total liabilities</b>	<b>17,205</b>	<b>16,972</b>	<b>18,211</b>	<b>22,064</b>	<b>22,662</b>	<b>23,046</b>	<b>23,251</b>
Minority interest	1,138	1,254	1,385	1,838	2,272	2,672	3,102
<b>Equity</b>	<b>18,944</b>	<b>15,876</b>	<b>22,424</b>	<b>26,966</b>	<b>32,436</b>	<b>36,714</b>	<b>41,364</b>
Share capital	892	610	843	1,083	1,083	1,083	1,083
Retained earnings	18,052	15,266	21,580	25,884	31,353	35,631	40,281
<b>Total liabilities and equity</b>	<b>37,287</b>	<b>34,102</b>	<b>42,020</b>	<b>50,868</b>	<b>57,370</b>	<b>62,431</b>	<b>67,716</b>

Source: Company, Sberbank CIB Investment Research

## Cash flow statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>EBITDA</b>	<b>8,070</b>	<b>5,291</b>	<b>5,556</b>	<b>7,602</b>	<b>10,251</b>	<b>9,066</b>	<b>9,259</b>
Taxes	(843)	(719)	(693)	(886)	(1,307)	(1,065)	(1,245)
Decrease in working capital	338	317	(54)	724	25	265	89
Increase in other assets	(407)	(10)	254	185	0	(0)	0
<b>Operating cash flow</b>	<b>7,157</b>	<b>4,880</b>	<b>5,061</b>	<b>7,626</b>	<b>8,970</b>	<b>8,266</b>	<b>8,103</b>
Capex	(6,977)	(5,693)	(5,807)	(6,124)	(6,002)	(5,936)	(4,781)
Other investments	(2,485)	379	852	757	516	969	1,389
<b>Free cash flow</b>	<b>(2,305)</b>	<b>(433)</b>	<b>107</b>	<b>2,258</b>	<b>3,484</b>	<b>3,298</b>	<b>4,711</b>
Increase in debt	1,871	1,881	(847)	60	-	-	-
Interest paid	(393)	(552)	(511)	(434)	(461)	(461)	(461)
Dividends	(1,148)	(563)	(40)	(855)	(1,219)	(1,881)	(1,732)
<b>Net cash flow</b>	<b>(2,226)</b>	<b>286</b>	<b>(1,321)</b>	<b>967</b>	<b>1,804</b>	<b>957</b>	<b>2,518</b>
FX and monetary effects on cash	703	100	(143)	(21)	-	-	-
<b>Change in cash position</b>	<b>(1,522)</b>	<b>385</b>	<b>(1,463)</b>	<b>945</b>	<b>1,804</b>	<b>957</b>	<b>2,518</b>

Source: Company, Sberbank CIB Investment Research

## Lukoil

## Income statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>Revenues</b>	<b>144,167</b>	<b>94,816</b>	<b>78,652</b>	<b>101,752</b>	<b>121,761</b>	<b>122,126</b>	<b>122,781</b>
Operating costs	137,041	87,333	72,379	93,080	108,974	109,552	110,560
<b>EBIT</b>	<b>7,126</b>	<b>7,483</b>	<b>6,273</b>	<b>8,672</b>	<b>12,788</b>	<b>12,574</b>	<b>12,221</b>
Depreciation	8,816	5,943	4,661	5,574	5,575	5,919	6,330
Impairment	1,753	-	-	-	-	-	-
<b>EBITDA</b>	<b>17,695</b>	<b>13,426</b>	<b>10,933</b>	<b>14,246</b>	<b>18,363</b>	<b>18,494</b>	<b>18,551</b>
Net interest expenses	(362)	(491)	(488)	(209)	(280)	(198)	(110)
FX gain	(355)	1,637	(1,642)	(327)	74	-	-
Net other expenses	363	(2,386)	(36)	870	351	351	345
<b>EBT</b>	<b>6,772</b>	<b>6,243</b>	<b>4,107</b>	<b>9,006</b>	<b>12,933</b>	<b>12,727</b>	<b>12,456</b>
Tax	(2,058)	(1,550)	(981)	(1,781)	(2,587)	(2,545)	(2,491)
Income before minority interest	4,714	4,693	3,126	7,225	10,346	10,182	9,965
Minority interest	32	(27)	(13)	(28)	(57)	(56)	(55)
<b>Net income</b>	<b>4,746</b>	<b>4,667</b>	<b>3,113</b>	<b>7,197</b>	<b>10,289</b>	<b>10,125</b>	<b>9,909</b>

Source: Company, Sberbank CIB Investment Research

## Balance sheet (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
Fixed assets and investments	89,041	52,234	61,972	68,022	72,035	75,661	78,842
Current assets	22,759	16,652	20,701	22,710	26,546	30,353	34,051
Stock and inventories	6,154	4,668	6,665	6,913	7,114	7,372	7,609
Accounts receivable	11,387	6,044	5,950	7,262	7,673	7,696	7,737
Cash and securities	3,004	3,530	4,309	5,736	9,029	12,555	15,975
Other current assets	2,214	2,411	3,777	2,800	2,731	2,731	2,731
<b>Total assets</b>	<b>111,800</b>	<b>68,886</b>	<b>82,673</b>	<b>90,733</b>	<b>98,582</b>	<b>106,015</b>	<b>112,893</b>
Current liabilities	14,212	9,538	13,695	16,647	16,956	17,341	17,694
Accounts payable	8,538	6,576	10,637	11,779	12,413	12,797	13,151
Short-term debt	2,168	830	963	2,235	1,910	1,910	1,910
Deferred taxes and provisions	3,506	2,132	2,095	2,633	2,633	2,633	2,633
Long-term liabilities	16,236	15,011	15,766	13,489	13,537	13,537	13,537
Long-term debt	11,361	10,966	10,554	8,466	8,466	8,466	8,466
Other long-term liabilities	4,875	4,046	5,212	5,023	5,071	5,071	5,071
<b>Total liabilities</b>	<b>30,448</b>	<b>24,549</b>	<b>29,461</b>	<b>30,136</b>	<b>30,493</b>	<b>30,878</b>	<b>31,231</b>
Minority interest	222	122	112	129	129	129	129
Equity	81,130	44,214	53,100	60,468	67,959	75,008	81,533
Share capital	4,539	1,791	2,154	2,271	2,271	2,271	2,271
Retained earnings	76,591	42,423	50,946	58,197	65,689	72,737	79,262
<b>Total liabilities and equity</b>	<b>111,800</b>	<b>68,886</b>	<b>82,673</b>	<b>90,733</b>	<b>98,582</b>	<b>106,015</b>	<b>112,893</b>

