

June 3, 2010

LUKOIL (LKOH)

1Q10 US GAAP review: strong cashflow

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Strong EBITDA due to lower operating costs and SG&A. Yesterday Lukoil released 1Q10 US GAAP financials, which surpassed the market expectations on EBITDA and net income lines. Revenue was roughly on the 4Q09 level and EBITDA remained practically unchanged q-o-q, in spite of higher taxes. Revenue was \$23,902 mn (in line with the market expectations and our forecast). EBITDA at \$3,684 mn was 13% above our estimates (6% above the consensus) primarily due to lower than expected production costs. Lukoil's operating expenses were down by 16% q-o-q, driven by a decline in the category "other operating expenses" (down by some \$300 mn from 4Q09). Selling, general and administrative (SG&A) expenses were also below our expectations, down by 12% q-o-q. Non-controllable cost items – taxes other than income (export duty, MET and excise tax) and transportation costs – were on the rise, up by 15% and 9% q-o-q, respectively. Lukoil considers continuously rising transportation tariffs as the main threat to its profit margins going forward. Overall, Lukoil's total operating costs declined by 3% q-o-q (to \$21,251 mn), while we forecasted a 1% increase. EBITDA margin remained at the 4Q09 level of 15%. Net income at \$2,053 mn (15% above our forecast and 10% above the consensus), up by 19% q-o-q, was also affected by lower currency loss (\$40 mn vs. \$183 mn in 4Q09).

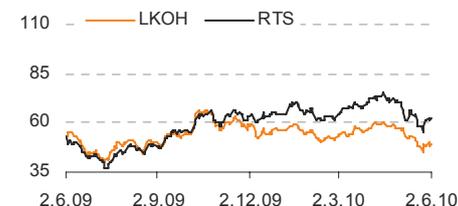
Small capex spending, net debt unchanged. In 1Q10, Lukoil's upstream capex declined by 8% q-o-q to \$1,117 mn that may be attributable to severe weather conditions in West Siberia (like in the case of other oil companies), as well as lower activity in Timan-Pechora (where Lukoil's core field South Khylochuya reached peak production) and Caspian (where the first greenfield – Korchagina – was brought on stream in April). The question remains whether this capex level is sufficient to maintain current production level. Lukoil also cut downstream capex by roughly a half from the 4Q09 level to \$228 mn in 1Q10. Net debt remained roughly unchanged q-o-q at \$6,781 mn as of 1Q10 vs. \$7,272 mn as of YE2009.

Upstream focus outside of Russia. During the conference call on 1Q10 results Lukoil re-stated its view on the sector trends and its strategy. Under the current tax regime, Lukoil sees limited opportunities for growth in Russia and is focusing on investments overseas (Iraq, Ghana). As a non-state company, Lukoil cannot formally participate in the upcoming auctions for strategic fields in Timan-Pechora and elsewhere in Russia, even via its upstream JV with Gazprom neft. Lukoil believes, however, that the government will eventually ease access to the strategic reserves to support production growth. Lukoil is optimistic about the possibility of being granted crude oil export duty tax breaks for its Caspian offshore fields and, if granted, will accelerate its development program. In regards to brownfields, Lukoil plans to resolve any remaining production constraints due to shortage of electricity supply by building power generation capacity for utilization of associated gas.

Pessimistic about gas, challenges in downstream. Lukoil remains pessimistic about the fundamentals of the global gas market and plans to focus on domestic market and access to end consumers (power generation, petrochemicals). Lukoil does not plan to buy any downstream assets (including ConocoPhillips' refineries) in Europe. Lukoil expects the competitive landscape in the European refining industry to improve after closure of several refining facilities (of simple configuration) which will lead to recovery in margins. Domestically, Lukoil fears that, in addition to widely discussed introduction of a price formula for oil products in Russia, the government may decide to increase taxes, i.e. include the transportation tax component into the excise tax, that will deteriorate the refineries' profitability.

LUKOIL		LKOH	
Price, \$			49.7
Recommendation			BUY
Target, \$			67.0
Upside			35%
MC, \$ mn	42 267	EV, \$ mn	51 168
	2008	2009	2010E
P/E	4.6	6.0	5.3
EV/EBITDA	3.0	3.6	3.7

Source: MICEX, TKB Capital estimates



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Lukoil's 1Q10 US GAAP results

	1Q09	1Q10	y-o-y, %	4Q09	q-o-q, %	1Q10E	diff, %	1Q10E (cons.)	diff, %
Crude oil production (incl. affiliates), Kbpd	1,965	1,959	-0.3%	1,927	1.6%				
Oil and gas production (incl. affiliates), Kboepd	2,244	2,305	2.7%	2,176	5.9%				
Refining throughput (incl. third-party), Kbpd	1,373	1,349	-1.8%	1,329	1.5%				
Average Urals price, \$/bbl	44.1	75.2	70.7%	74.2	1.3%				
Average crude export duty, \$/bbl	15.2	36.0	136.0%	33.8	6.5%				
Average MET, \$/bbl	5.6	13.0	131.6%	12.6	3.2%				
Revenue	14,745	23,902	62.1%	24,281	-1.6%	23,359	2.3%	24,217	-1.3%
EBITDA	2,499	3,684	47.4%	3,709	-0.7%	3,256	13.1%	3,466	6.3%
<i>EBITDA margin, %</i>	17%	15%		15%		14%		14%	
Net income (loss)	905	2,053	126.9%	1,726	18.9%	1,787	14.9%	1,864	10.1%
Estimated OCF	2,220	3,151	42.0%	2,838	11.0%				
Capex	1,466	1,468	0.1%	1,851	-20.7%				
Net debt	7,065	6,781	-4.0%	7,272	-6.8%				

Source: Company data, Bloomberg, InfoTEK, TKB Capital estimates

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