

Company Flash
Oil & gas
Russia
12 March 2009

Potential Rosneft / Surgutneftegaz merger

Take profits in Surgutneftegaz, Rosneft poised to benefit under most scenarios

- **The recent outperformance of Surgutneftegaz' common shares indicates the market appears to be pricing in a potentially value-accretive deal**, after merger speculation resumed following Surgutneftegaz CEO Vladimir Bogdanov's nomination to Rosneft's board. We see the core investment case of a cash-rich, debt-free SNGS as insufficient for investors to pay 11.3X 2009F P/E, which represents an 18% premium to Rosneft and a premium of almost 50% to the peer average of 7.5X.
- **In our view, investors who believe in the merger should play it through Rosneft, which stands to gain under most likely scenarios.** We believe the market is overly enthusiastic about a potential deal and see Surgutneftegaz' minorities at a disadvantage: either the merger is off, annulling the grounds for the recent rally, or it would take place at a depressed valuation for Surgutneftegaz relative to its current share price.
- **We believe the state would be reluctant to accept a share in the combined company of less than 50.1%** (excluding treasury shares), which limits the number of likely merger scenarios. We believe the two most likely ways of achieving this are using Surgutneftegaz' six-month trailing market capitalization valuation (20% below the current price), or applying unfavorable swap terms to reduce Surgutneftegaz' valuation by up to 25% to ensure the state receives its target stake in a share swap.
- **A further reason to take profits in Surgutneftegaz is the approaching dividend ex-date.** All the scenarios we see as likely involve a discount to Surgutneftegaz' current valuation of 20%-25%. We expect the market to begin factoring in the risks after the dividend ex-date in mid-March; if no merger occurs, Surgutneftegaz would be much less attractive at current multiples, with strong cash reserves but few projects and acquisition targets, low transparency and an inflated P/E valuation.
- **On a short-term basis, we suggest playing the merger story by going overweight in Rosneft and underweight in Surgutneftegaz after the dividend ex-date.** If the merger does not go ahead and dividends are lower than expected, we could see downside of 20%-25% for Surgutneftegaz. On a 12-month horizon, our target prices for Rosneft and Surgutneftegaz are \$4.01 and \$0.98 with **Hold** and **Buy** recommendations respectively.

	SNGS	ROSN
Recommendation	BUY	HOLD
Price on 10 March 2009	\$0.73	\$4.33
Target price	\$0.98	\$4.01
Upside to TP	34.6%	-7.4%
Cost of equity	19.3%	16.4%
High/Low (12M)	\$1.3/\$0.33	\$12/\$2.4

INVESTMENT HIGHLIGHTS

Surgutneftegaz is debt-free with \$20bn in cash
Rosneft has a heavy debt burden of over \$21bn
Weaker economy and lower budget revenues may spur the government to tighten its grip on oil

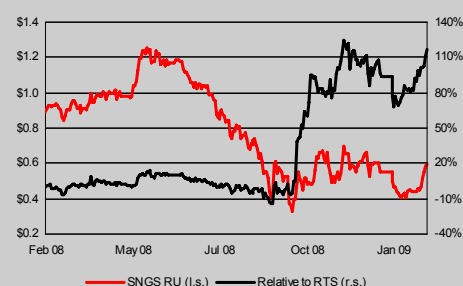
STOCK TRIGGERS

Details on potential merger of SNGS/ROSN
 SNGS dividend announcement

STOCK DATA	Common	Common
Bloomberg	SNGS RX	ROSN LI
Average daily volume (\$mn)	76.74	137.51
Free float (%)	20%	12%
Market capitalization (\$mn)	26,012	45,890
No. of shares (mn); (fully-dil.)	35,725.99	10,598.18
Net debt (\$mn)	-18,550	19,604
Minorities (\$mn)	0	277
EV (\$mn)	9,439	65,771
Local shares per ADS	10.00	1.00

UPCOMING EVENTS

2008 SNGS RAS financials Spring 2009


RELATIVE PERFORMANCE (% CHG.)