Source: Company, Sberbank CIB Investment Research

## Cash flow statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>EBITDA</b>	<b>17,695</b>	<b>13,426</b>	<b>10,933</b>	<b>14,246</b>	<b>18,363</b>	<b>18,494</b>	<b>18,551</b>
Provisions and non-cash items	(1,761)	1,519	1,386	1,357	436	456	557
Taxes	(2,300)	(1,509)	(1,069)	(1,514)	(2,539)	(2,545)	(2,491)
Interest paid	(565)	(675)	(742)	(666)	(487)	(487)	(487)
Decrease in working capital	(370)	2,013	1,865	(745)	22	103	75
Increase in other assets	2,869	(1,037)	(1,044)	336	111	351	345
<b>Operating cash flow</b>	<b>15,568</b>	<b>13,736</b>	<b>11,330</b>	<b>13,013</b>	<b>15,907</b>	<b>16,371</b>	<b>16,550</b>
Capex	(14,545)	(9,909)	(7,456)	(8,770)	(9,817)	(9,768)	(9,745)
Other investments	(98)	1,230	(22)	1,368	-	-	-
<b>Free cash flow</b>	<b>925</b>	<b>5,057</b>	<b>3,853</b>	<b>5,611</b>	<b>6,090</b>	<b>6,603</b>	<b>6,804</b>
Increase in debt	2,524	(1,507)	(446)	(1,003)	-	-	-
Dividends	(1,357)	(1,778)	(1,876)	(2,359)	(2,797)	(3,077)	(3,385)
Additional share issues/(purchases)	(107)	(710)	(825)	(880)	-	-	-
<b>Net cash flow</b>	<b>1,985</b>	<b>1,064</b>	<b>707</b>	<b>1,369</b>	<b>3,293</b>	<b>3,526</b>	<b>3,420</b>
FX and monetary effects on cash	(693)	(538)	72	58	-	-	-
<b>Change in cash position</b>	<b>1,292</b>	<b>526</b>	<b>779</b>	<b>1,427</b>	<b>3,293</b>	<b>3,526</b>	<b>3,420</b>

Source: Company, Sberbank CIB Investment Research

MAY 2018

RUSSIAN OIL AND GAS – TICKLING GIANTS

## Novatek

## Income statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>Revenues</b>	<b>9,388</b>	<b>7,791</b>	<b>8,053</b>	<b>9,995</b>	<b>10,808</b>	<b>10,822</b>	<b>11,830</b>
Operating costs	6,051	5,499	5,780	7,189	7,526	7,575	8,074
<b>EBIT</b>	<b>3,337</b>	<b>2,292</b>	<b>2,272</b>	<b>2,806</b>	<b>3,282</b>	<b>3,247</b>	<b>3,756</b>
Depreciation	450	327	521	592	652	652	652
<b>EBITDA</b>	<b>3,788</b>	<b>2,619</b>	<b>2,793</b>	<b>3,398</b>	<b>3,934</b>	<b>3,899</b>	<b>4,407</b>
Net interest expenses	(21)	63	108	140	138	135	135
FX gain	(599)	(147)	(402)	238	(98)	-	-
Net other expenses	(1,071)	(607)	1,532	245	393	1,660	2,339
<b>EBT</b>	<b>1,721</b>	<b>1,613</b>	<b>4,491</b>	<b>3,429</b>	<b>3,714</b>	<b>5,043</b>	<b>6,230</b>
Tax	(460)	(317)	(620)	(590)	(615)	(627)	(721)
Income before minority interest	1,261	1,295	3,871	2,839	3,099	4,416	5,510
Minority interest	9	7	(109)	(173)	(188)	(185)	(159)
<b>Net income</b>	<b>1,271</b>	<b>1,302</b>	<b>3,761</b>	<b>2,666</b>	<b>2,911</b>	<b>4,231</b>	<b>5,351</b>

Note: Novatek's income and cash flow statements now incorporate its share in Yamal LNG.

Source: Company, Sberbank CIB Investment Research

## Balance sheet (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
Fixed assets and investments	10,177	10,312	13,701	15,464	16,317	18,736	20,073
Current assets	2,250	1,763	2,189	2,664	4,317	5,408	8,322
Stock and inventories	125	113	149	192	229	231	236
Accounts receivable	615	515	686	773	835	837	914
Cash and securities	734	400	796	1,145	2,698	3,786	6,617
Other current assets	776	734	558	554	554	554	554
<b>Total assets</b>	<b>12,427</b>	<b>12,075</b>	<b>15,890</b>	<b>18,128</b>	<b>20,634</b>	<b>24,143</b>	<b>28,395</b>
Current liabilities	1,443	2,328	1,794	1,458	1,538	1,556	1,594
Accounts payable	544	666	634	851	949	969	981
Short-term debt	728	1,463	914	248	248	248	248
Deferred taxes and provisions	172	199	245	332	341	338	364
Long-term liabilities	4,103	3,872	3,253	3,204	3,286	3,265	3,239
Long-term debt	3,639	3,458	2,659	2,456	2,554	2,554	2,554
Other long-term liabilities	464	413	594	748	733	711	685
<b>Total liabilities</b>	<b>5,546</b>	<b>6,200</b>	<b>5,047</b>	<b>4,661</b>	<b>4,825</b>	<b>4,821</b>	<b>4,833</b>
Minority interest	42	29	154	309	497	683	841
Equity	6,839	5,846	10,689	13,157	15,311	18,639	22,721
Share capital	470	353	408	405	405	405	405
Retained earnings	6,369	5,494	10,280	12,752	14,906	18,234	22,316
<b>Total liabilities and equity</b>	<b>12,427</b>	<b>12,075</b>	<b>15,890</b>	<b>18,128</b>	<b>20,634</b>	<b>24,143</b>	<b>28,395</b>

