

Rating: Buy  
S&P 500: 1268

## **Gazprom**

### **Raise Net Present Value to \$120 a Share**

<i>Symbol</i>	(OGZD) OGZPF	<i>Ebitda Next Twelve Months ending 12/31/06 (US\$m)</i>	22,700
<i>Rating</i>	Buy	<i>North American Natural Gas/Ebitda (%)</i>	0
<i>Price (US\$/sh)</i>	67.40	<i>Natural Gas and Oil Production/Ebitda (%)</i>	100
<i>Pricing Date</i>	11/25/05	<i>Adjusted Reserves/Production NTM</i>	20.0
<i>Shares (mm)</i>	2,026	<i>EV/Ebitda</i>	6.4
<i>Market Capitalization (US\$m)</i>	136,500	<i>PV/Ebitda</i>	11.1
<i>Debt (US\$m)</i>	8,100	<i>Undeveloped Reserves (%)</i>	71
<i>Enterprise Value (EV) (US\$m)</i>	144,700	<i>Natural Gas and Oil Ebitda (US\$/boe)</i>	7.18
<i>Present Value (PV) (US\$m)</i>	251,200	<i>Present Value Proven Reserves(US\$/boe)</i>	2.31
<i>Net Present Value (US\$/share)</i>	120	<i>Present Value Proven Reserves(US\$/mcfe)</i>	0.38
<i>Debt/Present Value</i>	0.03	<i>Earnings Next Twelve Months (US\$/sh)</i>	6.22
<i>McDep Ratio - EV/PV</i>	0.58	<i>Price/Earnings Next Twelve Months</i>	11
<i>Dividend Yield (%/year)</i>	0.6	<i>Indicated Annual Dividend (US\$/sh)</i>	0.41

Note: The Russian government owns about 50% of the equity.

Reported results may vary widely from estimates. Estimated present value per share revised only infrequently.

### **Summary and Recommendation**

We increase our estimate of net present value for buy-recommended **Gazprom (OGZPF)** to \$120 a share from \$90 after more detailed financial analysis including results through the second quarter of 2005 just disclosed. Rapidly growing cash flow may reach \$23 billion for 2006. That would still be less than one-fourth of the global market because of price controls in Russia and contractual lag in price to Europeans. A present value cash flow multiple of 11 times also understates appreciation prospects considering the company's long reserve life and undeveloped resources. As prices adjust and more reserves are developed Gazprom may become the world's first trillion dollar resource stock up from a current market cap of under \$150 billion. Though subject to unexpected change, the politics appear favorable with the Russian government, a million Russian investors and the global capital markets sharing a common interest in the company's success.

### **Progressing to Global Standards**

To begin to develop a basis for estimating present value we look at the company's current financial progress. Coincidentally, the unrecognized potential of a global resource stock may match the timing and format of its financial disclosures. Gazprom reported results for the second quarter of 2005 on November 25. The other Russian stock and two Chinese stocks in our coverage reported first half results two and three months ago respectively. Nor are we being critical, we see opportunity instead. The company is adapting rapidly to global standards along with rapid changes in its structure, ownership and government restrictions on trading of the stock.

There is enough audited financial disclosure for us to construct a useful model that characterizes the company's most important business (see table Operating and Financial Results). Natural gas sales to Europe account for about 30% of volume and near 60% of natural gas revenue.

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**Gazprom**  
**Operating and Financial Results**