	1M	3M	6M
SNGS RX	23.3%	19.3%	33.6%
Relative to RTS	20.5%	26.0%	173.1%

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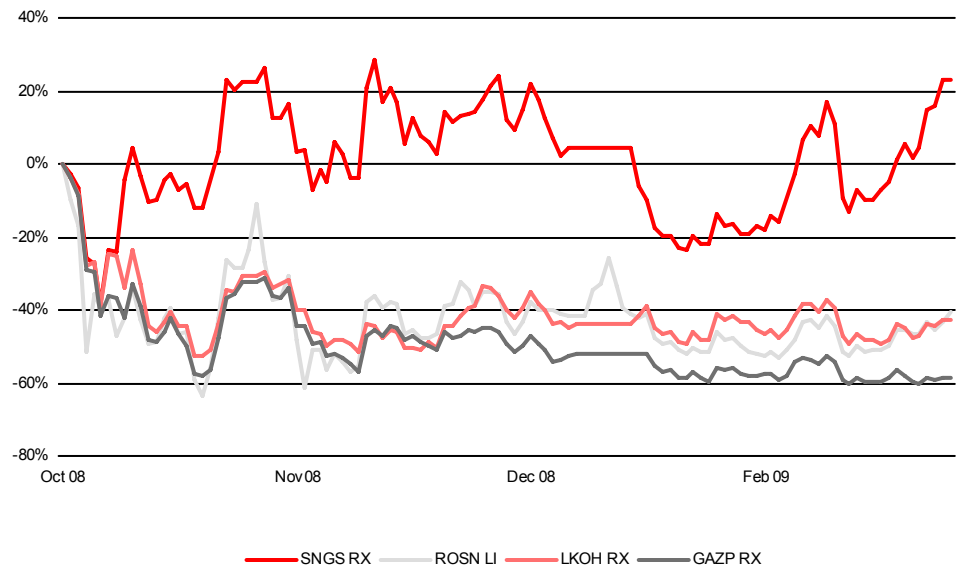
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Take profits in Surgutneftegaz, Rosneft poised to benefit under most scenarios

The recent outperformance of Surgutneftegaz' common shares indicates the market appears to be pricing in a potentially value-accretive deal, after merger speculation resumed following Surgutneftegaz CEO Vladimir Bogdanov's nomination to Rosneft's board. SNGS has outperformed Lukoil and Rosneft by almost 70% over the past six months. We see the core investment case of a cash-rich, debt-free SNGS as insufficient for investors to pay 11.3X 2009F P/E, which represents an 18% premium to Rosneft and a premium of almost 50% to the peer average of 7.5X. The market appears to see Surgutneftegaz' minorities benefiting from the potential deal, but our scenario analysis indicates otherwise.