Source: Company, Sberbank CIB Investment Research

## Cash flow statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>EBITDA</b>	<b>3,788</b>	<b>2,619</b>	<b>2,793</b>	<b>3,398</b>	<b>3,934</b>	<b>3,899</b>	<b>4,407</b>
Taxes	(694)	(270)	(423)	(559)	(631)	(648)	(747)
Decrease in working capital	66	(84)	217	88	7	15	(45)
<b>Operating cash flow</b>	<b>3,160</b>	<b>2,266</b>	<b>2,587</b>	<b>2,927</b>	<b>3,310</b>	<b>3,266</b>	<b>3,615</b>
Capex	(1,608)	(826)	(514)	(512)	(1,065)	(1,869)	(911)
Other investments	377	(1,748)	721	(385)	124	458	1,261
<b>Free cash flow</b>	<b>1,930</b>	<b>(308)</b>	<b>2,794</b>	<b>2,030</b>	<b>2,369</b>	<b>1,856</b>	<b>3,965</b>
Increase/(decrease) in debt	13	919	(1,533)	(913)	-	-	-
Dividends	(751)	(582)	(622)	(721)	(757)	(903)	(1,269)
Additional share issues/(purchases)	(72)	(13)	(14)	(25)	-	-	-
<b>Net cash flow</b>	<b>1,120</b>	<b>16</b>	<b>625</b>	<b>371</b>	<b>1,613</b>	<b>953</b>	<b>2,696</b>
FX and monetary effects on cash	376	22	(147)	(11)	-	-	-
Other sources/(uses) of funds	(81)	(142)	(302)	(72)	(60)	135	135
<b>Change in cash position</b>	<b>1,414</b>	<b>(103)</b>	<b>176</b>	<b>288</b>	<b>1,553</b>	<b>1,088</b>	<b>2,831</b>

Note: Novatek's income and cash flow statements now incorporate its share in Yamal LNG.

Source: Company, Sberbank CIB Investment Research

## Rosneft

## Income statement (IFRS), \$ mln

	2014	2015	2016	2017E	2018E	2019E	2020E
Revenues	145,887	84,808	74,886	102,060	126,063	131,260	134,642
Operating costs	129,287	73,194	65,270	92,405	109,021	111,721	115,272
EBIT	16,600	11,614	9,616	9,655	17,042	19,539	19,371
Depreciation	12,099	7,458	7,242	10,047	10,538	11,075	11,533
EBITDA	28,699	19,072	16,858	19,702	27,580	30,614	30,904
EBITDA (adjusted)	28,699	20,493	18,858	23,011	30,260	31,924	32,214
Net interest expenses	(4,586)	(3,439)	(1,510)	(2,024)	(2,508)	(1,921)	(1,240)
FX gain	267	1,353	(1,033)	75	-	-	-
Net other expenses	196	(1,771)	(2,185)	(927)	(1,882)	975	1,345
EBT	12,478	7,757	4,888	6,779	12,653	18,593	19,475
Tax	(3,168)	(1,735)	(1,805)	(1,678)	(2,531)	(3,719)	(3,895)
Income before minority interest	9,310	6,022	3,083	5,101	10,122	14,875	15,580
Minority interest	(72)	(16)	(315)	(1,285)	(4,246)	(4,868)	(4,826)
Net income	9,238	6,006	2,768	3,816	5,877	10,007	10,754

Note: Adjusted EBITDA includes the portion of revenues from supplies under prepayments not reflected in the income statement.

Source: Company, Sberbank CIB Investment Research

## Balance sheet (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
Fixed assets and investments	117,405	97,197	143,924	172,482	176,633	180,770	183,799
Current assets	37,879	35,043	37,918	39,792	46,177	54,481	62,515
Stock and inventories	4,142	3,005	4,666	5,625	6,636	6,801	7,017
Accounts receivable	9,847	5,035	7,996	14,635	13,470	14,025	14,386
Cash and securities	3,857	7,697	13,057	5,816	12,355	19,940	27,397
Other current assets	20,033	19,305	12,200	13,715	13,715	13,715	13,715
Total assets	155,283	132,240	181,842	212,274	222,809	235,252	246,314
Current liabilities	36,101	25,795	45,716	66,597	69,565	71,106	72,675
Accounts payable	8,781	6,531	9,611	16,858	18,401	19,668	20,912
Short-term debt	23,037	15,916	31,752	43,281	43,281	43,281	43,281
Deferred taxes and provisions	3,573	2,003	3,759	5,503	6,928	7,202	7,526
Other current liabilities	711	1,345	594	955	955	955	955
Long-term liabilities	67,972	66,257	74,699	73,055	72,351	71,317	70,234
Long-term debt	54,694	55,816	57,702	53,906	53,906	53,906	53,906
Other long-term liabilities	13,278	10,441	16,997	19,149	18,445	17,411	16,328
Total liabilities	104,073	92,052	120,415	139,652	141,917	142,423	142,909
Minority interest	160	590	6,875	9,792	14,037	18,905	23,731
Equity	51,050	39,598	54,553	62,830	66,855	73,924	79,675
Share capital	8,781	6,970	9,958	10,903	10,903	10,903	10,903
Retained earnings	42,269	32,628	44,595	51,927	55,952	63,021	68,772
Total liabilities and equity	155,283	132,240	181,842	212,274	222,809	235,252	246,314