	<i>Q2</i>	<i>Q3</i>	<i>Q4</i>	<i>Year</i>	<i>Q1</i>	<i>Q2</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Next Twelve Months</i>
	<i>6/30/04</i>	<i>9/30/04</i>	<i>12/31/04</i>	<i>2004</i>	<i>3/31/05</i>	<i>6/30/05</i>	<i>9/30/05</i>	<i>12/31/05</i>	<i>2005E</i>	<i>12/31/06</i>
<b>Volume</b> (billion cubic meters)										
Europe	37.0	34.6	39.8	<b>153</b>	43.9	37.5	35.3	40.6	<b>157</b>	<b>160</b>
Former Soviet Union	15.3	18.1	18.2	<b>66</b>	19.2	17.2	18.1	18.2	<b>73</b>	<b>73</b>
Russia	57.7	46.4	96.3	<b>306</b>	106.2	55.9	46.4	96.3	<b>305</b>	<b>305</b>
Total (bcm)	110.0	99.1	154.3	<b>525</b>	169.3	110.6	99.8	155.1	<b>535</b>	<b>538</b>
Total (bcf)	3,883	3,498	5,447	<b>18,518</b>	5,976	3,904	3,523	5,475	<b>18,878</b>	<b>18,989</b>
Daily (bcfd)	42.7	38.0	59.2	<b>50.6</b>	66.4	42.9	38.3	59.5	<b>51.7</b>	<b>52.0</b>
Days	91	92	92	<b>366</b>	90	91	92	92	<b>365</b>	<b>365</b>
<b>Price</b> (Russian Rubles/thousand cubic meters)										
Europe	2.90	2.90	3.32	<b>2.93</b>	3.48	3.59	3.77	3.96	<b>3.69</b>	<b>4.47</b>
FSU	1.00	1.04	1.11	<b>1.05</b>	1.26	1.26	1.38	1.52	<b>1.35</b>	<b>1.94</b>
Russia	0.83	0.83	0.81	<b>0.82</b>	0.99	1.03	1.11	1.22	<b>1.09</b>	<b>1.55</b>
Total (RR/mcm)	1.55	1.59	1.49	<b>1.46</b>	1.67	1.93	2.10	1.97	<b>1.89</b>	<b>2.47</b>
Rubles/Dollar	28.91	29.17	28.49	<b>28.80</b>	27.84	28.10	28.52	28.87	<b>28.33</b>	<b>28.33</b>
Total (\$/mcf)	1.52	1.55	1.49	<b>1.44</b>	1.70	1.95	2.08	1.93	<b>1.89</b>	<b>2.47</b>
Henry Hub (\$/mmbtu)	6.10	5.75	7.10	<b>6.15</b>	6.27	6.76	8.56	13.04	<b>8.66</b>	<b>10.65</b>
<b>Revenue</b> (RUB billion)										
Europe	107.1	100.3	132.0	<b>448</b>	152.6	134.6	133.0	160.6	<b>581</b>	<b>717</b>
FSU	15.3	18.8	20.3	<b>69</b>	24.2	21.6	25.0	27.7	<b>98</b>	<b>141</b>
Russia	48.0	38.7	78.3	<b>250</b>	105.4	57.6	51.3	117.1	<b>331</b>	<b>471</b>
Total Natural Gas	170.4	157.7	230.6	<b>767</b>	282.2	213.8	209.3	305.4	<b>1,011</b>	<b>1,329</b>
Other	45.2	54.1	62.8	<b>209.3</b>	57.1	58.2	58.2	58.2	<b>231.6</b>	<b>232.8</b>
Total	215.6	211.9	293.5	<b>976.8</b>	339.2	272.0	267.5	363.6	<b>1,242.3</b>	<b>1,561.6</b>
<b>Expense</b>	140.6	125.1	183.1	<b>594.1</b>	181.0	150.6	155.2	210.9	<b>697.6</b>	<b>905.7</b>
<b>Ebitda</b> (RUB billion)	75.1	86.8	110.3	<b>382.7</b>	158.2	121.4	112.4	152.7	<b>544.7</b>	<b>655.9</b>
Deprec., Deplet., & A	24.7	21.2	32.6	<b>110.3</b>	35.2	26.2	23.3	35.8	<b>120.5</b>	<b>132.6</b>
Other non cash	7.7	2.1	(16.7)	<b>(22.7)</b>	(2.9)	6.9			<b>4.0</b>	<b>-</b>
<b>Ebit</b>	42.7	63.5	94.5	<b>295.2</b>	125.9	88.3	89.0	116.9	<b>420.2</b>	<b>523.3</b>
Interest	3.1	-	3.4	<b>9.6</b>	2.2	1.6	2.0	2.0	<b>7.8</b>	<b>8.0</b>
<b>Ebt</b>	39.6	63.5	91.1	<b>285.6</b>	123.7	86.7	87.0	114.9	<b>412.4</b>	<b>515.3</b>
Income Tax	15.7	15.6	25.6	<b>79.9</b>	32.1	25.5	25.6	33.8	<b>117.1</b>	<b>151.7</b>
<b>Net Income</b> (RUB billion)	23.9	47.9	65.5	<b>205.7</b>	91.6	61.2	61.4	81.1	<b>295.3</b>	<b>363.6</b>
<b>Shares</b> (billions)	20.1	20.1	20.2	<b>20.1</b>	20.1	20.3	20.3	20.3	<b>20.2</b>	<b>20.3</b>
Per share (RUB)	1.19	2.38	3.24	<b>10.25</b>	4.56	3.02	3.03	4.00	<b>14.61</b>	<b>17.95</b>
Ebitda Margin (NatGa)	44%	55%	48%	<b>50%</b>	56%	57%	54%	50%	<b>54%</b>	<b>49%</b>
Tax Rate	40%	25%	28%	<b>28%</b>	26%	29%	29%	29%	<b>28%</b>	<b>29%</b>