SURGUTNEFTEGAZ OUTPERFORMED ITS PEERS OVER THE PAST SIX MONTHS



Source: Bloomberg

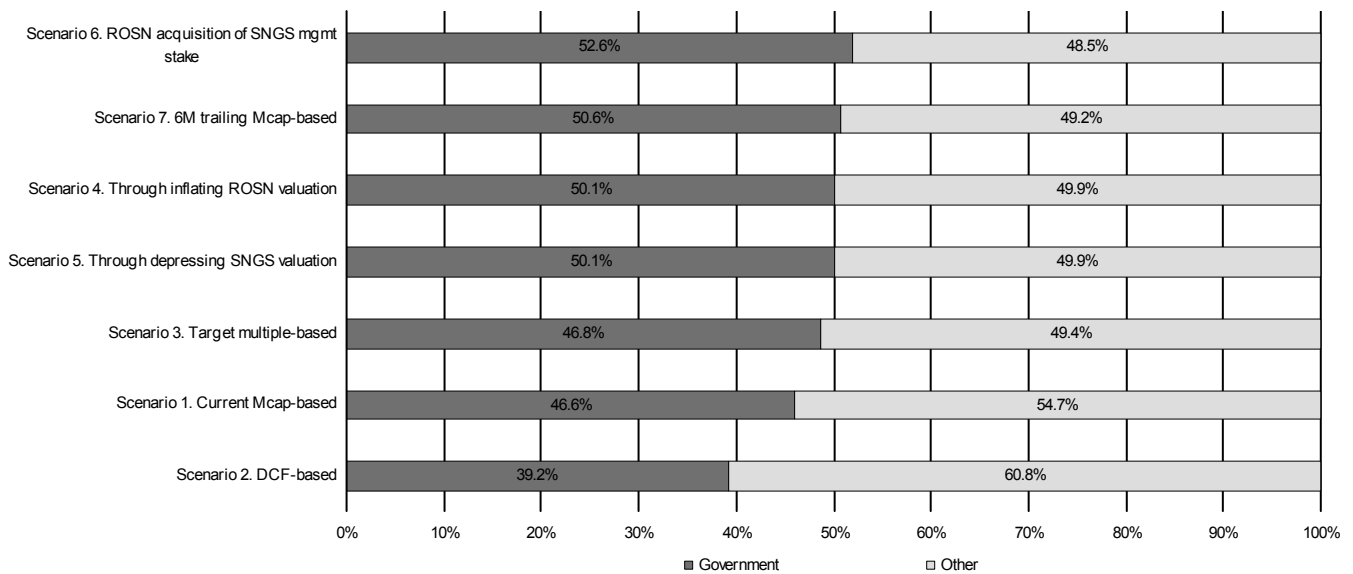
In our view, the likelihood of a merger is now higher than ever, even with the \$15bn loan from China pre-negotiated. We would expect Rosneft to draw on the Chinese loan over several years to cover medium-term refinancing, with SNGS' free cash potentially as support for Rosneft's aggressive expansion policy: valuations of many assets are currently distressed, creating acquisition opportunities. Economies of scale following a potential merger could create a global oil leader with valuable synergies and more accessible financing; we note, however, that deteriorating economic conditions could induce the state to tighten its grip on the oil and gas sector.

In our view, investors who believe in the merger should play it through Rosneft, which stands to gain under most likely scenarios. We suggest investors consider taking profit from the six-month rally in SNGS' stock once the dividend catalyst passes, as we believe the merger potential and its effect on minorities would then become the stock's key drivers. We doubt that the state would accept a disadvantageous deal, implying that Surgutneftegaz' shareholders are likely to see their assets' valuations depressed.

We assume the state would not accept less than 50.1% in the combined company (excluding treasury stock). We analyzed a number of acquisition scenarios using different

valuation assumptions and methods to determine the stakes shareholders are likely to receive after the merger. We assume the state taking over 50%, but believe the 9.44% treasury stock held by Rosneft should not be treated as state controlled, as it is partly pledged and largely held for future financing purposes. Our calculation, based on the companies' current market position, shows that a ratio of 2.012/1 (Rosneft to Surgutneftegaz) would be needed for the state to preserve its minimal acceptable stake in the combined company.

SCENARIO ANALYSIS – 50.1% IS THE STATE'S MINIMUM OWNERSHIP THRESHOLD



Source: UniCredit Research estimates

We see Surgutneftegaz' value falling if a merger occurs, based on market valuations and the adjustments needed to keep the state's stake above 50%. Should the current market cap or other straightforward methods be used, we see difficulties for the government to secure the required stake:

- If current market valuations were used, the state would take just 45.3% in the combined company (i.e. less than control);
- Our projected valuation using a target EV/EBITDA of 6X for Rosneft and 4X for Surgutneftegaz (based on our mid-cycle multiple projection for the companies) points to a state share of only 47%, which we believe is also unacceptable to the state. Achieving a 51% stake would require the state to discount Surgutneftegaz by at least 50% to Rosneft on EV/EBITDA terms in the valuation process.
- Our DCF derived valuations point to a stake of just 39% that the state can secure in the new company, far below the minimal threshold.
- Surgutneftegaz could acquire 9.44% of Rosneft's treasury stock (partially pledged) as well as up to 25% of the state's share, crossing the 50.1% threshold at a potential cost of \$3.5bn-\$13bn, which could be used as indirect financing through Rosneft's controlling company Rosneftegaz. We see this possibility as remote, as Rosneft would not receive control over Surgutneftegaz (i.e. no incentive for diluting the state's interest), although in-

clusion of treasury stock may increase the likelihood of this scenario somewhat.