Source: Company, Sberbank CIB Investment Research

## Cash flow statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
EBITDA	28,699	19,072	16,858	19,702	27,580	30,614	30,904
Provisions and non-cash items	8,742	3,023	1,161	4,086	928	3,948	4,629
Taxes	(5,074)	(1,980)	(554)	(2,055)	(3,234)	(4,753)	(4,978)
Interest paid	(2,255)	(2,466)	(2,642)	(3,412)	(3,553)	(3,553)	(3,553)
Decrease in working capital	13,183	17,929	(5,475)	(12,550)	3,122	821	991
Operating cash flow	43,295	36,999	11,348	9,080	27,523	28,388	29,303
Capex	(17,966)	(10,085)	(11,086)	(15,842)	(13,613)	(13,948)	(13,342)
Other investments	(13,631)	(2,889)	(4,577)	(4,028)	713	946	1,362
Free cash flow	25,329	26,914	262	(6,762)	13,910	14,440	15,961
Increase in debt	(9,423)	(14,735)	10,176	11,261	-	-	-
Dividends	(3,748)	(1,377)	(1,935)	(1,770)	(1,851)	(2,938)	(5,003)
Additional share issues/(purchases)	(2,531)	(1,521)	2,712	(3,013)	(3,553)	(3,553)	(3,553)
Net cash flow	(4,005)	6,392	6,639	(4,312)	9,219	8,895	8,766
FX and monetary effects on cash	1,724	791	(1,705)	(401)	-	-	-
Change in cash position	(2,281)	7,183	4,934	(4,714)	9,219	8,895	8,766

Source: Company, Sberbank CIB Investment Research

MAY 2018

RUSSIAN OIL AND GAS – TICKLING GIANTS

## Surgutneftegaz

## Income statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>Revenues</b>	<b>35,711</b>	<b>20,946</b>	<b>18,356</b>	<b>23,510</b>	<b>28,324</b>	<b>28,364</b>	<b>28,353</b>
Operating costs	31,324	16,896	14,458	18,817	22,226	22,516	22,687
<b>EBIT</b>	<b>4,387</b>	<b>4,050</b>	<b>3,899</b>	<b>4,693</b>	<b>6,099</b>	<b>5,849</b>	<b>5,666</b>
Depreciation	1,920	1,150	1,157	1,142	1,158	1,167	1,174
<b>EBITDA</b>	<b>6,307</b>	<b>5,200</b>	<b>5,056</b>	<b>5,836</b>	<b>7,256</b>	<b>7,016</b>	<b>6,840</b>
Net interest expenses	1,613	1,503	1,615	1,669	759	808	860
Monetary gain/(loss)	20,204	9,067	(6,440)	(2,041)	892	-	-
Net other expenses	(42)	6	(33)	(75)	-	-	-
<b>EBT</b>	<b>26,162</b>	<b>14,625</b>	<b>(959)</b>	<b>4,246</b>	<b>7,654</b>	<b>6,657</b>	<b>6,526</b>
Tax	(4,529)	(2,494)	135	(891)	(1,531)	(1,331)	(1,305)
Income before minority interest	21,633	12,131	(825)	3,355	6,123	5,326	5,221
<b>Net income</b>	<b>21,633</b>	<b>12,131</b>	<b>(826)</b>	<b>3,354</b>	<b>6,122</b>	<b>5,324</b>	<b>5,219</b>

Source: Company, Sberbank CIB Investment Research

## Balance sheet (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
Fixed assets and investments	20,665	17,704	22,945	25,737	27,200	28,728	30,324
Current assets	38,101	37,889	41,707	47,868	51,939	54,963	57,859
Stock and inventories	1,163	1,041	1,403	1,411	1,384	1,411	1,436
Accounts receivable	1,074	817	1,431	1,585	1,909	1,912	1,911
Cash and securities	34,521	35,314	37,739	44,062	47,836	50,830	53,702
Other current assets	1,343	717	1,133	810	810	810	810
<b>Total assets</b>	<b>58,766</b>	<b>55,593</b>	<b>64,652</b>	<b>73,605</b>	<b>79,139</b>	<b>83,690</b>	<b>88,183</b>
Current liabilities	3,161	3,034	3,502	5,621	5,565	5,583	5,590
Accounts payable	766	710	806	828	441	448	455
Deferred taxes and provisions	1,298	914	828	1,145	1,477	1,487	1,487
Other current liabilities	1,097	1,410	1,868	3,648	3,648	3,648	3,648
Long-term liabilities	3,896	3,403	4,349	5,256	5,256	5,256	5,256
Other long-term liabilities	3,896	3,403	4,349	5,256	5,256	5,256	5,256
<b>Total liabilities</b>	<b>7,058</b>	<b>6,437</b>	<b>7,850</b>	<b>10,877</b>	<b>10,821</b>	<b>10,838</b>	<b>10,845</b>
Minority interest	3	3	4	5	7	9	10
Equity	51,706	49,153	56,798	62,724	68,311	72,844	77,328
Share capital	3,777	2,915	3,503	3,689	3,689	3,689	3,689
Retained earnings	47,929	46,238	53,295	59,035	64,622	69,155	73,639
<b>Total liabilities and equity</b>	<b>58,766</b>	<b>55,593</b>	<b>64,652</b>	<b>73,605</b>	<b>79,139</b>	<b>83,690</b>	<b>88,183</b>