About 20% of total revenue is from other businesses including oil and the former Communist Party newspaper, *Iszvestia*. Oil operations are likely to be more significant as a result of the acquisition of 73% of oil producer Sibneft for \$13 billion in October 2005. The price paid is presumed to be advantageous to the buyer. The transaction has not been included in our projections.

For now we allocate all of cash flow to natural gas. The company further discloses results by production, transportation and distribution segments, but readily points out that the allocation may not reflect market conditions. About 50% of natural gas revenue becomes cash flow, or Ebitda. The percentage could also be higher in the future as most oil and gas producers report cash flow at more than half of revenue.

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### **Cash Flow One-Fourth the Global Market**

Europeans are paying more than three times the price that Russians are paying for Gazprom's product. Neither is paying enough by global market standards. Therein lies the company's major opportunity.

Expecting gradual adjustment to world prices, we project a price for Europe in 2006 that is up to little more than 40% of the U.S. price in the futures market; for Russia, 15%. Those low levels average less than one-fourth of the futures market for 2006 and about one-fourth of our long-term expectation of \$10 a million btu in constant dollars.

Gazprom prices won't get to the global level overnight, but the trend should be unmistakable. Russian President, Vladimir Putin, and Gazprom Chief Executive Officer, Aleksei Miller, are too smart not to strive for that goal.

### **Cash Flow Multiple Understates Long Life**

After estimating cash flow we apply a cash flow multiple to approximate present value. Our main quantitative guide in assessing the multiple is adjusted reserve life. Arbitrarily we limit adjusted reserve life to 20 years. On that basis, our current correlation of cash flow multiple with adjusted reserve life index for natural gas producers would suggest a multiple of 11.4 times. Estimated net present value of \$120 a share corresponds to a multiple of 11.1 times. We think the multiple understates the potential because proven and probable reserves audited by DeGolyer and MacNaughton are some 53 times annual production (see <http://www.mcdep.com/ogz50915.pdf>).

As rich as Gazprom's resources may be, they are expensive to develop and transport. The company gains economies of scale in operating the world's largest diameter long distance pipelines. For new, large volume, long distance projects, transportation costs for natural gas are near \$2.00 a million btu (see <http://www.jai-energy.com/pubs/Piomanzu.ppt#8>). That does not include field development in a hostile Arctic location. Massive investment is required and there is high risk of cost inflation as in all new energy supply projects.

The rich resources are a magnet for investment by international energy companies. Gazprom has outstanding opportunities to make deals that bring in other people's money and expertise while creating special advantages for Gazprom.

### **The World's First Trillion Dollar Resource Stock**

Gazprom produces as much natural gas as all the producers in the U.S. Our current estimate of present value is about \$250 billion, \$23 billion of 2006 cash flow times 11. Scale up cash flow by four times to reflect global pricing and present value would be a trillion dollars. The added enhancement of cash flow multiple may further magnify future returns for patient investors.

### **Common Interest in Success**

Like a shrewd capitalist, President Putin appears to be grooming Gazprom as a vehicle to lead Russia into an energy future with natural gas a star player on the global stage. Innovative management has a long-term vision and is doing creative deals. Four of our buy-recommended

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companies are vying to provide the risk capital and contribute expertise to develop Shtokman, Gazprom's super-giant Arctic natural gas field. For another intriguing example, the company proposes to swap Russian gas in France for liquefied natural gas to be sold in the U.S. where the price is higher.

Apparently a million Russians own stock in their natural gas supplier. Gazprom stock may be a powerful vehicle to spread the rewards of capitalism among a citizenry long deprived. If we were living in Russia and anyone complained about their natural gas price going up from 15% of the world price, we would suggest that the person buy Gazprom stock. A world price would encourage more efficient use of natural gas domestically, free up more gas for export, strengthen Gazprom and strengthen Russia, as we see it.

Finally, it is likely that by year end or soon thereafter restrictions on foreign ownership of Gazprom will be lifted. That may eventually lead to more active trading of the American Depositary Receipt among other benefits of a wider market for the shares.

Kurt H. Wulff, CFA

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