At the same time we see the following scenarios as more likely:

- If the deal goes through at Rosneft's current market capitalization, Surgutneftegaz' contribution would likely be depressed by a lower swap ratio or a buyout of current shareholders at a discount (we see a 25% downside risk from the current level);
- If the merger were based on a six-month trailing valuation, we see downside of 20% from the current price;
- Buying the 75% stake in the company that is owned by management would likely trigger a buyout of minorities at a six-month average price, which would depress the price they receive;
- The third scenario, which we see as neutral for SNGS' shareholders, involves using its current valuation and inflating the value of Rosneft to the level necessary to achieve the state's minimum ownership threshold. This implies 22% upside for current Rosneft shareholders and underpins our point that the merger story is better played through Rosneft; we believe, however, that this scenario is unlikely, as it would require a significant inflation of current valuations.

We note that the legal issues surrounding any large-scale merger may significantly change the picture, just as a change in market conditions closer to the date of a potential merger.

Overall, we suggest taking profit in Surgutneftegaz after the ex-date for dividends. We believe there little chance of the state accepting a stake below 50.1%, so a merger suggests downside for SNGS of up to 25%. Although we see SNGS as fundamentally sound over the long term, its current attractiveness mainly lies in its cash pile and high dividend yields (projected at 6% for commons and 19% for prefs). Given the current volatility, we believe taking profit after the recent rally may be a wise choice; investor sentiment towards the cash reserves may change, as could the company's ability to continue generating cash. If SNGS' cash drops by 50%, our target price would fall 19%, decreasing 12-month upside potential to just 22%, with downside of as much as 25%, if a merger occurs on unfavorable terms.

On a short-term basis, we suggest playing the merger story by going overweight in Rosneft and underweight in Surgutneftegaz after the dividend ex-date. If the merger does not go ahead and dividends are lower than expected, we could see downside of 20%-25% for Surgutneftegaz. On a 12-month horizon, our target prices for Rosneft and Surgutneftegaz are \$4.01 and \$0.98 with **Hold** and **Buy** recommendations respectively.

APPENDIX 1: SCENARIO ANALYSIS

Scenario 1: Merger based on current market capitalization				Scenario 2: Merger based on DCF-based target prices and 25% pref/common discount at Surgutneftegaz			
	Shares, mn	Price, \$	Mcap, \$mn		Shares, mn	Price, \$	Mcap, \$mn
Rosneft	10,598	4.33	45,890	Rosneft	10,598	4.01	42,498
Surgutneftegaz' com.	35,726	0.73	26,012	Surgutneftegaz' com.	35,726	0.98	35,011
Surgutneftegaz' pref.	7,702	0.24	1,848	Surgutneftegaz' pref.	7,702	0.49	3,774
Combined entity (incl.):			73,750	Combined entity (incl.):			81,283
State			47%	State			39%
SNGS management			27%	SNGS management			33%
Free float			21%	Free float			23%
Treasury shares			6%	Treasury shares			5%