Source: Company, Sberbank CIB Investment Research

## Cash flow statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>EBITDA</b>	<b>6,307</b>	<b>5,200</b>	<b>5,056</b>	<b>5,836</b>	<b>7,256</b>	<b>7,016</b>	<b>6,840</b>
Provisions and non-cash items	663	163	65	178	19	20	21
Taxes	(3,101)	(2,456)	(795)	27	(1,531)	(1,331)	(1,305)
Interest received	1,944	1,889	966	1,382	759	808	860
Decrease in working capital	(0)	115	(134)	296	(352)	(13)	(17)
<b>Operating cash flow</b>	<b>5,813</b>	<b>4,909</b>	<b>5,157</b>	<b>7,718</b>	<b>6,151</b>	<b>6,500</b>	<b>6,399</b>
Capex	(4,102)	(2,791)	(2,715)	(2,760)	(2,640)	(2,714)	(2,792)
Other investments	(2,390)	(136)	(1,278)	(3,625)	-	-	-
<b>Free cash flow</b>	<b>1,710</b>	<b>2,119</b>	<b>2,442</b>	<b>4,958</b>	<b>3,511</b>	<b>3,785</b>	<b>3,607</b>
Dividends	(935)	(1,325)	(1,163)	(449)	(534)	(792)	(735)
Additional share issues/(purchases)	306	440	297	1,208	-	-	-
<b>Net cash flow</b>	<b>(1,309)</b>	<b>1,097</b>	<b>298</b>	<b>2,093</b>	<b>2,977</b>	<b>2,994</b>	<b>2,872</b>
FX and monetary effects on cash	255	24	(50)	5	-	-	-
<b>Change in cash position</b>	<b>(1,054)</b>	<b>1,121</b>	<b>248</b>	<b>2,097</b>	<b>2,977</b>	<b>2,994</b>	<b>2,872</b>

Source: Company, Sberbank CIB Investment Research

## Tatneft

## Income statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>Revenues</b>	<b>17,155</b>	<b>10,830</b>	<b>10,041</b>	<b>13,242</b>	<b>16,123</b>	<b>16,698</b>	<b>16,738</b>
Operating costs	14,210	8,653	7,842	10,481	12,408	12,916	12,955
<b>EBIT</b>	<b>2,945</b>	<b>2,178</b>	<b>2,199</b>	<b>2,762</b>	<b>3,715</b>	<b>3,783</b>	<b>3,783</b>
Depreciation	553	410	324	427	470	492	510
<b>EBITDA</b>	<b>3,546</b>	<b>2,679</b>	<b>2,561</b>	<b>3,451</b>	<b>4,185</b>	<b>4,275</b>	<b>4,293</b>
Net interest expenses	35	59	23	59	57	59	71
FX gain	313	34	(50)	(27)	-	-	-
Net other expenses	21	19	(19)	23	(0)	(0)	(0)
<b>EBT</b>	<b>3,314</b>	<b>2,289</b>	<b>2,137</b>	<b>2,802</b>	<b>3,772</b>	<b>3,841</b>	<b>3,854</b>
Tax	(700)	(530)	(527)	(679)	(914)	(931)	(934)
Income before minority interest	2,614	1,760	1,610	2,123	2,857	2,910	2,920
Minority interest	(146)	(113)	20	(13)	(17)	(18)	(18)
<b>Net income</b>	<b>2,468</b>	<b>1,647</b>	<b>1,630</b>	<b>2,110</b>	<b>2,840</b>	<b>2,892</b>	<b>2,902</b>

Source: Company, Sberbank CIB Investment Research

## Balance sheet (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>Fixed assets and investments</b>	<b>9,818</b>	<b>8,499</b>	<b>12,564</b>	<b>14,272</b>	<b>15,449</b>	<b>16,374</b>	<b>17,327</b>
<b>Current assets</b>	<b>3,210</b>	<b>2,459</b>	<b>5,482</b>	<b>4,955</b>	<b>5,363</b>	<b>6,160</b>	<b>6,881</b>
Stock and inventories	577	440	549	683	795	849	823
Accounts receivable	819	825	1,053	1,069	1,288	1,349	1,352
Cash and securities	768	342	1,271	743	820	1,503	2,247
Other current assets	1,047	852	2,608	2,460	2,460	2,460	2,460
<b>Total assets</b>	<b>13,028</b>	<b>10,959</b>	<b>18,046</b>	<b>19,227</b>	<b>20,811</b>	<b>22,534</b>	<b>24,207</b>
<b>Current liabilities</b>	<b>1,217</b>	<b>946</b>	<b>4,721</b>	<b>5,318</b>	<b>5,515</b>	<b>5,621</b>	<b>5,694</b>
Accounts payable	932	846	1,142	1,308	1,466	1,572	1,645
Short-term debt	282	72	318	693	733	733	733
Other current liabilities	3	27	3,261	3,316	3,316	3,316	3,316
<b>Long-term liabilities</b>	<b>1,462</b>	<b>990</b>	<b>1,638</b>	<b>1,431</b>	<b>1,509</b>	<b>1,636</b>	<b>1,763</b>
Long-term debt	229	177	574	120	74	74	74
Other long-term liabilities	1,232	813	1,063	1,311	1,436	1,562	1,690
<b>Total liabilities</b>	<b>2,679</b>	<b>1,935</b>	<b>6,359</b>	<b>6,749</b>	<b>7,025</b>	<b>7,257</b>	<b>7,457</b>
Minority interest	467	403	89	119	137	154	172
Equity	9,882	8,621	11,598	12,359	13,650	15,122	16,578
Share capital	1,764	1,330	1,599	1,670	1,670	1,670	1,670
Retained earnings	8,118	7,291	9,999	10,688	11,980	13,452	14,908
<b>Total liabilities and equity</b>	<b>13,028</b>	<b>10,959</b>	<b>18,046</b>	<b>19,227</b>	<b>20,811</b>	<b>22,534</b>	<b>24,207</b>

Source: Company, Sberbank CIB Investment Research

## Cash flow statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>EBITDA</b>	<b>3,546</b>	<b>2,679</b>	<b>2,561</b>	<b>3,451</b>	<b>4,185</b>	<b>4,275</b>	<b>4,293</b>
Provisions and non-cash items	592	138	54	148	123	127	127
Taxes	(700)	(530)	(527)	(679)	(914)	(931)	(934)
Decrease in working capital	200	(132)	46	269	(178)	(9)	96
Increase in other assets	(200)	67	79	(1)	-	-	-
<b>Operating cash flow</b>	<b>3,439</b>	<b>2,222</b>	<b>2,212</b>	<b>3,189</b>	<b>3,215</b>	<b>3,462</b>	<b>3,582</b>
Capex	(1,622)	(1,517)	(1,428)	(1,457)	(1,647)	(1,417)	(1,463)
Other investments	(241)	(439)	720	(469)	-	-	-
<b>Free cash flow</b>	<b>1,577</b>	<b>266</b>	<b>784</b>	<b>1,732</b>	<b>1,569</b>	<b>2,044</b>	<b>2,119</b>
Increase in debt	(875)	(210)	(121)	(60)	-	-	-
Interest paid	35	59	23	59	57	59	71
Dividends	(484)	(392)	(369)	(1,860)	(1,548)	(1,420)	(1,446)
Additional share issues/(purchases)	(46)	(32)	(107)	0	-	-	-
<b>Net cash flow</b>	<b>207</b>	<b>(309)</b>	<b>930</b>	<b>(598)</b>	<b>77</b>	<b>683</b>	<b>744</b>
FX and monetary effects on cash	41	18	(22)	(5)	-	-	-
<b>Change in cash position</b>	<b>248</b>	<b>(291)</b>	<b>908</b>	<b>(603)</b>	<b>77</b>	<b>683</b>	<b>744</b>

Source: Company, Sberbank CIB Investment Research

MAY 2018

RUSSIAN OIL AND GAS – TICKLING GIANTS

## Transneft

## Income statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>Revenues</b>	<b>20,370</b>	<b>13,425</b>	<b>12,733</b>	<b>15,163</b>	<b>16,689</b>	<b>17,492</b>	<b>18,296</b>
Operating costs	14,143	9,540	8,541	10,779	11,667	12,081	12,479
<b>EBIT</b>	<b>6,226</b>	<b>3,885</b>	<b>4,192</b>	<b>4,384</b>	<b>5,022</b>	<b>5,411</b>	<b>5,817</b>
Depreciation	2,968	2,274	1,920	2,617	2,614	2,797	2,973
<b>EBITDA</b>	<b>9,195</b>	<b>6,158</b>	<b>6,112</b>	<b>7,001</b>	<b>7,636</b>	<b>8,209</b>	<b>8,790</b>
Net interest expenses	(466)	(153)	(535)	(433)	(618)	(462)	(275)
FX gain	(956)	(791)	603	155	-	-	-
Net other expenses	(1,681)	(93)	219	39	266	266	266
<b>EBT</b>	<b>3,123</b>	<b>2,848</b>	<b>4,479</b>	<b>4,144</b>	<b>4,671</b>	<b>5,216</b>	<b>5,808</b>
Tax	(995)	(402)	(1,027)	(863)	(973)	(1,087)	(1,210)
Income before minority interest	2,128	2,446	3,452	3,281	3,698	4,130	4,598
Minority interest	(26)	(1)	(1)	3	3	4	4
<b>Net income</b>	<b>2,102</b>	<b>2,445</b>	<b>3,451</b>	<b>3,283</b>	<b>3,701</b>	<b>4,133</b>	<b>4,602</b>

Source: Company, Sberbank CIB Investment Research

## Balance sheet (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
<b>Fixed assets and investments</b>	<b>31,583</b>	<b>27,691</b>	<b>36,783</b>	<b>42,184</b>	<b>41,400</b>	<b>42,432</b>	<b>43,500</b>
<b>Current assets</b>	<b>12,398</b>	<b>8,794</b>	<b>8,830</b>	<b>7,949</b>	<b>8,577</b>	<b>9,642</b>	<b>11,705</b>
Stock and inventories	533	481	510	532	616	629	641
Accounts receivable	1,790	1,007	1,218	1,349	1,485	1,557	1,628
Cash and securities	2,010	1,272	1,230	1,322	1,730	2,711	4,690
Other current assets	8,065	6,033	5,872	4,745	4,745	4,745	4,745
<b>Total assets</b>	<b>43,981</b>	<b>36,485</b>	<b>45,613</b>	<b>50,133</b>	<b>49,977</b>	<b>52,074</b>	<b>55,204</b>
<b>Current liabilities</b>	<b>6,821</b>	<b>3,299</b>	<b>4,844</b>	<b>4,869</b>	<b>5,060</b>	<b>5,169</b>	<b>5,275</b>
Accounts payable	3,587	2,181	3,047	2,964	3,155	3,264	3,370
Short-term debt	3,234	1,118	1,798	1,905	1,905	1,905	1,905
<b>Long-term liabilities</b>	<b>12,829</b>	<b>12,770</b>	<b>12,472</b>	<b>13,133</b>	<b>9,909</b>	<b>8,693</b>	<b>8,152</b>
Long-term debt	10,261	10,750	9,768	10,055	6,894	5,677	5,137
Other long-term liabilities	2,568	2,020	2,704	3,078	3,015	3,015	3,015
<b>Total liabilities</b>	<b>19,650</b>	<b>16,069</b>	<b>17,317</b>	<b>18,002</b>	<b>14,969</b>	<b>13,862</b>	<b>13,427</b>
Minority interest	471	23	30	31	28	24	20
Equity	23,861	20,392	28,267	32,100	34,980	38,188	41,757
Share capital	5	4	5	5	5	5	5
Retained earnings	23,856	20,388	28,261	32,095	34,975	38,183	41,752
<b>Total liabilities and equity</b>	<b>43,981</b>	<b>36,485</b>	<b>45,613</b>	<b>50,133</b>	<b>49,977</b>	<b>52,074</b>	<b>55,204</b>