Scenario 3: Merger based on target multiples and 25% pref/common discount at Surgutneftegaz				Scenario 4: Merger based on government securing at least 50.1% in the combined company by inflating Rosneft's relative value				
	Normal-ized EBITDA 2007-2009F	Target multiple	Target valuation, \$mn (incl. net debt, other)	Price, \$		Shares, mn	Price, \$	Mcap, \$mn
Rosneft	14,045	6.0	72,173	6.81	Rosneft	10,598	5.30	56,192
Surgutneftegaz' com.	7,464	4.0	37,367	1.05	Surgutneftegaz' com.	35,726	0.73	26,012
Surgutneftegaz' pref.			6,042	0.78	Surgutneftegaz' pref.	7,702	0.24	1,848
Combined entity (incl.):			115,582		Combined entity (incl.):			84,121
State			47%		State			50%
SNGS management			25%		SNGS management			24%
Free float			23%		Free float			20%
Treasury shares			6%		Treasury shares			6%

Scenario 5: Merger based on government securing at least 50.1% in the combined company by depressing Surgutneftegaz' relative value				Scenario 6: Merger based on Rosneft acquiring only management's common shares in Surgutneftegaz			
	Shares, mn	Price, \$	Mcap, \$mn		Shares, mn	Price, \$	Mcap, \$mn
Rosneft	10,598	4.33	45,890	Rosneft	10,598	4.33	45,890
Surgutneftegaz' com.	35,726	0.59	21,081	Surgutneftegaz com.	35,726	0.73	26,012
Surgutneftegaz' pref.	7,702	0.22	1,727	Surgutneftegaz pref.	7,702	0.24	1,848
Combined entity (incl.):			68,697	Combined entity			65,399
Government			50%	Government			53%
SNGS management			23%	SNGS management			30%
Free float			21%	Free float			11%
Treasury shares			6%	Treasury shares			6%

Scenario 7: Merger based on 6m trailing market caps				Alternative: Financing based on Surgutneftegaz buying out 25% of Rosneft stock for cash			
	Shares, mn	Price, \$	Mcap, \$mn		Shares, mn	Price, \$	Mcap, \$mn
Rosneft	10,598	4.15	43,982	Rosneft	10,598	4.33	45,890
Surgutneftegaz com.	35,726	0.54	19,456	Surgutneftegaz com.	35,726	0.73	26,012
Surgutneftegaz pref.	7,702	0.23	1,756	Surgutneftegaz pref.	7,702	0.24	1,848
Combined entity (incl.):			65,194	Combined entity (incl.):			73,751
State			51%	State			50%
SNGS' management			23%	SNGS' management			42%
Free float			21%	Free float			2%
Treasury shares			6%	Treasury shares			6%

Source: UniCredit Research estimates

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Until April 1, 2007, the investment ratings used HVB Milan Branch (formerly UniCredit Banca Mobiliare S.p.A.) were judgments based on the expected total return (price performance plus dividend) relative to the total return of the stock's local market over the next 12 months. The ratings used by HVB Milan Branch (formerly UniCredit Banca Mobiliare S.p.A.) until that date were as follows: Buy – expected to outperform the market by 10 or more percentage points; Accumulate: expected to outperform the market by 5-10 percentage points; Hold: expected to perform in line with the market, plus or minus five percentage points; Reduce: expected to underperform the market by 5-10 percentage points; Sell: expected to underperform the market by 10 or more percentage points.

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Our investment ratings are in principle judgments relative to an index as a benchmark.

Issuer level:

Marketweight: We recommend having the same portfolio exposure in the name as the respective reference index (the iBoxx index universe for high-grade names and the ML EUR HY index for sub-investment grade names).

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Instrument level:

Core hold: We recommend holding the respective instrument for investors who already have exposure.

Sell: We recommend selling the respective instrument for investors who already have exposure.

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Trading recommendations for fixed-interest securities mostly focus on the credit spread (yield difference between the fixed-interest security and the relevant government bond or swap rate) and on the rating views and methodologies of recognized agencies (S&P, Moody's, Fitch). Depending on the type of investor, investment ratings may refer to a short period or to a 6 to 9-month horizon. Please note that the provision of securities services may be subject to restrictions in certain jurisdictions. You are required to acquaint yourself with local laws and restrictions on the usage and the availability of any services described herein. The information is not intended for distribution to or use by any person or entity in any jurisdiction where such distribution would be contrary to the applicable law or provisions.

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