Source: Company, Sberbank CIB Investment Research

## Cash flow statement (IFRS), \$ mln

	2014	2015	2016	2017	2018E	2019E	2020E
Cash receipts from customers	21,824	14,246	13,453	16,261	16,553	17,421	18,225
Cash paid to suppliers	(14,796)	(9,340)	(8,784)	(10,410)	(8,946)	(9,187)	(9,413)
Interest paid	(884)	(730)	(697)	(790)	(979)	(847)	(719)
Income tax paid	507	1,005	935	604	(973)	(1,087)	(1,210)
<b>Operating cash flow</b>	<b>6,651</b>	<b>5,181</b>	<b>4,907</b>	<b>5,665</b>	<b>5,656</b>	<b>6,301</b>	<b>6,883</b>
Capital expenditures	(7,952)	(5,262)	(4,832)	(5,263)	(3,991)	(3,830)	(4,040)
Other investments, net	2,409	2,009	998	546	-	-	-
<b>Investing cash flow</b>	<b>(5,543)</b>	<b>(3,253)</b>	<b>(3,833)</b>	<b>(4,718)</b>	<b>(3,991)</b>	<b>(3,830)</b>	<b>(4,040)</b>
Increase in debt	(2,126)	(1,093)	(761)	127	(1,550)	(1,500)	(667)
Dividends	(218)	(47)	(198)	(991)	(821)	(925)	(1,033)
Additional share issues (purchases)	0	(1,325)	(146)	0	-	-	-
<b>Financing cash flow</b>	<b>(2,343)</b>	<b>(2,465)</b>	<b>(1,104)</b>	<b>(863)</b>	<b>(2,371)</b>	<b>(2,426)</b>	<b>(1,700)</b>
FX and monetary effects on cash	844	170	(175)	(3)	-	-	-
<b>Change in cash position</b>	<b>(392)</b>	<b>(366)</b>	<b>(206)</b>	<b>82</b>	<b>(706)</b>	<b>45</b>	<b>1,142</b>
Cash at beginning of period	3,184	2,010	1,272	1,230	1,322	1,730	2,711
Cash at end of period	2,010	1,272	1,230	1,322	1,730	2,711	4,690

Source: Company, Sberbank CIB Investment Research

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By **Brian Bonner**. Published Feb. 12. Updated Feb. 12 at 12:25 pm.




 Ukraine's oil and gas company Naftogaz Chief Executive Officer Andriy Kobolyev talks during a press conference after a meeting with the European Commission vice-president in charge of Energy Union and Russian representatives at the EU headquarters in Brussels on Jan. 21, 2019.

Photo by AFP

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If there's a single company that is the bellwether of where Ukraine's reforms are heading, it's state-owned Naftogaz, the energy monopoly with close to \$10 billion in annual revenue that contributes at least 15 percent of revenues to the state budget of nearly \$40 billion.

And the Naftogaz story is a complicated one.

In some ways, the Naftogaz turnaround is remarkable: from losing up to \$8 billion a year as recently as 2014, to making a net profit of \$1.5 billion in 2017, the most

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But the transformation is also far from complete and, according to the man who has led Naftogaz since March 2014, under constant threat from an array of corrupt, monopolistic and political interests.

CEO Andriy Kobolyev told the Kyiv Post in an interview at Naftogaz headquarters that he fears the giant enterprise will return to its “darkest times” because of current political demands that undermine the independence and restrict the authority of the company’s supervisory board.

If such political interference returns, Kobolyev said in the Feb. 8 interview, “everything that has been achieved so far can be destroyed.”

Kobolyev is under fire from many quarters, including Prime Minister Volodymyr Groysman, who on Jan. 16 demanded a new contract for Kobolyev with lower pay.

“I believe – and not only me – that the contract, which has been in force for five years, contains conditions that are currently unacceptable,” Groysman said. “I mean the conditions of labor remuneration and various rewards that the Naftogaz board receives.”

Kobolyev received \$1.7 million in total compensation in 2017. He didn’t want to talk about his 2018 pay until Naftogaz’s official financial statement for the year is released in April.

His current five-year contract was initially set to end on March 22. But he said the decision on the contract’s extension and its terms should belong to the supervisory board, not the prime minister or Cabinet of Ministers.

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Kobolyev said.

He would know something about that era. From 2006 to 2007, he was director of the corporate finance and price policy department and from 2008 to 2010 he was an adviser to the chairman.

To defuse the issue of his salary and focus public debate on protecting the independence of the supervisory board, Kobolyev in January announced that he will donate his entire 2019 compensation, including salary and bonuses, to three charities. One of them supports families of slain soldiers, another helps the army and a third assists children with cancer.

"I can afford to be doing this to make sure corporate governance reform and Naftogaz's achievements will not be dismantled," he said.

Kobolyev wasn't the only top manager of a state company who came under fire for his salary. In December, President Petro Poroshenko had a special televised meeting with Igor Smelyansky, the CEO of the state postal service Ukrposhta, where he told him to review his salary.

Smelyansky was paid about \$145,000 in 2017, or 10 times less than Kobolyev. But even that was unacceptable, according to Poroshenko, who also demanded that Smelyansky not lay off any postal workers.

Kobolyev thinks that the issue of Naftogaz top managers' salaries has been politicized because of the coming presidential and parliamentary elections this year. He believes elected officials' real aim may be to get rid of the supervisory board or further curb its powers.

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the board, in turn, were chosen by the Cabinet of Ministers.

Kobolyev believes that the supervisory board should have greater authority, not less, including the power to approve the company's strategic and financial plans as well as appoint executives. It currently approves only contracts, loan agreements and procurement.

The powers to decide the terms and conditions of the CEO's contract would shift to the Cabinet of Ministers "if there is no supervisory board," Kobolyev said. "Why would Groysman make a public statement about something which is not within his authority and put public pressure on the supervisory board, which is designed not to take into account politics and public pressure?"

Having a supervisory board that bows to political demands, Kobolyev said, will be a "suicidal step because you undermine the whole point of your existence."

"This brings me to the conclusion that salary was not the object or major aim of this political request. Corporate governance was. What happens when supervisory boards are put under severe political pressure? They might resign. For Naftogaz, in a year of elections, the resignation of the supervisory board can mean a full reverse of all we have done so far."

#### **'Last bastion' remains**

"That is why preserving existing corporate governance is one of the major tasks of those who support reforms of state-owned companies," Kobolyev said. "They are the last bastion preventing outside political forces, corrupt forces, from putting their hands back into

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The board, he said, insulates him from the way Naftogaz used to be run, when politicians “could call the Naftogaz CEO and ask him to do something.” Without the insulating role of the supervisory board and market salaries for top managers, he said the company will be taken over by executives who will return to the days of taking bribes and not running the company in the interests of the nation.

“Some of them were buying Boyko’s drilling rigs, some were establishing RosUkrEnergo,” Kobolyev said.

His reference was to Yuriy Boyko, the member of parliament and former Yanukovych vice prime minister and energy minister who also ran Naftogaz from 2002-2005 under ex-President Leonid Kuchma.

After the EuroMaidan Revolution, Boyko came under criminal investigation for the alleged large-scale embezzlement of \$700 million during the sale of natural gas and a separate case involving the alleged embezzlement of \$400 million during the purchase of oil and gas offshore drilling rigs.

But lawmaker Sergii Leshchenko and prosecutor Sergii Gorbaturk have alleged that Prosecutor General Yuriy Lutsenko thwarted the prosecution as part of a political deal. Boyko and Lutsenko deny the charges.

### **Firtash’s monopoly**

RosUkrEnergo was a gas-trading intermediary that used to be owned by billionaire oligarch Dmytro Firtash, who is fighting U.S. bribery charges that he denies from exile in Austria. Firtash amassed great wealth through non-transparent gas deals. RosUkrEnergo’s most lucrative and controversial period stretched from 2004 to 2009,

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networks and other intermediaries that Naftogaz is forced by government decree to sell gas at discounted prices.

Firtash and others linked to the former Party of Regions privatized the regional gas distribution business in 2010-2011, shortly after Yanukovich became president. In 2015, these distribution companies spun off gas supply companies, which they still own, Naftogaz says.

Kobolyev, in an interview with the Atlantic Council think tank in 2017, said that he had evidence that gas was being stolen by regional intermediaries. Additionally, last year Kobolyev said the state is losing at least 1 to 2 billion cubic meters of gas annually because intermediary trading companies were legally allowed to hide from the public the true customers of gas. He suspected that businesses are the true beneficiaries of subsidized prices that are supposed to go only to individual households.

Additionally, on Jan. 28, Kobolyev said that local and regional gas distributors now owe about \$2.2 billion to Naftogaz.

Oleksandr Kharchenko, managing director of Energy Industry Research Center in Ukraine, said that a move to solve the chronic debt problems was scuttled by Groysman in 2017. The change would have forced the regional gas traders such as Firtash-owned ones to make automatic payments to Naftogaz on delivery instead of accruing debts.

Kharchenko wrote on July 28, 2018 for the Atlantic Council that Firtash owns almost 75 percent of Ukraine's gas distribution companies.

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created to implement corrupt schemes, rip off taxpayers, and they do not belong in a country that aspires to move to Western business practices.”

Moreover, Naftogaz released a statement in December saying that the regional distributors are trying to “disrupt the demonopolization of the gas market by any means necessary.” Additionally, according to Kharchenko, regional distributors were allowed to keep up to 15 percent of their cash flow, up from 2.5 percent before January 2018, and were keeping subsidies meant for poor customers.

Naftogaz representatives have expressed doubts that the state enterprise will ever be repaid the money.

Suspicious about why Firtash still commands such political power were fueled when Poroshenko and now Kyiv Mayor Vitali Klitschko flew to Vienna ahead of the May 2014 presidential election.

The talks led to what has been derided by many, including lawmaker Leshchenko, as the “Vienna Agreements” in which Firtash and Poroshenko reached an agreement to scuttle criminal investigations of the exiled oligarch. Both Firtash and Poroshenko have denied such back-door deals took place.

### **Multibillion-dollar savings**

One big victory for Naftogaz came in two rulings of the Arbitration Institute of the Stockholm Chamber of Commerce against Kremlin-controlled Gazprom. Those cases, he said, saved Ukraine potentially \$70 billion in fines.

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to meet the agreed transit volumes, awarding it \$4.6 billion in damages, discounted to \$2.6 billion because of debts owed by Naftogaz to Gazprom for supplies.

The dispute over gas supply, transit and pricing centered on the 2009 agreement between Ukraine and Russia, brokered under duress when the Kremlin cut gas supplies to Ukraine. Ukraine is trying to recover the money by getting courts to seize Gazprom assets outside of Russia.

### Other problems

But Naftogaz is facing numerous other challenges as Ukraine struggles to become energy independent.

While Ukraine's gas consumption remained steady at 32 billion cubic meters in 2018, and the nation cut its gas imports by 25 percent to 10.6 billion cubic meters, it has a long way to go to reach energy independence.

The nation hasn't produced much more than 20 billion cubic meters of natural gas, mostly from its state-owned Ukrgezvydobuvannya, annually since independence in 1991.

One reason critics cite for the lackluster performance is delays in the unbundling process to separate production, storage and distribution functions. There is also contradictory messages sent out about whether Naftogaz will remain state-owned or eventually be privatized.

The Stockholm Arbitration ruling complicated the unbundling by not approving transfer of the gas transit contract with Gazprom to someone else. Meanwhile, Gazprom has refused to change the transit contract with

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Germany press forward with completion of the undersea Nord Stream 2 pipeline that bypasses Ukraine, which has been the main transit route of Russian exports to Europe, reaching 93 billion cubic meters in 2017.

### Will not hit 27 bcm production goal in 2020

Domestically, Kobolyev acknowledges that Ukraine will not reach its 2020 goal of producing 27 billion cubic meters of gas domestically.

He said that existing gas fields are 90 percent depleted.

“We need to start growing faster,” Kobolyev said. “We are not making up as much on our capital as proper international companies do... For the Naftogaz group, the major source of growth in future should be greenfields” — completely new projects — “or unconventional sources. That’s what we’re working on.”

As part of the plan, Ukrgezvydobuvannya, or UGV, has been split into three separate business units run by three different individuals. CEO Oleg Prokhorenko stepped down by mutual agreement in the reshuffle.

But there are huge obstacles to tapping new fields in the search for what has been estimated as potentially 1 trillion cubic meters of natural gas deposits.

Among them are unfavorable regulations that govern licensing, dissemination of geological data, production sharing agreements, along with lack of trust in courts.

And not least of the problems, Kobolyev said, are unfair obstacles erected by regional government authorities in licensing land plots to allow drilling for new gas.

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